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WHY RECENT CREDIT FEARS ARE OVERBLOWN

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Markets have started the year in a jittery mood. Credit spreads have widened and stocks fallen, as concerns over a US recession have spooked investors still twitchy from last year's volatility. But while a recession in the near term cannot be ruled out, we do not think a recession is imminent. As a result, we believe credit is still a safer investment than consensus would have you 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, however – and this time is no exception.

But we can draw some conclusions.

On the one hand, the US economic cycle is clearly at a late stage: corporate earnings are peaking; US 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 materialise (although the yield curve does appear close to inverting). In addition, T. Rowe Price's own models suggest there is a low probability of a US 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, these have tended to occur in several waves: the first period of spread widening typically comes 6-9 months before a recession; the second usually arrives 3-6 months before the recession; and the third during the recession. Focusing on US investment grade, spreads widened 40 basis point 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 unlikely in the next three months, while a recession in 11-12 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 possibly widening after that (if a year-end recession materialises). Anticipating this, we increased our credit exposure in global multi-sector and diversified income funds – primarily through liquid and shorter-dated instruments – in the latter 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 historic exposure range.

We certainly do not want to be too long credit in the current environment – the market is not cheap and the global economy faces a number of risks. Overall, however, we take the view that the probability of a recession in the near term is less than markets believe, and therefore it makes sense to raise credit exposure while we continue to evaluate the data as it unfolds.

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