Credit is Normalising, But…

Credit securities, both in Australia and globally are getting back on their feet. The bookbuilds this week of $1 billion of corporate debt by Woolworths, $1.25 billion of RMBS by La Trobe and the $500 million of hybrids by Macquarie are all positive signs. However, secondary trading in many debt sectors is light and a few sectors remain moribund. Whilst the signs are generally encouraging, three dark clouds on the horizon point to the possibility of worsening conditions.

The leverage fuelled, panic driven sell-off started on February 24th and ran until March 23rd. The circuit breaker was the Federal Reserve's announcement of "unlimited quantitative easing". At that time, there were widespread reports of global investors struggling to sell even the highest quality government bonds. Given how dire it was, it has been a relatively quick journey back from the abyss.

In Australia, major bank senior bonds recovered first and are now trading at similar spreads to three months ago. Corporate and securitisation debt has had a far slower recovery with trading remaining patchy. The large issuance this week by Woolworths and La Trobe, as well as a smaller issue by Liberty showed that buyers were willing to return. But unlike major bank bonds, spreads on corporate and securitisation debt have been reset at much higher levels.

At the same time as credit markets are improving, the economic outlook is also brightening in some ways with the gradual easing of restrictions on business. There is a growing view that the worst of Covid-19 has past and that a vaccine or drug treatment might not be far away. The optimism of the human spirit seems boundless with some investors seeing the pandemic as just another opportunity to buy the dip.

Where many investors are seeing mostly positives, I'm seeing mostly negatives. Australia has gone nearly 30 years without a recession leaving our economy fat and lazy. Asset prices (notably housing) have been propped up by population growth, credit growth and interest rates cuts, all factors unlikely to repeat. We've had over a decade of Federal Government deficits, destroying the legacy of Peter Costello's decade of fiscal discipline. The economic buffers we had before the last crisis have been frittered away, leaving Australia poorly placed to withstand and rebound from the current economic and financial crisis. Given this backdrop, there are three standout risks for investors to factor in.

Remember 2007 – Fundamentals Matter

The bounce back in the last two months reminds me a great deal of 2007. In July 2007 credit markets slammed into a brick wall with credit default swaps and CDOs taking substantial damage. Bank bonds sold off as the riskier European banks started to have their solvency questioned. Yet after an initial shock, some of the markdowns turned around offering a window to get out with limited losses.

At first, equities and property continued on their merry way oblivious to the damage in credit markets. Australian equities peaked in October 2007 but held near record levels until January 2008. In December 2007, the property sector was slammed as Centro disclosed it couldn't roll over its debt. Both at the time and in hindsight, the second half of 2007 was a bizarre period where fundamentals and market prices were so divergent. Given the medium term outlook for Australia includes significant unemployment and business failures, it is hard not to conclude that most investors are ignoring the fundamentals, just like they did in 2007.

Quantitative Easing

If the global debt markets are likened to plumbing, then quantitative easing is the duct tape used to cover the cracks. Central bank buying of government debt has delivered liquidity to debt markets at a time when governments and corporates are going on record borrowing sprees. If investors weren't able to sell assets to governments via quantitative easing programs, they wouldn't have capacity to buy the new issuance and bond yields would soar. Quantitative easing is beating back the bond vigilantes temporarily.

Australia has been a late entrant to this charade but is making up for lost time with the RBA hoovering up 7% of Australian government bonds in two months. At this rate, they will own the entire government bond market by the end of 2022. Whilst the RBA buying government bonds is the main game, there's also been cheap funding for banks and the securitisation market. It's no longer a case of merely providing liquidity against super safe assets, the recent purchases of sub-investment grade securitisation tranches come with the meaningful possibility of capital losses.

Whilst quantitative easing has yet to hit its unknown limits in developed economies, emerging markets have shown what happens when citizens and investors lose confidence in a fiat currency. The widespread use of US dollars in Argentina, Ecuador, Lebanon, Venezuela and Zimbabwe is the practical outworking of a country adopting funny money practices. At some point, the duct tape stops working and the value of the currency goes down the drain.

Global High Yield and Emerging Market Debt

Whilst most credit sectors are recovering well, corporate high yield debt and emerging market debt are on life support. The US high debt market has recovered around half of the losses that occurred since mid-February. However, this has been a quality driven rally with BB rated companies able to issue whilst B- and CCC rated companies are stuck in the doghouse. Several failed transactions have been a clear warning that lenders have little appetite for companies that can't demonstrate their solvency in the medium term. The weaker airlines, energy companies and tourism associated businesses are looking at their cash positions and making calls about when to enter bankruptcy.

It's a similar outlook for the weaker sovereign borrowers, particularly in emerging markets. The years leading up to this crisis saw an explosion in lending to the lowest rated sovereigns. Many of these countries are now turning to the IMF for bailouts; at last count roughly half of the world's countries had put their hands up for help. There's a global wave of jobs that will be lost as the weakest companies and countries are forced to reign in their spending. Whilst investors are pricing in a solid probability of defaults, they are ignoring the wider economic impacts of defaulting borrowers on the global economy.

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Disclosure