July 13th, 2020

Is Anyone Listening to Dr Fauci?

- **As Dr Fauci gives clear warnings of a building problem in the US markets continue to gain.**
- **Rising credit defaults – high yield defaults have doubled and may double again**
- **Fed has provided stability to high yield but not stopped a divergence from investment grade**
- **Be vigilant in the financial sector, anything beyond a 'base case scenario' may cause trouble**

It is reported that the US top infectious diseases expert Dr Fauci has not spoken to President Trump in two months. You could also surmise that for two months the markets have not listened to Dr Fauci.

Markets have largely shrugged off the recent bad news from the virus front. Despite previous warnings from the medical and scientific community, many states in the US had re-opened in what appears to be an ill-fated attempt at restarting moribund local economies before there was enough evidence of a sustained reduction in the infection rates to do so safely. As a result, the numbers are looking grim. At the current rate of COVID-19 case progression, the US will surpass more than 4 million reported cases within a month, and fatalities will reach beyond 150,000 long before the end of the year.

Financial market calculus does not take into account the human angle. Even so, the odd wobble over the past week or two would suggest that the inexorable spread of the virus registers with investors to the extent that it impacts the economy, and by extension market valuations. Taking that view, and ignoring for a second, the possibility of further drastic lockdowns by policymakers, the downside risk to markets from the virus will be linked to the impact on real economic activity.

A second round of lockdowns will prove to be tough to implement, especially in the US, where universal acceptance did not greet even round one. Nonetheless, at the time of writing, new efforts to introduce the steps required to slow the spread has been implemented sporadically, not across the board. The predictable effect is going to be the lamentably high numbers mentioned above.

While equity markets are waiting to see clarity in the form of second-quarter earnings reports, credit markets do not have to wait. Credit downgrades and defaults are happening already. Moody's reports that in the US, the trailing high-yield default rate has more than doubled in a year (as at May) from 3.1% to 6.4%. It has projected that defaults will reach 11.9% by the fourth quarter, and possibly marginally higher in 2021. Analysts point out that actual default rates are not always an accurate predictor of high yield spreads or total returns in subsequent periods. Indeed, despite concerns over defaults high yield bond returns have been good since the market low in price (high in spread over Treasuries) reached at the end of March.

High yield – not as good as you may have thought
On the surface, high yield bonds have given reasonable returns in the market's eyes helped by the Fed's actions. However, the yield ratio between high yield and investment-grade bonds has risen to levels not seen before. The yield on the high-yield credit index in US investment grade is now at 6.58%, compared to 1.97% for investment-grade, non-government bonds. The wide gap undercuts to a significant degree the argument that the Fed has caused a sea-change in the credit market. The Fed has provided an effective backstop to halt a disorderly market.
And yes, the Fed is intervening directly in the credit market to support firms that are facing stress related to the COVID outbreak. However, the level of dispersion indicates that the market is taking a view that the Fed's intervention is more limited/effective than previously thought.

For one thing, the continuing stream of defaults makes it clear that the reach of monetary policy is not infinite. There is a steady stream of new bankruptcy filings going to Chapter 11 court daily.

All of these have investors ruing the day they may have bought the bonds in question. Predictably, the energy, retail, and real estate sectors have borne the brunt of the pain. Any renewed lockdown, or even just tighter movement control, could cause an outcome even worse than modelled by the rating agencies.

Be vigilant for stress in the financial sector
It is not just in high yield where vigilance will pay. A significant contributor to the global issuance of investment-grade issuance in the financial sector is banks and insurance companies. A prolonged recession, even a shallow one, is set to cause substantial damage to earnings and likely to balance sheets too. In the insurance sector, a metric to monitor is the fallen angel ratio: the number of bonds previously rated BBB- or better that fall below that grade. Many insurance firms have significant amounts invested in mandates or in policy products that are governed by rules that prescribe the credit quality of allowed assets.

A continued rise of fallen angels can cause strain in this sector.
Banks globally have rightfully won plaudits for learning the harsh lessons of 2009 by shoring up their balance sheets and generally dealing with risk and leverage more sensibly this time around. However, the system is not out of the woods yet. The damage caused to the global economy will begin to crystallize in the business of banking industry as of Q2 2020. Estimates by S&P Global Research puts the increase in credit losses from COVID at 75% for 2020-2021 on the 2019 base. A comparison with 2009 is not exact, because the updated regulatory regime in force today requires much more timely recognition of credit losses. For reference, the credit cost ratio in 2020 globally will average 160 basis points, roughly double the level of 2019, and much higher than the (artificially low) 100 bps in 2009.

There are some very distinct regional differences in the burden of these losses in the financial sector. The bulk of the hit looks like it will fall in Asia, with China taking half of the Asian hit. Asia overall is expected to account for 60% of the impairments; China's share will be close to $400 billion. The US and Europe take $240 billion and $120 billion respectively.

These are big numbers, but as they stand, they can mostly be absorbed by the companies in this base case scenario. That is to say, the robust nature of financial company balance sheets and their ability to provision for bad loans and reduced business activity should enable to work through the expected impact of how the crisis unfolds. However, beyond a base case, there is little headroom to absorb further damage.

For reference, the base case used by S&P research calls for 7.4% GDP growth in China in 2021, and 5.2% in the US. Squaring the circle from the point made above about the current pace of the spread of the virus and lockdown part II: policy is caught in the vice of trying to fight the virus and its human toll, but at the same time trying to strike a balance with the damaging economic impact of severe movement restrictions. Markets will do well to pay heed to this reality and reflect on the caution being espoused by Dr Fauci and others.

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