MACRO WRAP-UP

Credit Checkup

November 22, 2019

From a macro perspective, equity and corporate credit indexes have much in common. Both like strong economic growth and low interest rates but tend to perform badly during recessions. They can move up slowly for long periods and then fall sharply during downturns. In that sense, owners of both credit and equities are temperamental optimists, but they are different kinds of optimists. Credit investors are more pragmatic. They want companies to do well enough to pay off their bonds. Credit analysts approach companies like aloof doctors. They run tests to see how healthy the companies are, but these doctors only care about whether the patient survives, not about its quality of life.[1] The most important word for a credit investor is "default." Equity investors care more about another word, "growth." Their approach is more like a guidance counselor's. They look for the upside potential in their investments. If you buy the bond of a company and hold it to maturity, the most you can make is the payments, whereas the equity value of a company can increase exponentially.[2] Equity investors want capital appreciation whereas many credit investors are looking to earn carry.[3]

Because investors in both assets are concerned about similar macro-economic outcomes, they can look to each other for clues about the economy and interest rates. Some economists, however, are skeptical of the stock market's value as a predictor of recessions. Recall Paul Samuelson's quip that the stock market had predicted nine of the last five recessions.[4] Maybe credit spreads are a little more judicious in warning of a coming downturn.

As the global economy has become more varied and complex, the manufacturing cycles that dominated the economies of early industrial countries are no longer the primary cause of developed world recessions. The current economic environment is case in point: we're seeing a sharp pullback in manufacturing activity around the world, but very few countries are in recession. One of the most commonly cited reasons is that in service-based economies, credit plays a larger role. When credit is available as it is now, economies tend to grow, and when it is tight, economies risk contraction.

This is why credit, and in particular credit spreads, can be so useful to monitor. Widening credit spreads can provide several pieces of information. They may tell you that companies' balance sheets are deteriorating, and the market thinks these companies will be unable to repay their debts. It may also tell you that liquidity is drying up, and that banks or other lenders have their own problems which make them unable to provide financing. These types of credit crunches have been responsible for many downturns in the post-war era.

We saw an enormous credit crunch prior to and during the most recent global recession, and spreads widened to record levels. They returned to more normal levels during the recovery. In Europe they blew out again prior to and during the sovereign crisis. In the U.S. we saw a moderate, but not insignificant, widening in high-yield spreads in 2015. At the same time, U.S. equities were mostly flat. As we all know, this did not lead to any sort of credit crunch. In that case, the widening was the result of a specific sectoral issue rather than a systemic issue. Oil prices had fallen by 68% from 2014 to their lows in 2015, and some of the members of the U.S. CDX high-yield index were involved in shale production and related activities.[5] Investors feared that the low oil prices would bankrupt those producers. Defaults rose but peaked in early 2017. In retrospect, the move was probably an overreaction.

Default rates in high-yield bonds fell in 2018. The continued strong economy, combined with Fed rate cuts in the middle of the year, has led to double-digit returns for both stock and credit indexes in the U.S.[6] However, there is something unusual about the rally. Normally, outsize returns on credit indexes are driven by lower quality bonds, because they have further to rally and are more sensitive to economic variables precisely because of their precariousness. In this case the high yield rally has been led by the BB bonds.[7] BB is the highest rating a bond can have and still be considered high yield.[8] We're seeing a somewhat contradictory combination of spread tightening and movement out of weaker names.

Some analysts view this paradox as another sign of an imminent economic apocalypse. BB bonds outperformed prior to the bursting of the tech bubble. There is some evidence that corporate borrowing is excessive, and this could pose risks to the financial system. The least creditworthy companies would likely be the first to show signs of trouble if there were a retrenchment in the corporate sector. While it is not without merit, this view may be overstated – the information in the tightening of spreads is probably more important than the distribution of those returns. While it is important that investors who know a lot about balance sheets of CCC-rated companies are concerned about their health, it is also important that markets are pricing credit across the curve to be less risky than it was a year ago.[9] And low-rated bond yields aren't showing signs of acute stress, they are just underperforming the BBs.[10]

So the doctors of the credit world are saying U.S. corporates are healthy, and this is a positive sign for the economy. If conditions change, and credit spreads widen significantly, it would be a strong warning to investors. It would not likely be another 2015 false alarm. As liquidity

has been very important to asset prices and growth, its absence could indicate a turning point. If you only look at one indicator on the economy, then you probably aren't a good forecaster. But you could do worse than using credit spreads.

What We Are Watching

Reserve Bank of Australia Governor Lowe Speech (Tuesday)

The Reserve Bank of Australia (RBA) has cut its key policy rate three times this year to a record low rate of 0.75%. RBA Governor Philip Lowe has skirted the issue of how the RBA would react if it needed to provide meaningful further monetary stimulus and could no longer rely on interest rate cuts. Recently Governor Lowe stated, "I'm not going to speculate on negative interest rates and quantitative easing in Australia other than to say I think negative interest rates are extraordinarily unlikely in my country." [11] This week, in a speech titled, "Unconventional Monetary Policy: Some Lessons from Overseas," Lowe could provide additional insight into the RBA's current stance on extraordinary monetary policy. Any discussion around favored unconventional tools or the sequencing of monetary policy tools the RBA could use in the next downturn would provide the market with a clearer framework to think about the future of Australian policy.

Canada GDP (Friday)

Canadian GDP missed expectations in August by a slim margin on a smaller-than-expected rebound in mining, oil and gas production after a maintenance-related contraction in July. Canadian manufacturing has been resilient, slowing down to a lesser extent than in other developed economies and doing so without any apparent spillover into the labor market. Household consumption continues to support the economy, benefiting from low unemployment and rising wages. Despite this benign domestic backdrop, the Bank of Canada introduced a dovish bias in its October meeting, moving moderately towards the type of "insurance" cuts embraced by the Fed this year. Investors appear uncertain whether to focus on healthy economic data or dovish BoC rhetoric, with fixed income markets pricing only a modest chance of a cut over the next few BoC meetings. In light of these conflicting signals, GDP data has the potential to prompt significant moves in domestic fixed income and the Canadian dollar.

Sweden GDP (Friday)

Swedish growth has lost momentum over the last two years, weighed down by weakness in the country's large manufacturing sector and trade linkages with the slowing eurozone economy. GDP rose only 1% YoY in 2Q as investment activity contracted for the second quarter in a row. In spite of slower growth, policymakers at the Swedish central bank (the Riksbank) appear determined to bring an end to almost five years of negative rates. The Riksbank hiked its repo rate from -0.5% to -0.25% late last year, and the minutes of the most recent meeting stated that "the rate will most probably be raised in December to zero per cent." [12] While global developments could always cause policymakers to change their minds in the next few weeks, Sweden's third quarter GDP report is perhaps the most important piece of domestic data to be released before the December meeting. A significant downside surprise might dissuade the Riksbank from following through on its planned rate hike.

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[1] Their bedside manner may not be so great either.

[2] A credit trader can leverage an investment and sell out early, of course. Also, in some cases, the yields are so high that the upside may match the best case scenario for many equities. Note there is downside risk here as well.

[3] This is not to say there aren't credit traders who look to turn their bonds for a quick buck if their value goes up.

[4] Paul A. Samuelson, "Science and Stocks," Newsweek, September 19, 1966.

[5] Western Texas Intermediate crude oil front month futures prices closed at a 2014 high of $107.26/barrel on June 20, 2014 before collapsing to a 2015 low of $34.73/barrel on December 15, 2015. Source: Bloomberg.

[6] The year-to-date through November 20, 2019 total returns for the S&P 500 index is 26% and for the U.S. CDX HY index is 10%. Sources: Bloomberg and Citi.

[7] Index quality is defined and assigned by S&P.

[8] It is possible for BBs to outperform because of changes in ratings. For example, a group of bonds may get upgraded or downgraded and their performance moved to the new rating group. These kind of technical factors do not seem to be what has driven the BB returns this year.

[9] Index quality is defined and assigned by S&P.

[10] In fact, in aggregate CCC rated bonds have provided positive, if modest, returns for investors. Past performance does not guarantee future results.

[11] Reserve Bank of Australia, Governor Philip Lowe, "Governor Talk," 10/18/19. Speech to International Monetary Fund.

[12] Sveriges Riksbank: "Minutes of the Monetary Policy Meeting held on 23 October 2019," 11/5/2019.

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