



September 14th, 2020

## The Storm before the Calm or the Calm before the Storm?

- **Brexit negotiations take a turn for the worse – sterling still at near term risk**
- **UK and EU may take it all the way to the wire before agreeing to a compromise**
- **Policy makers in main economic blocs go quiet – but there is still work to be done**
- **High Yield market not as good as the indices suggest**
- **Stay with the quality in junk!**

### **Brexit– the Storm before the Calm?**

Sterling's tumble from close to \$1.34 on the 1<sup>st</sup> of September to last week's close of \$1.2825 tells the story of the UK's political blow-up concerning its supposed aim to leave the EU gracefully at the end of the year. Sterling lost 3.6% against the dollar this past week, and 4% versus the euro. Worryingly that may not be the end of the weakness. Last week's decline of 4% in sterling's broad index reacquainted investors with the real risk that talks may yet collapse in a manner that requires the UK to trade on WTO terms with Europe within months. In the end, we would expect some semblance of common sense to prevail even if at the last minute

**Analysis of market positioning suggests that traders do not have significant sterling shorts yet.** Before this past week's political blow-up, 40% of economists polled by Reuters believed that the UK would leave the EU without a deal.

Unfortunately, the UK's decision to push ahead with what is termed the Internal Markets Bill has put the UK and the EU on a collision course that could lead to sanctions on the UK as early as the end of September. It appears to be a high stakes game of poker.

As we survey the current wreckage of the UK's political relationship with Europe, you have to ask yourself why the UK government proposes to break the terms of an international treaty it signed less than eight months ago.

Excuses for the UK government's recent behaviour range from the deflection of attention from a probable climb-down, the wish to create a future UK tech champion, through to wilful incineration of Britain's international reputation in pursuit of supplying supermarkets in Northern Ireland! We leave it to our betters to parse this government's Brexit plan. What matters for markets is whether an agreement, however threadbare, can still be signed off by the end of the year.

Amid the political fury, we would quietly draw the following conclusions. First, neither party wants to be the first to walk away from the table – the blame game is too treacherous. Second, both sides still want to reach an agreement being aware of the severe pitfalls linked to failure. Thirdly, ignore the 15th October, the real deadline for reaching an agreement is still at least six weeks away, and the issues involved are eminently open to compromise in that time.

**So, looking at year-end as against today, sterling should eventually incorporate a lower Brexit risk premium and reduced volatility.** The problem is that both sides now have a rather large, pointless hole to climb out of in coming weeks.

**We sense that a truce will begin to take form as UK parliamentary resistance builds.** Referring to the contentious issues (of practice here rather than principle) to the Joint Committee set up under the Northern Ireland protocol of the Withdrawal Agreement should offer a fig-leaf for a face-facing compromise.

We cannot exclude the possibility of further slippage in a dysfunctional relationship over the coming weeks. Still, in the end, we would expect some semblance of common sense to prevail even if at the last minute.

#### **Policymakers go quiet – the Calm before the Storm?**

The global economy, by no means, looks secure in its recovery. The support of both central banks and governments is still dearly needed. However, at the margin, we see some hesitation by policymakers to push the buttons for either monetary easing or fiscal support. Indeed could this be the calm before the storm?

**Last week the ECB slightly disappointed the markets** by not following through with a further easing of monetary conditions. Particularly surprising was that the ECB did not indicate more strongly that the strength of the euro was posing a problem for the growth and inflation outlook. The ECB staff projection is that core inflation will rise modestly to just 1.1% by 2022, well below the ECB's target. Economists still expect a further monetary stimulus of Euro 750bn by year-end, but there does not appear to be any urgency at the ECB... for the moment.

**EU finance ministers are meeting to flesh out their plans for the Euro 750bn recovery plan.** Thankfully much of the early news from the forum was that the ministers were in no rush to start discussing fiscal consolidation but more prepared to push on with supporting the economy. Instances of COVID19 are rising again, particularly in Europe. There must be a risk some localised lockdowns maybe even at a nation-state level. We suspect that EU economies will need further special programmes of support outside of the current framework to provide relief from a further stuttering of the economy.

**In the United States, it now appears likely that Congress will not pass a fiscal stimulus bill before the Presidential election.** Last week the Senate failed to pass a "skinny bill" that commentators hoped would buy some time. The absolute need for a further fiscal stimulus has waned given recent robust consumer spending data, even in the face of the reduction of unemployment benefits. However, it might just be a matter of time before consumers notice the lack of income. Also, recent employment data has come in below expectations suggesting trouble ahead. Watch out for US August retail sale figures this coming week; the market is expecting an upbeat data point of 0.6% month-on-month headline sales growth.

The focus of the US fiscal outlook will now fall on the government budget funding, which will need congressional approval to extend beyond the end of September. The hope would be that where fiscal policy comes up short the Fed will fill the gap. However, economists are not anticipating anything significant from the Fed at their meeting this week. Previously there had been some hope the Fed would change their forward guidance on the path of interest rates; however, current thinking is that the Fed meeting will be unremarkable.

This week's Bank of Japan meeting is unlikely to deliver any surprises. Despite the likely backdrop of a nationwide core inflation data point likely to show the economy back in deflation, the BoJ is expected to leave policy unchanged. Much focus will be on the likely elevation of Yoshihide Suga to Prime Minister. Mr Suga is expected to maintain former Prime Minister Abe's policy of prioritising economic growth over a fix of the country's enormous debt. We would not expect any headline-grabbing fiscal easing for the moment, more a commitment to reforms of the banking sector and promotion of incentives for SMEs.

#### **High Yield Bonds – the Index does not tell the whole story**

With so much pain being inflicted on firms in the US – shopping malls, airlines, car rental companies – spread compression in high yield has been followed, broadly, by spread stability. Does this mean that the coast is clear and that the coming default wave predicted before is not materialising? The answer is not a clear "no"; the sector is suffering despite the numbers looking more benign than might have been expected.

In the world of "distressed debt", one must keep in mind that there is a difference in the use of the term in the language of index constructors, compared to hedge fund operators. In the former, it is purely definitional and is usually defined as a bond that trades at 1000 basis points above its point on the Treasury curve. Once that happens, it drops out of conventional indices. Therefore, as more of these names fall out of conventional indices, the index spread naturally tightens, despite there being no real money flow driving the shift. This has certainly been one factor that helps to explain why index spread levels have behaved. Of course, that does not mean that all investors are all getting a free bail-out. Those holding the defaulting paper suffer losses; it just won't show in the official index calculations.

In some selloffs, it is common to see in the initial phases, an indiscriminate risk-off move. March and April had some of this characteristic, but the subsequent market action is reflective of the fact that the strain in the composition of the stress in HY has been quite well predicted: the energy sector. All of 30% of currently defined "distressed" credit is in this sector, with the second place being filled by capital goods at a mere 12.8% (data courtesy BofA and Creditsights). For the rest, the distribution is fairly even, and more in line intuitively with a pattern of a typical recession (not overly concentrated).

So, assuming that investors were holding reasonably diversified portfolios in March, the hit to the energy sector is likely to be less of a concern than if it had been in other sectors. Furthermore, the rate of US bankruptcies is already similar to 2009, although the cycle has yet to complete. For now, the 2009 experience is still the worst on record. The summer months have seen a moderation in new filings, but absent a new stimulus package from Congress, the expectation is that the pace will pick up. With the Fed still in the mode of underwriting the credit market, the losses will possibly be felt, in bonds and sectors that have fallen far below even fallen angel status, and that no longer make up much of the headline numbers or the broader HY market index.

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