24 March 2020

Before reality sets in

The economic shock from Covid-19 is being underestimated. This is natural when the immediate priority is safeguarding human life, which is materially different from protecting the economy. This will require a far larger policy response than is currently envisioned. Many of the more radical ideas floated will eventually be deployed, but only in response to the downturn, not pre-emptively — however it may appear. In such fast-changing times that's the critical point. Much damage can be done before the fire engine arrives at the correct scene.

Corporate debt has proved highly vulnerable, particularly in the higher-yielding space, bordering investment grade and junk. Indeed, spreads over US Treasuries have blown out 1000bps and more than double that in the sectors front and centre of the crisis. Arguably much of this paper is junk, certainly in those sectors that already faced structural pressures. But as an asset class overall, the blow out in yields should not prove enduring. And in the post Covid-19 world, when we get there, yield will be an even rarer beast. We'd use this time of stress to build selective longs — for which you need a good bottoms-up credit analyst — seeing it as a lower risk knife to catch than equity.

As we noted in our report *Different types of panic*, 3 March 2020, the ongoing systemic shock is very different from any normal economic or financial market event. It impacts human health and that fear as well as the resulting panic can make the irrational seem rational. So the probability of non-optimal outcomes is high, if not outright inevitable. By non-optimal we mean more negative over the duration of the crisis and its immediate aftermath.

The starting point is as perhaps as important as the shock. Markets were arguably priced for perfection before Covid-19 appeared. Furthermore, they had been absorbing risk after risk for several years, from US/China trade wars, Brexit, the auto sector crisis, negative interest rates and central bank money printing and the resulting 'asset bubbles' etc. This stacking is a process

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The macro sandpile

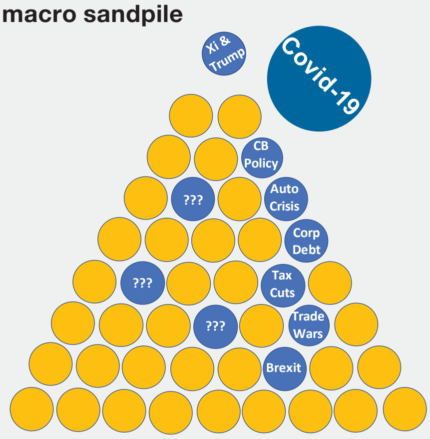

Figure 1. *Source: Independent Strategy*

US non-financial corporate bond debt by rating, US$bn outstanding

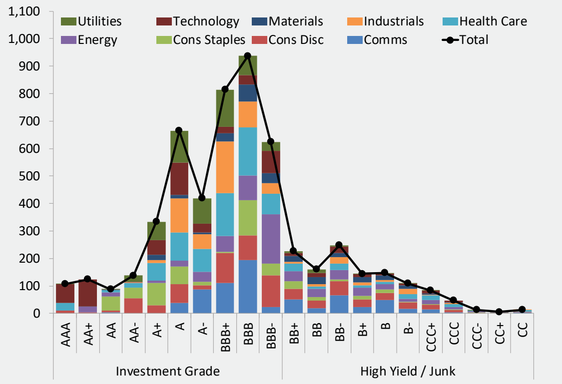

Figure 2. *Source: Bloomberg, Independent Strategy*

that over time increases market instability — see our report *Living on the sandpile*, 26 June 2019 (Figure 1).

Sandpiles always stabilise after they collapse. But whilst you're in the mist of the slide and collecting new grains, it is tough to pick when that point will be. That's the phase we find ourselves in now, falling and with plenty of potential granules still to collect. That risks inflicting longer-term damage on the global economy, beyond the inevitable one or two quarter hit that looked likely before Covid-19 became a true pandemic. This arrest will reveal exactly where the real points of stress have built up in the financial system over the past decade while also accelerating the demise of those industries already in structural decline.

Lower-rated corporate debt is one area that regularly tops the list of risks, being the perfect mix of leverage and vulnerable credit quality. In the US, total non-financial corporate debt has risen by around US$6.7trn since the financial crisis according to the BIS. Bond issuance has driven much of this, particularly at the lower end of the investment grade curve (Figure 2). Depending on how you measure this, there is around $2.3-2.8trn of BBB rated paper out there currently.

This is not necessarily indicative of a classic bubble, driven by investors reaching for yield and issuers using low rates to pursue less than optimal investments. The overall credit profile of the market has changed since the global financial crisis, with many high-profile corporate names now burdened with not so illustrious credit ratings. But undoubtedly the concentration of issuance at the lower-end of the credit curve signifies corporate vulnerability of one sort or other.

At the lower end of the investment-rated curve the energy sector continues to present the largest nominal risk (Figure 3, page 3), having the highest concentration of paper in the BBB and BBB- groups. Not only has energy demand been hit by Covid-19, but the Saudis have also torn up the old OPEC-Russia pact. Their decision to engage in an all-out price war, working on the assumption that Saudi Arabia can make up most of the lost revenues with volume, looks a foolhardy strategy for a state that already needed $85/pb prices (based on the old production levels) to balance its books. This self-harm doesn't mean the pain is isolated.

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US 'BBB' rated non-financial corporte debt by sector, US$bn

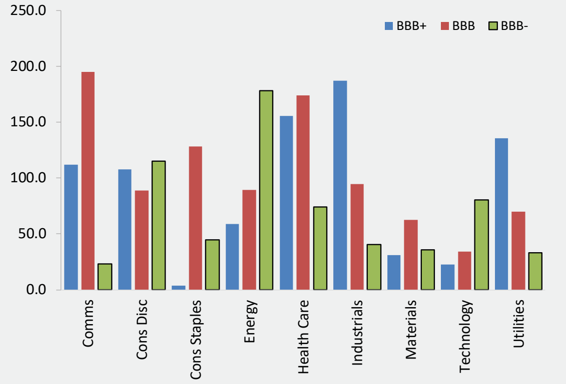

Figure 3. *Source: Bloomberg, Independent Strategy*

US energy production vs. oil rig count

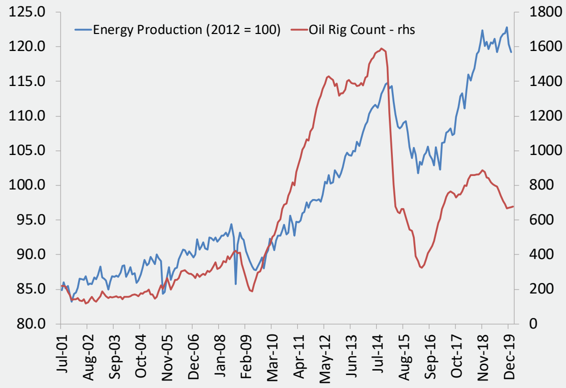

Figure 4. *Source: Datastream, Independent Strategy*

High yield vs. HY energy, leisure & air, YTM %

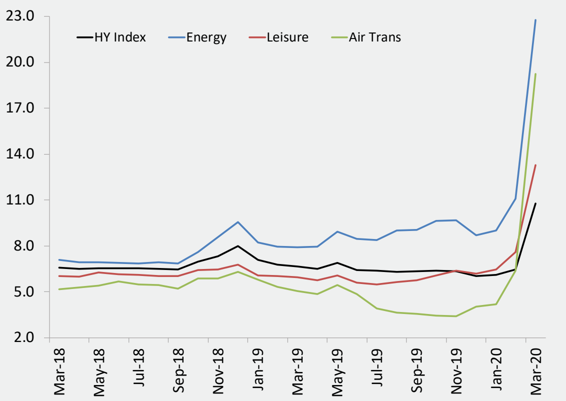

Figure 5. *Source: BoA ML, Independent Strategy*

It will have a direct knock-on effect on the US shale sector. While fracking firms might have adapted following the oil price collapse of 2014/15, which drove consolidation and efficiency improvements (Figure 4), it can't mitigate a near 60% decline in crude prices, which is what we're currently dealing with.

Much of this paper will be on the cusp of multi-notch credit downgrades. Of course, losing a rating and defaulting are not the same thing. But even the more resilient names will be forced to cut production and cancel planned investments. This will not only be a significant drag on these regional economies but drag on overall fixed capital formation. This really is just a microcosm of the pending GDP shock that collapsing demand across the global economy will generate.

The sub-investment grade bond market looks even more precarious. Overall, high-yield spreads have blown out to close to 1000bps, but in the sectors most directly exposed to these events the shock has been even more violent (Figure 5). This reflects the impact of the liquidity shock borne by these sectors, which becomes a self-fulfilling prophecy if deployed stabilisers can't address the loss of confidence and demand. They can't. Leisure issues are a good example of this, as travel and tourism volumes slump, solvency quickly becomes an issue. Auto makers should also be on the critical list. They account for half of the value of bonds in the BBB consumer discretionary band and were already facing an existential crisis due to the shift towards electrification.

The main question is whether this dislocation can be addressed with monetary and fiscal policy measures, or whether the current economic stop evolves into a more prolonged slump. That seems to be the underappreciated risk at the moment.

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With the global economic machine halted and resumption likely to be both slow and asynchronous it going to take time for things to get moving again. Sectors tied to global supply chains could be inoperable long after local circumstances have improved. This is due to the staggered rate of spread of Covid-19 and the varying degrees of success jurisdictions have had in dealing (or not) with the problem.

Furthermore, the risk of second-wave cases and renewed quarantine steps means policy makers are now tied to extreme caution, which is not compatible with any sort of V-shaped recovery. Indeed, economic health will only begin to be viewed at a comparable level to the human health crisis once a depression is underway. By that we mean double-digit GDP declines. The notion that because the infrastructure is still there everything is operable, only works on the assumption that the business (and human capital) that inhabited these shells has not imploded.

So how will the corporate bond landscape survive this trauma? Mixed is the answer.

Looking at the immediate backdrop one has to be pretty naive to imagine that investors are not facing severe losses. Of course, as we saw in the financial crisis, desperate times force desperate measures. Policy makers are not just going to put up their hands and admit they've exhausted their limits. In this story, the monetary policy zombie doesn't suffer from mortality issues, even if we do. That means unconventional policy will become even more unconventional.

We've already seen rapid expansion of liquidity measures globally, both via local central bank asset purchases and loan/liquidity facilities as well as the enhancement of the Fed's dollar swap lines with its peers, which over time should alleviate some of the dollar shortages that market stresses are currently generating. And if you read the latest statement on asset purchases from the Bank of England, you'll see the MPC will keep the case for intervening in the primary market under review, which would be the literal debt monetisation everyone thought vanilla QE was!

US Non-financial corporate debt* & interest costs, % of GDP

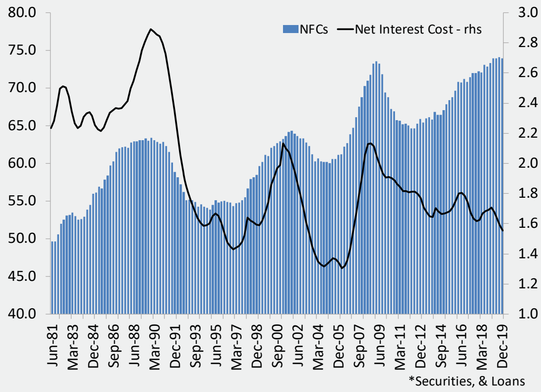

Figure 6. *Source: Federal Reserve, Independent Strategy*

As this crisis is a temporary (which isn't the same as short-lived) exogenous shock, there are plenty of incentives for the authorities to do "whatever it takes" to keep the economy ticking (or at least maintain its current comatose state). That applies across all sectors of the economy. It could well extend beyond simple liquidity provision to expanding asset purchases to cover a far wider range of credits and sectors. This should ultimately reduce the rollover risk that can topple more leveraged credits in an economic crunch.

Corporate debt also has other merits. While as a share of GDP it might look high, the notion that these issuers have abused low rates and are

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US non-financial corporate liquid assets to short-term liabilities, %

Figure 7. *Source: Federal Reserve, Independent Strategy*

now dangerously leveraged is an exaggerated narrative. Notional outstanding does not reflect the real debt burden. The secular decline in interest rates means that debt servicing costs remain low (Figure 6, page 4) and corporates have sufficient short-term liquidity, especially when measured against short-term liabilities (Figure 7). A lot of this might be concentrated in the cash-generating tech giants. However, this also mirrors bond issuance for the large part, sales that were largely financial/tax engineering allowing firms to retain corporate income of overseas sales offshore (in US$ assets) and using domestic bond proceeds to fund things like stock buybacks. But the benefit of low rates has been a gift to all sectors.

The blow-out in spreads then looks to be an event that will eventually present attractive opportunities to longer-term investors. Bonds should also fare better than equity. Shareholders fare poorly through bankruptcy proceedings and we expect to see plenty of Chapter 11 filings in this time of distress. Bond holders might take a haircut, but they're higher up the credit food chain and in a diversified book, ex-ing out those sectors that face specific structural risks, these pressures should be manageable. And yield in a post-virus world is likely to be an even rare beast than it was before Covid-19.

The risk that all of this turns into a real and prolonged debt-deflationary period lies with economic growth. That is the ultimate source of debt solvency in a world without nominal or real policy interest rates. If the economies drop by double-digit percentages now, as we think they will, they will have to start recovering — albeit gradually — well before year-end if real Armageddon is to be avoided.

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