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ISG Insight

Too far, too fast – Is it time to add credit?

March 2020

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ISG Insight

Too far, too fast – Is it time to add credit?

The Investment Strategy Group (ISG) brings together investment professionals from across the global fixed income platform and outside, providing a forum for research and debate on the key areas of Fixed Income Asset Allocation and Macro (rates/FX). The two sub-groups are designed to bring together our best ideas globally, aiding decision-making by portfolio managers around portfolio positioning and risk allocation.

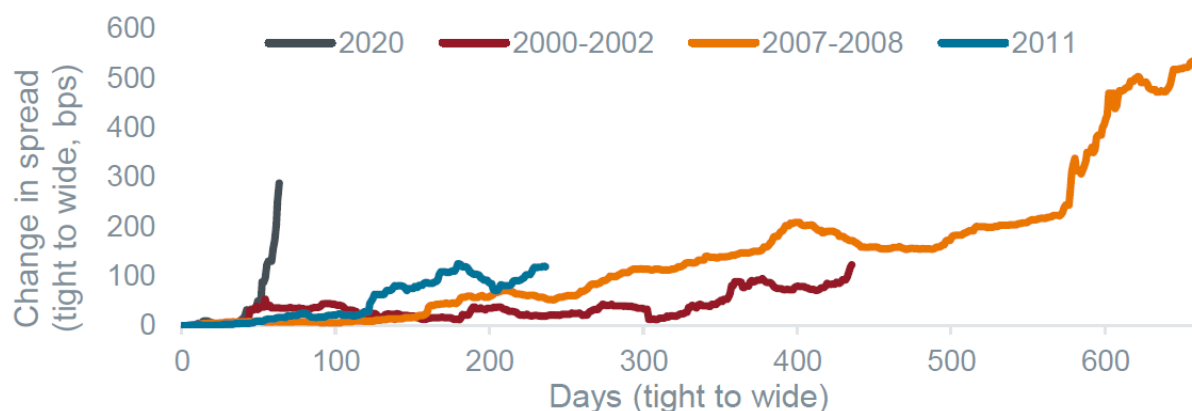
Due to coronavirus fears, March has seen one of the fastest collapses in asset prices since the Great Depression. Equally, we have also seen the swiftest-ever policy response to such a crisis. Is this peak panic and does it present a buying opportunity? The ISG met to discuss the recent sell-off and the potential opportunities and risks. We summarise the discussions and output on three key areas:

1. What are the risks?
2. Key signposts to become more bullish on the asset class
3. Relative value within credit

The facts:

- This is not just a financial crisis like 2008 but a health crisis that affects everyone and every aspect of life. It was on the cusp of developing into a liquidity crisis.
- The spread of the coronavirus and subsequent shutdowns will have a huge impact in the short term. Aggregate corporate earnings growth estimates for 2020 have moved from +5% in January to -20% today or worse; likely adding one to two turns of leverage metrics for companies. Moreover, markets have not had to deal with a -20% quarter-on-quarter GDP number in living memory – we have not experienced such disruption / shutdown in economic activity.
- The policy response has been staggering: unlimited quantitative easing (QE), liquidity backstops; corporate bond buying and fiscal programmes. Some of the actions we have seen from central banks and governments could be in place for much longer than 2020. It took a crisis to move the dial and unlock fiscal policy as a tool to complement easy monetary policy.
- Credit spreads have now widened to extreme levels – moving from close to decade tight to the top quartile of widest spreads based on historical data. Buying credit at these levels historically has always generated attractive returns in the subsequent 12-18 months.

Figure 1: The pace of the sell-off is at a record. US IG spread moves



Source: Deutsche Bank, ICE Indices, at 20 March 2020. IG = investment grade, bps = basis points. Past performance is not a guide to future performance.

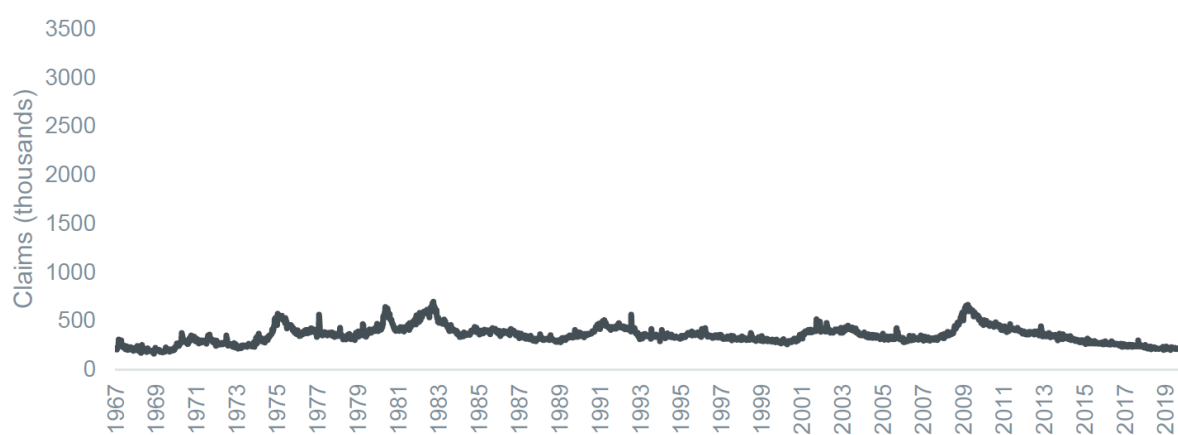
What are the risks?

Systemic risk is the big issue because it is a tail risk that can create a default cycle that is worse than historical precedent. However, policymakers and central banks stand ready to do whatever is required and suppress those extreme tail risks. This was the material development during late March.

The shut down for the global supply chain will be painful and may take many months to repair. The depth and length of the slowdown will have a huge impact on the shape of the volume of defaults. Nevertheless, it is too early to tell what kind of a default cycle we will witness and the extent of fallen angels (companies losing their investment grade rating) in 2020.

Economic survey data will be very weak and contains much less tradeable information. Rather, the focus should be on the COVID-19 peaks in different countries within mainland Europe given their earlier outbreaks, followed by the UK and then the US. If they are able to stabilise like China and Korea, the economic impact will be shorter and more manageable. China has seen a very small number of new cases of COVID-19 now but there is a risk that the virus will return so this warrants monitoring going forward.

Figure 2: Economic data will be bad – US jobless claims jump to 3.3 million



Source: Bloomberg, US initial jobless claims, weekly, seasonally adjusted, 6 January 1967 to 20 March 2020

There was a breakdown in correlations in mid-March in which safe-haven assets, such as US treasuries and gold, sold off alongside steep falls in risk asset prices. This was deeply concerning for investors looking to mitigate risk through traditional hedges. We feel this is a transitory effect stemming from asset deleveraging. The likely cause of this dysfunction was the sharp pick-up in volatility, which led to leveraged investors (CTA, risk parity funds, hedge funds) to de-risk. We expect volatility to remain elevated but for correlations to revert.

This has all happened very quickly and flows tend to be reactive. There are likely to be further outflows from credit in the short term, but this is now balanced by central bank buying programmes and markets which are open for investment grade companies – we have seen US\$169bn issuance in the US during March (Source: JPMorgan to 25 March 2020).

What do we need to see to add to credit risk again?

We discussed the key signposts, which we summarise below as:

- Attractive valuations
- Policymakers panicking and over-delivering on stimulus measures (resulting in a return of risk appetite)
- Economic data takes a back seat to virus data. The market needs to see a turning point / peak in infection rates that shows that the duration of the disruption is limited to a few more months not multiple quarters.

Valuations

Credit valuations are cheap (on a historic basis), with credit spreads having moved from their tightest quartile to widest quartile in the space of six weeks (Source: Bloomberg, utilising spreads on

Bloomberg Barclays US Aggregate Corporate Average OAS and Bloomberg Barclays US High Yield Corporate Average OAS, OAS = option-adjusted spreads, 31 December 1999 to 27 March 2020).

Default rates implied by spreads are above what has occurred in the worst five default cycles. Current market implied default rates are shown in the table below which are well above the worst cumulative 5-year default rate (since 1970). Based on previous cycles, the market tends to price in 2x default losses (implied vs realised).

Figure 3: Actual and implied US investment grade (IG) and high yield (HY) default rates since 1970.

Market pricing			5-year cumulative historic default rate	
USD	5yr spread (basis points)	Implied default rate	Actual (worst)	Actual (average)
IG All	390	21%	2.9%	0.9%
A	273	15%	1.2%	0.4%
BBB	477	26%	5.1%	1.7%
HY All	1,089	50%	32.5%	17.0%
BB	856	41%	19.8%	8.3%
B	1,133	51%	40.0%	20.1%
CCC	1,939	70%	68.5%	49.4%

Source: Deutsche Bank. Assumes 20 % recovery rate, which is conservative. Past performance is not a guide to future performance.

Across various risk measures, many are at 2008 levels, such as volatility (Vix), but this has often signalled a buying opportunity as volatility subsides (credit spreads are highly correlated to volatility).

Policy response

Policymakers are “all in” and central banks are doing everything they can to try to avoid a ‘doom loop’ in which economic problems beget a vicious spiral. The US Federal Reserve (Fed) announced purchases of corporate bonds, which should help to improve market functioning and put a floor under a market that had been in freefall. After an alarming rise in real yields mid-month, central banks recognised this and boosted their QE programmes. This has helped to lower real yields again and is a positive sign for riskier asset classes.

The path from here is long and will zig-zag. US employment data this week was a stark reminder that we are at the beginning, not the end, of the virus impact. Fiscal response is imperative – we still need the US to deliver on expectations because governments need to fill the gap left by the private sector in these shutdowns. Otherwise the damage to the labour market and supply chains will grow exponentially if this lasts beyond one or two quarters and there will be negative compounding effects due to interconnected global supply chains.

Technicals

A severe liquidity freeze has likely been alleviated by the Fed and other central banks, which is a necessary but not sufficient condition for a turnaround in spreads. The trajectory of economic data will determine whether this is simply a bear market rally.

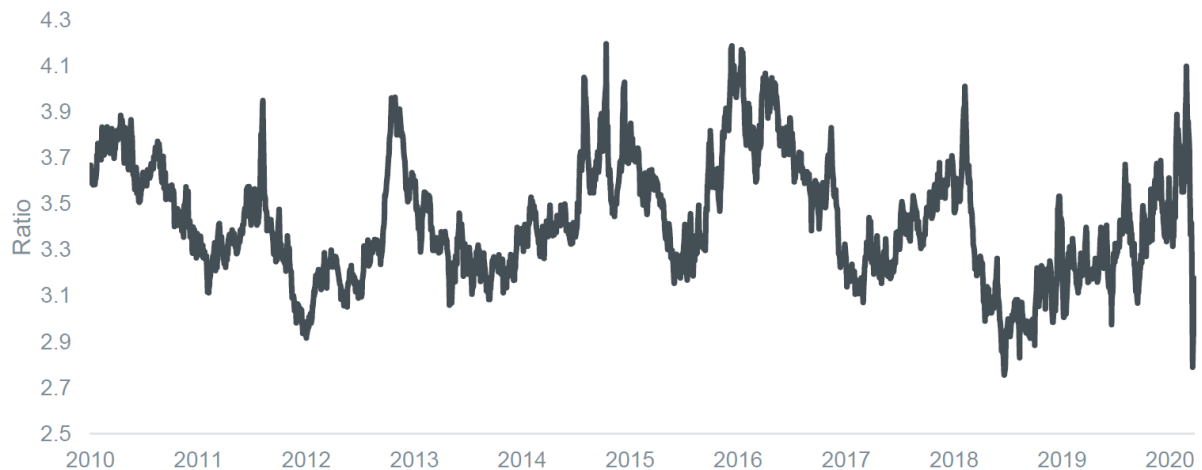
Rebalancing flows could prove supportive of equities versus bonds in the near term. This is because the significant underperformance of equities in Q1 is likely to require sales of high-quality fixed income and the purchase of riskier asset classes such as equities to rebalance allocations back to their strategic benchmarks. The risk is that this leads to a short-term rally in credit and risk assets that is nothing more than a bear market rally, with the peak in spreads not yet reached.

We moved on to analyse different parts of the credit markets and whether any one area stood out as offering better value on a risk-adjusted basis.

- AAA Agency mortgage-backed securities (MBS) as an asset class offers a high-quality spread but has more than halved from the wides reached in mid-March and is being bought by the Fed in large size (US\$50bn per day). As a result, other areas appear more attractive such as IG corporates and non-agency MBS or asset-backed securities (ABS). In addition, the spread duration of MBS has shortened to two years so offers less capital upside from a normalisation in spreads.
- IG credit has underperformed HY on a risk-adjusted basis, particularly in the US, which is shown in the chart below – the HY/IG spread ratio is still at tight at around 3x. With the Fed

now joining other central banks in buying IG corporate bonds and larger companies expected to be more resilient, we believe this sector of corporates, i.e. IG, offers the most compelling relative value on a risk-adjusted basis.

Figure 4: HY/IG spread ratio



Source: Bloomberg, ratio of Bloomberg Barclays US Corporate High Yield Average OAS/Bloomberg Barclays US Aggregate Corporate Average OAS, OAS = option-adjusted spreads. 4 January 2010 to 26 March 2020

- In HY bonds, default rates will pick up but there is much pain priced in. We expect to witness a material pick up in defaults in some sectors, such as energy, which cannot survive on US\$25/barrel oil. Companies within HY will be more sensitive to economic downturn in the coming quarters. The HY market is also likely to have to handle a large volume of fallen angels, although this factor is secondary to the default cycle.
- In emerging markets, the risk is that some smaller countries with less well-developed health systems struggle to contain the virus, and thus they will have to prioritise saving lives over paying debt. A stronger dollar will hurt, so this is key to watch.
- Hedging costs are coming down for foreign investors in US bonds as all central banks move rates to close to zero.

Summary

- Credit spreads have moved to levels not seen since 2008 in the space of six weeks. On a 12-18-month time horizon, valuations at these levels have historically resulted in significant positive excess returns.
- An improvement in credit markets has emerged but this could be a bear market rally, in which case we might not have seen the peak in spreads.
- Economic data will be ugly, and the length of the economic disruption is uncertain. It could therefore make sense to average in rather than trying to time the entry point.
- IG corporates have been disproportionately affected in this sell-off, particularly in the US. With central banks now buying corporate bonds, this should help markets find a floor and more of an equilibrium between buyers and sellers. Large cap corporates are generally more able to weather these tough times.
- HY (and bank loan) markets have also seen very significant spread widening to around 900-1000 basis points. We will see a material pick up in defaults from companies in this space, as they are more sensitive to coming economic downturn. We believe that this favours staying up in quality (e.g. non-cyclical BBs) until the smoke clears.

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