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Covid-19 Fixed income

Public credit – The end of the beginning

April 2020

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- Credit markets have continued to develop in recent weeks as participants digest events and various official intervention strategies, and consider the ramifications for taking credit risk in the future.

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If a week is a long time in politics…

In a previous note on 30th March we wrote: "……sections of the credit markets have had a remarkable reversal of fortunes. From bid-less to bid-only, from panic about owning too much risk, to panic about not owning enough, markets have rallied hard in the face of deteriorating economic data and company forecasts, spurred on by some of the most generous monetary and fiscal conditions in decades".

However, if a week is a long time in politics, then almost two weeks in markets might be bordering on a lifetime…

		Index performance vs. swaps		
Index ticker	Market	March 2020	April to date	Year to date
C0A0	US Investment Grade	-10.86%	3.26%	-14.24%
C8A0	15yr+ US Investment Grade	-17.13%	5.60%	-25.34%
ER00	EUR Investment Grade	-6.02%	1.26%	-6.85%
ER09	10yr+ EUR Investment Grade	-11.25%	1.48%	-13.60%
UC00	GBP Investment Grade	-7.48%	3.28%	-8.61%
UC08	15yr+ GBP Investment Grade	-10.74%	6.72%	-13.27%

Source: M&G, ICE BoA indices, as at 14 April 2020

In the last week alone we have seen the Bank of England lurch into action and restart their corporate bond purchase programme and the Federal Reserve in the US has made clear its intentions towards corporate credit markets. Whilst the Old Lady of Threadneedle Street has simply dusted off her financial crisis playbook (more of that later), the Fed has brought a whole new playbook to the game. For the first time the Federal Reserve will expand its balance sheet by buying US corporate bonds but more than this it will buy the bonds of fallen angels (once investment grade companies that have recently fallen to high yield), and also potentially buy investment grade and high yield ETFs. This expansion of the balance sheet into true risk assets was viewed at the time of announcement with awe (despite it being relatively late, as the Bank of Japan has been doing this for a while).

Buying the debt of fallen angels is particularly important in the current market context. With trigger happy rating agencies cutting the credit ratings of numerous companies (see charts below, courtesy of Deutsche

Bank) the investment grade market has been worried about holding BBB and BBB- rated bonds for fear of a move to junk, and high yield markets have been bracing themselves for a wave of new entrants – many of a size not usual to their market.

Figures 1 and 2. The amount of outstanding bond debt from fallen angels has grown quickly in 2020

Figure 1: USD DM (left) and EM (right) YTD fallen angels ($bn)

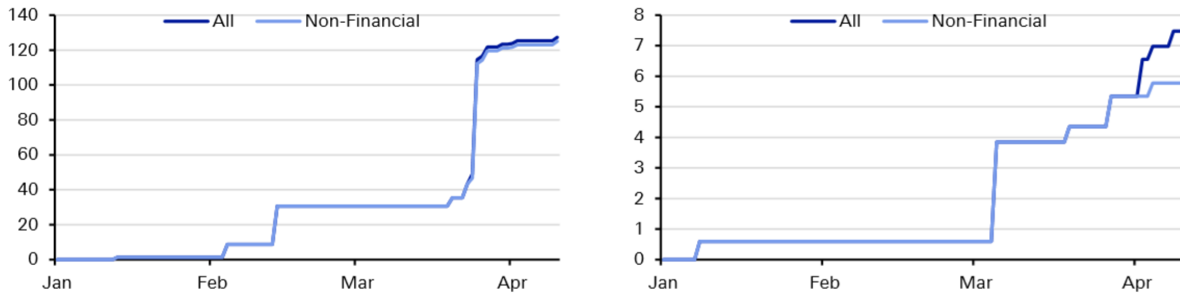
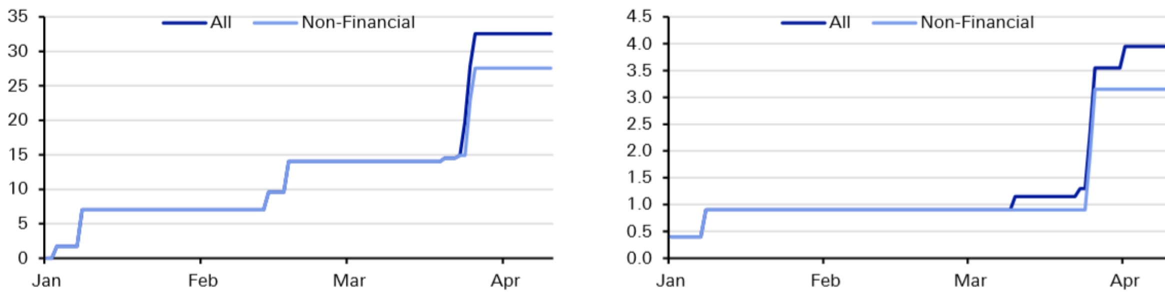


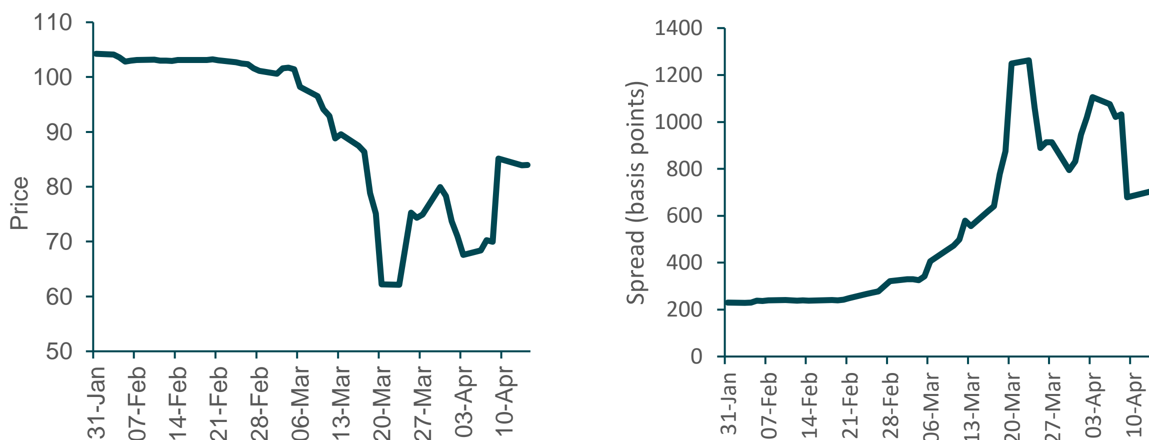
Figure 2: EUR (left, €bn) and GBP (right, £bn) YTD fallen angels



Source: Deutsche Bank, ICE indices As at 14 April 2020

The net result has been that those companies caught in the crossfire, that were excluded from the market and saw their existing bonds trade at heavily discounted prices, roared back to life.

Figure 3. Ford 4.346% 2026 (Left Hand Panel: Price / Right Hand Panel: Spread to Benchmark)

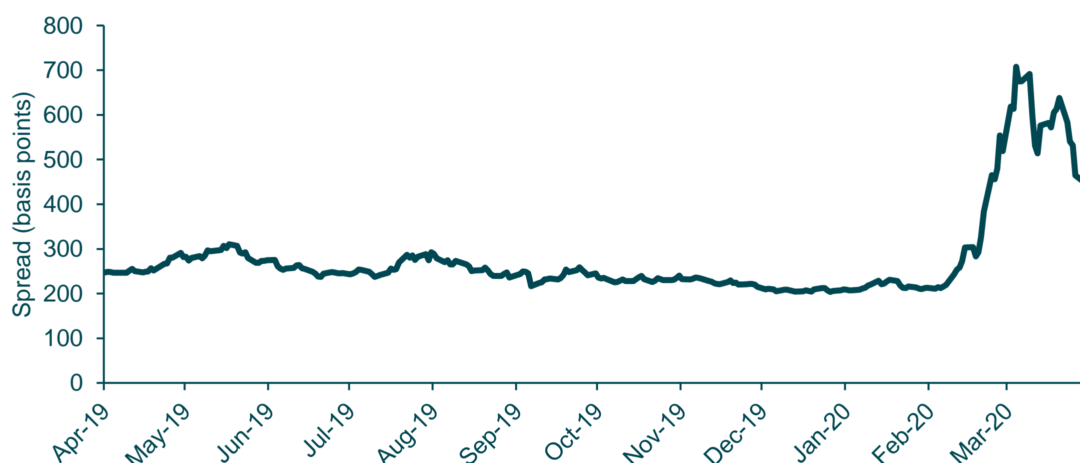


Source: M&G, Bloomberg. As at 14 April 2020

Ford shown in Figure 3, is a prime example and (for us a painful position) that has been pushed around in just this way.

With the central bank support, It is not surprising that the markets should end the week on such a positive tone and that risk assets should be in such high demand. The iTraxx Crossover CDS index (XOver) of BBB/BB rated spreads ended some 120bps tighter at 441bps and the CDX High Yield index 170bps tighter on the week. Worth noting that we took a position in the XOver CDS index at around +500bps, when we were all still going in to the office every day and thinking about our upcoming Easter break and the school holidays.

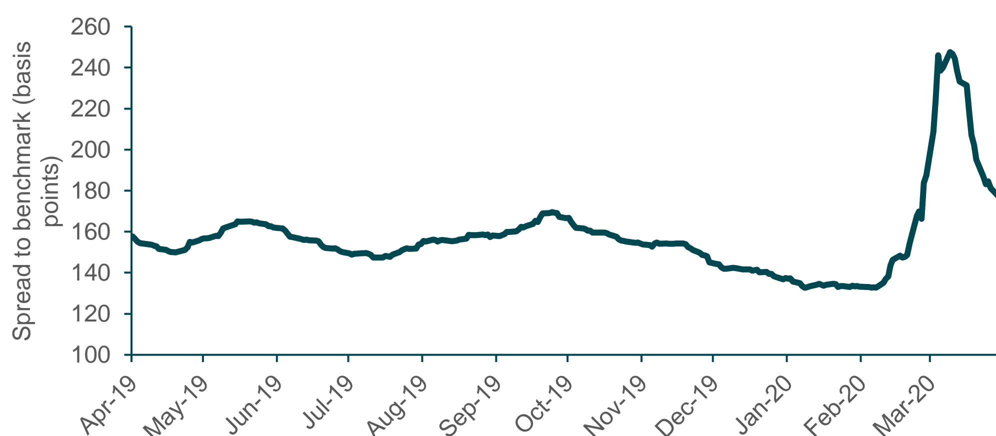
Figure 4. iTraxx Crossover CDS index spread



Source: M&G, Bloomberg, iTraxx. As at 14 April 2020

At this point, we will take a quick detour to look at developments in Sterling investment grade. Why? Well, the change in tone of global credit markets a few weeks ago saw spreads begin to rally, but whereas in the US the Federal Reserve appears to have identified key areas of tension within their credit system (e.g. 'fallen angels') the Bank of England has simply rehashed their Global Financial Crisis playbook and bought bonds across the maturity spectrum. What this means in practice is that long dated Sterling credit is once again very hard to get your hands on: with minimal new issuance and keen buy and maintain buyers spreads have tightened back in to levels last seen only at the end of 2019. With the Bank of England also prepared to buy these bonds it has only added fuel to the fire.

Figure 5. Thames Water 5 1/8% 2037 (credit spread to benchmark)



Source: M&G. Bloomberg. As at 14 April 2020

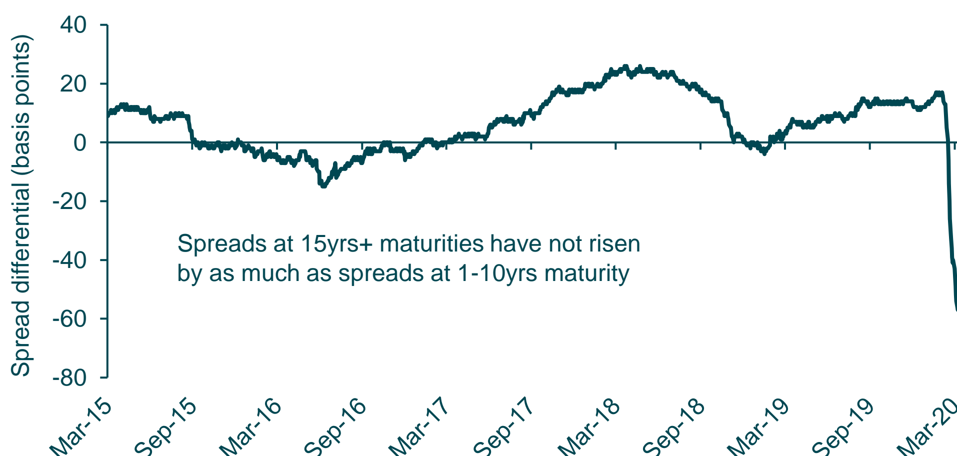
Take for example, Thames Water 5 1/8% 2037 (Figure 5). These bonds are back within 10bps of their 2019 range. Currently marked around Gilts +180bps, the 2019 range was 170bps to 140bps. To us, that is hardly an attractive market valuation when so much of the Euro credit market is still sitting at multi-year wides.

Figure 6. Long-dated European credit has widened considerably more than its Sterling equivalent

Source: M&G. ICE BoA indices. Euro Investment grade 10yrs+ index (ER09), Sterling Investment grade 15yrs+ index (UC08). Asset swap spreads normalised to 100, as at 10 April 2017. As at 14 April 2020

Indeed, much of the better quality longer end of the Sterling market is back at levels where historically we have shunned the risk. This comes at a time, where other parts of the same market are finding it difficult to attract interest - for example shorter dated credit remains unloved. As a result the additional spread on longer dated issues has fallen relative to those available on shorter maturity bonds; in market speak, credit curves have flattened. Indeed the flattening has reached levels not seen since the 2011/12 European sovereign debt crisis.

Figure 7. The Sterling credit curve has flattened significantly and quickly



Source: M&G, ICE BoA indices. Sterling Investment grade 1-10yrs (UC05) option adjusted spread (OAS), Sterling Investment grade 15yrs+ (UC08) OAS. As at 14 April 2020

Perhaps, the Bank of England should be focusing their purchases on areas of the market where the greatest distortions lie: not the long end, but shorter maturities further down the curve?

With that (important) detour done, where does that leave us in terms of our appetite to take risk? Counter intuitively, we began to take some risk off the table late last week. With strong market bids for, in particular, US long dated bonds we decided to trim some of our recently acquired holdings. For example, the new issues for Morgan Stanley and Wells Fargo had come to market in the last 3 weeks with healthy new issue discounts at the wides of the market. The subsequent rally in spreads has seen these bonds tighten significantly by c. 175bps on 15+years of duration bonds – delivering handsome returns. Similarly, one or two of our high yield purchases in the depths of the market trough have performed particularly well and have been or are in the process of being sold. More broadly, we have taken many of our institutional funds long of credit risk against their performance benchmarks over the last few weeks and we are happy to sit and to observe at this stage. There is little compunction to chase this market tighter, and we have no fear of missing out. Of course, as further opportunities present themselves we have further dry powder, but for now we are set.

This leaves one final set of observations, albeit each probably warrants a note in its own right (but for brevity kept to the key points). The markets have an inability to look too far ahead, the current problem is usually sufficient to draw all of its energy, but we should always operate under the assumption that we do not and cannot know the future and therefore must recognise and position portfolios in such a way that they can take advantage of whatever the future may bring. We therefore offer a few final thoughts:

1. There is a broad expectation that the post Covid-19 recovery will be ‘V’ shaped. Could we not, though witness a change in consumer behaviour post crisis? Would households not want to build up precautionary savings. Might the patterns of consumption change, or the usage of retail parks and leisure habits change? Could air travel change. Might the density of consumers change – where once an aircraft sat 300 people, might we want a bit more personal space. What about restaurants or cinemas?
2. Similarly, governments are likely to change their priorities as we emerge from this crisis. US trade director Navarro stated that ‘never again…so dangerously dependent upon global supply chains for essential medical equipment and countermeasures’. Might, de-globalisation take a new leap forward? Over 50 countries have imposed protectionist measures (Even within the EU, and certainly in direct violation of the founding treaty of Rome and its more recent iterations). Do governments begin to set domestic industrial policy and move manufacturing back onshore. Will historic ties and military alliances hold when all countries are pursuing the same domestic (and distinctly anti-global) agenda.
3. The extreme levels of fiscal profligacy of governments may be sowing the seeds for the next sovereign crisis. Morgan Stanley estimates that the 2020 US fiscal deficit could hit 18% of GDP. In the EU that number is closer to 3% of GDP but liquidity guarantees equating to a further 18% of GDP have been extended. Does the already indebted world have the capacity to carry this?
4. In the Global Financial Crisis looser fiscal measures were met by tighter financial conditions (despite easier monetary policy banks were forced to reign in their balance sheets), a deflationary or at best neutral outcome.. Today, looser fiscal policy is going hand in glove with looser monetary policy – this time could it be inflationary?

At this stage the market has yet to focus on any of these, and only time will tell how they will unfold. But each of these potentially holds the key to dramatic changes in the performance of risk assets. Food for thought.

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