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Three Risks to Credit Markets This Summer

Why I'm becoming more cautious on corporate debt.

June 2020

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After a very difficult few months, the credit market is looking strong again. Central bank bond buying has made investors long cash, there have been strong inflows into the market, and spreads have retraced about three-quarters of the widening in the first quarter. Our macro market and sentiment indicators are still suggesting that being long credit risk in our portfolios could be the correct approach. However, there are three potential sources of upcoming uncertainty that pose a risk to this picture: a second wave of the coronavirus, a worsening economic outlook, and market volatility ahead of November's U.S. presidential election. Let's look at each of these in turn.

I think a second wave of the coronavirus looks unlikely in the near term. There has generally been a minimal increase in virus transmission rates in places where the lockdown has been eased and it seems that progress is being made on developing vaccines. This does not mean that there won't be a second wave at some point, but it does not look like it will happen this summer. It may be a risk for the autumn.

The economic outlook is harder to call. It was predictable that there would be a massive decline in economic activity as lockdowns were put in place across the world, followed by a resurgence in activity once those lockdowns were lifted. More difficult to predict is the rate of growth after all the offices, shops, and restaurants are open again. Activity won't return to its previous peak immediately; I believe it will quickly rebound to some point below the peak before climbing at a slower pace after that. The inflection point and pace of that second phase of the recovery will impact corporate profitability, unemployment, fiscal stimulus programs, and monetary policy in the fourth quarter and in 2021. Hence, there is significant uncertainty about what those will look like.

Ahead of the U.S. election, presumptive Democratic presidential candidate Joe Biden is comfortably ahead in the polls. How will his rival Donald Trump react if that does not change? It's difficult to say, but he probably won't go quietly. As the election looms, policy surprises and rising geopolitical tensions are

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very possible as Trump seeks to reinvigorate his voter base. And if Biden maintains his poll lead, markets will begin to weigh up the likely impact of a Democrat victory on the economy. Either way, the lead-up to November's election is likely to bring uncertainty for financial markets.

So, of the three potential sources of uncertainty I've highlighted, I think one is low risk, one is moderate risk, and one is high risk. Cheap valuations can act as a buffer to uncertainty and, until recently, spreads were pricing in a lot of bad news, including the recession. However, spreads have tightened a lot since late April, so that buffer is no longer there. Spreads may need to widen again as economic and political uncertainty rises.

In the early days of the coronavirus, negative sentiment also provided a buffer to uncertainty (downside surprises are less damaging when everybody already expects the worst). But as economic data improve and optimism about the post-coronavirus future builds, the risk of disappointment will increase. What's more, very high rates of corporate bond issuance are causing the market to gradually adopt longer credit risk positions as it absorbs the new debt. That will further reduce the buffer to uncertainty as investors will not have room to add on any sell-offs.

This combination of rising uncertainty and less protection against that uncertainty means that credit markets are likely to become more volatile in the summertime, in my view. This does not mean I'm bearish on credit (I'm not yet), but it does mean that I've become a little more cautious.

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ID0003408 (06/2020)
202006-1217966