The Credit Cycle: Maturing, but not Rolling Over yet

Stockholm (HedgeNordic) – Asgard Credit Fund manager, Daniel Vesterbaek Pedersen (*pictured*), expects that the credit cycle could have at least another year or two to run, but he is quite cautiously positioned ahead of the eventual tipping point – choosing sectors and names carefully, and completely avoiding long exposure in certain areas, including US technology and European financials.

Pedersen disputes the consensus view that the US economy is at full employment and that the credit cycle is at a very late stage. "Headline US unemployment rates of 3.7% – which have historically preceded recession – appear to be at a 50-year low, but ignore those who have dropped out of the labour force. Employment rates of 79.7% for those of prime-age (25-54) are actually 2% below the previous peak of 81.7% seen in 2000" he says. Therefore, Pedersen believes that there is spare capacity in the US economy. The growth rate of the economy might not peak until 2019 or 2020. This also explains why average wages are only growing at around 3%, which in turn helps to keep inflation under control; Pedersen reckons, "wage growth in the area of 4% would be needed to push inflation permanently over the Fed's 2% target". This also means the market consensus is factoring in too many hikes in the US Fed Funds Rate, which may not hit 3% by the end of 2019.

For now, many US economic statistics, such as capex up 7% annualized in 2017-2018, retail sales up 5% annually also in the last two years, and industrial production has been accelerating for three years now and is up 5.1% YoY as of September 2018. The acceleration in growth is partly due to deregulation and tax reform. The market has sold off during the last couple of months. Consequently, Pedersen views selected US corporate bonds as offering the best spread versus risk, hence they are the largest weighting. Pedersen is avoiding several sectors, including technology, due to rising regulation; autos, owing to downgrades and auto loan sensitivity; and basic materials, as spreads are too tight.

Medium Term Risk

Pedersen expects average annual default rates to remain pretty low for at least the next year, at around 2.5% in the US and 2% in Europe. This is partly because it takes 12- 24 months for Fed rate rises to feed through to corporate balance sheets, and Pedersen does not expect the ECB will begin raising rates until 3Q 2019.

But he does see potential for an explosion of default rates at some stage. Pedersen reminds us that "the past 30 years have seen two multi-year episodes when the cumulative default rate exceeded 30% in high yield: 1988- 1992 and 1999-2003 (and also during the depression, 1931-1935). And it was about 25% from 2008-2012. When the economy does break, you will see default rates spike and spreads massively widening".

What's more, "corporate leverage at 45.5% of US GDP is close to its three prior peaks of 43% in 1990; 44.5% in 2002, and 45% in 2009 – and it has reached these levels without a recession. When a recession comes, corporate leverage will further increase, as will debt to EBITDA ratios. Meanwhile, recovery rates tend to fall in a recession" he recalls. Corporate leverage is already guiding sector selection: "the increase in leverage is more than priced in terms of credit spreads within IT services whereas this is less clear within energy and health care," says Pedersen.

As Europe is at a later stage of monetary policy normalisation than the US, Pedersen believes that European credits will eventually be most vulnerable, for several reasons. The absolute level of yield is so low that some companies may struggle to service debt when rates move towards more normal levels. Whereas the Fed only bought Treasuries and mortgages, ECB asset purchases encompassed a much wider range of assets, including asset-backed securities, covered bonds, and corporate bonds – and will cease net buying in December 2018.

Investors are already starting to price that in: "European investment grade corporates have widened by almost 50 basis points and names that are close to getting downgraded have seen their spreads blow out by 100 basis points in a week, which translates into a mark to market loss of 5% on a five-year bond" says Pedersen.

Value Emerging in Europe

His strategy, which is currently net long, has not been immune from market volatility. It lost 3.5% in October, and it is down 1.1% year to date as of November 13th – and more value is starting to emerge, and Pedersen is constructive on the economy. He judges the European economy to be well below potential growth rates, and argues that women going back to work, especially in Italy, can enhance growth. For instance, female participation in Spain has risen by about 10%-points, following similar moves seen in Germany and the Nordics. This has not yet happened in Italy.

Pedersen is selectively buying some liquid and cash-rich European BB credits, which can yield around 3%, and is switching into longer-dated bonds to take advantage of the steeper curve. In the local Danish market, only three names meet Pedersen's liquidity criteria, and he judges one of them – Maersk – to be attractive at a spread of 200. Similarly, some Finnish corporates are interesting but there are not that many liquid ones. Swedish corporates trade too tight for Pedersen's liking however. Elsewhere, "investment grade credit in Europe now offers a spread of 132 basis points that is slightly higher than the US," he says.

Pedersen has the freedom to select from both the high yield and the investment grade corporate universes, in contrast to some silo managers who may be forced to sell paper that gets downgraded. Pedersen pays more attention to fundamental analysis of balance sheet strength, debt burdens and interest rate costs than he does to credit ratings. Pedersen views the lower end of the BBB corporate segment in Europe as too risky, paying just 1.5% against 4.25% before 2008.

Pedersen's general focus is on corporates but in one Southern European market, Pedersen prefers the sovereign. Having spent more than a year short of Italian bank debt in a trade started at a spread of1.50%, he now finds it is worth owning Italian government bonds at a spread of 3% – but sizes this position in the same way as a corporate name, at a few percent of NAV. By way of contrast, Pedersen does not find Italian (and Spanish) industrials attractive at the same spread as comparable US companies. He believes they should offer a yield premium for taking on European peripheral risk.

The long Italian sovereign is paired against shorts in some Italian bank paper. In other financials, Pedersen is simply standing aside rather than being short. Certain categories of European financial debt have sold off, arguably in sympathy with European bank equities down around 15-40% in 2018, and some managers are drawn to the yield pickup.

Pedersen disagrees: "I am very sceptical on AT1 and Cocos. The prospectus of AT1 bonds warns you that the coupon is at the full discretion of the management. Cocos were specifically designed to absorb losses in the next crisis. They behave okay when the economy and the capital market is okay, but are the worst bonds to own when the market breaks. The yield premium is a jump risk premium, which is the worst kind of premium to be exposed to”.

“I want to create a portfolio with as much yield and carry as possible, and as little tail risk as possible” he adds.

Asset-backed securities and aircraft leasing certificates are also avoided for now. They are the types of more exotic instruments that he might look to buy when and if a recession leads to substantial spread widening.

Basis Trades

Pedersen has the flexibility to choose between cash bonds and CDS – and sometimes uses both to create a negative basis trade, with positive carry, on the same name. As cash yields have increased by more than have CDS, it can be worthwhile to buy the cash bond and hedge it with CDS, but the yield gap is nowhere near as wide as it was in 2008 – and Pedersen certainly expects that this basis could go more negative in a crisis.