



# Why the Market's Fears Over Credit May Be Overblown

A recession may not be as imminent as many believe.

January 2019

Markets have begun the year in a jittery mood. Credit spreads have widened alongside falling stock prices as concerns over a U.S. recession have spooked investors still twitchy from last year's volatility. But while a recession in the near term cannot be ruled out, I don't think one is likely to occur in the immediate future—and, as such, I believe that credit is probably a safer investment than many others seem to think.

As recessions tend to cause higher default rates, the primary determinant of credit spreads is the economic cycle. Predicting the timing of a recession is notoriously difficult, though, and this time is no different. On the one hand, the U.S. economic cycle is clearly at a late stage: Corporate earnings are peaking, U.S. monetary policy has tightened, and economic growth is slowing. On the other hand, some classic leading recession signals—such as an inverted yield curve—have yet to materialize (although the yield curve does appear close to inverting). In addition, T. Rowe Price's own models suggest that there is a low probability of a U.S. recession within the next year, albeit with a higher cumulative probability of recession within the next two to three years.

Wider credit spreads are themselves a traditional signal of recession. Historically,



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these have tended to occur in two to three waves: The first period of spread widening typically comes six to nine months before a recession, the second usually arrives three to six months before the recession, and the third during the recession. Focusing on U.S. investment grade, spreads widened 40 basis points between February and July and another 50 basis points between September and year-end. If we take last February's spread widening as the typical starting point, we would expect a recession to begin within the next three months; if we begin from September's spread widening, we would expect the recession to begin around the end of 2019.

Based on all the available evidence, a recession seems extremely unlikely in the next three months, while a recession in 11 to 12 months is plausible. In either case, spreads can be expected to move sideways or even tighten slightly for the first six months of this year before

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possibly widening after that (if a year-end recession materializes). Anticipating this, we increased our credit exposure in global multi-sector and diversified income strategies—primarily through liquid and shorter-dated instruments—in the back half of December 2018. Our credit risk exposure is now the longest it has been in over 12 months and approximately at the midpoint of our historical exposure range.

I certainly do not want to be too long credit in the current environment—the market isn't cheap, and the global economy faces a number of risks. Overall, however, I think that the probability of a recession in the near term is less than the markets believe; therefore, it makes sense to raise credit exposure for now while we continue to evaluate the data as it emerges.

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