Back to the Grind - High Quality Credit Spreads

Dan Krieter:
Hello. Welcome to Macro Horizons, high quality spreads for the week of January 20th, Back to the Grind. I'm your host, Dan Krieter, here with Dan Belton, as we discuss credit spreads that are now closing in on historically low levels and why we expect a powerful yield grab environment to continue propelling spreads to even narrower levels in the weeks ahead.

Dan Krieter:
Each week we offer a view on credit spreads, ranging from the highest-quality sectors such as agencies and SSAs, to investment grade corporates. We also focus on US dollar swap spreads and all the factors that entails, including funding markets, cross-currency markets and the transition from [inaudible 00:00:36]. The topics that come up most frequently in conversations with clients and listeners form the basis for each episode. So please don't hesitate to reach out to us with questions or topics you would like to hear discussed. We can be found on Bloomberg or emailed directly at Dan.Krieter K-R-I-E-T-E-R @bmo.com. We value and greatly appreciate your input.

Speaker 2:
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Dan Krieter:
Well, Dan, the title of our podcast episode today is Back to the Grind. We are clearly not referring to the work grind as we sit here at our home office for the 10th straight month. Never thought I'd say I missed the grind, but I think we can all sympathize with that sentiment these days. No, but instead back to the grind, we were referring to the grind in credit spreads, which... It's been two weeks since our last podcast, so why don't you get us caught up on the mood in spreads in the past couple weeks.

Dan Belton:
So spreads currently sit four basis points narrower on the year and that's come amid mixed headlines. So on one hand we have some pretty bad data which has been largely expected given the increase in virus transmission rates, and that's something that has been priced and something that the market has been able to look past. There's also been disappointment on the vaccine rollout. And then on the other hand, you have positive headlines with respect to stimulus, which has surprised to the upside. Now President Joe Biden has proposed a $1.9 trillion stimulus package, which could pose significant tailwind for credit spreads. But I think the main story here with respect to spreads this year so far, is that we are now firmly inside of pre pandemic levels. The Bloomberg Barclays index closed at 92 basis points yesterday, which is a level we haven't seen since about February of 2018.

Dan Krieter:
Yeah, I agree with you, Dan. That's definitely the headline for me in credit markets at the moment. The Bloomberg Barclays index inside of 92 basis points yesterday, a three-year low and less than eight basis points from post-crisis lows, which were hit in February of 2018, around 84 basis points. Now looking pre-crisis, there are some observations there that are narrower than the 84 we hit in February, 2018. There was [inaudible 00:02:42] in '05 where credit spreads got down to the 75 basis point arena. And then looking back to the nineties, even lower than that, but we should also acknowledge that we're

dealing with a much different index now than we were then. Obviously since the dot com bubble burst really we've seen the composition of the index start to change both from a credit quality perspective. We've seen a shift downward in credit quality, as well as a shift out in duration.

Dan Krieter:
So we try to normalize for those factors, at least to the extent that we can. Normalizing for credit quality, not as straightforward, but we can sort of normalize for duration and just look at index spread as a ratio to index duration. Now if we look at that normalized metric, at least adjusting for duration, we are currently sitting at the narrower spread levels since the index started printing daily spread levels in August of 2000. Again in the nineties, there is data that goes lower than that, but we're looking at adjusting for duration, the lowest spreads in the last 20 years or so. And you're starting to see more and more commentary on, well, how much further can spreads go? And I think that that's a very, very important question, Dan, especially given our expectation for spreads to continue grinding narrower. How have you begun to answer that question?

Dan Belton:
It's true that credit spreads are historically very tight right now, but when you look around at other asset classes, the same can be said for virtually all risk assets and even non-risk assets. So if you look at equities, there are near all time highs. Treasuries are very rich relative to historicals. You have 10 year Treasuries at just over a hundred basis points. Even things like Bitcoin are soaring to all time highs. It's hard to look around and find something that stands out as significantly attractive relative to historical valuations right now. So I think you have to look at credit spreads in that context and say, okay, even though spreads are very tight right now, you have to park your money somewhere. And there are significantly worse options out there than credit spreads right now.

Dan Krieter:
Yeah. I agree with you. I mean, obviously one that keeps coming up is break evens, that spreads only have to widen X basis points to wipe out your carry advantage and that's the lowest in decades, and yeah, that's all true. Except you can say that for just about any asset class, even just looking at Treasury as well. Look, Treasuries are yielding 110 in the 10 year and much lower than that inside the curve. You take that duration risk and Treasuries only needed to move higher by X basis points. And it would've been better for you to just sit in cash. That break even analysis, that can be made for just about any asset class. So while we accepted that that's true, you have to look at the fundamental picture and the fundamental picture right now for credit spreads is there's just not much reason to expect spreads to move wider.

Dan Krieter:
And fundamentally, right now we're in this sort of like period of limbo, I like to call it, like you talked about earlier, Dan, you mentioned how the economic data is starting to take a turn for the worst. And that's true. Obviously we saw very disappointing retail sales numbers, [inaudible 00:05:22] payrolls for December, but the market base looked past it. And I think that's going to be the trend we're looking at here, because we have two things. We have a stimulus package that's going to fill some of that hole. And we also have some willingness to look past given Fed liquidity, stimulus, blah, blah, blah, some willingness to look past this period of rough economic growth until a stronger economic reopening later in the year that will presumptively come when people are widely vaccinated.

Dan Krieter:
But on the other hand, we really have no credible evidence that there's going to be widespread vaccinations, that people are then going to return to normal, that we're going to get this strong economic reopening. That's not going to happen for months. So we're just in this like sort of limbo now where, from a fundamental perspective, spreads are just sort of adrift while we await evidence that this economic reopening is actually going to meet everyone's optimistic expectations and without fundamentals really providing a strong push pull in either direction, I think it's going to really come down to technicals. And I think from a technical perspective, things are looking very good for credit spreads, right now.

Dan Belton:
Yeah Dan, they are. So when we talk about technicals, I think it's important to focus on supply as well as demand technicals. And the demand technicals are extremely strong right now. When you look at, for instance, new issue concessions in the primary market, it's very evident to me how much demand there is out there for credit. New issue concessions have been negative on average for each of the past six months in the corporate market. That's largely been a function of the Fed urging stronger demand for corporate debt, like we've talked about given how rich all other asset classes are. And then on the supply side, there's also reason to think that technicals are going to turn a little bit more constructive than they were in 2020. Of course, 2020 brought record heavy supply. We don't expect light supply in 2021, but it shouldn't be as much of a headwind as it has in recent quarters. And as a result, we are overall pretty constructive on technicals.

Dan Krieter:
Yeah, I want to come back to the supply estimate and we'll talk a bit about supply later on, but I want to circle back first to one of the key points you made there and that's that demand technicals remain extremely, extremely strong. And so if from a fundamental perspective, we don't expect spreads to really feel strong influence either way, it's going to be technicals that keep grinding the market narrower. Eventually higher Treasury yields is going to be something that's going to be a concern, but Treasury yields have found stability in the past week or so after a run up to 119 and tens.

Dan Krieter:
And there's just this growing acceptance that it's going to take a lot for Treasuries to get above that level anytime soon, until we start to see some of that credible evidence that we're not going to really be able to see for the next few months. So we're going to have Treasury rates anchored at very low levels and strong technicals that we think can continue to push credit spreads narrower and rival that 84 basis point low we hit in February, 2018. I think that's well within range the next couple of months, but it will likely be a slow grind there as technical sort of push their way down and cash gets put to work. It won't be a sharp repricing to the 80 to 85 basis point range.

Dan Krieter:
And then I do want a second your point that there is evidence of this yield grab that we've been sort of harping about, and it is driving our view. There is evidence of it. Net new issue concessions, like you said, have been negative for six months in a row. And I think it's also important to note that they've been more negative for some of the traditionally lower liquidity or lower credit quality borrowers. You're seeing out-performance from those borrowers, it's really exemplary of a yield grab type environment. And then, yeah, I think we should return to your discussion on supply because after a really, really gangbusters first week of the year, IG supply is sort of disappointed these past couple weeks.

Dan Belton:
Yeah. So to start off the year, we saw 55 billion in IG corporate supply, which is pretty heavy, just a little bit below 2020s pace. But since then we have disappointed last week, we saw just 26 billion and this week it's looking like we're going to be even below that. So through the first three weeks of the year, it seems like this is going to be just above the lightest we've had in the past five years, which was 2019 we saw 79 billion, but supplies should be considerably lighter than each of the other past five years.

Dan Krieter:
And I think that's really important because our forecast for IG supply this year, assume that issuance should be relatively front-loaded. We saw that there would be this period of uncertainty in the beginning of the year ahead of vaccinations, that there would be more issuance at the beginning of the year, and then issuance would slow into the second half of the year. But now in the heaviest issuance months of the year, precisely in this period, when we were expecting uncertainty, that portends to me a middle of the road to potentially lighter year than we were expecting. And in looking at street projections for corporate issuance this year, we were pretty much middle of the pack. It was a wide range this year. We were close to the middle with a pretty heavy concentration there around the 1.3 trillion mark.

Dan Krieter:
So, obviously three weeks, we're not going to draw broad sweeping conclusions over three weeks. It has been, I don't want to say a high-risk three weeks, but maybe if you look at this January compared to January's in the past, we had the special Georgia election, maybe there was some more slightly reason for caution. I don't totally believe that as you can tell by my inflection in my voice going way up there. But yeah, I guess the point is we can't draw any broad conclusions yet, but supply potentially falling short of expectations now has to be on the radar and would only further enhance the rationale behind this yield grab being even that much more powerful and putting that much further downward pressure on credit spread. So I think that's definitely something to monitor.

Dan Krieter:
Very quickly, I'll touch on the SSA market. Issuance hasn't been as light there, obviously issuance in the government and government related sectors is going to be much higher this year, just given the outsize government response to the pandemic, but even where issuance has been heavy in the SSA market, we saw 20 billion in issuance last week. That's only the second time since 2010 that SSA issuance has breached 20 billion in a single week. We saw huge demand and negative new issue concessions on most of the deals, particularly even looking at like 10 year [inaudible 00:11:05] deals or an issue from Korea Development Bank. Like some of these issuers that typically trade out at a wider spread, you're seeing negative three, four new issue concessions on those borrowers because you're getting incremental yield there. So really across the credit spectrum, we're seeing this building evidence of yield grab. And I think that's what is really the driving force behind our expectation for credit spreads to continue narrowing here.

Dan Krieter:
So Dan, as we wrap up here, we've established we expect credit spreads to continue narrowing, but is there any particular way that you prefer to express that view?

Dan Belton:
Yeah, so I think in the IG corporate market, there's a decent amount of value right now in triple B's. So if you look at the spread relationships from different credit ratings, single A's are very rich to double A's

right now. And there's a little bit more value in triple B's to single A's. Now this relationship is not wide by historical standards as we've discussed, nothing really is right now, but we see some potential for triple B's to narrow relative to single A's. In contrast, when you look at the single A to double A relationship, that is near multi-year historical tights right now, and this is typical of a yield grab environment. It typically starts with the highest credit quality and moves out the credit spectrum.

Dan Belton:
So we think that triple B's are going to outperform single A's. And if you look even further up the credit spectrum, the double B to triple B relationship, or the fallen angel spread as we call it, is at multi-year wides right now. And so this cheapness of triple B's could be somewhat a function of fallen angel risk, but we think that all these relationships are going to start to narrow in the next few months, as there becomes more clarity with respect to the economic fundamentals in the medium term.

Dan Krieter:
Finally, I just want to talk very briefly about a bit of news surrounding GSE reform after FHFA and Treasury agreed to some new amendments to the senior preferred stock purchase agreements that govern GSE conservatorships. I'm not going to go super in-depth, but it is an important story and I'll just hit the very high level bullet points that came out of the amendment. So I think the big headline obviously is that the GSEs will be allowed to build capital now and they'll be allowed to build capital until they reach the capital goals established in the recently finalized 2020 GSE capital rules. So that rule is the one that calls them to hold approximately $275 billion worth of liquidity compared to the current cushion that's allowed of 45 billion. So obviously a ton of liquidity that needs to be built there. It's going to take them at least a decade if they do it just via retained earnings.

Dan Krieter:
So this basically means that the GSEs aren't going to be paying dividends to the Treasury for the foreseeable future. So as compensation for no longer receiving dividends, I think the key point here is that now Treasuries ownership stake in the GSEs, referred to as evaluation preference, is going to increase by the amount of each GSEs net worth going forward. So the big factor heading into these amendments since they were widely expected, but the one unknown was whether or not Treasury would reduce its ownership stake in the GACS and potentially paved the way to letting them out of conservatorship. It turns out not only did they not lower their ownership stake, but they actually sort of went the other way as it will continue to increase.

Dan Krieter:
Now, there is, at the end of the amendments, there's a call for FHFA and Treasury to put forth a plan in front of the Biden administration by the end of September, where Treasuries ownership stake is going to be reexamined. So potentially restructured at that point. I think it actually says explicitly looking at restructuring Treasuries ownership. But for right now, it did not go down, it only went up. And so, where does this leave us? Basically, the Trump administration has now punted GSE reform to the Biden administration and the Biden administration is not expected to make GSE reform a priority. And so we're just back to kind of square one where we've always been with GSE reform, that there's no real path in sight. So it's going to be a very, very close line between the GSEs and Treasury for the foreseeable future.

Dan Krieter:
There were some other changes. Most notably that their retained mortgage portfolio is now capped at 225 billion. Doesn't really have any impact, that was already the FHFA mandated cap. Now they've just

codified that into the SPSPA. So a lot of sort of things were changed cosmetically, but at the heart of it, nothing's really changed. The GSE is going to remain in conservatorship for the foreseeable future. So just wanted to talk about that. Obviously we can go in more detail if anyone has interest. Please feel free to reach out to us on that or anything else really. And I think that'll wrap up this week's edition. So thanks for listening to Macro Horizons.

Dan Belton:
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