Credit Market Turbulence. How To Think About Credit Investing August 2014

After a year of abnormally low volatility, high yield markets are correcting across the globe. Since 2008 the high yield market has experienced 3 bouts of turbulence

1. The European sovereign crisis in 2011.
2. The “Taper Tantrum” of 2013.
3. The last few weeks.

Why have high yield credit markets exhibited this volatility recently?

Purported reasons:

A number of events have coincided with the back up in spreads. I am not so sure they are good explanatory factors.

- The Ukraine troubles and sanctions against Russia are certainly increasing geopolitical risk.
- General turbulence in the MENA region has also increased but these have not been cited as factors.
- Argentina’s default has also been cited as a factor, however, Argentina has been isolated from international capital markets and contagion risk is low.
- Portugal’s banking troubles, specifically Banco Espirito Santo’s reorganization has been cited, but again there is little contagion risk and the Banco du Portugal has been quick to force a reorganization through the creation of a bad bank.

Other Possible Reasons:

- Market complacency. Implied volatilities are acutely low across
    - Treasuries
    - Equities
    - Credit

    - Commodities
    - FX
    - Swaptions

  The level of implied vols do not reveal much about skews but generally the market was very complacent coming into the last couple of weeks.

- Realized or historical volatility has been abnormally low in the preceding 12 months. The volatility we have seen in the last couple of weeks is actually closer to normal volatility.
- While fundamentals remain healthy in the US and are improving in China and Europe, asset prices have run ahead of themselves in the US and Europe across equities, bonds and loans. A good asset bought at too high a price is a risky investment. A bad asset bought at a sufficiently low price is a less risky investment.
- Simple mean reversion in realized volatility.

Risks: Here are some of the more topical ones.

- Geopolitical risks will remain high but this is likely to be a long term problem going forward. It is not easily foreseeable so we have to either live with it and apply tighter risk management or increase our risk aversion. The slower pace of global growth, global recovery notwithstanding, is ushering in a new era of contentiousness between friend and foe alike. Expect less cordial negotiations in trade, commerce, and strategic matters in the foreseeable future. Risk = High.
- Economic growth. On the whole, global growth is stabilizing around a slower long term potential growth rate. There will be oscillations around this new rate but slower credit creation, more mature demographics, a relative de-globalization will slow the long term potential growth rate. While the secular trend is slower, the phase in the cycle is positive for the US, China and Europe. Emerging economies with small domestic demand bases or lower technology manufacturing will be at a disadvantage. Countries like Brazil for example will face not only a slower economy but a slower long term potential growth rate, inviting higher inflation at each level of growth. Reform in India and Japan are beginning to gain traction which will

pay long term dividends. Indonesia's prospects are good if the new President is able to consolidate, unite and execute. Risk = Low.

- Valuations are high in the developed markets across most asset classes from equities to bonds to loans to rea
l estate. The concerted action of central banks has led to asset reflation almost across the board. The MV=PQ equation has not failed. The conspicuous absence of inflation has distracted the market from the obvious inflation of asset prices. The P in the equation is a vector whose components consist not only of goods and services but assets and forward markets. The liquidity operations of central banks has leaked into the asset markets while goods and services inflation has grown more moderately. As mentioned before, the risk of buying a good asset at an overly inflated price is high whereas the risk of buying a poor asset at a sufficiently low price, is comparatively low. The actions of central banks have led to a loss of price discovery in the free market. Risk = High.
- Liquidity I: Liquidity is a fickle friend. It is ample when not required but deficient precisely when it is required. The only markets with constantly high liquidity are the USD and US treasury markets where safe haven status can lead to higher liquidity in stress situations. In the context of credit markets, current liquidity remains good but untested. A test may soon be underway. Bond dealers' ability to provide liquidity has been seriously diminished. Risk = High.
- Liquidity II: An underappreciated risk is the how investors gain access to an asset class. They do so in what can best be described as aggregation vehicles. The collective investment scheme is one example. So is the CDO or the CLO. These are significant investors across all credit assets from bonds to loans to asset securitizations. In all of these cases, the capital of a collection of investors is pooled into a single vehicle and placed under the management of a professional manager. The consequence of aggregation vehicles is that it concentrates decision making of large amounts of capital in the hands of small numbers of decision makers who often have the same behavioral traits, often the consequence of their contractual and compensation arrangements. That large swathes of the industry rent or purchase the same risk systems is another risk. Certain purveyors of risk system either dominate the market or are large asset managers themselves. By correlating the behavior of a smaller set of decision makers controlling large amount of capital, aggregation vehicles and common risk systems or

standards add to liquidity by creating one way liquidity, ample on the way in and not so ample on the way out. Risk = High.

Mitigation:

- Decision making is very difficult in the face of market volatility, even if it is upside volatility. Downside volatility circumvents most human logic circuits. The decision to buy must be accompanied by sell discipline and a list of sell triggers. Too many investors buy without a selling plan. With defined triggers and milestones, a market move can be analysed with disinterest and the optimal decision taken.
- Diversify. The only investor who doesn’t need to diversify is the one who is always right. I have yet to meet this person. Diversify by region, by asset class, by issuer quality, by priority of claim. And watch those correlations. Institutional investors search relentlessly for low correlation strategies which they value as part of their diversified portfolios.
- Understand what you are buying. A thorough understanding of an investment one is making allows one to make informed decisions when prices move. Up or down. When do you average up, or down? When should you take profit or cut loss? Generally, for directional long only (or short only strategies), add risk when you move into profit and cut risk when you lose. For arbitrage strategies, almost always you should add risk when you move into a loss. That’s the rule of thumb. When the investment thesis is invalidated, sell, even if you are making money. When an investment thesis continues to hold but a position goes into loss, that’s the most difficult situation. Are you wrong? Is the market wrong? Lord Keyne’s said, some 80 years ago, the market can stay irrational longer than you can stay solvent…
- There are several ways to de-risk a portfolio.
    - Increase the cash allocation by selling some risky assets.
    - Switch from lower quality issuers to higher quality issuers.
    - Switch from junior and subordinated assets to senior and secured assets.
    - Switch from expensive assets to cheaper assets.

Practical matters:

- For investors who have a high allocation to high yield we counsel caution. We did not say sell. In particular we did not recommend a sell on European HY. We focused our caution on US HY where we felt that spreads were too tight and did not refl
ect value despite healthy corporate fundamentals.
- In the US, we recommend diversifying from HY to IG thus moving up the credit quality scale.
- In Europe, we recommend remaining in HY but to be more specific, buying subordinated capital of financials, that is, bank capital securities.
- In Asia, equities are undervalued. So, while equities are the junior security, we recommend diversifying credit exposure into equity exposure.

Bottom line:

European high yield remains attractive. While some sovereign risk remains, and will remain as long as the European persist with the EUR, the ECB’s promise to do ‘whatever it takes’ is a back stop for the European credit markets. That inflation is low also underpins duration in European credit. The region is improving in terms of credit quality. While the US is in re-leveraging mode Europe remains in recapitalization and deleveraging mode which is constructive for credit. Pricing is certainly not as cheap as it was a year ago and bonds trading well above par are vulnerable to mark to market price volatility. Credit quality, however, is improving and underwriting standards are being maintained. European bank capital has been a big theme. While the asset class has done well, the volume of issuance, driven by increased regulation, has maintained spreads at attractive levels. Security selection is key as the theme is fairly mature. Fortunately, the variety of complex structures, amd differential triggers and capital treatment, provides ample alpha opportunities.

In the US, high yield pricing is more stretched, not only against the sovereign curve but against investment grade credits. While investment grade is also trading tight, spreads are still reasonable against both high yield and treasuries. That said, high yield spreads remain some 50% wide of 2007 tights. IG spreads, however, are double their 2007 tights. Corporate balance sheets remain cashed up, however, balance sheets are being relevered once more and underwriting standards are faltering. The majority of leveraged loans issued this year are covenant lite. We remain optimistic about US RMBS, in particular in the Option Arm and Alt-A’s while eschewing the riskier sub-prime loans.

Asian high yield spreads are quite attractive, some 200+ basis points cheap to their developed market counterparts. The pendulum seems to be swinging towards Asia as China recovers and India and Japan pursue reform. A more accommodative PBOC can easily precipitate a risk on environment in the region. LatAm, on the other hand seems to be swooning with Brazil, once the darling of the BRIC facing stagflation and Argentina default. While EM may look attractive in parts, equities remain cheap to credit and are the preferred trade expression.

A word about convertible bonds. Issuance has been well bid and valuations are rich and getting richer even as issuers tend to be riskier. Demand has been driven by credit and yield investors (as opposed to arbs) who see converts as a yield enhancement alternative. The market appears to be demand driven with little consideration for monetizing the embedded vega or indeed value and could be vulnerable if fund flows reverse.