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BP Trades as Junk, Credit-Default Swaps Invert: Credit Markets

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June 10 (Bloomberg) -- BP Plc bonds and credit-default swaps are trading as if the energy company has lost its investment-grade rating as costs mount from the worst oil spill in U.S. history.

BP's $3 billion of 5.25 percent notes due in 2013 fell as low as a record 89.94 cents yesterday, pushing the yield to 7.57 percentage points more than Treasuries. The spread compares with an average of 7.26 percentage points for junk bonds, Bank of America Merrill Lynch indexes show. The cost to protect $10 million of BP debt for a year with credit-default swaps almost doubled to $512,000, according to CMA DataVision. It was $29,000 on April 30.

"That's just pure out panic," said Michael Donelan, who oversees $3.5 billion of bonds at Ryan Labs Inc. in New York. "That's like, 'Get me out of here now.' What the market is pricing in now is increased regulatory oversight and heavy, heavy punitive damages."

Debt investors are losing confidence in London-based BP as the company fails to contain the oil leak in the Gulf of Mexico. BP said June 7 it has spent $1.25 billion so far, or about $27 million a day, related to the accident. Credit Suisse Group AG estimated the total cost may reach $37 billion.

Credit-default swaps on BP implied a Ba2 rating for the company as of June 8, nine steps lower than its actual Aa2 grade at Moody's Investors Service, based on data from the ratings firm's capital markets research group. The implied rating was as high as A3 on May 28, the data show. Junk bonds are rated below Baa3 by Moody's and lower than BBB- by Standard & Poor's.

Counterparty Hedges

Banks and other trading partners may be buying short-term protection from losses on derivatives they have with BP, said Tim Backshall, chief strategist at Credit Derivatives Research LLC in Walnut Creek, California.

One-year credit swaps are trading 125 basis points more than the annual cost to protect the bonds for five years in a so-called inverted curve, according to CMA prices. Derivatives used for hedging foreign-exchange risk used by companies such as BP tend to be shorter-dated, Backshall said.

Elsewhere in credit markets, two-year interest-rate swap spreads, a measure of bank risk, fell to the lowest in three weeks. Fannie Mae, the U.S.-supported mortgage company, plans to sell $3 billion of five-year benchmark notes after issuing $1 billion in a reopening of two-year debt, while Citigroup Inc. issued $1.88 billion of securities.

Swap Spreads

The difference between yields on two-year Treasuries and the rate to convert fixed payments to floating narrowed as much as 3.6 basis points to 38.4. Two-year interest-rate swap spreads soared to a 13-month high of 52.25 basis points on May 24 as investors fled all but the safest government securities. The spread dropped to 9.63 on March 24, the narrowest since 1993.

The average spread on Merrill's Global Broad Market Corporate index rose 1 basis point to 199 basis points, or 1.99 percentage points, yesterday. The yield was 4.08 percent.

Fannie Mae's five-year notes will be sold today, it said in an e-mailed statement. The Washington-based company's $4 billion in 4.375 percent notes due in 2015 yields 2.44 percent and pays 47 basis points more than similar-maturity Treasuries, Bloomberg data show. Citigroup's 6 percent debt maturing in 2013 yields 5.43 percent and pays a 425 basis point spread.

Spreads on emerging-market bonds narrowed 1 basis point to 337 basis points, according to JPMorgan Chase & Co.'s Emerging Market Bond index. The gap has ranged from a low of 230 basis points on April 15 to as high as 346 on May 20.

Bond Risk

The Markit CDX North America Investment Grade Index, which investors use to hedge against losses on corporate debt or to speculate on creditworthiness, rose 2.3 basis points to a mid- price of 131.8 basis points as of 5:48 p.m. in New York, according to Markit Group Ltd. That's the highest end-of-day level since July 14, according to CMA.

The Markit iTraxx Asia index rose 1 basis point to 154 today, according to Deutsche Bank AG. The Markit iTraxx Australia index climbed 3 basis points to 145 in Sydney, its highest since Sept. 2, Nomura Holdings Inc. and CMA prices show.

Swaps on Woodside Petroleum Ltd., Australia's second- largest oil and gas producer, climbed 27.5 basis points to 217.5 at 3:20 p.m. in Sydney after earlier jumping by as much as a record 60 basis points, according to Deutsche Bank and CMA.

Credit swaps pay the buyer face value if a borrower fails to meet its obligations, less the value of the defaulted debt. A basis point equals $1,000 annually on a contract protecting $10 million of debt.

Oil Bonds

Losses on bonds of BP, The Woodlands, Texas-based Anadarko Petroleum Corp. and Transocean Ltd. of Vernier, Switzerland, the other two companies involved in the oil spill, have sparked a 2.34 percent drop in Bank of America Merrill Lynch's U.S. Corporate Energy index since April. A global broad corporate bond index is down 0.24 percent in the same period.

BP has seven bonds with a face value of $10.6 billion in the Bank of America Merrill Lynch energy index. The spread on the bonds widened an average of 162 basis points to 541 basis points yesterday. The gap on the index is 239.

Anadarko bond spreads increased 37 basis points to 501 on average, and Transocean surged 42 to 539.

Ian MacDonald, an oceanographer at Florida State University in Tallahassee, estimated the well is leaking 26,500 barrels to 30,000 barrels a day into the Gulf, six times more than the figure used by BP and the government from April 28 to May 27.

"The piece of news that seems to have broken the camel's back was an increase of estimated spill volumes," said Guy Lebas, chief fixed-income strategist at Janney Montgomery Scott LLC in Philadelphia.

Investors should be "underweight" oil and gas debt, a change from "marketweight," Lebas wrote in a June 7 report, amid greater regulation and a halt to drilling projects.

Obama Study

President Barack Obama said this week he would have fired BP Chief Executive Officer Tony Hayward for saying he wanted to end the leak because he wanted "his life back." Obama said he has made three trips to the Gulf to find out who to hold responsible, "so I know whose ass to kick." Lawmakers led by Representative Peter Welch, a Vermont Democrat, wrote to Hayward urging him to stop paying dividends and cancel an advertising campaign in the U.S. until the cleanup is done.

BP shareholders got $10 billion in payouts last year. Should BP keep the same dividend this year as in 2009, the ratio of payouts to share price will be more than 10 percent, the highest among 18 of the company's peers tracked by Bloomberg.

As recently as the end of April, BP bond spreads averaged 46 basis points. The increase amounts to an extra $33 million in interest a year on every $1 billion BP borrows. BP has about $24.9 billion of debt, with $1.32 billion due this year and $5.96 billion maturing in 2011, according to data compiled by Bloomberg.

Relative Value

The 5.25 percent BP notes due in 2013 fell 5.75 cents to yield 7.89 percent as of 5:01 p.m. in New York, according to Trace, the bond-price reporting system of the Financial Industry Regulatory Authority. That compares with 9.45 percent for high- yield, high risk corporate debt, according to Bank of America Merrill Lynch index data.

Anadarko's $1.75 billion of 6.45 percent bonds due in 2036 tumbled 5.75 cents to 76.5 cents for a yield spread of 4.63 percentage points, Trace data show. Credit-default swaps on its debt increased 221 basis points to 655.

Transocean's $1 billion of 6.8 percent securities due in 2038 fell 4.75 cents to 80.25 cents, for a spread of 4.58 percentage points. Credit-default swaps on its debt jumped 98 basis points to 613.

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