Technical Support - High Quality Credit Spreads Transcript

Dan Krieter:
Hello, and welcome to Macro Horizons: High Quality Spreads the week of February 10th, technical support. I'm your host Dan Krieter here with Dan Belton as we discuss credit spreads now trading at multi-year lows and whether or not the rally is running out of steam. Finally, we revisit swap spreads that have widened particularly in the belly in the past couple of weeks, and update our views for the path to swap spreads in the near term.

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 LIBOR to SOFR.

Dan Krieter:
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 email directly at dan.krieter@bmo.com. We value and greatly appreciate your input.

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Dan Krieter:
Well, Dan, it's been two weeks since our last podcast, why don't you quickly get us caught up on the important trends and spreads in the last couple of weeks?

Dan Belton:
Yeah. Dan, well, as you alluded to spreads are currently sitting right on top of cyclical tights. So we're at 91 basis points in the Bloomberg Barclays Index and 98 basis points in the [ICE BofAML 00:01:31] Index. But either way, these spreads are tight of pre-pandemic levels and just about the tightest we've seen this business cycle. And as we've discussed in recent podcasts and in our written work, this is mostly a technically driven move. And we see that in a couple dimensions that I want to highlight.

Dan Belton:
First, this narrowing in credit spreads has been accompanied by significant spread compression. So just to put some numbers around that, Single-A corporate credit currently picks up only 13 basis points to Double-A's. And that's the tightest spread pickup that we've seen between those two classes since 2007. Further down the credit spectrum, Triple-B's pick up 47 basis points to Single-A's, which is also very tight by historical standards, but we did see tighter spreads in early 2018.

Dan Belton:
So we're seeing a move that is largely driven by lower graded credit products as investors move out the credit spectrum to grab yield. And just one more quick stat for you, Double-A corporates are five basis points wide of levels seen one year ago. Whereas, Triple-B's are 12 basis points tight of those levels.

Dan Belton:
Secondly, we see evidence of this in the primary market and primary market demand is very typical of a yield grab environment as well. Taking just yesterday as an example, we saw a Triple-B minus price to negative concessions of 24 basis points after narrowing nearly 60 basis points from IPTs with an order book almost seven times subscribed after drops.

Dan Belton:
On the other hand, Double-A's, I've seen an average concession of positive three and a half basis points this year. Whereas, the market in general has average, slightly negative new issue concessions. So, Dan, we don't view this as a fundamentally driven rally, rather it's attributable to a lot of liquidity in the system to continued Fed intervention, alongside expansionary fiscal expectations compounded by low Treasury yields.

Dan Krieter:
Yeah, Dan, I think you hit the nail on the head and that's really what's been underpinning our views of credit spreads would continue narrowing that would have this extremely strong yield grab environment as a result of the factors you just laid out. I want to highlight the last point you made and that's the Treasury yields have remained very low. That's been tested a couple of times here in the new year. In early January we saw 10-year Treasuries move all the way up to 118 before rallying back down. And then just this week, alongside inflation data coming out and 10-year Treasury auctions, we saw twice the 10-year get up to just under 120 and both times it's rallied back down. And I think that's extremely important because alongside Fed accommodation and cash everywhere, like you talked about Dan, low Treasury yields is key to our view.

Dan Krieter:
And that's because of the relative value of the credit spread still continue to offer, even though we're what, six basis points off 20-year lows in the Broad IG Index. Despite a significantly longer duration and lower credit quality profile of the index, we're six basis points off the lows, but relative value metrics are still not at extreme observations. In fact, they still look relatively attractive. I updated some numbers yesterday and as of yesterday, the Broad IG Index added 77% yield enhancement over Treasuries. Looking back over the past 10 years, that's average 74%. So we're really just an average relative value metrics. And even those are somewhat skewed by 2020, obviously, where we saw an extreme back-up in credit spreads. If we take out 2020, the average yield enhancement of the Broad IG Index drops to 62%. So we're still significantly above average levels in terms of yield enhancement over Treasuries in the Broad IG Index.

Dan Krieter:
In fact, it's worth pointing out that the relationship traded as low as 30% the last time IG spreads hit their lows of 84 basis points. They traded at 30% over Treasuries. And for the majority of the time period between 2016 and 2019, IG spreads traded in the 45% to 50% range. To put that in numbers now, if we assume Treasury yields of 1.2%, a return to 50% yield enhancement implies index credit spreads of 60 basis points. Now, we're not saying that credit spreads are going to get to 60 basis points. There's key differences between now and the 2016 to 2019 environment. Specifically, that those years were typified by a sort of late cycle yield grab where the perception of risk was relatively low. Here, in 2021, there's obviously still a significant uncertainty over the virus and we're at the beginning of an economic recovery where we expect the Fed and long-end rates were moving higher.

Dan Krieter:
So we don't expect a return to 50%, but at 77% yield enhancement with Treasuries where they are, IG spreads continue to have relative value. And given all the factors you discussed earlier, central bank liquidity, fiscal stimulus, all that; we continue to that spreads can continue to narrow into the 80 to 85 basis point range and actually make new lows on an absolute basis to Treasuries. But with that said, Dan, we're now what, at around 90 basis points. So there's not a ton of juice left in the trade and we have to start asking ourselves the question, what is the largest threat to the narrowing narrative that we continue to harp on?

Dan Belton:
Yeah, Dan, the first and probably the most obvious one, it almost feels like a disclaimer at this point, but we have to point out the possibility that something derails vaccine effectiveness and ultimately the ensuing economic reopening. The variants that we've seen in COVID-19 are certainly a reason for concern, but it doesn't seem overly likely that they pose a game changer with respect to vaccines. So while this is still a lingering risk, I think it's outside of our base case. Would you agree with that?

Dan Krieter:
Yeah, I would agree with that. I agree that we have to at least make the disclaimer, but I'm actually starting to think at this point that even if the vaccine somehow falls short of expectations, I wouldn't rule out a sharp economic recovery. I think that when the summer gets here, people are just going to be over this. And if the vaccine fails, it will be like, well, we gave it our best shot. And that's not going to happen. The vaccine is not going to outright fail. We have already observed the South African variant. You have lowered effectiveness there from the current vaccinations. But even some of the early trials say, for example, Moderna says that there was still effective immunity against the South African variant, even though it was six times less powerful than against the standard COVID variant or the UK variant, there was still effective immunity in lab tests. And even some immunity, I think is all people need to get out. Even with no immunity, I mean, anecdotal, you go to restaurants now here in Illinois that are open for business, indoor dining. They're pretty full. I think people have had enough of the pandemic here. So while we have to acknowledge the risks, that's not the main one in my view.

Dan Belton:
And just to build off your point earlier, the market could sustain some amount of ineffectiveness from the vaccines. I think it's becoming more and more clear that the outcome with respect to the vaccines is not going to be binary. We're not going to eradicate this virus from the planet anytime soon. And so it's likely going to be something that we're going to have to live with for the foreseeable future. But that's not to say that the vaccines will not be effective. Some effectiveness in vaccines is certainly incrementally bullish for credit spreads. And so with that said, the largest threat to me is actually an increase in Treasury rates, specifically stemming from a sustained increase in inflation. We saw inflation this morning underwhelmed and Treasury yields rallied on the back of that, which should be bullish for credit spreads as well. But inflation is likely to pick up in the coming months, particularly as we see the base effects of March and April feed into the year over year CPI numbers. And if we see a reaction in Treasury rates to that, that could derail some of this technically driven widening in credit spreads

Dan Krieter:
Yeah, I agree with you Dan that the biggest threat to credit spreads here is a significant and sustained upward move in Treasury yields. And I think for evidence of that, you don't have to look any further than 2018. Recall that in 2018, the Fed actually was able to lift rates four times in a single year and 10-year yields hit their post 2011 highs at 3.25% or right around there with inflation moving to its highest levels

since 2011. And probably not coincidentally, 2018 was not a great year for credit spreads. We talked about credit spreads hitting their lows in February 2018 of 84 basis points. They ended the year around 150. So obviously I'm cherry picking the low there, but we saw credit spreads move effectively in one direction for the majority of 2018. And we know that if inflation is high and Treasury yields are high, that the economic backdrop was actually pretty supportive.

Dan Krieter:
Obviously yields wouldn't have gotten so high if there wasn't a supportive economic environment. So that widening credit spreads came alongside a very supportive economic outlook. And that's because we have this sort of counter-intuitive relationship where higher Treasury yields then begins to feed into questions surrounding these debt-laden corporations and debt service costs is they have to refinance debt into higher yields. And I think there's a potential for that dynamic to be even more acute this time around because not only would we have potentially higher debt costs from higher Treasury yields, but there's also the potential for higher costs in other parts of a corporation, namely wage costs with the expectation that minimum wages might be raised across the board. There's going to be higher taxes under the Biden administration once the health crisis is out of the way. So in addition to higher Treasury yields erasing that technical tailwind that I was talking about just a bit ago, it also leads to fundamental questions about the level of where credit spreads should be.

Dan Krieter:
So inflation, I agree, Dan, is a major threat. However, you made the point that we're going to see inflation pop here in the next couple of months. A big reason for that is going to be base effects. There's also expectations that we're going to have a sort of transitory burst of optimism as people do emerge from quarantine that will have lasted about a year, even more than a year once it's over. And we'll sort of maybe go gangbusters a little bit. And the expectation is that burst of optimism would be temporary. It's expected that the market will look through that. The Fed has already instructed the market to look through that. The Fed has said they're going to look through it. And I think the market will as well. But I think that will only last for about the first half. If inflation continues to print higher, once you get into July, August, then I think the market will start to worry more meaningfully about inflation.

Dan Krieter:
But Dan, it's also worth mentioning that inflation isn't the only way that we could have higher Treasury yields or at least not by itself. There's another major factor that I keep returning to as I look out over the remainder of the year, and that is the question surrounding heavy Treasury supply that we talked about in great detail on last week's Macro monthly podcast with the whole team. We put it into numbers, how much Treasury supply was coming. We talked about potentially some challenges in digesting that Treasury supply and what it might mean for credit spreads. But Dan, you listened to the study into the impact of Treasury supply on credit spreads, what did you find?

Dan Belton:
Yeah. So Dan, just to put some numbers around that. We're expecting Treasury coupon supply after Fed purchases in 2021 will grow by $1.76 trillion or about 15% increase in the overall size of the market available for the public. Now that's going to be an unprecedented increase after Fed purchases. So we looked at the potential impact of Treasury supply on credit markets by incorporating it into our econometric model. And we suspected that Treasury supply could have a non-linear impact on credit spreads. And what we mean by this is there's reason to think that small increases in Treasury supply could be a credit spread narrower as increases in supply should reduce the scarcity value of Treasuries and modestly cheapen Treasury rates. Now, if that cheapening doesn't feed into demand for corporate

debt, then we should see all else equal, a slight narrowing in credit spreads. However, there's also reason to think that more considerable increases in Treasury supply could crowd out corporate funding.

Dan Belton:
And we saw something like this in early 2018 when Treasury bill issuance totaled about $330 billion over just seven weeks. And that sent LIBOR-OIS to about 60 basis points, representing an increase in funding costs for corporations in the CP market. Now you could see a similar dynamic unfolding given this flood of Treasury supply that we're expecting out the curve in 2021. If the Treasury market sort of buckles under this heavy Treasury supply, we could see ripple effects out into spread markets. And to test this hypothesis, we incorporated the change in Treasury supply as well as its square and its cube just to allow for some nonlinearities in our econometric model. And the bottom line is that we found evidence of this hypothesis being true. Specifically, we found that small increases in Treasury supply, call it 3% or 5% increases, could narrow credit spreads by as much as about 10 basis points, but more meaningful increases would have a crowding out effect and would widen credit spreads over a longer term. And so in 2021, the question will become, will this Treasury supply bleed into the credit market? Will we hit that point of saturation where Treasury supply becomes a negative for credit spreads? And I think that's going to depend crucially on the demand for Treasuries. Specifically, what buyer base is going to step in and take on these increased Treasuries?

Dan Krieter:
Yeah. We talked a little bit about this in the Macro episode last week, but just to stress it because I think it's important. The most applicable environment we have to the current one was back in 2010 when the government was similarly funding the bailout for the global financial crisis. And looking at the numbers back then, the closest we got to the $1.7 trillion in supply we're expecting for this year was $1.4 trillion in net coupon supply after Fed purchases that came in 2010. And if you look at who bought that, the primary buyer was foreign investors and the other three largest were the Fed, which we already talked about. They're not really in the number. So excluding the Fed, US banks and then the US household sector, which is generally thought of as hedge funds in the US. Well, two out of those three, there are significant questions over whether or not they're going to be buying Treasuries in big size this time around.

Dan Krieter:
On the foreign investor front, obviously we have a declining US dollar. We also still have elevated trade tensions with some of the US's largest purchasers of Treasuries historically that may also work to constrain demand. And then looking at US banks, obviously the banking sector was in much weaker shape following the global financial crisis, there was a flight to liquidity, a flight to quality and ultimately the implementation of Basel ratios. So that happened over the course of years. There was just this general desire to go up in quality. This time around the banks are already sitting on massive amounts of high quality liquid assets. And not only would the regulatory regime will not be supportive if this SLR exemption that is set to expire at the end of March ultimately goes through, we estimated the flow at $150 billion in reserves/Treasuries that banks will have to shrink. Now, they could raise some capital against that, but they'll more likely want to shrink those balances, and deposits are notoriously difficult to shrink.

Dan Krieter:
So the SLR exemption is something very important to watch. Opinions are sort of all over the place on it, whether or not it's going to be extended. Our base case is that it will be extended, but that's a low conviction idea. There's just not much to go on. The Fed has been very, very quiet on that. So really all

we're saying there is that it makes sense to extend it so we think that they will, but we also thought they'd probably give the corporate facilities another three months because why not? But there was a strong reason why not. And they ultimately expired at the end of the year. So there is a real risk that the SLR exemption does indeed expire at the end of March. And then you've got even bigger questions around who's taking down Treasury. So just to bring it all together back to a high level, I think the near term outlook is still pretty bullish for credit spreads.

Dan Krieter:
We still have strong relative value and the primary threat, higher Treasury yields, doesn't seem like it's going to happen anytime soon. On the inflation front, we saw we had a pretty inline print today. Actually, it was actually slightly lower than expected. And even if we get high prints in the next few months, they're likely going to be discounted by the market, just primarily given base effects. And then the other way that we could get higher Treasury yields is through heavy Treasury supply, our analysis suggests that's going to take time. In the initial stages, as Treasury coupon supply begins to build, it could actually be a credit spread narrower as some of that scarcity value erodes. It's not until you reach a certain level of demand where that stock gets so high that then you start to crowd out investors. And I do think there's a real risk that could happen later this year, but I don't see it in the near term.

Dan Krieter:
So everything points to spreads continuing to grind lower here on the back of very, very strong technicals. But the rationale is building for the idea that later in the year might not be as supportive for credit spreads, given Treasury supply, given the potential for the Fed to take their foot off the accommodation gas pedal, given the possibility that the Biden administration starts to turn towards some of those less supportive business measures from a regulatory and taxation standpoint. The conviction's growing that spreads aren't going to be so low later this year, but for now I see no reason for the music to keep going for at least a couple months. And then Dan, before we wrap up here, the topic of heavy Treasury supply segues nicely to just an update on swap spreads, which we talked about at our last podcast two weeks ago, that they were moving higher, higher than they had in years in fact.

Dan Krieter:
And actually, we've started to field questions on, when is this disconnect going to sort of catch up. And by disconnect, I'm talking about the disconnect between swap spreads and credit spreads. Typically, the two are related. They are both generally viewed as risk metrics, swap spreads that spread between LIBOR and repo is credit sensitive, so obviously are credit spreads, but there's obviously been a big decoupling here. Credit spreads continue to narrow, swap spreads at multi-year highs. So the question we've seen is, is that correlation a comeback or is, for whatever reason, the correlation not as strong this time around?

Dan Belton:
Yeah, well, this move in swap spreads is also a pretty technical move and more so than a widening move in swap spreads. We're really seeing a steepening in the spread curve. So we're seeing a lot of outperformance by five-year and ten-year swap spreads, but two-year spreads, while they're trading at the wide end of their recent ranges, they really haven't broken out of that range. They're still trading in the high single digits and we attribute that to LIBOR remaining at the low end of its historical trading range. And so what are the reasons for this move and swap spreads? Well, I think it's primarily a repo story. Repo rates remain very low. So far printed at two basis points on both Friday and Monday of this week, before yesterday increasing to five basis points. But as long as repo remains low, I think that's going to pose a tailwind for swap spreads.

Dan Belton:
A couple other factors that we've cited as reasons for this move, there's increased bank demand for Treasuries. Alongside flows, there's mortgage convexity hedging, variable annuity convexity hedging and then of course, the pricing of assumed as the fall backs past that June 2023 date. So as for the path forward for swap spreads, I think that in the medium term, I think we're going to see the issues in the repo market worked out whether it's through a Fed adjustment to RRP and or IOR or heavy bill supply coming on the back of the fiscal stimulus agreement normalizing repo rates.

Dan Krieter:
So given that view, it seems like the correlation is just not going to come back this time because it's not really the drivers of wider swap spreads here. It's not anything to do with credit or risk. It is a tactical move, like you said, driven by repo and other factors. And just taking those factors you listed one by one, they should all start to be exerting less pressure on swap spreads to continue widening. Looking at the LIBOR fallbacks, we talked about that a little bit in our last episode. They're basically priced at this point, so to the extent that those were influencing swap spreads wider at all, that should be done here. And then bank demand for Treasuries in particular, I think this is an important one because I think anecdotally we've seen pretty strong evidence that this is at least contributing alongside repos, probably the second largest driving factor. But now 10-year Treasury OIS is basically trading just above IOER.

Dan Krieter:
So the bank buying in the belly, it's fair to question how much more juice there is in that. And then going back to the SLR exemption we talked about earlier, banks will be incentivized to reduce their Treasury holdings, not build them come the end of March. So it's possible that there are people that know that it's going to be extended, that we just don't know yet. That's certainly very possible, but going off of what we know now, there's just no reason to think that it's going to be extended yet. So that's another reason to think bank demand could fall. And then on the convexity hedging, I think that that could have been a significant factor as well, just given the move higher in long end Treasury yields and swap rates. But again, that too should start to run out of gas. And we've seen that. We've seen the widening in swap spreads now at least stabilize. They haven't retraced that move, but swap spreads have at least stabilized.

Dan Krieter:
Now we've seen some strengthening in repo. And I think looking ahead, I think repo's just going to do this. I think we kind of have this stable range in repo, and you're just going to have times where cash outweighs collateral and you have these moves lower. And in that lens, swap spread should stay toward the upper end of the recent trading range. I don't think that there's much room for them to continue widening, but I also don't necessarily think they're going to fall in the near term. I think long-term is that Treasury supply starts with the market upward pressure on repo could materialize, but again, like the impact on credit spreads that's going to take some time. And of course there will be people that say, okay, well what about bill issuance, it's supposed to be extremely negative. I want to stress right now that that's not a real bill number.

Dan Krieter:
Those numbers are on extremely negative bill supply. Those came out after the last Treasury financing estimate, which included no further stimulus in their projections. Well, we know for a certainty that's not the case. There's going to be more stimulus. And most recent headlines suggest it's going to be relatively large. The Democrats are pushing through with the larger package through the budget

reconciliation process. So that means that basically the entire size of the next stimulus package will be funded in bills. So this negative $1 trillion bill issuance, that's not going to happen. In fact, I think it's more likely that that bill issuance this year is closer to zero than it is to negative $1 trillion. So long-term, as Treasury supply starts to be digested, I think upward pressure on repo rates will come, but I don't think it's yet. So just putting a bow on swap spreads here, I think this stability here at the upper end, I think is what we should expect going forward with just transitory drops towards zero in repo until collateral starts to catch up in the form of both bills and coupons further out the curve.

Dan Krieter:
The big wild card here, of course being Treasury's cash balance. And its sort of this game of trying to guess what's going to come first. The decline and Treasury's cash balance or increase in Treasury supply. And that's not a game that anyone's going to tell you with certainty they know the answer to. So that's a big wild card and something to keep an eye on, but if you have to make some projection, it does seem like Treasury really is going to run down their cash balance this time in the first quarter or maybe into the second quarter. And that reserve supplies just start to hit the short end before major collateral increases. So that just really strengthens the rationale to think that swap spreads could stay wide here in the near term and then look for narrowing later in the year as collateral starts to catch up, starts to overwhelm cash supply. And that's when you start to see that upward pressure on credit spreads, at the same time swap spreads start to come back down again. Dan, any other thoughts there before we wrap up?

Dan Belton:
No, I think that just about covers it and looking down at the recorder, I think we are probably over time for today. So I think we should probably leave it there.

Dan Krieter:
Sounds good to me, Dan. Thanks for listening to Macro Horizons.

Dan Belton:
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