June 11, 2020

The credit cycle ends and a new one is born

The bulk of returns are typically made in the early stages of the cycle

The credit cycle has ended abruptly, with a purge of the weakest borrowers through defaults and downgrades looking inevitable. A new cycle is born in which companies that survive should eventually emerge stronger as balance sheet restraint is likely to be exercised. Early stages of the credit cycle typically benefit investors and this time should be no different, especially as credit spreads have become an instrument of monetary policy.

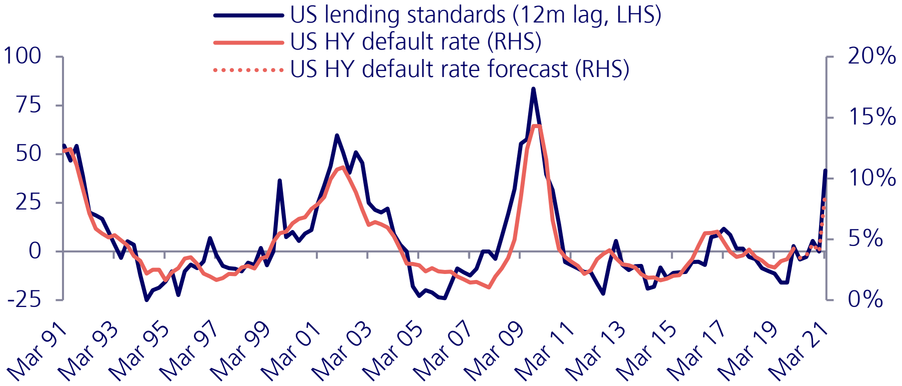
Source: iStock

The credit cycle ends with a purge

We had been fundamentally negative on credit for the last couple of years as high leverage, tight spreads and a favouring of shareholders over creditors made credit markets unattractive as an investment. Moreover, many credit funds and ETFs promised daily liquidity to investors, while the underlying corporate bonds tended to be highly illiquid under stress. This was a major risk because if investors were to pull out money aggressively, it could cause significant dislocations and stresses in credit markets. Furthermore, record leverage had indeed sown the seeds of defaults and downgrades even before the COVID-19 driven economic shock hit the markets. We felt investors and market pricing were ignoring many of these underlying risks in credit markets.

All these vulnerabilities came to the forefront in March 2020 when economies were locked down to limit the spread of the coronavirus.

A purge of the weakest borrowers is underway

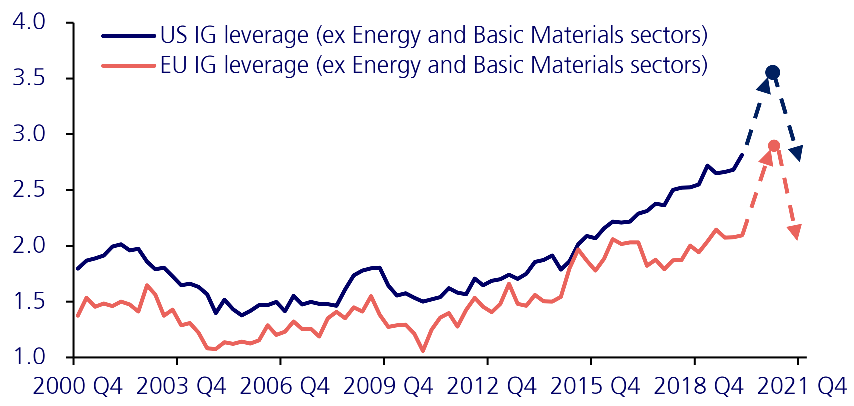


Source: ZIG, Bloomberg

Investors who had been bullish for years were forced to liquidate portfolios, while ETFs started trading at heavy discounts to underlying bonds, which sold off aggressively in thin liquidity. Consequently, credit had a horrible performance in Q1 2020, with US nonfinancial corporate credit excess return to Treasuries reaching around -20% by late March, which made the over 30% drop in the much higher beta US S&P 500 Index look tame. Stresses in credit markets picked up sharply, which we believe caused central banks to take aggressive actions. Many central banks, especially the Fed, announced programs to support credit markets, which we think is eventually leading, albeit implicitly, to credit spreads becoming an instrument of monetary policy.

The COVID-19 shock is likely to negatively impact cash flows and earnings significantly in 2020, especially in Q2. A significant number of the weakest investment grade companies have been already downgraded to junk and more downgrades are highly probable. At the same time, default rates are expected to rise in high yield markets. In fact, we forecast around a 10% default rate in high yield in 2020, which is also consistent with indicators such as lending standards to large companies from the US Fed's Senior Loan Officer Opinion Survey, as shown in the chart.

Leverage will rise this year, but should come down later on



Source: ZIG, Bloomberg Note: Leverage is defined as the ratio of median Net Debt to EBITDA

However, what has changed over the last couple of years is that these downgrades and defaults are widely expected and therefore likely to be priced into bonds of the affected vulnerable borrowers, as these bonds trade at wider spreads than others. It is worth noting that actual default rates and downgrades typically tend to lag the price action in credit markets.

A new credit cycle is born and companies which survive should emerge stronger

The COVID-19 shock increased leverage in Q1 this year but not by much, although a further sharp rise is expected in Q2 2020. The key question is whether the rise in leverage will be transient or permanent. We believe that for most of the companies, and especially those that retain their investment grade status, the rise in leverage will probably be transient and leverage levels are likely to be worked down in the second half of 2020 and in 2021. That said, on a historical basis, leverage is nonetheless likely to remain high for some time, as shown in the chart above.

Credit fundamentals will be so weak after the COVID-19 hit to cashflows that companies will likely not have any choice but to deleverage in the next one to two years. The deleveraging over the next couple of years would hence be driven by necessity rather than choice. Without deleveraging, many companies risk being downgraded or are likely to default on a small earnings shock in the future. As a result, we expect corporate management to largely focus on reducing debt in 2H 2020 and 2021, rather than engage in activities such as share buybacks and expensive M&A.

Most investment grade companies should be able to survive the COVID-19 hit

Encouragingly, most investment grade companies should now have ample liquidity to weather the COVID-19 hit to cashflows.

Looking at investment grade issuers in Europe and the US on a combined basis, a total of around USD 1.5tn in investment grade corporate debt has been issued so far this year. This exceeds maturing debt by around USD 700bn for non-financial corporates, which is the net issuance. Another USD 250bn in credit lines has been drawn down, while over USD 300bn has been raised in more credit line commitments. In addition to all this, the US Fed's primary market facility (more on this later) can lend another USD 500bn to US investment grade companies and, if it is required, we think the Fed could double this facility to around USD 1tn. As a result, and illustrated in the chart below, companies can withstand comfortably a 20% full year EBITDA drop from 2019 as forecast by analysts for broader US and European stock indices, or as was seen during the 2008 financial crisis. As also shown in the chart below, even double the expected hit to a 40% full year EBITDA drop could be withstood from a liquidity perspective in our view without the Fed having to increase its primary market corporate facility or other liquidity sources needing to be accessed. Given the Fed's ability to increase the program even as of now, we think the Fed's primary facility is likely to be increased in size, were it to be necessary due to an even sharper than expected earnings drop. Of course, a larger than expected drop in earnings is likely to require even sharper deleveraging and would elevate risks.

Cash flow hit is likely to be brutal in Q2, but green shoots are emerging

The hit to earnings and cashflows from the COVID-19 economic shock should be most brutal in Q2, before recovering somewhat in the second half of the year.

Indeed, it is encouraging to see that there are already signs that the worst could soon be over from an economic perspective. US nonfarm payrolls for example, shocked economic forecasts by showing that 2.5mn new jobs were created last month in the US, while Purchasing Manager Indices (PMIs) for many countries have started recovering from depressed levels, although many remain below the expansion/contraction line of 50.

A sharp virus resurgence to the degree that it necessitates a wave of further lockdowns is a core risk, although it is not our base case assumption.

Credit is now an instrument of monetary policy across major economies

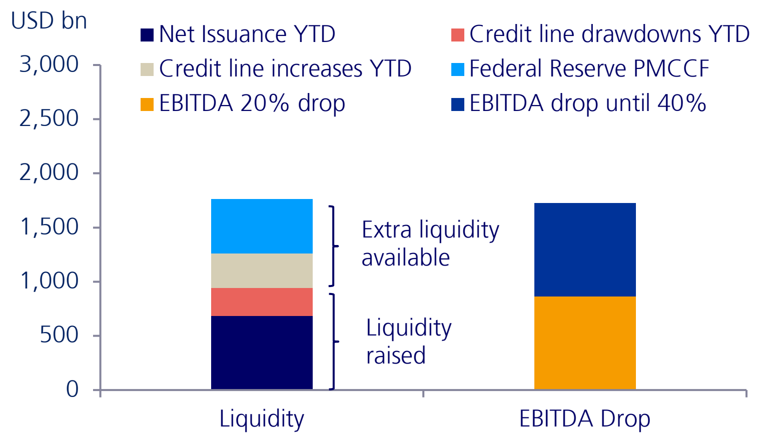
We think the most significant development of the crisis has been that credit seems to have become an instrument of monetary policy. Most major central banks are now directly participating in credit markets, essentially making survival of large companies a top priority.

The Federal Reserve's credit programs announced in early April 2020 have significant scale and target a broad range of credit markets. The Fed's credit programs total over USD 2.7tn and could be upsized to USD 4tn in our view, were the need to arise. The Fed's key programs for corporate credit are the following:

The Fed's secondary corporate credit market facility is significant

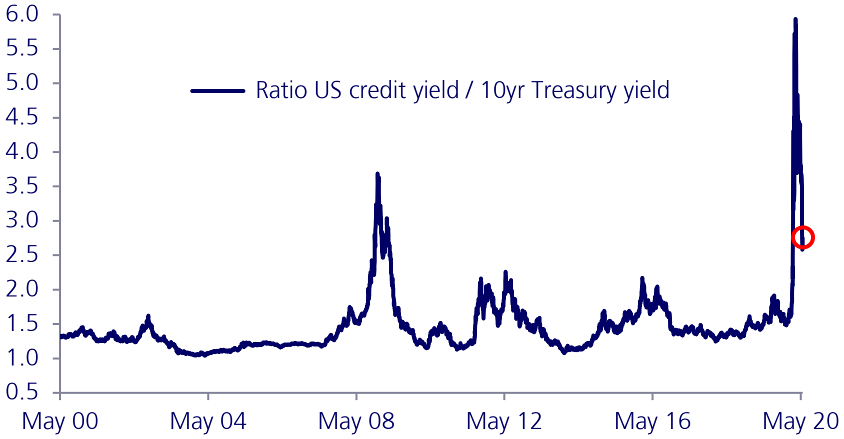
The secondary market facility has a maximum size of USD 250bn and is to be used to buy ETFs and investment grade corporate bonds that have five years or less of remaining maturity in the secondary markets. In this program, the Fed will buy both investment grade and high yield ETFs, especially when they trade below the net asset value. The Fed will also buy bonds of investment grade companies including those of so called 'fallen angels' as long as issuers were investment grade rated on March 22, 2020 and are still rated in the BB bucket of high yield. The extension of credit to fallen angels is significant as it benefits companies that may have sound business models but are more

Most corporates should be able to weather the COVID-19 hit



Source: Bloomberg Note: EBITDA used is combined EBITDA of US and European investment grade universe

The allure of income pick up in credit will be hard to avoid



Source: Bloomberg Note: Red circle represents current level

cyclically exposed to the expected dramatic drop in earnings during Q2 2020.

The Fed's direct funding programs

The Fed's 'Primary Market Corporate Credit Facility' (PMCCF) and 'Main Street Lending Program' are programs targeted at providing direct funding to investment grade and smaller borrowers, which are likely to include many in the high yield and leveraged loan segments, respectively. The PMCCF is expected to have a maximum size of USD 500bn while the Main Street Lending Program is targeting USD 600bn in funding. Both provide funding backstops for companies to deal with cash flow shortfalls arising from the COVID-19 crisis.

Other programs such as the commercial paper facility, municipal liquidity facility and money market mutual funds liquidity facility are also important and sizeable programs for other segments of credit markets.

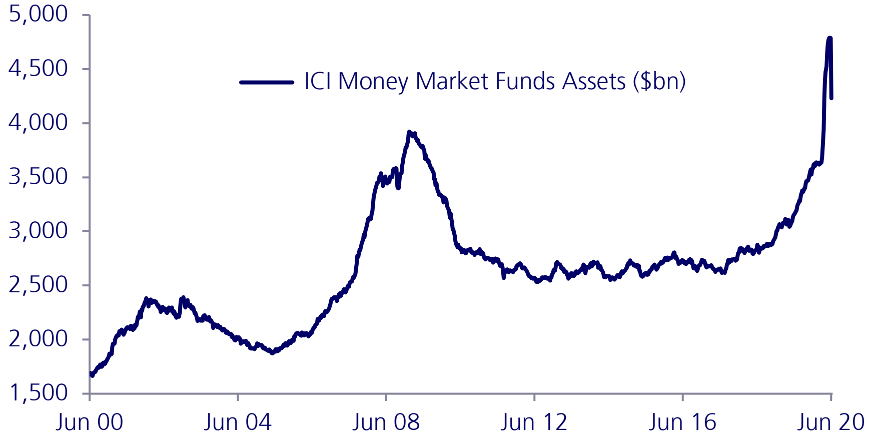
Lastly, other central banks such as the ECB and BOJ are also buying credit, providing support to credit spreads.

It is hard for income driven investors to ignore the allure of credit

Amid extremely low bond yields, the income increase on a percentage basis by moving from government bonds to credit, which is important for income starved investors, has rarely been so dislocated. This percentage increase in income is implied by the ratio of US credit yield to US government bond yield, which was only briefly higher than it is today during the peak of the financial crisis and over recent months, as shown in the chart above. The comparison in the Eurozone is even more stark, as a majority of government bonds in the five-year space are trading at negative yields. Consequently, investors will find it hard, if not impossible, to resist credit within portfolios, especially fixed income portfolios. This compulsion will drive more flows into the asset class, which has been evident recently.

Credit markets seem to have lagged the rally in other risk assets, largely due to the heavy pace of supply. While spreads are now well below their peaks, they are still around a 70% level on a historical percentile basis in Europe and the US. A point to note here is that both during 2008 and 2020, the spread peaks were driven during periods of very thin liquidity with limited trading. If one were to exclude the periods where prices were cheap, but investors could hardly transact, credit would presumably be even cheaper on a historical percentile basis.

There is a lot of cash on the sidelines



Source: Bloomberg

Declining supply amid central bank liquidity to skew supply demand balance

As we mentioned earlier, companies have already raised or secured a significant amount of liquidity. Consequently, it seems likely that the frenetic pace of supply is likely to ease going forward. This should improve the supply/demand dynamic in the market, which weighed on credit spreads from the mid-April to mid-May 2020 period. In addition to easing supply, the credit purchases by the Fed and the ECB could create a rush for credit assets.

The USD 250bn size of the Fed's secondary market facility implies a run rate of around USD 60bn of purchases every month for the Fed to reach its target by September's end, which is the foreseen end date of the program. This, together with inflows into credit, could offset a fair chunk of gross bond issuance, potentially leading to bond scarcity for investors wishing to catch up with the rally. It must be said that the Fed has been slow so far, as operational hurdles remain in place, but we think to establish its credibility the Fed is likely to deliver on the program. The Fed has until now only bought a small volume of ETFs, which has driven large flows into ETFs as investors seem assured that the Fed will diminish the tail risk of significant discounts to the net asset value, as this has been an explicitly stated goal of the Fed's policy.

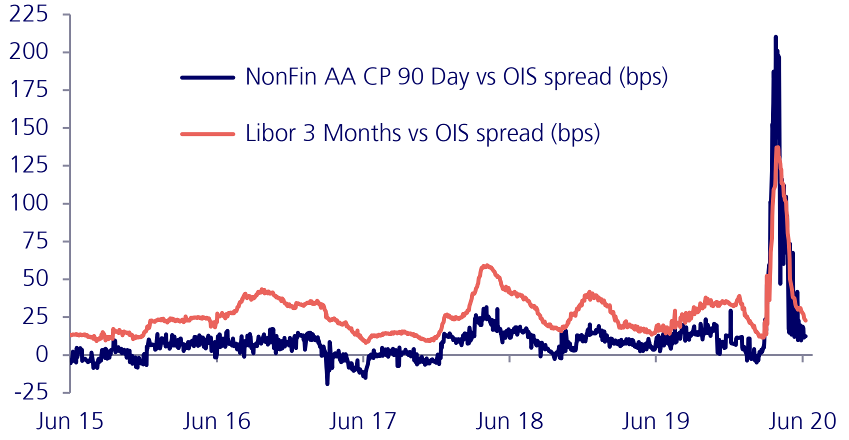
Cash holdings remain historically high, as many investors remain sceptical

We believe many credit investors do not see the recent strength in credit as sustainable. This is also true for the broader risk asset universe, as evidenced by high gold prices and some equity investor sentiment surveys and short positions in equity derivative markets. At the same time, there seems to be quite a bit of cash on the sidelines, not only within investor portfolios but also in money market funds that have more assets today than at the peak of the financial crisis, as shown in the chart below.

The predicament of cautious investors is further exacerbated by the cash flowing into the credit market from asset purchases by central banks. Central banks are expanding their balance sheets at a historic pace. The Fed's asset purchases of US Treasury and Mortgage backed securities (MBS) is theoretically unlimited, while its credit programs, which are expected to exceed over USD 2tn, could be increased to around USD 4tn in our view, if the need arises. Global central banks have already injected over USD 4tn into markets primarily through their purchases of government bonds this year, and we think more is likely to be injected over the coming months.

This liquidity will find its way into credit markets and will lead to even more inflows into the asset class, with inflows to credit markets hitting records recently. Credit ETF flows have also hit a record. Furthermore, if the Fed's primary market facility, which has a potential size of USD 500bn is not fully utilised by companies due to ample liquidity or fear of a stigma, some of this could potentially be reallocated to the secondary market facility. We suspect some of this reasoning may be behind the motivation of

Tail risk has diminshed significantly



Source: Bloomberg

credit ETF investors as inflows far exceed what the Fed has bought so far.

Indeed, as can be seen in primary markets, there seems to be a scramble for recent deals, which have been heavily subscribed with companies being able to now issue bonds at lower credit spreads than their outstanding bonds of similar maturity.

Winds of change in Europe are also encouraging

We believe the European corporate credit market is generally of a higher quality and is less leveraged than the US, as can be seen from the chart shown previously on historical and expected leverage. While the economic shock from COVID-19 and historically elevated leverage levels are common to both markets, there are some factors that impact the European market uniquely. The two key risks in European credit markets in our view are the debt sustainability of peripheral sovereigns and the vulnerability of the banking sector. While the banking sector situation still calls for some caution, both the ECB and European governments have taken significant steps to lower peripheral risks. Spreads of peripheral government bonds have been successfully suppressed in secondary markets by the ECB despite a dire short-term economic outlook. The ECB has upsized its Pandemic Emergency Purchase Program (PEPP) to EUR 1'350bn, which adds further liquidity into investor portfolios, and has already been buying corporate bonds in secondary markets.

Additionally, we are encouraged by the recent EU recovery fund initiative that we believe is a first step towards some debt mutualisation, which is needed to contain the risk to Eurozone integrity as governments emerge out of the COVID-19 crisis with higher debt loads.

Tail risks of a market dislocation have diminished

Due to the targeted intervention by the Fed, several market stress indicators have normalised to pre-COVID levels. LIBOR-OIS spread and commercial paper spread are two such examples. We consider LIBOR-OIS spread between 3m LIBOR rate and Overnight Index Swaps to be a good indicator of liquidity conditions within the banking system and in general. A sell-off in LIBOR-OIS is often coincident with a sell-off in corporate bonds as it indicates an elevated liquidity premium. In March 2020, the LIBOR-OIS spread had reached levels not seen since the financial crisis, but with targeted Fed actions, it has since nearly reached the pre-COVID range. Commercial paper spreads also reached the highs of 2008 in March 2020 but have since retraced most of the spread widening. Commercial paper is a key to funding short-term needs for companies and this normalisation has largely been driven by the confidence the Fed has injected through its commercial paper facility, announced in March.

This, together with the ETF and secondary market purchases by the Fed and the ECB, are likely to limit extreme dislocations as seen during 2008 and March 2020. It is worth noting that the Fed is likely to buy greater volumes of ETFs when they trade at a significant discount and in addition to investment grade ETFs, the Fed is also willing to buy high yield ETFs.

Consequently, the tail risks seem to have indeed diminished for investors.

High yield credit's outlook is more opaque

We have been focusing primarily on investment grade credit in this paper, due to its importance to both the economy and most fixed income investors. The high yield and leverage loan markets are likely to witness significant default rates, which together with technical forced sales for lower quality paper will lead to a more mixed outlook. The direct support from central banks is also more limited relative to investment grade credit and in some sectors the fundamental outlook is poor.

Risks remain, particularly of a virus resurgence and further lockdowns

There are three core risks that we see. Namely a virus resurgence, geopolitical tensions and some overheated markets.

Firstly, the chances of a significant virus resurgence and further lockdowns remains the biggest risk in our view. However, this is not our base case expectation, which rather anticipates recovery in economic activity in both the US and Europe during the second half of 2020 and in 2021, after significant declines during Q1 and Q2.

Secondly, geopolitical tensions have risen around the globe. Further escalation in geopolitical tensions will likely impact investor sentiment negatively and lead to increased volatility.

Thirdly, some markets, most notably in stocks, seem overheated in the short term, which could raise the prospect of indigestion filtering into credit. While credit markets have been strong, they have been lagging other risk assets. A consolidation or a shallow correction is a risk, but without a virus resurgence, this will likely see a buy on dip mentality as perception of a 'central bank put' is likely to remain in place.

Summary and conclusions

The economic shock caused by COVID-19 and the accompanying lockdowns have deteriorated credit fundamentals irreparably for the most vulnerable and leveraged sectors within the credit market. A significant number of defaults in the high yield market looks inevitable, as we project default rates to reach 10% this year. At the same time, leveraged borrowers in investment grade have been downgraded into high yield and more will likely follow. Amid this purge of the weakest borrowers through downgrades and defaults, we conclude that the long running credit cycle, in which leverage was considered more of a virtue than a sin, has ended. Consequently, a new credit cycle has begun in which we expect companies are likely to exercise balance sheet restraint. This will be borne out of necessity rather than choice, as without such restraint many companies will be left with debt burdens that are untenable.

The early stage of the credit cycle is normally a decent environment for credit investors, despite deteriorating fundamentals and rising defaults, which typically lag the markets. We see this time to be no different due to several supportive factors.

There is light at the end of the tunnel for credit fundamentals, as leverage should eventually fall going into 2021, while liquidity risks for corporates have diminished substantially. At the same time, credit spreads have become an implicit instrument of monetary policy. It is hardly an option to avoid credit today for income driven investors, as the ratio of credit to government bond yields is at historically dislocated levels. Investment grade companies seem to have access to enough liquidity to weather the earnings shortfall and may have even overdone the bond issuance. This implies that supply is likely to shrink from recent extreme levels. While supply wanes, demand is likely to remain strong not only due to a liquidity glut created by central banks, but also because of risk aversion and extreme levels of cash assets. These should drive a continued flow into credit funds and ETFs. Tail risks of market dislocations seem also to have diminished through the actions of central banks.

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