Riding the Blue Wave – High Quality Credit Spreads Transcript

Dan Krieter:
Hello, and welcome to Macro Horizons, high quality spreads for the week of January 6th, riding the blue wave. I'm your host Dan Krieter, here with Dan Belton, as we discuss the somewhat surprising result of Georgia's runoff elections and what a democratic control of the Senate might mean for credit spreads, both in the near and longterm in 2021. Finally, we conclude with a brief discussion on corporate MSSA issuance in the first week of the year.

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 currency markets, and the transition from LIBOR to SOFR. 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:
Happy New Year everybody. I want to start off by saying we hope you had a very relaxing holiday season. Hopefully you had a chance to take some time off and relax a little bit during the holiday season, after a very trying 2020. We certainly did. We haven't recorded in the past couple of weeks, and I think it was a much needed and very welcomed break for everybody. But we're back now in 2021 and hitting the ground running with a major market moving event in just the first week was the Georgia runoff elections being held yesterday. But before we get to that, Dan, why don't you, in two minutes or less, try to do your best to catch us up on what we missed in spread markets in the last two weeks.

Dan Belton:
Yeah. So spreads spent the second half of December grinding narrower, despite a couple of potential headwinds that they faced. So first we had this new variant of COVID, which originated in the United Kingdom and has since spread elsewhere. And secondly, some disappointing headlines with respect to the vaccine distribution. But importantly, both of these issues are things that the market is willing to look past. So with respect to the new strain of COVID in the United Kingdom, it's not obvious that that is more deadly than the original strain of COVID or that it's more resistant to the vaccines. And then with respect to the distribution issues with the vaccines, that was largely priced and something that's likely to improve over the coming weeks and months as logistical issues are ironed out. So spreads, despite these factors, continued to outperform, which is really to me, emblematic of the strong demand for credit. So

spreads currently sit right around pre-pandemic lows and right around levels that we saw at the beginning of 2020.

Dan Krieter:
Yeah. And you used the words looking past. I think that is really the most important thing is that we continue to look past what's expected to be a pretty difficult time in the winter months regarding COVID and these variants, it's something definitely to keep an eye on. You mentioned the one in the United Kingdom. It does appear to be more communicable, but it is maybe not more deadly nor is it vaccine resistant. We're tracking the one in South Africa as well. There's a bit more concerned in the South African variant that there could be some resistance to therapies that may eventually lead to resistance to vaccine. But so far we've been given no reason to think that vaccines will not be effective against these new variants. And just for clarity sake, when I say effective, I'm really referring to near term immunity granted by vaccines. The one thing these variants do seem to increase the likelihood of, if not ensure, is that we will need to be vaccinated against COVID at regular intervals, perhaps as frequently as annually like we get the flu shot.

Dan Krieter:
Now, there's not going to be lasting durable immunity, it seems, now with these variants, but I don't think that represents a change from the base case. I don't think anyone is expecting durable immunity at this point. So if that's the main takeaway from the variants, then I don't think that should result in a big reprising of spread. So this continued downward grind, that's what we were expecting. And as we iron out some of these technical issues with vaccine distribution, and as long as variants in vaccines stay on path, I think that's the way the market will continue to trend.

Dan Krieter:
Although I guess the one trend that maybe we have to continue monitoring is willingness to take the vaccine. There's been some debate about that back and forth over the course of the past year. I did think after the results of the trials were so compelling, I thought that that might start to fade, but it appears that vaccine willingness is still something that the market will be contending with going forward. But like you said, Dan, we're looking past all that for the time being, I think that's the way we've been leaning as well heading into this year. But now in just the first couple of business days of 2021, the market is dealing with its first big surprise. And that is that the Democrats have indeed taken control of the Senate after winning or apparently winning both runoffs in the Georgia elections taking place yesterday. And Dan, how has the market reacted to that outcome?

Dan Belton:
Yeah, somewhat surprisingly, equities are up as we record this, the Dow is up between one and a half and 2% with the S&P up 1%. The NASDAQ is lagging, which is unsurprising given the likely headwinds that some tech companies are likely to face.

Dan Krieter:
So a couple of ways to interpret the NASDAQ under performance. I think the one is that yes, a unified Congress and president might lead to the potential for more antitrust scrutiny on the tech giants. The other one just being that the tech giants, obviously that's where we've been going for this safe haven type of trade. And now with more students likely to come, that you want to be on more higher beta type of stocks that are going to participate more directly in a recovery. Which do you find more likely here?

Dan Belton:
Personally, I think the former is more likely. I think it's going to be pretty name specific and increased regulation I think is one of the major things that's likely to come from this blue wave. Then credit spreads are also about one basis point better today, not terribly surprising. But I think one of the most important market moves is the bear steepening of the treasury curve. And that could lead to some potentially longer term headwinds for credit spreads, right?

Dan Krieter:
Yeah. I think biggest news of the day in response to the Georgia election is probably not in the credit spread market, it's in the treasury market where we've seen the ten-year treasury sort of blow through 1%. And as we record this podcast, it's trading at basically 1.05. So I think that's certainly the takeaway. I'm looking at the screen now, the Dow's up 527. So that's definitely a reversal where we were heading into the day. Obviously, risks got off to a more tepid start. But now as the Georgia results are really becoming clear and it's pretty obvious now the Democrats are going to take the Senate, it's shifted to a risk on tone, and that's what we were expecting heading into the Georgia election. At first, that might seem a little counterintuitive since the risk on response to the November result was partly attributed to the fact that there's going to be gridlock that was going to prevent the Democrats from pushing through some of the more progressive agenda. Then if that gridlock is priced out, knee jerk, you should see spreads suffer.

Dan Krieter:
But heading into the Georgia election, we thought actually, just given the momentum and given all the monetary accommodation that continues to course through the financial system that a blue wave would actually be looked upon favorably by risk assets, just given what that pretends for fiscal stimulus, both in terms of size and timing after President Biden's inauguration. So it does seem like that is what's settling in now is optimism there around stimulus. But to your point, I do think looking longer term, we think spreads will continue to narrow in the near term. I do think that now because Democrats are in control, maybe the lows of 2021 won't be as low as they would have been if gridlock had remained in place. Does that make sense?

Dan Belton:
And just to add one point to the reasons for this market optimism we're seeing today. This 50/50 split in the Senate, yes, the Democrats have the tie break from the vice president. But I think there's some reason to believe that the chances of pushing through stimulus are significantly greater today than they were yesterday. Whereas the odds of pushing through major tax reform are less meaningfully changed than they were yesterday, just because of the

filibuster and potentially less political willpower to get something like that through. Whereas stimulus seems all but a certainty at this.

Dan Krieter:
Yeah. I can get on board with that interpretation. But even still, at the end of the day now, Democrats, if they really want to, can push through whatever they need to push through, through Congress. And yes, while I agree with you that means that maybe some of the very most progressive platforms on the democratic agenda won't make it through, certainly now it's inarguable I think that the odds of tax increases have also increased here and have potentially more regulations surrounding corporations. So long-term, I think that will weigh on spreads maybe in the second half of the year. Assuming everything stays on track with the health crisis, once people have been vaccinated, we can hopefully move on and Democrats are able to refocus on some of those high priority campaign promises moving on to healthcare or talking about tax reform, the market will price in a higher likelihood of that.

Dan Krieter:
As well as you mentioned the stimulus is basically a foregone conclusion at this point. I agree with that. You could even say that an infrastructure package, that many, including ourselves, has discounted with the split Congress. Now, all of a sudden, you have an infrastructure package back on the table here that could actually be really inflationary. So obviously the reflation trade is what's putting upward pressure on treasury yields today and low treasury rates was something that was a key factor underpinning our call for credit spreads to hit all time lows this year. Treasury yields staying very, very low was one of the main factors behind that call. And this reflation rate, even if we continue to think that actual inflation won't take off the way the market might be expecting it to at this point, even if it's not realized in the longterm, I do think that this reflation idea, it's going to have legs now for a while, and that will keep an upward influence on treasury yields that might prevent credit spreads from reaching the lows we had originally thought they might reach in the first half of the year.

Dan Belton:
Yeah, Dan, I agree. Just from the technical standpoint, I think treasuries now look marginally more attractive than spread products, all else equal. Now that 10 year treasuries have a one handle. And I think as long as we stay in that range, it's not going to be a significant headwind for credit, but it does remove some amount of the impetus to believe that spreads are going to reach this 75 basis point range that we had been expecting.

Dan Krieter:
Right. I think the outcome of the election was enough to get us to change our forecast. Coming into the year, we were projecting spreads to make all time new lows on the index with our target in the 70 to 75 basis point range. Just given the outcome of the Georgia election and its ramifications for what it means for both treasury yields and potential legislation later in 2021 or even next year, we revised our targets higher this morning. And now look at spread lows for 2021 falling in that 80 to 85 basis point range, which is basically in line with all time lows, depending on exactly what you consider all time lows. I think we can get there. We'll have this

grind narrower in the early part of the year as vaccine optimism stays on track more and more people get the vaccine and we have this bigger push of stimulus.

Dan Krieter:
I want to touch very briefly on swap spreads, which have moved in response to the Georgia election. We've seen a bit of a narrowing this morning and we actually now in a basis point and a half on short end spreads since the beginning of the year. And now basically sit smack dab in the middle of the six basis point range that spreads have been contained in since May. And the narrowing this morning makes sense, just given what the increased stimulus package means for treasury supple going forward, that increased collateral should weigh on spreads. Dan, what are your expectations for swap spreads here going forward?

Dan Belton:
Yeah. Swap spreads have not been very volatile over the past, call it six months. I don't expect that to change meaningfully. As long as the fed is in the market doing QE, I don't expect there to be a significant narrowing in swap spreads like we saw in 2019, with this excess collateral problem. So we're going to have two major forces continuing to be active in the repo market, which is heavy treasury supply. And that's going to be largely offset by active fed purchases. And so I expect continued range-bound trading and front end swap spreads. This blue sweep probably has a marginal narrowing pressure, and we could see further narrowing if there are additional developments leading to heavy treasury supplies, such as an infrastructure spending program. But I think this range in the end is likely to hold for the foreseeable future.

Dan Krieter:
I think that this neutral stance is probably the way to go. If I had to pick one, I'd probably rather be short spreads than long at this point. But like you said, with the fed buying so much in the treasury market, it's hard to see spreads really narrowing much. And you have this persistent upward pressure from the market continuing under price is the fallbacks surrounding LIBOR transition. That matters less now that LIBOR was pushed out to June 2023, but it is still a factor that we'll still keep at least some upward pressure on swap spreads and likely keeping them in the range.

Dan Krieter:
So if I had to pick one, I'd pick short, but I don't have much commitment in either direction, and I think the neutral stance is the way to look at it. It's just going to be in this range now, I think, with the fed so involved in the financial system. Okay, Dan, why don't we transition the conversation over to primary markets, if not for the Georgia election, that would certainly be the topic that we're focusing on today. Obviously January the largest month of the year in corporate and SSA supply, really sets the tone for the rest of the year. So other than Georgia primary market's likely the biggest story, how has corporate issuance unfolded in the first couple of days of the year?

Dan Belton:

So just through the first two days, we're off to a remarkably strong start in corporate supply. We've had about $43 billion issued through the first two days, which is somewhat coincidentally the exact same number that we saw in the first two days of 2020. Now the first week of 2020 ended with about 63 billion. We might come a little bit short of that. We were expecting about 50 billion this week, which was, I think, a little bit higher than most of the rest of the street. But I would say likely to come a little bit above that 50 billion mark. We had projected 150 billion in supply for the month of January back in December. And I think that seems still largely on track. We're going to see continued heavy supply next week, and then it should drop off a little bit as domestic companies enter earnings blackout periods. So I think around 150 billion for January remains a reasonable pace to expect, and that would be pretty high. That would be the highest total since 2017.

Dan Krieter:
And another trend I want to highlight is just as pushed towards green or sustainable debt issuance in the corporate market. We've talked a lot about this in our written work. We haven't talked about it so much here, but just to put it into numbers, last year, sustainable debt issuance, I'm talking labeled sustainable bonds, breached 450 billion for the first time. For reference, the previous record, 2019, was about 270 billion. So we're still on this exponential growth in the sustainable debt market. And that's really being driven by not green labeled issuance, but issuance in the sustainable or social bond market. Last year, social and sustainable bond issuance was 215 billion, nearly as much as green bond issuance of 240. For reference, in 2019, green issuance was 2015 billion and social sustainable issuance was just 55. Now I'm talking all currencies around the world. So obviously in the US dollar market, these numbers are lower, but the trend I'm trying to highlight is just this growth in green slash social slash sustainable debt markets, ESG if you will as a whole, continues to be exponential.

Dan Krieter:
And I think with President Biden taking office, we could see a push in the United States to increase quote unquote greenification of the financial system, if you will. Incoming treasury secretary, Janet Yellen, has already talked about incorporating more ESG credentials into the financial process. The fed has recently signed on with the group of other central banks around the world. We're seeing the US starting to engage more and more on the sustainability front, and it's worth noting that President Elect Biden, when he was campaigning for president, he put forth a plan for an infrastructure spending program, and there was a green component to that spending program. Now could that eventually someday be partially financed with green bonds? Certainly not this year and probably not even next year, but years down the line, it's a possibility. We know treasury monitors markets for new types of issuances.

Dan Krieter:
They brought out a floater. Expectation is they'll be bringing a SOFR floater in the not-too-distant future. Certainly they've been monitoring what's going on in the sustainable debt markets globally. So it's just a trend that's worth keeping your eye on is the big growth in social and sustainable debt markets and green markets in the United States. Particularly in the corporate sector, I think we'll continue in 2021. And now finally, just transferring over to the

SSA market, issuance to start the year has been relatively light. Actually we've only had three new deals, a $5 billion issue from EIB, and then we had a 10-year benchmark from IADB and another five-year from KBN. Just three new deals, totaling 11 billion so far. For reference, over the past five years, that would be the lowest in the past five years. The previous lowest 2019, where we had five deals for a total of 12 and a half billion. Obviously we're beneath that now. It looks like we'll finish that way with the slate empty so far this morning.

Dan Krieter:
Typically we see issuance on average over the past five years, even including that late 2019, we'd average about seven deals in the first week of the year with supply above 18 billion. So this week's been disappointing. It's possible that that's just because borrowers wanted to avoid the Georgia elections. And if that's the case, issuance should be huge next week. But if next week comes and goes, we don't see a relatively large bump in SSA supply, it might be time to start looking more deeply at potential other explanations. So far, our forecasts for January supply of around 50 billion remains intact, and we still expect to see heavy supply both this month and this year, with SSA barring programs remaining large, but we are not off to a hot start in 2021. And that just lends credence to the notion that any new issuance session and deals coming out should be looked at as attractive if supply is going to continue to remaining light.

Dan Krieter:
Okay, Dan, well before wrapping up, any other thoughts you want to share on corporate supply?

Dan Belton:
Just piggybacking off of your point about the new issue concessions, demand for corporate credit remains very, very strong, and any concessions is seemingly pretty hard to come by. We've had an average of -0.4 basis points of new issue concession through the first two days of this year. So in the same sense we recommend in the corporate market as well, getting involved in any deal that, as any new issue concession has tight pricing in the primary market is likely to continue for the next several weeks or months.

Dan Krieter:
Just one final note, things we're looking for, there's only what, less than 15 days in Trump's administration remaining. And we are looking for a modification to the treasury's preferred stock purchase agreements with the GSE's between now and January 20th. So be on the lookout for that. We'll be back with our thoughts if and when that does materialize in both written and podcast form in the next week. And otherwise, I think that'll do it for us. Thanks for listening.

Dan Belton:
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