

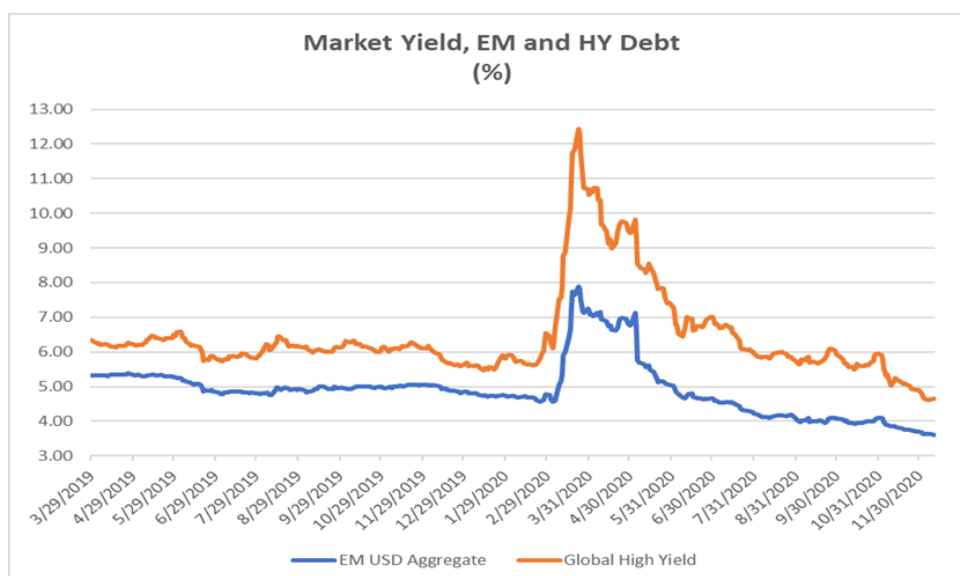
December 14th, 2020

Credit in 2020 – the default Tsunami that became a Ripple

- In Q2, a colossal default wave looked to be crashing down on markets
- Into 2021, default risk has been mitigated, but sectors and regions face continued issues
- Absent a return to crisis mode there is still value to be found
- Regional differences will persist and present threat and opportunity in equal measure

The overall assessment for credit globally for 2021 is one of selective optimism. Outright yields are low but much higher than in government bond markets. Risks are plentiful, and probably manageable for the most part, or avoidable where not. And, with the overall mood in risk assets going into 2021 still positive, the best investment strategy is still to remain invested in credit until there is good reason to exit.

In the European economy, more help is needed. The new measures required to try to create a pause in the speed of virus spread into the Northern winter is not going to make things better faster, despite the availability of a vaccine. The quicker a vaccine can be rolled out (effective one), the quicker sectors like travel, hospitality and non-essential retail will be able to recover. These have been under survival pressure since April, and at the very least the first quarter of 2021 looks to be as challenging as 2020 was.



Source: Bloomberg

The difficulty will remain for the embattled financial sector as well. It is an over-publicised fact that the yield curve is very flat. S&P estimates that the return on equity in this sector is running at 4.6%. With a large amount of stimulus that has been directed at the economy, the base-case estimate is that banks will

be able to withstand the earnings impact still to hit in the first half of 2021 without the need for additional capital.

For some areas of credit, care should be taken before taking exposure on the basis that the pandemic is over. The particular issue is that stimulus could begin to run low by the second half of the year. Structured credit with mortgages, credit cards, or auto loans as underlying collateral stands to deteriorate only late on in the year. This might play into the troubling outlook for the banking sector, leaving it in a pickle for much of 2021.

Asia is cruising as close to normal as possible, given circumstances. However, the recovery is going along bumpily with stark regional differences. In aggregate, the region will grow close to 6.8% in GDP terms, led by China. Of the larger credit issuers, we expect India, Indonesia and Malaysia to be the laggards, with the rest somewhere in the middle. Not all of the countries in the region, with a population over 4.5 billion people will be able to administer a vaccine effectively in short order. Disruption risk is still alive for the names above.

In China, there are clear signs that credit is deteriorating. The government is ending 2020 signalling that it will tolerate defaults in state-run enterprises that are struggling to maintain cash flow and solvency metrics. The government appears to be using the bankruptcy channel in two ways: to allow for deleveraging, and as a policy tool to sanction firms and investors that have been on a borrowing spree.

In North America, the significant variable for 2021 is the rise in the overall level of debt.

S&P estimate the number to be 277% of GDP. This has come about as predominantly governments and corporates have borrowed to cope with the effect of the pandemic. The vaccine cannot come soon enough.

The dip in growth in 2020 will turn about to be just below 4%; for 2021, the expectation is that the snapback will deliver about that or maybe towards 4.5%. That would be necessary to maintain momentum in the credit markets, especially the high yield one, where the Fed was the saviour in 2021. As stimulus (presumably) begins to fade in the second half of 2021, the real economy will have to take the baton and make a run. There cannot be a perpetual fiscal stimulus to keep things afloat.

At 4% or more, the recovery will be just enough to help companies stay on an even keel. Compared to 2019, corporate debt issuance was up 60%.

Such a spike will be tough to manage if the market has to re-assess the positive outcomes currently being discounted for more fiscal support and a swift vaccine roll-out.

Thus, for those who may have been on a different planet this year, the start of 2021 bears a striking resemblance to 2020. With a vast quantity of direct and indirect support has been forthcoming, and more stimulus likely to be on the way, the outlook for the global economy is for one of stability and adjustment to a new circumstance, but not one of collapse.

Brexit not quite there....

In the UK another day, another Brexit deadline expires. At least Sunday's communique from PM Johnson and EU Commission President Ursula Von der Leyen omitted any further commitment to break-off talks if progress isn't achieved. It is to be welcomed despite the very late hour in negotiations and the mounting logistical challenges in getting any agreement over the line by December 31st – UK MPs Christmas holidays are at serious risk.

Despite a downbeat statement from the Prime Minister, it does appear that advances are being made ever-so-painfully in particular around the core level-playing field issue to ensure fair competition. To remind readers, notwithstanding the cry for full sovereignty, the UK government has already committed to a 'non-regression' clause in which they undertake to at least maintain the *current* level of environmental, labour and product standards. The present argument is about *future* or *dynamic* changes to minimise divergence (at least as a negotiation objective of the EU) where a 'ratchet clause' is being haggled over. It looks like the bargaining is finally focusing on when, where and how this review mechanism might be applied. Automatic application of remedies by the EU on its own assessment is unacceptable to the UK side. Yet it does appear that some objective appraisal of the incidence of significant divergence (UK vs EU) on regulations and then a separate arbitration process over subsequent remedial action is being painfully constructed.

Two very big stumbling blocks at this point are (i) the treatment of state aid and whether the EU recovery/cohesion funds fall in the terms of reference (UK demand) and (ii) the option for the EU to cross-retaliate on an issue in one sector with exclusions/tariffs on trading elsewhere; something that is being stoutly resisted by the UK.

The risk persists that all this is simply not do-able by December 31st. An extension to the transition would involve tinkering with the actual Withdrawal Agreement that was signed in January and specifies the time frame for a transition for the UK's full exit. Any move would, at the very least, require the unanimous support of the EU members with France likely to extract a price. There is no question that a full-blown collapse in talks would be extremely painful for the UK, short term. Based on the assessment of both the Bank of England and Office of Budget Responsibility, most of any recovery in the first half (as Covid restrictions ebb), would be wiped out. Further easing by the MPC would be unavoidable and likely spark at least an initial move toward \$1.25 level for sterling. Watch this exhausted space.

Chart 2: GBP/USD



Source: Bloomberg

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