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The Credit Story in 2020

- There is still ample opportunity to generate income streams of acceptable quality in global credit markets
- Rising risks that accompany the end of a prolonged economic cycle appear to be priced by the market
- Active management might be the way to go here, to avoid areas that are becoming too risky

A brief look back at 2019 reveals fixed income overall and credit bonds as an asset class specifically had a pretty decent year – using Bloomberg Barclays Total Return Indices as a guide. Globally, aggregate credit exposure would have returned an investor about 11.5%. Considering that US Treasuries gave 7-8%, the rest of the return came from the higher interest rates on offer on credit at the beginning of the year, with a smattering of spread tightening thrown in.

As is usually the case when the economic backdrop is benign, the weaker parts of the credit spectrum performed better than the more defensive, safer areas. US High Yield and Emerging Market bonds were above 12%, and in some parts of the financial subordinated market, returns were in the 15% range.

Spectacular blow-ups also happened this year, illustrating the critical importance of diversification in portfolios where idiosyncratic risk abounds. Argentina dropped by 50% in a fortnight on adverse political developments, and closer to the end of the year, Lebanese bondholders were exposed to a shock of similar magnitude. At the country and regional level, Asia performed worse than most with a meagre 2.2% return, dragged lower by China and South Korea.

The Usual Mantra in Credit: No Defaults, No Risk?

Credit investors know full well that the greatest source of risk for a long-term portfolio is defaults. Short term spread movements can cause temporary pain, but if no defaults ensue, then the damage is just that: temporary. Knowing what the default outcome will be, gives one an edge in the market. The downside risk of a series of corporate failures is far worse than the upside of even a strong credit rally. Best to avoid defaults then.

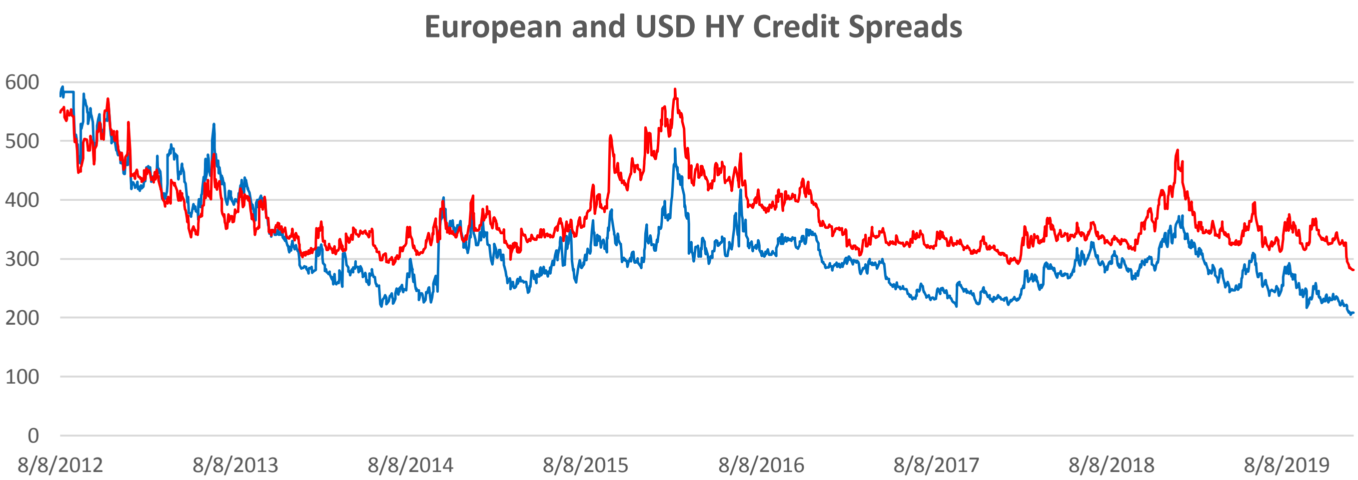
As 2020 starts, default rates look to be well under control. Globally, Moody's estimates that 2.6% of HY bonds are defaulting on an annualised basis. That compares to the average rate of 4.1%. In the US the rate has edged closer to the average: 3.6% compared to 4.6%. Keep in mind that the average can be a bit misleading as it would be dragged higher by the few recessionary episodes when it spiked. For non-recessionary periods, we are running around the expected average rate of default.

Should this continue into 2020, credit markets promise to be a fruitful source of income for investors, for at least another year. However, caution is warranted. In most economies, growth looks like it will be lower in 2020 compared to 2019. It has been shown that historically, slower growth pushes defaults higher. It is thus no surprise to note that Moody's is forecasting that default rates among corporate borrowers will be on the rise in 2020, possibly drifting upwards towards the historical average by the end of the year.

A good source of return for credit investors is spread compression: when the risk premium demanded by investors for holding credit bonds over government bonds decrease. There is little reason to expect much of this phenomenon in 2020, as the premium is already quite small. Further compression is possible but the scope for it is limited.

Credit Positioning in 2020: The Key Issues

While we still think the notion of holding credit for income is sound, the end of the cycle brings reason for caution. Some areas of the credit universe are showing the strain that is unavoidable given such a prolonged economic cycle, and also such a long period of easy monetary policy. The strain can be observed in certain sectors, or in some specific regions.



Source: Bloomberg

Too Many BBB Bonds?

One specific area that keeps attracting comment is the "growing" amount of BBB-rated bonds as a percentage of the overall issuance of investment-grade bonds. This could be an issue because a very large proportion of the funds and ETF's that hold BBB bonds are not allowed by their mandates to hold high-yield bonds. In theory, if there was a large number of downgrades, pulling many BBB bonds into BB, the fear is that the forced selling that will ensue, as funds offload junk bonds, will cause a dislocation in the market.

This fear is understandable but possibly overdone. Looking at the proportion of BBB-rated bonds as a ratio of the overall issuance, it is now at 55%, much the same as over the last number of years. Furthermore, the rate at which these turn into so-called "fallen angels" is not excessive, even when looking only at periods of outright recession. During such periods, Moody's data suggests that about 6% of these bonds will become junk on an annualised basis for as long as the recession lasts. The fact that at least some of them recover their status fairly soon (up to a quarter over the past 20 years) is not material to the argument: the concern is a short-term dislocation driven by forced selling. Given this risk is well-flagged and understood by now, the best idea is to remain invested, track developments but resist the temptation to be drawn into panic selling.

Leveraged Loans

The overall view on credit also applies to loans: in the absence of a recession, the market should provide a good source of income. Loans are almost exclusively instruments that price relative to money market rates, and hence have no scope for capital gains under normal conditions.

In this market, some developments warrant careful attention, as some of the errors of the GFC appear to be repeated. The two main ones are, first, a deterioration of covenant quality, and second, a growing influence of Collateralised Loan Obligations (CLO's) as key investors keeping the market going. Déjà vu? Both these factors should remind those who survived the 2008 meltdown of the market of the dangers embedded in this otherwise docile market.

Covenants are simply the terms and conditions that borrowers must abide by when they take up funding from banks or other lenders. Once covenants become looser, the risk to the end investor increases. Typically, where revenue targets are easier to meet, more balance sheet leverage is allowed etc., a so-called "cov-lite" situation arises. This is of little concern if the going is good; if businesses start running into trouble, investors will suffer the consequences in the form of poor recovery values on secured assets.

Assessing the CLO concentration risk is very difficult, as this market is not always as transparent as some other public markets. Anecdotally, the sense is that there are some large CLO manufacturers in the market at the moment, and also a quite select group of heavy buyers. This could potentially increase concentration risk and perhaps impair liquidity in the event of stress in the underlying loan market.

Emerging Markets

The broad category had a mixed 2019, reminding investors that a strong bottom-up process pays dividends in avoiding some of the idiosyncratic issues that are simply part of the territory. This year brought us the collapse (again) of Argentine government bond prices, as well as those for Lebanon.

However, even if the outlook for growth is somewhat less optimistic than what 2019 delivered, a non-recessionary outcome for 2020 should still be broadly supportive of the asset class. As always, there will be regional and sector-driven nuances that need to be monitored, but the level of income available in even the more conservative exposures is still attractive enough.

As the Fed looks to have come close to the end of their easing cycle, albeit with scope to do a bit more, we do not view the USD as being particularly vulnerable against the broader complex of EM currencies. For hard-currency EM debt, this would be a further source of support.

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