Insights

Has Goldilocks run out of porridge?

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Geraud Charpin, Portfolio Manager for credit alpha long short expects financial market instability to continue rising going forward and provides his contrarian views and approach to trading the current market environment.

Buy at your own risk

Over the last four years, monetary policy across major economies has been so supportive for risk assets that a 'buy-the-dip' mentality was driving our investment strategy. We now see the future through a much darker lens.

Risks have accumulated from a macro, credit fundamental and market perspective, at a time when monetary policies are not only diverging across regions but also running out of efficacy. As a result, risks are now heavily tilted to the downside and justify shifting to a 'sell-the-rally' attitude and a focus on finding fault lines rather than on faith that central banks (CBs) will be successful at supporting risk assets ad infinitum.

Our base case is now bearish; a more severe 'black swan' event where financial markets suffer meaningful dislocations is now equally as likely in our mind as one where the 'Goldilocks' conditions that prevailed for the past four years are allowed to continue a little longer.

In our opinion a contrarian approach to market trends and positioning is appropriate in this environment.

We are translating this into our long short strategies by building short positions in corporate credit where we currently see the most asymmetry and downside risk. This is the asset class where widespread herding and lack of regard for anything but momentum is, to us, the most obvious. Sovereign spreads are cheap in comparison to corporate spreads but will move in the same direction, so we tend to ignore this as a metric while we are bearish. Interest rates are also a space where our conviction is low as we can paint a scenario where they go much lower and, equally as likely, one where they are the catalyst to our bearish view and go much higher. Finally, we utilise currencies to implement tail hedges, in case our most sinister scenarios do materialise.

RBC Global Asset Management

Our views are based on a number of factors that, when combined, leave seasoned investors needing a strong stomach.

1. Can central banks still save us?

The European Central Bank (ECB) and Bank of Japan (BoJ) are increasingly at pains to find effective ways to stimulate economic activity held back by structural rigidities. Markets have pushed back on negative rates in Japan and Europe, primarily because they are bad for banks, bad for borrowers and a headache for investors. In our view we have reached the limits of what monetary policy can do – there is not much more 'just right' porridge left – unconventional tools are distorting the proper price formation mechanism even more, thereby increasing volatility and systemic risk.

Fiscal policy and structural reforms are tools at the hands of governments that are, most often, politely ignoring the advice given by central bankers. Central banks are now only able to buy time rather than change the course of economics. The ECB's corporate sector purchase programme (CSPP) is the latest example of such dangerous price distortion.

Investors have rushed into corporate bonds ahead of the ECB taking spreads back to last October's levels and yields just a whisker away from historical lows. Indeed, we have seen pure play Spanish corporates issuing 10-year debt at a yield 30% lower than their own government is able to fund itself. There are multiple similar examples of mispriced risk across the EUR corporate market. At these levels it is unsurprising international investors are moving to greener pastures – US bond markets have experienced significant inflows.

The ECB will most likely absorb less than half of the growth in EUR corporate issuance. By comparison, the ECB absorbs more than four times the growth in government bond supply, but BTP spreads have widened since QE started. Corporate bonds are not bought at these levels for the right reasons (value) meaning that secondary liquidity will be close to zero when market conditions get tougher. The ECB is only concerned with increasing the amount of credit and facilitating access for issuers, it is not concerned with liquidity and will not be a buyer of last resort. To us, this is a reason to consider this a big short.

2. Market liquidity is a material systemic risk

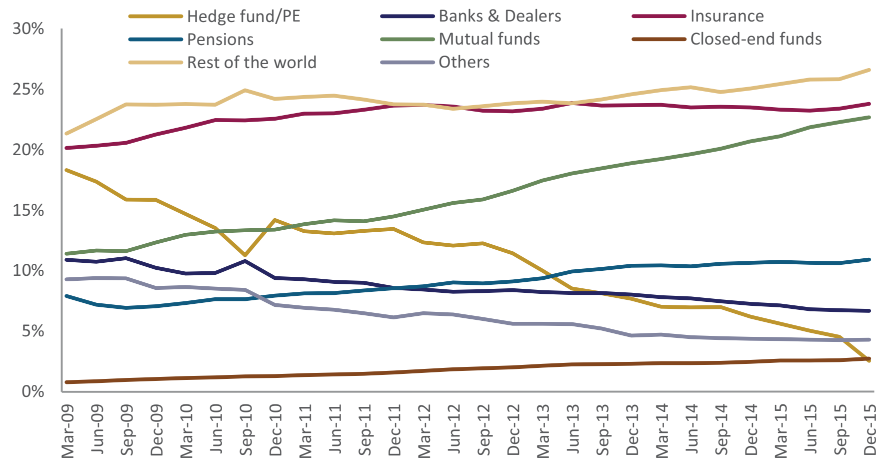
The investor base across most financial market assets is dominated by daily liquidity products with narrow risk parameters and a growing share of passive products (Fig. 1). The herd mentality caused by the continued inflows into these types of products is thus only getting stronger. Meanwhile, the system's ability to absorb or facilitate flows is vastly diminished – dealer's balance sheets have shrunk, hedge funds are a smaller portion of the industry and a new 'brokerage industry' is struggling to emerge.

As Fig. 2 highlights, US mutual funds are now 20 times the size of dealer inventories, up from just twice the size before 2008. The result is that there is no countercyclical buffer available and therefore a small amount of flows can lead to very large moves in price.

The vast concentration of assets amongst very few managers makes this liquidity risk even greater. While anyone trading in financial markets is experiencing the deterioration in market liquidity (a combination of price and volume) and the absence of a price continuum in periods of stress, it is an experience that no-one has yet been able to quantify. Indeed, regulatory authorities have produced charts that suggests liquidity conditions are improving! These imbalances are therefore unlikely to be addressed, let alone fixed, before an accident happens.

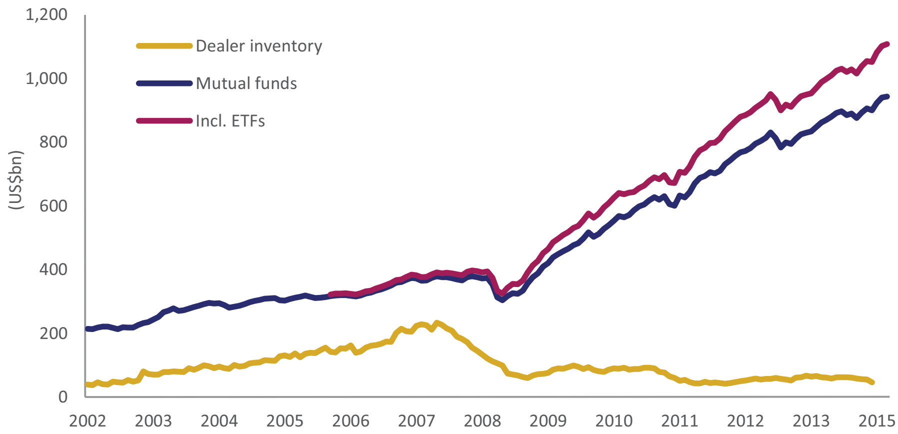
In 2007, bund yields were around 4% and therefore able to cushion a shock to fixed income valuations. Today, with bunds yielding around 0.15% their ability to act as a cushion to any further shocks is questionable.

Fig. 1 US credit ownership: daily liquidity mutual funds, foreign investors and no hedge funds!



Source: UBS, Federal Reserve, as at 31 December 2015

Fig. 2 Credit funds versus dealer inventory



Source: Bloomberg, BlueBay Asset Management, as at 31 December 2015

3. The commodity complex is a headwind, not a tailwind

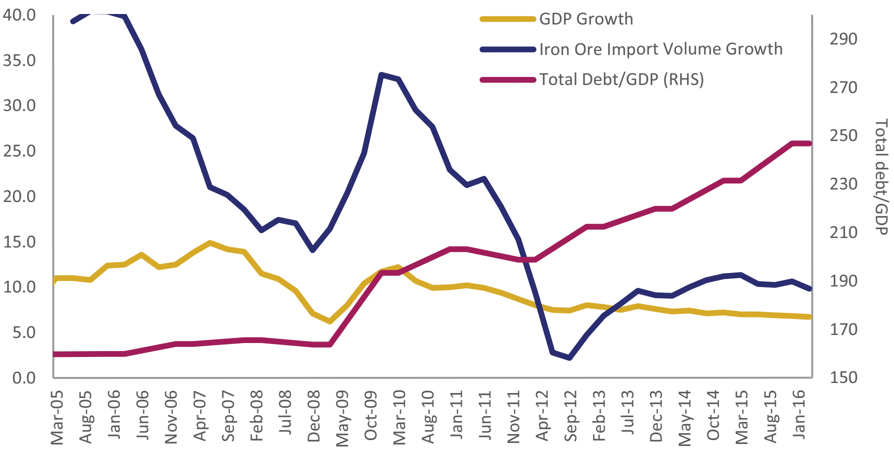
The current global macroeconomic backdrop is laced with headwinds. In particular the commodity complex, which had benefited from steady and synchronised global growth, is now struggling with structural imbalances; demand for oil, iron ore and copper dropping along with global growth just when supply is becoming more plentiful.

The downturn in commodities is relatively young and, without any positive growth shock, could continue for some time before reaching a trough. The disposal of assets will continue to be a painful exercise for an industry that found itself conservatively funded with iron ore hyper-inflated at US$180 per tonne, but is seriously over levered now that prices have dropped to US$60.

Looking forward there is no short-term fix to this situation, just a difficult road ahead and almost guaranteed stumbles along it. China is the world's largest commodities consumer (around 50% of supply) and will undoubtedly remain a source of volatility and uncertainty. The country's iron ore imports are still growing at 10%+ a year, funded by an increasing debt burden, while GDP growth has fallen to around 6.7% and is most likely to fall further (Fig. 3).

As a result, the commodities complex is a prime target of our 'sell-the-rally' investment strategy, given the volatility in asset prices in this sector.

Fig. 3 China's unresolved imbalances



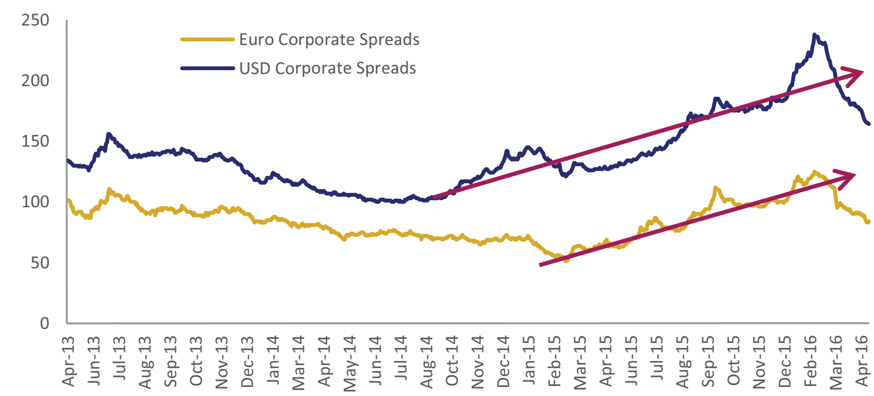
Source: Bloomberg, as at 31 March 2016

4. 'Free money' + low growth = credit deterioration

The default cycle appears to have turned for both US and European corporate issuers. It could remain shallow for longer, given the still supportive monetary conditions, but the deterioration in credit quality is clear and spreads already began widening in mid-2014 in the US and mid-2015 in Europe (Fig. 4).

US debt accumulation is now consistent with previous down cycles, according to research by Deutsche Bank (Fig. 5) and the lowest quality issuers (CCC rated) have largely lost access to the market (Fig. 6). The US defaults count has doubled in 2016 compared to 2015.

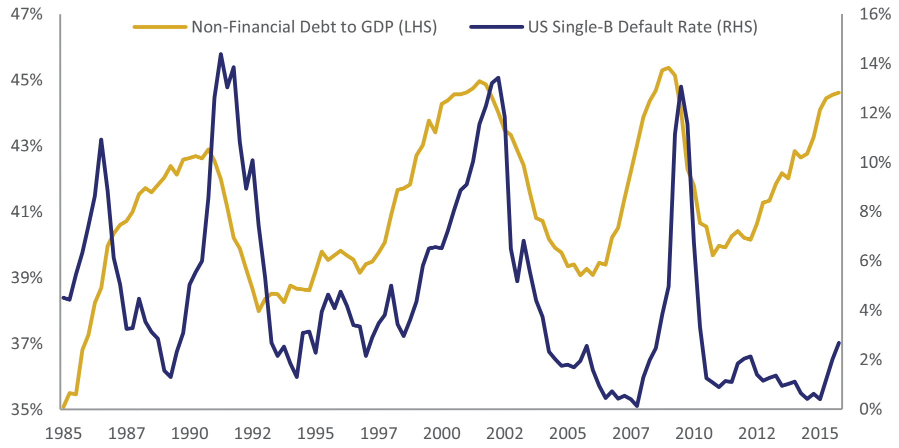
Fig. 4 Corporate spread trend has turned on both sides of the Atlantic



Source: BoA Merrill Lynch Global Research, as at 29 April 2016

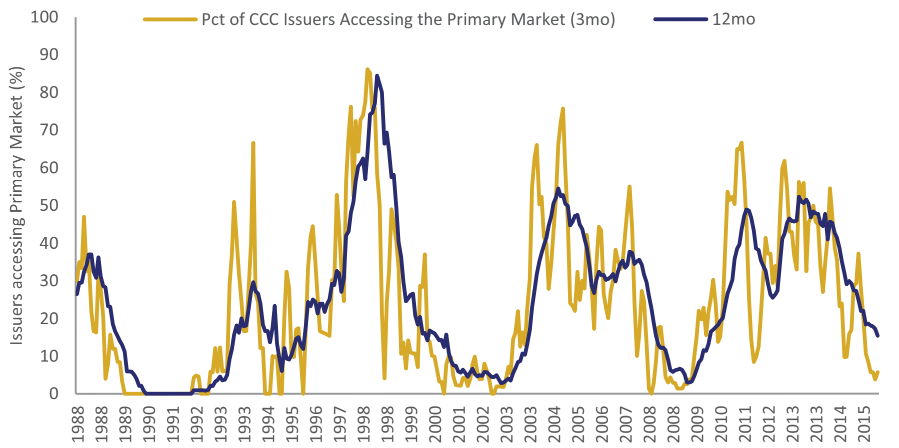
Meanwhile, healthier corporates are heavily incentivised to use remarkably cheap financing to fund share buybacks. Of course, cheap money provided by ultra-accommodative central banks should serve to fund growth capex. Unfortunately declining global growth, the lack of structural reforms and the ambient political uncertainty (in particular but not exclusively in the EU) are not providing enough growth visibility for corporates to be willing to commit even 'free' money (some corporate issuers have been able to issue zero coupon bonds recently). This money therefore tends to serve for share buybacks instead, thus contributing to balance sheet deterioration.

Fig. 5 Non financial debt to GDP versus US single-B default rate



Source: Deutsche Bank, as at 31 December 2015

Fig.6 CCC US issuers accessing primary market



Source: BAML, as at 29 February 2016

5. The EU's existential crisis – the next chapter

The immediate risk of 'Brexit' is not the only 'make or break' test facing the EU block in the near term. While a vote to leave should upset markets, a 'stay' vote may only provide very short respite. In our view, the UK will experience huge economic challenges were it to vote for 'Brexit'. However, it will also create large political ripples across the EU whether it leaves or stays.

In addition, the migrant crisis, the relentless rise in parties hostile to Brussel, Greece's lingering problems, the legal challenges to the ECB's efforts, elections and pro-independence noise in Spain, the crawling pace of structural reforms and the long overdue restructuring of the Italian banking sector are all further underlying challenges that keep international investors away from European assets, making us aware that behind one risk lies a number of others.

With the yield on BofA Merrill Lynch's Euro Government Bond Index now below 0.5%, we see little incentive for any investor to buy this asset class unless they are obligated to.

Conclusion

With all these points in mind, we see the most likely outcome as one of rising price volatility and diminishing asset liquidity. We do not believe in a 'Japanification' scenario because there is no incentive for investors to accept minimal expected returns if default risk is not eliminated and volatility reduced. None of these are likely within developed economies.

Central bankers have indeed been supporting more volatility in risk assets and, while they can do many things, preventing defaults is not one of them. Importantly, crowded positions and herding are standard features of financial markets in the post-2008 era and we do believe they will be both growing and enduring.

We also have to face many macro headwinds, such as those mentioned above, that constantly force investors to reconsider asset valuations. These valuations are unanchored due to significant distortions that ultra-accommodative monetary policies are creating. We can see scenarios where asset prices continue to go up and scenarios where they go down. For now, we do not see a scenario where they remain stable and we do not see a scenario where liquidity will improve to such a point where a contrarian approach is not necessary to generate acceptable returns.