Income & Fixed Interest Newsletter

Vimal Gor

Fade it, and you've made it

So far this year, if you've faded every North Korea missile launch, every impeachment headline, and every "Taper Tantrum II" concern, you'd be pretty happy with yourself right now. In fact, until August, we haven't seen any meaningful S&P 500 sell-off which has lasted more than two weeks. Even August, with its well-known seasonal curse, wasn't capable of producing much apart from a slowing of equity market momentum. Similarly, US 10-year Treasury bond yields have found it tough to rise past the 2.40% mark since the end of March. Systematic models have been selling volatility like it's going out of fashion, fixed income asset managers have been reaching for high yield credit in search of "alpha", and the bond bears have been throwing in their towels. Who cares about eerily low levels of volatility when central banks have had our backs since the GFC? Who cares that it's really higher credit beta which is currently masquerading as alpha? And what's really different about the latest North Korean scares and US debt-ceiling brinksmanship? The market has been rewarded for buying the dip in risk assets, but we are not convinced. Against this backdrop of an uneasy calm we had a decent month of performance, with all flagship funds outperforming their respective benchmarks.

The only consensus trade we'd agree with at present is the long bias in Treasury yields, driven by the ongoing low-flation quandary, and certainly not helped by continued geopolitical tensions and the looming threat of a US government shutdown. However, the consensus trade we'd vehemently disagree with is the idea of reaching ever deeper into the barrel of high yielding credit, backed by blind faith in the central bank put. Perhaps a liquidity put option exists - at the extremes - but the put certainly won't extend to 7-times leveraged Tesla bonds issued at 330bps over US swaps. For all the emphasis that has been placed on the issue of financial stability by the BIS and various central bankers, it would be all-out irresponsible to allow any expectations of bail-outs, and especially not for the pundits who never demanded reasonable compensation for the risks they were taking in the first place. In this newsletter I look to challenge the existing consensus of a benign macro backdrop, and aims to explain our fundamental concerns on US high yield credit in particular.

The great vol crash

Chart 1: Vol leads HY spreads lower

Source: Bloomberg

We have been living in a low-vol world for a while now, driven by a massive alphabet soup of central bank liquidity which have been delivered globally. If it's not the Fed engaging in QE's 1, 2 and 3, it's the ECB's PSPP and CSPP bid, BoJ's QE and yield curve control, or simply the massive stimulus delivered by PBoC. But the persistence of low volatility and low yields is also thanks to what seems like a Goldilocks global growth picture. The US economy has put in a sufficient recovery over the last year such as to allow the Fed to have hiked three times without much ado from the markets. Similarly, European growth hasn't been this stellar since the Eurozone sovereign crisis, which put most of the continent into a coma for the last five years. And of course, against all devaluation expectations, the Chinese Yuan and economy have both charted a firm and steady course so far this year.

Put it all together, and you have a global economy probably past its peak but not yet falling over, and activity levels that are holding up but not so strong as to warrant a sharp rise in interest rates. But what lies beneath may not be so Goldilocks. The economy is both "too hot" (US labour market) and "too cold" (global inflation), and it is precisely such opposing forces that currently result in a benign macro backdrop. In the tug-of-war between a Fed determined to pursue monetary normalisation and a stubbornly weak (or at least weaker-than-expected) inflation picture, the yield curve has flattened and low-flation has won.

Certainly after five disappointing US inflation prints, a belief has set in that we are now in a structurally lower inflation world, perhaps as a result of the success of inflation-targeting central banks.

Regular readers will know that I am strongly of the view that low inflation is a structural phenomenon, but given the extent to which inflation expectations have adjusted, there is perhaps a more even chance of some positive surprises in the next few months. There are also those who argue that the Fed's balance sheet tapering will necessarily result in an imbalance in Treasury supply and demand dynamics, which ought to send yields higher. While we agree with this view we believe it will be a slow-burn with the cumulative effects (stock) much more important than the monthly flow. At some point the market will wake up to a large net issuance problem, but we don't expect that to be a factor in the short-term. In any case, it is all too simplistic to argue that QT is just the opposite of QE, and even if that were the case, bouts of QE have generally resulted in higher yields, and prior attempts to taper have resulted in lower yields. Ultimately, to produce a sustained sell-off in US yields, the debt ceiling storm clouds need to part, and positive economic momentum needs to grow some legs.

It was only 18 months ago when the world was convinced that the US was headed into recession. By the start of 2016, WTI crude oil had found new lows in the mid-$20s, US GDP growth had more than halved in less than a year, and ISM PMIs were firmly in contractionary territory. Between mid-2015 and early 2016, US high yield credit spreads had almost doubled to 600bps. Concerns over the US being "late-cycle" had quickly escalated into fears of the next US recession, and no investor wanted to touch US retail with a ten-foot barge pole.

Then in what felt almost like an overnight move, things started to improve. We all know very well by now that the Chinese credit stimulus of late 2015 "made America great" by delivering the impulse needed to avoid the next dip. Soft and hard data based as commodity prices lifted off their lows, and however "late-cycle" the US might have been then, the economy had once again peered over the edge but stepped back from the abyss. Asset volatility, risk premia, and credit spreads globally followed the US recovery, and the rest is history.

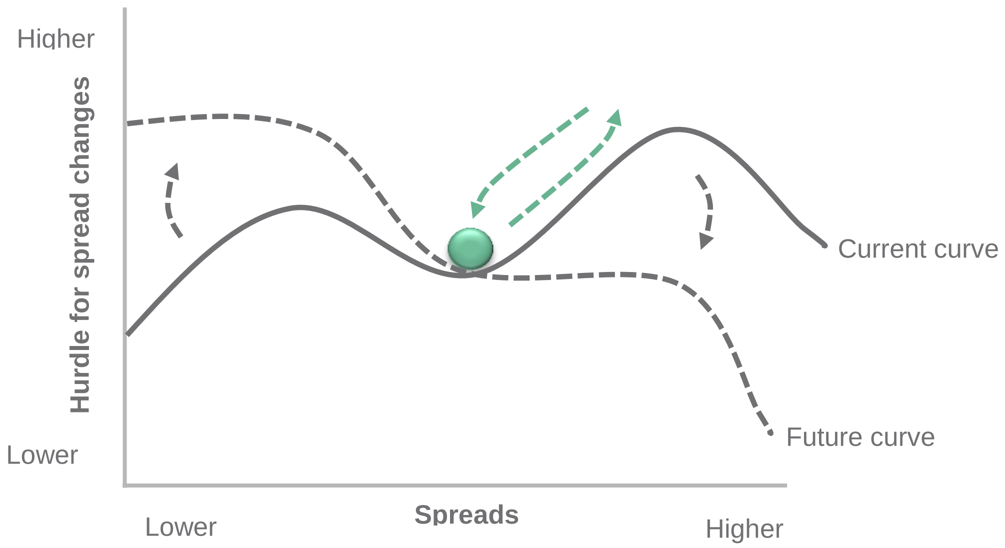
An unstable equilibrium

So now here we are, with volatility and credit spreads at, near or through their cyclical tights, and so far no catalyst has managed to cause a significant enough shift in fundamentals to disrupt the ecosystem. This is a market conditioned to buy the dips and ignore high stakes.

We are therefore in an equilibrium of sorts, although this equilibrium may not be as stable as you think.

Chart 2 below is a stylised depiction of how we view the dynamics of credit spreads currently. The X-axis is credit spreads, running from tight (LHS) to wide (RHS) levels. The Y-axis is the probability hurdle of getting to such spreads. The pinball is where credit spreads currently are, which is a level the market is quite comfortable to stay at or gravitate back to, absent of any meaningful disruption. You'll notice that the hurdle is lower for tighter spreads than wider spreads from here, and this is exactly how credit markets have been behaving. It has been easier to bet on falling credit spreads than rising credit spreads, if only because the carry works in your favour. However, we've also seen multiple shocks to risk sentiment, which has caused the pinball to be pushed uphill towards wider credit spreads. Since the probability hurdle for credit spreads to widen has been higher, especially in the absence of further negative shocks to propel the pinball along, a natural gravitational pull (the hunt for yield) rolls the pinball down to its equilibrium level.

Chart 2: Pinball wizard



Source: BTIM

We question whether this can be a stable equilibrium for high yield credit spreads. The bulls would argue that with strong US corporate earnings and a still low interest rate environment, owning higher yielding bonds is surely a one-way bet. But there is a growing list of risks that can start to change the shape of this probability curve and tilt the pinball towards higher credit spreads. In fact, we believe that this shift has already started to occur. Even with the illusion of abundant market liquidity propagated by passive ETF strategies, year-to-date net inflows into the US high yield bond market have struggled to stay positive.

Shaken, not stirred

When volatility has been crushed in the face of ever increasing risks, it is easy to get trapped into the psyche of a perma-bear. Even when risk-reward is in the bear's favour, the rewards can seem ever illusive. Indeed, when there is attractive risk premia built into asset valuations, the odds may well favour the dip-buying strategies, especially when the catalyst which has caused a dip is an exact re-run of a movie we've seen before. The problem is that risk premia have all but vanished, and it may look like the same movie but the cast has changed. The market thinks it is being stirred, when in fact, it is being given a damn good shaking.

The issue of North Korea is tragic, yet as a global threat it had, so far, been fairly inert. That is, until they started threatening to go nuclear. The game theorist would predict that North Korea will continue to pursue full nuclear capabilities as that is what's needed to strengthen their bargaining position. However, North Korea doesn't want a nuclear war. What they have previously bargained for was the lifting of sanctions and foreign aid, because trade and aid are required to sustain the status quo. The to and fro between North Korea and the West under the late Kim-Jong Il was very much this type of repeated game. It is not unreasonable to assume that Kim-Jong Un also wants to preserve the status quo, but at only 33 years of age, he likely suffers from the ignorance of youth. And sitting across the bargaining table from an oppressive dictator is another volatile character: The Donald.

The more that Kim-Jong Un feels he is not being taken seriously, and the more that the US President chooses to rattle his own sabre, the more there is a potential for miscalculations and accidents. The missile that caused the brief market frenzy on 29 August (which of course has been quickly faded, again), was the first to fly over Japan, and is a sign that the supreme leader is becoming desperate to be heard. Let's hope that this geopolitical threat doesn't become any more real than it already has done, but we find it difficult to stay so sanguine.

The issue of the US debt ceiling was also fairly inert, until it became conditional upon The Wall. Game changer. Do we think it likely that there is a US debt default? Probably not, as it would be an incredibly stupid move. Do we think it likely that we see a government shutdown? It's happened before, and given the players involved this time, we think the chances are much higher than what the market is prepared to believe. If government shutdown is Trump's chosen battle ground, then default is his nuclear option, and an option that he has exercised numerous times before on a personal and corporate level. With his approval ratings down in the dumps, Trump's desperation to reach out to any faction of his original supporters cannot be overly discounted. Protracted shutdown without any resolution over the debt ceiling issue would ultimately entail one of two outcomes: default, or a drastic cut to fiscal expenditure. In the case of the latter, the magnitude of the cut that would be required would equate to over 3.5% of GDP. Forget about late-cycle; that is definitely recession territory.

Tightly coiled spring

Assuming the market is right to fade geopolitical and political concerns, we're still not out of the woods. Early warning signals are beginning to flag in a number of areas that cause us to be particularly concerned for US junk debt. America's car dealerships have been slashing prices by the most seen since the economy was last in recession, in a desperate attempt to rev up sales. And whilst delinquencies are still at very low levels, due to the loosening of banks' lending standards from 2014, credit card charge offs are on the rise.

Chart 3: Auto is looking weak

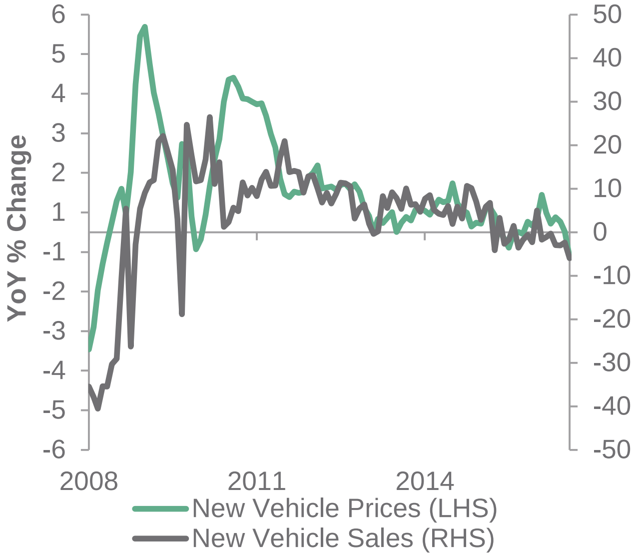
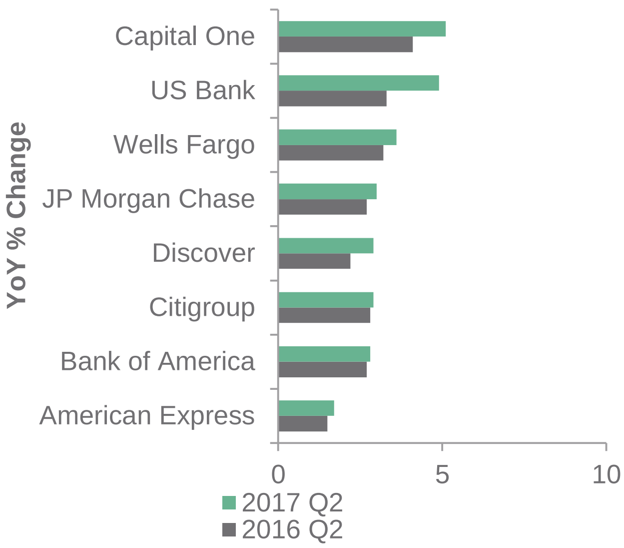


Chart 4: Net charge-off rate (%)



Source: Bloomberg, Companies

With the US economy now in its 99th month of expansion, it naturally brings about familiar late-cycle concerns. Cross asset correlations have been falling versus a year ago and reinforce the late-cycle view. The last time cross asset correlations were so low was in the lead-up to the GFC. How late cycle we are becomes much harder to judge.

Chart 5: Morgan Stanley Global Correlations Index

Source: Morgan Stanley, Bloomberg

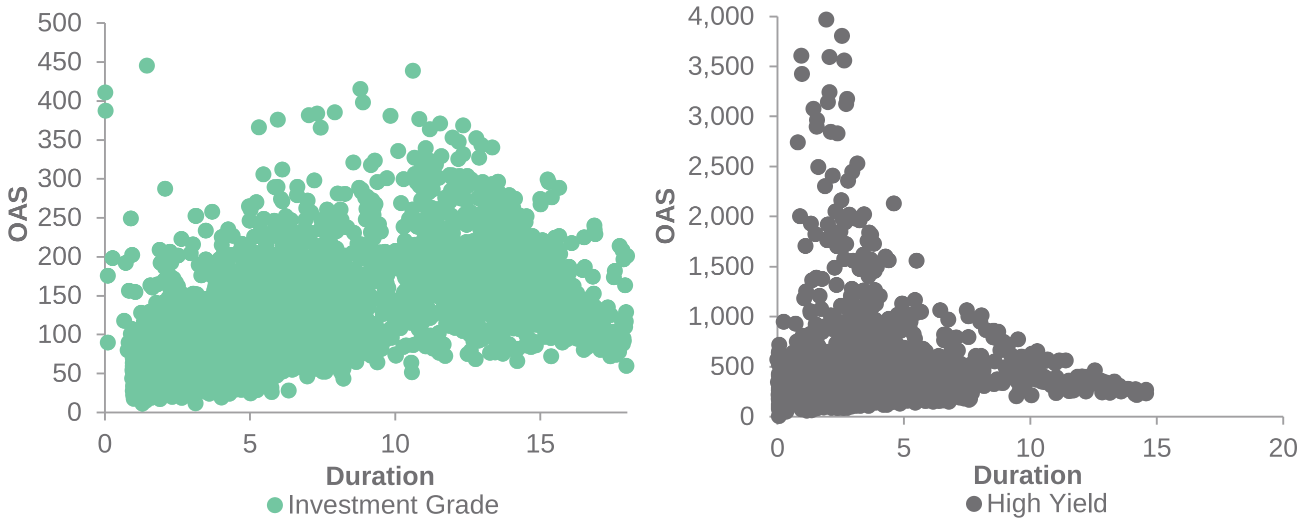
Chart 6: Regional correlations within asset class

	Equity	Credit	Rates	FX
Equity	-18%			
Credit	-19%	-25%		
Rates	-12%	-11%	-6%	
FX	-20%	n/a	-17%	-26%

represent regional correlations within that asset class

Whilst cross-asset correlations are low, intra-asset correlations are high, and most notably, dispersion in corporate earnings and performance is low. A low-dispersion world is a challenging backdrop against which to generate any true credit alpha, and the collapse in dispersion for investment grade credit has forced credit investors to reach for ever poorer credit quality where higher carry can pretend to be alpha as long as volatility remains low.

Chart 7: Low dispersion in IG pushes hunt for alpha into HY



Source: Deutsche Bank, Bloomberg

The trouble with credit risk is that it is both asymmetric and non-linear. Unlike equities, where in theory your upside can be unlimited, the upside for a credit investor who buys a bond at par is simply the yield (or coupon) you are paid for taking the risk that you might not get your money back. Of course, the reason for the asymmetry is that credit investors outrank equity investors if things really do go wrong. This is fine for a well-capitalised and lowly levered investment grade corporate, but the illusion of safety for highly levered junk-rated investments can be very dangerous. A 4-times levered company isn't simply twice as risky as a 2-times levered company, and similarly, every notch lower in credit rating does not amount to the same incremental rise in credit risk. According to S&P, companies rated B- or worse are on average ten times more likely to suffer a payment default than the rest of the high yield universe. Yet, the stretch for yields has caused risk premia to compress disproportionately for lower quality credits such that you are simply no longer being paid for owning this kind of junk.

Chart 8: High Yield risk premia

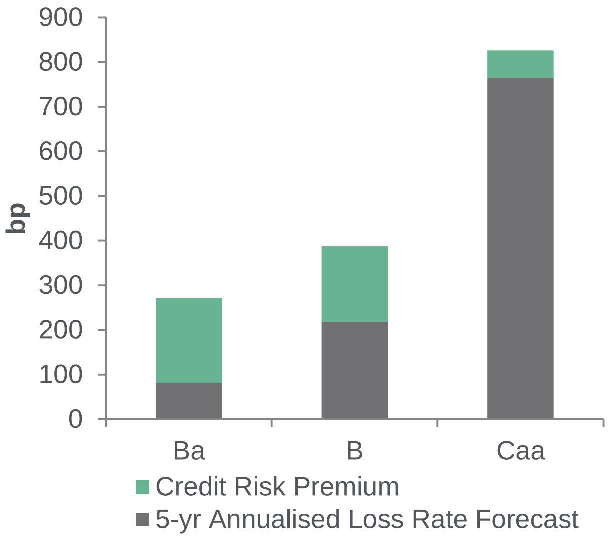
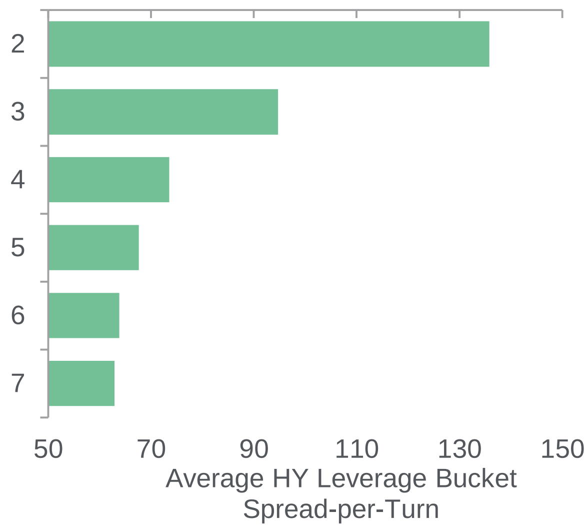


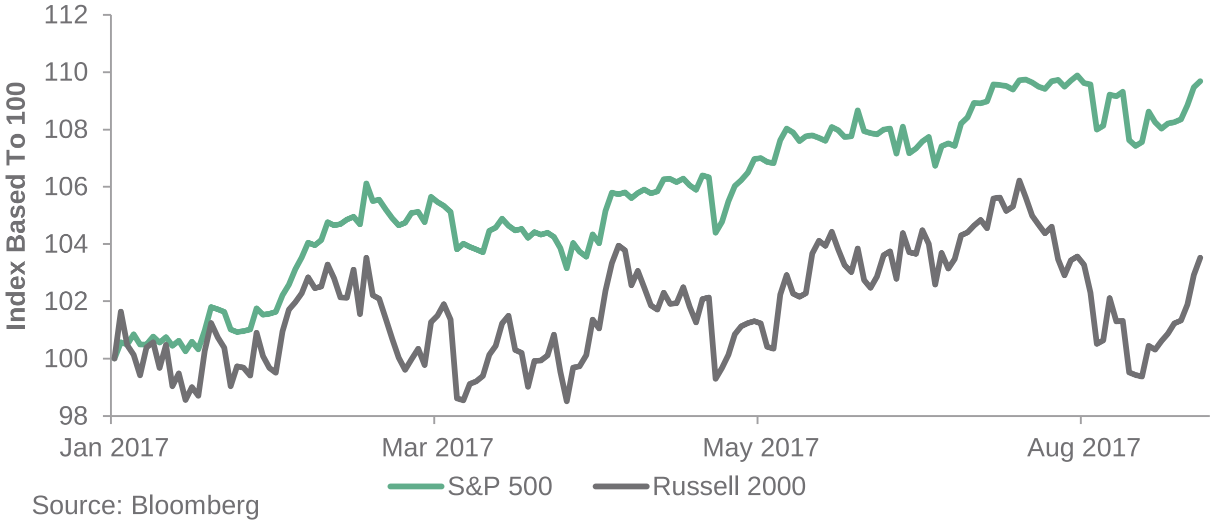
Chart 9: Dude, where's my yield?



Source: Goldman Sachs, Deutche Bank

Whilst reaching for the highest yielding asset may be a safe bet when times are good, the compression of junk spreads to investment grade credit spreads has been so strong that the spring is now very tightly coiled. It is becoming harder for this compression to continue, and any sustained unwind of this compression is likely to be brutal. This unwind has already begun in equities, where weak balance sheet corporates have significantly underperformed so far this year. Very simplistically, this can be seen in the divergence between the S&P 500 (dominated by large-cap investment grade corporates) and the Russell 2000 (which better represents the make-up of the US high yield bond index).

Chart 10: The broader market is a dog

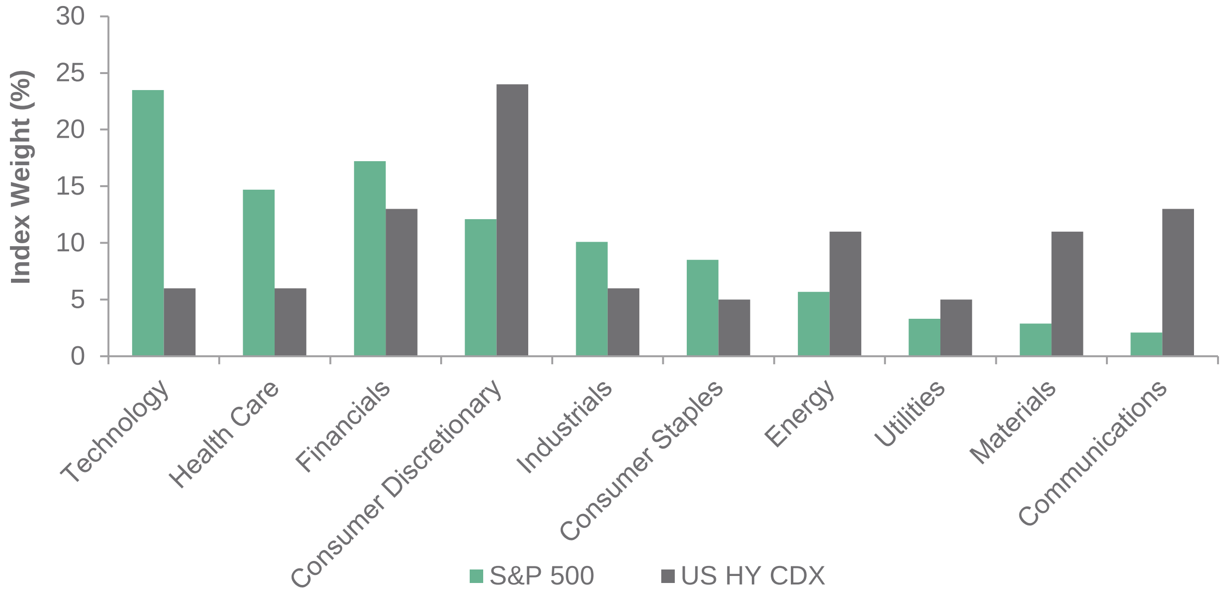


Source: Bloomberg

"But look at equities..."

Those who take comfort from stronger equity markets driven by robust corporate earnings should take note of the disparities between equity and (high yield) bond indices. US high yield indices suffer from a less favourable sector mix than the S&P 500.

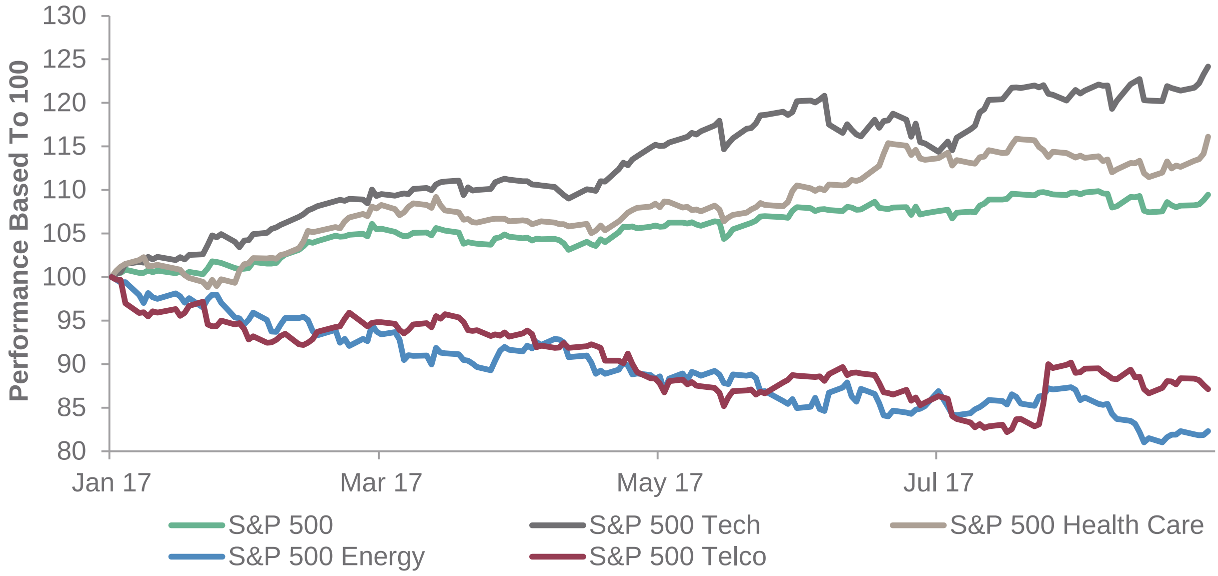
Chart 11: HY is a dog with fleas



Source: Bloomberg

This is important when you look at what has driven a lot of the S&P 500's gains so far this year: tech and healthcare. These are sectors that benefit the equity index far more than the high yield index. Instead, the latter is weighted towards sectors which are experiencing difficulties, both cyclically and structurally. This has been most apparent in the marked underperformance of the energy and telecoms sectors so far in 2017.

Chart 12: Those fleas have been biting hard



Source: Bloomberg

The problems of US retail have been a theme since the last time the market worried about a US recession, but more recently, the world of grocery shopping has been rocked by Amazon's announcement to buy Wholefoods. The way we shop and consume is changing and technology will undoubtedly have a larger role to play in the future. Highly levered US supermarkets have limited room to manoeuvre, innovate and lead in this changing landscape, so no surprise that they have been underperformers among US high yield of late.

When technological disruption is large and sustains meaningful shifts in how we behave, even well positioned industry leaders struggle to find shelter. If you thought in the 1990s that that one day we would be taking hundreds of photos of our kids/pets/flat whites with our smart phones (and rarely having any of them printed) then congratulations to you, but Kodak certainly didn't see that coming. Hence their fall from grace of a high single-A credit rating in the mid-90s to a hard D (for Default) in 2012 when they filed for Chapter 11. In a similar vein, US wireline telecommunications companies are finding it tough to keep up with the changing way we are using and consuming information. When was the last time you used your home landline to call someone? Do you even know your home phone number? I don't. Now it's all about data, content, and speed of delivery. Such changes are expensive for traditional telephone companies to take on, and tough to afford for those already elbow-deep in debt. So far, they've tried to merge and acquire their way out of the problem, but when the problem is structural, simply being a larger version of a redundant concept doesn't make the concept any less redundant. What's more, those M&A deals have been funded by new debt, which often involved a healthy deal cheque for the sponsors.

Another reason why equities and credit divorce beyond a certain point in the cycle is because operating earnings tend to fade as the cycle matures. For companies wanting to maintain the momentum in their share price, re-leveraging the balance sheet to invest or acquire is a rational strategy to offset the slowing momentum in organic growth. But as we've highlighted above, credit risk is asymmetric and the use of more debt to fuel growth strategies results in credit bearing the risk of failure and equities enjoying the fruits of success. What has exacerbated this asymmetry further in this cycle is the existence of extraordinary monetary policy which has resulted in abundant global liquidity, and fuelled a broader misallocation of resources. Not only have companies been borrowing more to buy other companies, but they have also been using debt to pay for higher dividends or share buy-backs. And if that's not enough, low interest rates have distorted companies' incentives to invest in favour of buying back their own shares. While shareholders have been laughing all the way to the bank, this doesn't sound like a sustainable situation in the long term.

Chart 13: Financial engineering 101 – sell bonds and buy back equity

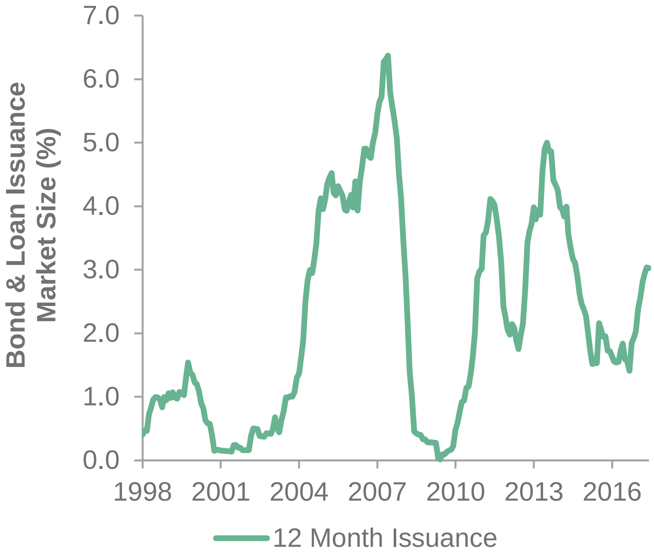
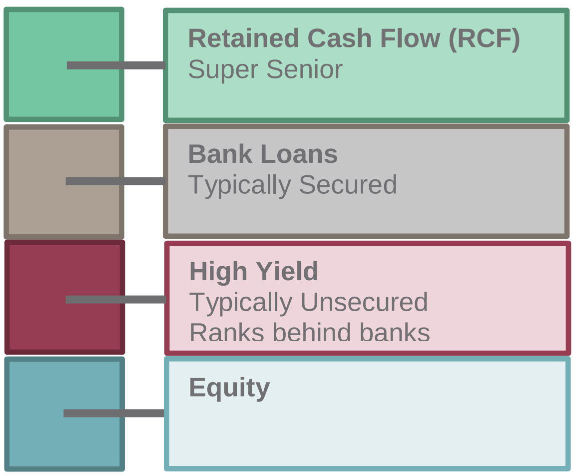


Chart 14: Increased leverage, anyone?



Source: Deutsche Bank, BTIM

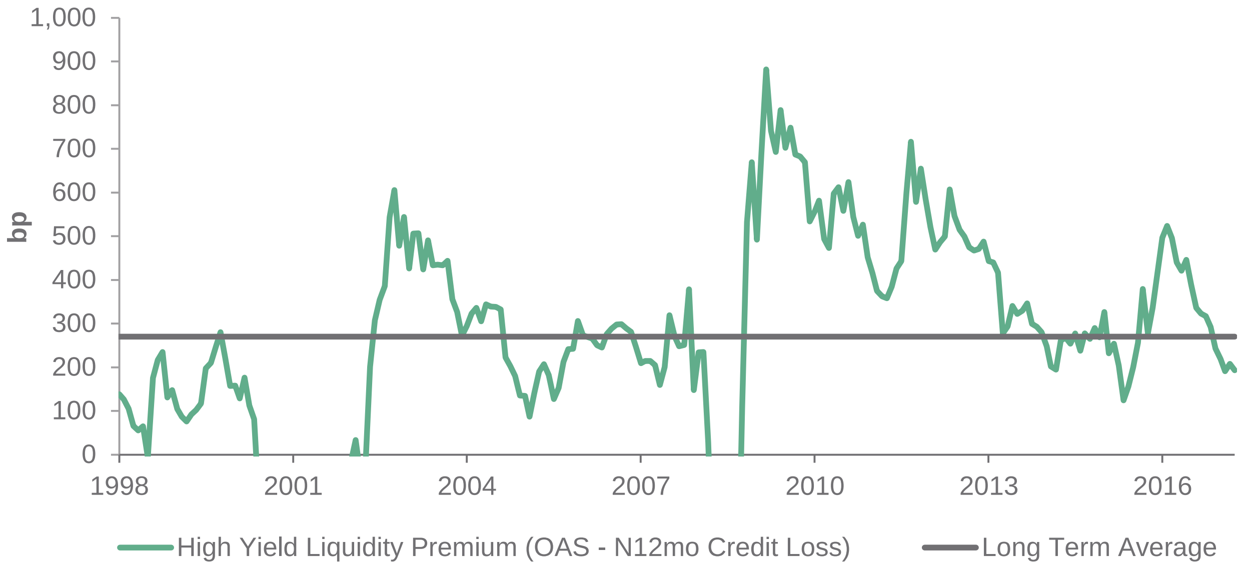
A point of similarity between credit and equities relates to the dynamics currently playing out in inflation expectations. History consistently shows a high correlation between credit spreads and inflation expectations, and what sustains the current Goldilocks growth picture is that inflationary pressures are subdued. Falling inflation expectations ought to lead to wider credit spreads and equity market underperformance because of the link between inflation and growth. Yet, falling expectations year-to-date has caused equities to rally, and has not been followed by widening in credit spreads. Despite falling inflation expectations, equities have still done well. If this is because we all now expect that low interest rates will support growth through stimulating productive activity, then inflation expectations will eventually recover and be in sync with credit spreads once more. But as I just discussed, companies haven't been investing in productive capacity, and it is more likely the debt-fuelled share buy-backs which have provided supported US equities this year.

Crash mats at the ready

The idea of "fair values" for various assets is interesting to opine about, but much harder to locate in practice. In a low yield and low volatility world, presented with an investment paying 2.35% (5 year yield for average US investment grade corporate bonds) and one paying over 5% (5 year average yield for US high bonds), we know which one looks more appealing. Yet when the credit spread of US high yield is 330bps, it is likely that what looks like a "crash mat" imbedded into the spread is more like a threadbare blanket. Credit spreads are the portion of bond yields that compensates the investor for the default and volatility risk they are taking when buying the bond. The long term average default rate for US high yield is around 5%, and the average recovery rate achieved by investors is around 40%. This translates to expected losses (probability of default multiplied by loss given default) of 3%, or 300bps. Buying US high yield credit at a spread of 330bps thus only provides a 30bp cushion for volatility. Granted, current rates of default are lower, with various rating agencies forecasting around 3.5% over the next year, but default recovery rates have also been falling versus their long term average. This isn't surprising, as in a world dominated by FAANGS, there is little to speak of in terms of tangible assets when it all goes wrong. Incidentally, in the Kodak default of 2012, the recovery rate achieved by investors was less than 24%.

The margin for error seems awfully thin. When high yield spreads are priced for perfection, small knocks to the status quo can cause big moves. You don't even have to expect geopolitical escalation, a debt ceiling crisis, or recession to imagine US high yield spreads 100bps wider than now. When spreads were at 430bps in September 2015, year-on-year US GDP growth was still running at 2.8%, compared to 2.2% now. Even at 430bps, the cushion for volatility is still nowhere near the crash mat that investors need when high yield credit goes bad, but thin cushions are again symptomatic of late-cycle market behaviour.

Chart 15: Nothing left to aim for



Source: Deutsche Bank

Collective lunacy

When the risks are so well known, and the rewards so unrewarding, why are investors still reaching for yield in the junk yard? The easiest answer is that timing the end to low volatility is impossible, and calling it too early is painful. We, too, have experienced this pain and have since positioned our shorts differently so as to dampen the impact of this collective lunacy. Nevertheless, if hedges are supposed to work, they ought to cost some negative carry, and we are okay with that.

What we are not okay with is joining ranks with the TINA and FOMO camps in the rush to own Tesla's new B-minus rated 8-year bonds paying a mere 330bps of credit spread. Regardless of whether you buy into the Elon hype (I personally do) or whether you think electric vehicles are the future, this is a 7.3-times levered company burning through $3.2bn of cash a year, famous for setting wildly ambitious production targets whilst having never hit any target to date. The long term cumulative survival rate for 8-year B-minus rated bonds is only around two-thirds. Moreover, the Ts&Cs are so loose on these bonds that in the event of default, bond investors might as well stand with shareholders in the queue. I don't know if the survival rate of Tesla bonds is likely to be better or worse than the historical average, but scarily, neither does Elon. When asked simple questions about capex and production targets, he claims "it's crazy hard" if not "fundamentally impossible to predict the exponential part of the manufacturing S-curve". But he does "aspire to be less dumb over time". These honest comments make me have huge respect for him as a person, but I certainly wouldn't buy his bonds.

One of the reasons for the popularity of the deal was the perception of the "tech" component being more important than the "car" component. Good luck with that. We've already witnessed the late-cycle toll taken by US car dealerships, and how the wobbling faith behind FAANGs has delivered several knocks to US equity markets this year. It will be interesting to see how these bonds fare when both idiosyncrasies hit at the same time. Just as one sector (energy) drove a wave of high yield defaults in 2015-16, what may begin as idiosyncratic can spread to being epidemic.

Please don't mistake us for perma bears on credit. Investment grade credit benefits from very different dynamics to junk debt in times of stress, and active investment grade strategies have a place in a defensive fixed income portfolio. There will also come a time when value returns to the land of high yield. Until then, we say "no" to collective lunacy. We have no fear of missing out. We think there are alternatives.

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BT Investment Management’s Income & Fixed Interest team of thirteen dedicated professionals, led by Vimal Gor, manage the #1 performing Australian composite bond fund of 2014 and 2011.

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