THE DRIVE YOU DEMAND

EXPLORING WHAT LURKS UNDER THE SURFACE IN CREDIT

Spotlight

December 2019 | Global Investment Committee

Union Bancaire Privée

Key points

- *The emergence of economic 'green shoots' suggests the US 'mini-cycle' slowdown is nearing its end. However, investors should recall that the previous mini-cycles in the post-crisis period have each involved a credit event.*

- *Recent shifts in Federal Reserve and ECB policy appear designed to pre-empt a similar credit event in this cycle. However, stress in US money markets since September suggests liquidity risks lurk in the background moving into the year end.*

- *In addition, while broader credit markets have rallied sharply in recent weeks, signs of credit stress are emerging in pockets of the US credit markets including the lower-rated high yield bonds, leveraged loan and collateralised loan markets and bear watching.*

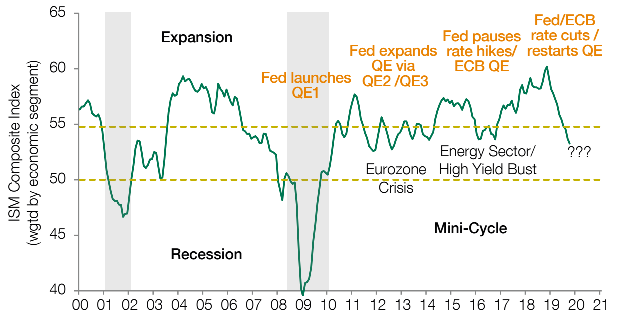
- *Proactive Fed action in October suggests that the American central bank stands ready to stem sustained stress from emerging in US credit markets. As a result, we encourage fixed income investors to look through near-term volatility and benefit from the additional carry afforded by active, quality-biased credit selection.*

- *Should transitory stress re-emerge, it may present an opportunity to add to positions generally and especially in Emerging Debt which offers increasingly attractive value especially relative to US corporate high yield bonds.*

'Mini-cycles' since 2008 have culminated in credit events

Green shoots are emerging across global economies bringing relief to investors who have had to reconcile rising markets with weakening economies through much of 2019. Indeed, the US economy appears to be nearing the end of its mini-cycle, anticipated in our May, 2018 Spotlight, *Navigating the Coming Mini-Cycle in the US Economy*.

Chart 1. As in 2012-13 and 2015-16, the US 'mini-cycle' is nearing an end…but beware credit events



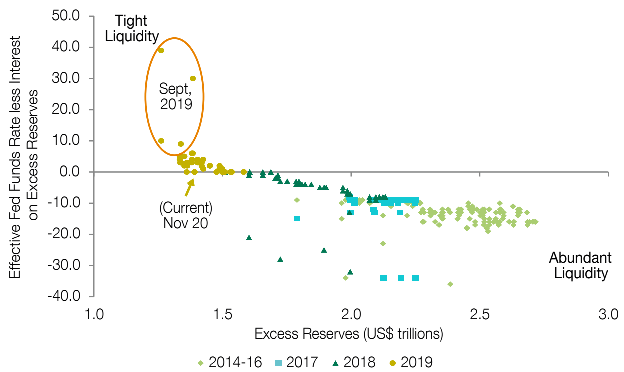
Sources: Institute of Supply Management, Bloomberg Finance L.P. and UBP * expansion and recession as defined by the National Bureau of Economic Research

As with previous mini-cycles, the US Federal Reserve and European Central Bank are now actively easing policy in order to arrest the slowdown. However, investors will recall that both the 2012-13 and 2015-16 mini-cycles culminated in credit events (Chart 1) that spurred more aggressive policy action. Encouragingly, the Fed and the ECB have both moved more proactively in a clear attempt to pre-empt such credit events especially in light of the ongoing instability in US money markets since September.

Indeed, the American central bank has quietly been intervening in the domestic money markets since mid-2018 (via adjustments to its interest rate on excess reserves). However, beginning in mid-September 2019, despite what had been originally characterised by the Fed's leadership as 'temporary', increasingly large-scale intervention including the restart of the Fed's balance sheet expansion has been needed simply to stabilise money markets

With the Fed's extraordinary measures, USD liquidity has only returned back to where it was in early-2019 suggesting more work is required to mitigate the risks of a liquidity shock like the one seen in September in a more durable way, especially moving into the year end and US tax season in March-April 2020.

Chart 2. US liquidity pressures have eased, but not yet easy



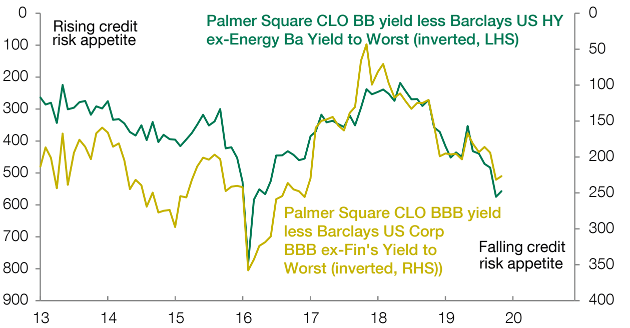
Sources: MSCI, Bloomberg Finance L.P. and UBP

Credit investors are becoming more discerning just as bond maturities are set to accelerate

In the leveraged loan market, default rates are rising in predictable sectors like retail and energy. However, more worryingly, defaults have also been rising across other sectors of the economy. Indeed, according to Standard & Poor's, credit downgrades in the leveraged loan space are 2.9x the number of upgrades in the year since September 2018. Perhaps more concerning has been the number of downgrades taking place in credits falling to B- or CCC+ suggesting that negative reassessments are taking place at the higher quality end of this admittedly risky asset class.

In addition, credit investors are increasingly selective about the risks they are willing to bear. Looking at the Collateralised Loan Obligation (CLO) market, where investors can access pools of structured credit, it seems that from 2016-18, investors were willing to assume the added risk of this market in exchange for premium returns (at a comparable rating). However, in the past year in particular, investor risk appetite has been waning with risk aversion nearing the extremes seen at the trough of the 2015-16 US shale energy bust (Chart 3).

Chart 3. Credit risk appetite has been waning since 2018



Sources: Palmer Square Capital Management, Barclays, Bloomberg Finance L.P. and UBP

With credit investors increasingly discerning about the risks they are willing to take and with the liquidity picture less abundant than in previous years, issuers will be challenged, given a backdrop of US$4 trillion in corporate bond maturities due over the coming years.

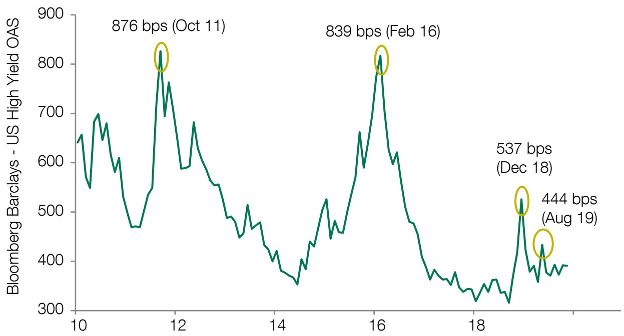
Encouragingly, credit spreads in the US investment grade and high yield markets are approaching historical tights last seen in 2014 as the third round of quantitative easing came to an end and in 2018 following the Trump fiscal stimulus of late-2017 suggesting that investor caution remains limited to niche areas of the broader credit spectrum.

Central banks pre-emptively intervening to avoid a credit cycle

Fortunately for credit investors, the actions of both the Federal Reserve and the European Central Bank in recent weeks have telegraphed their approach to smoothing out the prospect of growing signs of credit stress and/or illiquidity in corporate bond markets.

Indeed, in late 2018 and again in mid-2019, Fed and ECB policy action aimed to contain a sustained widening in credit spreads and signs of emerging illiquidity in USD and Euro credit markets. Looking ahead, though such stresses may spread from niche areas to the broader credit market, we expect that both central banks will remain responsive to any signs of such stress helping to give an element of reassurance to USD and EUR corporate credit investors.

Chart 4. Fed responsiveness to credit stress has been increasing since 2016



Sources: MSCI, Bloomberg Finance L.P. and UBP

As a result, we prefer quality focused, active credit strategies which look through short-term volatility rises should they emerge in USD and EUR corporate credit. EM USD bonds seem unlikely to benefit from similar responsiveness from the US or eurozone central bank in the event of credit stress. However, should such stress spur either or both central banks into action, EM debt should be a primary beneficiary looking forward.

Chart 5. EM debt increasingly attractive vs. USD high yield bonds

Sources: Barclays, Bloomberg Finance L.P. and UBP

On balance, despite the green shoots emerging within the economy, the prospect of near-term volatility exists underneath the optimistic surface of US credit markets. We prefer a quality-focused, hold to maturity approach in credit to look through this volatility. At the same time, we will actively and opportunistically manage our broader 'risk-off' asset portfolios to ensure sufficient cushion in the event such market events are realised and until the Federal Reserve successfully restores a constructive liquidity backdrop in the face of rising refinancing needs among USD corporates as well as the US government in the years ahead.

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