Fed installs Backstop for Corporate Bonds

June 24th 2020

FED addresses Lack of Liquidity in Corporate Bond Market

Last Week, the Fed announced that it is going to buy single corporate bonds to ensure a functioning secondary corporate bond market, which is a historical move and a positive sign for a market that was close to collapsing in March this year, when liquidity disappeared just in a matter of days.

The Fed is going to expand the scope of its bond purchase program by creating a "broad, diversified market index" and purchasing individual corporate bonds in the secondary market. This is another remarkable step of the Fed to prove its commitment to install a backstop for the corporate debt market. With this adaption, the Fed will not only invest in bond ETFs, but also in single bonds. Federal Reserve Chairman Jerome Powell reinstated the central bank's goal of prioritizing a proper market functioning via its purchases. He added: "I don't see us as wanting to run through the bond market like an elephant doing things and snuffing out price signals or anything," Powell told the Senate Banking Committee. "We want to be there if things turn bad in the economy." Powell also said that market functioning has improved "substantially" since setting up its operations.

Broker Dealer Inventory of bonds in bn USD – No longer a reliable backstop

With new Dodd-Frank regulation after the global financial crisis in 2008, broker inventories collapsed, which has affected bond liquidity negatively.

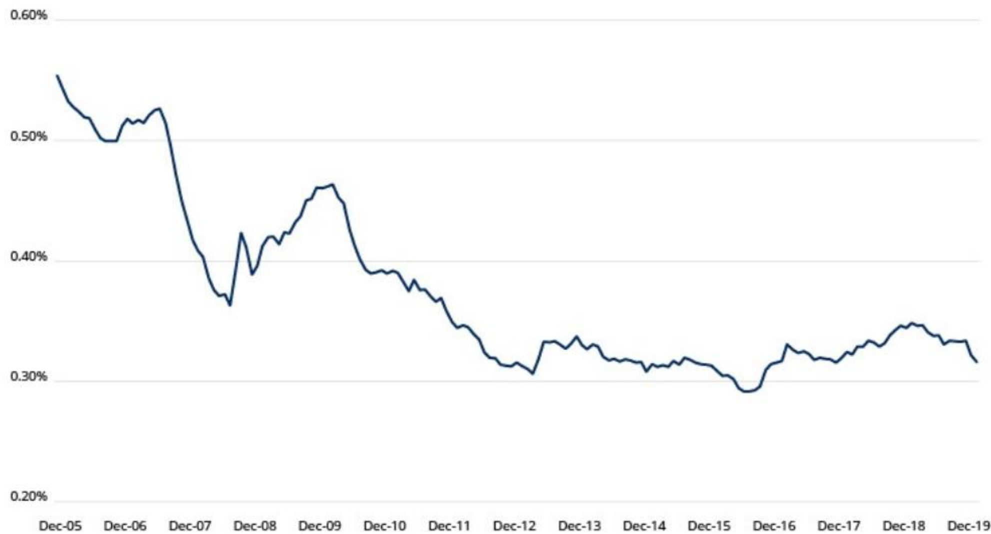
Source: Federal Reserve, Schroders

Since the second week of May, the Fed has been purchasing corporate bond ETFs with "broad exposure" to U.S. investment-grade debt and some high-yield debt from companies that fell below investment-grade after March 22. The Fed's corporate bond purchases are currently done through its "Secondary Market Corporate Credit Facility", which began operations on May 12 with plans to continue through September 30. The facility is backed by USD 25 bn of equity from the U.S. Treasury, appropriated through the Coronavirus Aid, Relief, and Economic Security (CARES) Act passed in March. A separate facility, the "Primary Market Corporate Credit Facility", plans on purchasing corporate debt directly from the issuers themselves. The facility, which is backed by USD 50 bn of equity, has yet to go live. Combined, the two facilities can be levered up to support as much as USD 750 bn in purchases. As of June 10, the secondary facility had only USD 5.5 bn of purchases, all in bond ETFs.

Drop in Trading Volumes

Liquidity in corporate bond markets has been dropping since many years as the chart below does well demonstrate:

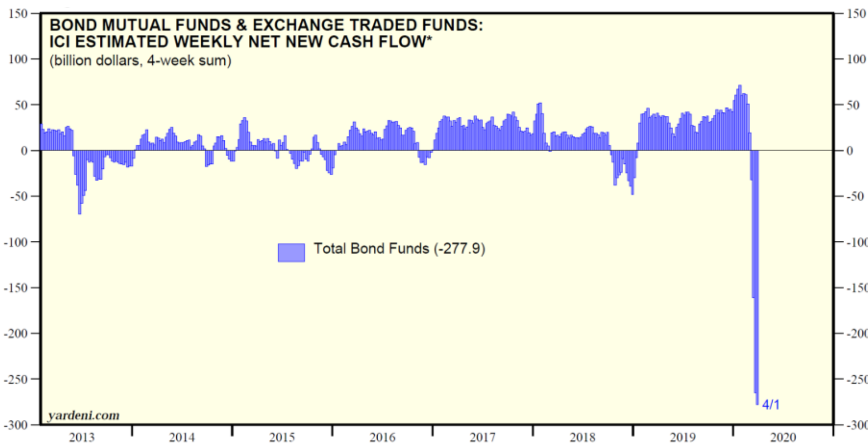
12-month average daily traded volume / market value outstanding



Source*:* FINRA TRADE, Refinitiv, Schroders

In March, when the Covid-19 crisis escalated, bond markets had been confronted with a sudden decline in liquidity. The immediate global lockdown resulted into a situation with close to zero demand for bonds and risky assets in general. Liquidity fell substantially at a time when investors were panic selling.

Weekly mutual and ETF bond fund flows in bn USD



Source: yardeni.com

Market sell-off in combination with an abrupt ebbing down of demand resulted in panic & forced (i.e. margin calls) selling. A vicious cycle that has led to the fastest liquidity shock in history.

Corporate Bond Risks: Liquidity, Default and Duration Risk

If we simplify the main risk factors for the determination of a bond price, we can summarize the following three main parameters among others in a given reference currency:

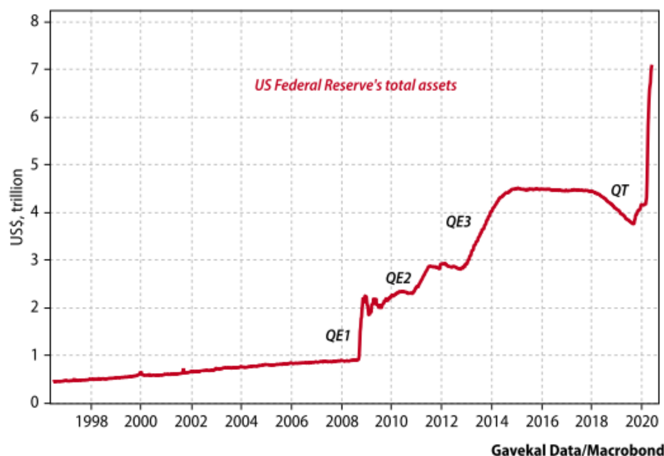
1. **Liquidity**
2. **Duration**
3. **Default**

Risk Factor	Risk & Characteristics	Reduce impact via	FED's direct impact
Liquidity	Widening bid-/ask spread Typically temporary	Focus on large issuers Holding bond to maturity	Reducing bid/ask spreads
Duration	Rising rates Cycle dependency (inflation)	Focus on short-term bonds Holding bond to maturity	Keeping rates low
Default	Payment default Permanent loss of capital	Focus on high quality bonds Selection & diversification	Reducing credit spreads

Source: Alpinum IM

While Central Banks used to have a primary focus on steering the level of short term interest rates, their scope of actions and influence has grown exponentially after the financial crisis in 2008 and got now a further push with the "Covid-19" crisis.

US Federal Reserve's total assets "exploded"



Unprecedented market stimulus benefitted disproportionally the most liquid bond markets (i.e. US Treasuries, IG bonds), while other more niche credit markets have only partially rebounded and offer significant relative value.

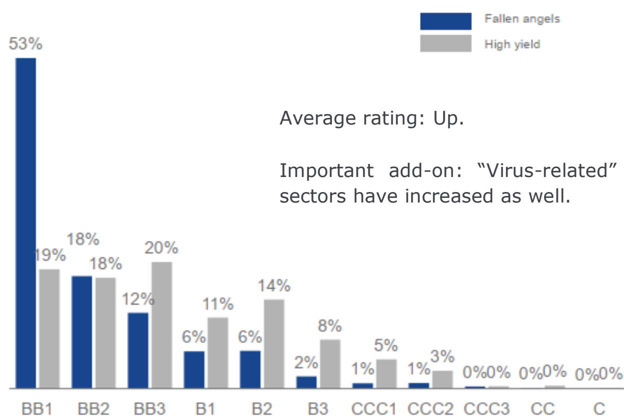
Historically lowest interest rates, lower credit spreads and increasing liquidity leads not only to a better functioning market and higher bond valuations, but it ultimately **reduces also the number of corporate defaults. While this is a welcomed short-term positive, it also increases the number of "zombie" companies**. Such companies can only "survive" thanks to the benign market conditions, but would otherwise go bankrupt. Hence, this massive market support leads to long-term costs for the economy as the capital will not be efficiently allocated. Productivity gains will be diminished and the long-term GDP growth rate will be negatively affected.

Some niche or more complex to understand markets have not equally benefitted from the "liquidity avalanche" and (barring a renewed global lockdown due to "Covid-19") offer today **very attractive relative value**. In the following pages we illustrate a few interesting relative value or catch-up opportunities in the field of fixed income. **Importantly, the general path will depend on the economic environment and the inherent default and recovery probabilities.** We will briefly touch on some of these topics in the following pages.

Rating Downgrades and Spiking Default Rates

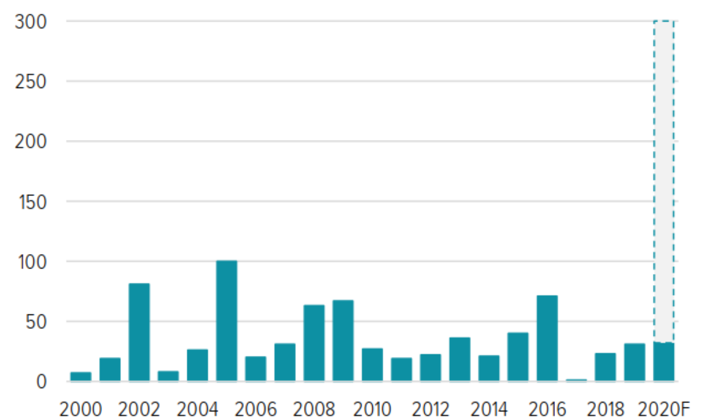
The turmoil in connection with the "Covid-19" has affected the global financial market in a never seen speed and magnitude. In-line with most other asset classes, credit markets were faced with a significant sell-off across all rating categories and segments. During the crisis, the number of bonds trading at distressed levels has increased significantly. A wave of rating downgrades has occurred including downgrades from investment grade down to high yield ("fallen angels"). The number and size of the downgrades are unprecedented and has also meaningfully affected the current split of the high yield market - in a "positive" sense, as the average rating quality has increased.

Fallen Angels flood the HY market



Source: ICE BofAML; data as of end April 2020

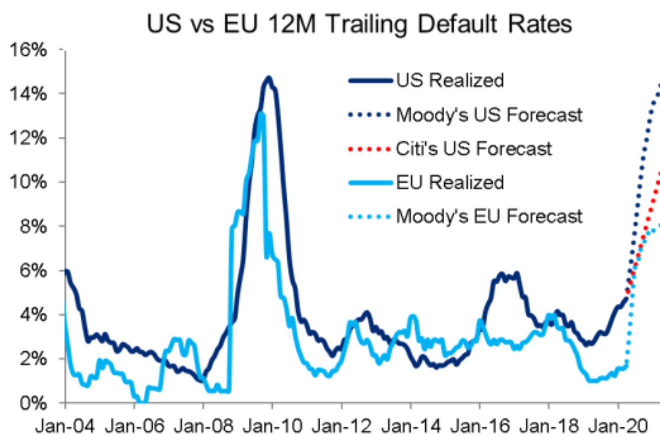
Downgrades from BBB to below IG in USD bn (Est.)



Source: BB, Fed; Kempen; Forecast by JPM, Citigroup, Marathon

While we face the fastest economic downturn since WWII it is still unclear, what the economic damage will be over a 12 months horizon. For sure, default rates will spike and the unprecedented fiscal and monetary stimulus will prevent the economy from a total fallout. At the moment, most credit experts expect either a similar default cycle as experienced during the "GFC" (Great Financial Crisis) in 2008 (peak defaults ~14%) or a softer outcome. The chart below illustrates a variety of forecasts, which have on the margin been improved in recent weeks.

Default rates should spike to similar levels as in 2009



Source: Moodys, Citi

Corporate default rates are spiking, but might be not as bad as originally feared two months ago.

Expected loss rate if US HY defaults were 10%:
10% ./. estimated average recovery rate of ~30% = -7%.

Given the abrupt economic shock and the fast increase of corporate defaults, it is expected that the recovery rates will be negatively affected. Please see for further information on the next page.

Syndicated Loans

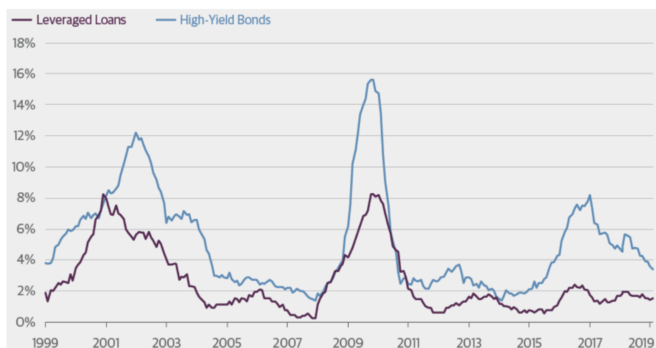
Syndicated loans (synonyms are "loans", "leveraged loans" or "bank loans") have recovered a bit more than two thirds of their March-drawdown. The average loan price (measured by the S&P Leveraged US Loan index) traded down from around 97 cts to the lows of 76 cts and rebounded now to a level of around 90 cts. Please see the chart below for a long-term perspective in terms of return generation for this asset class. Over the last 20 years, loans suffered two significant drawdowns, one in 2008 and now in March 2020. The price recovery had been strong past the 2008-crisis and for the current sell-off, the asset class is so far also on a promising track.

Growth of 1 USD in the S&P/LSTA Loan Index – A longer term perspective

Source: LCD, S&P/LSTA Leveraged Loan Index, Alpinum IM

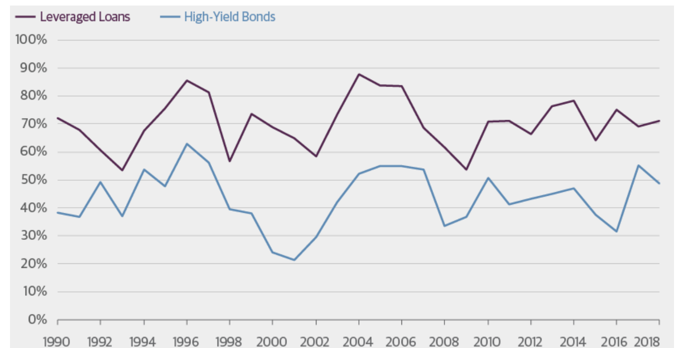
The default rates for Loans vs. HY bonds have always been lower (➔ more senior in capital structure) and the recovery rates higher (stronger covenants). Historical loan recoveries have averaged at around 70%, but because of current looser covenants, recoveries should be lower, i.e. 50-60%. This leads to an estimated loss of ~4% (~8% defaults x 50% "severity"), which would be compensated by the yield of the asset class, which is now 5.6% p.a.

Default Rates: Loans vs. High Yield Bonds



Source: Guggenheim Investments, Wells Fargo

Recovery Rates: Loans vs. High Yield Bonds

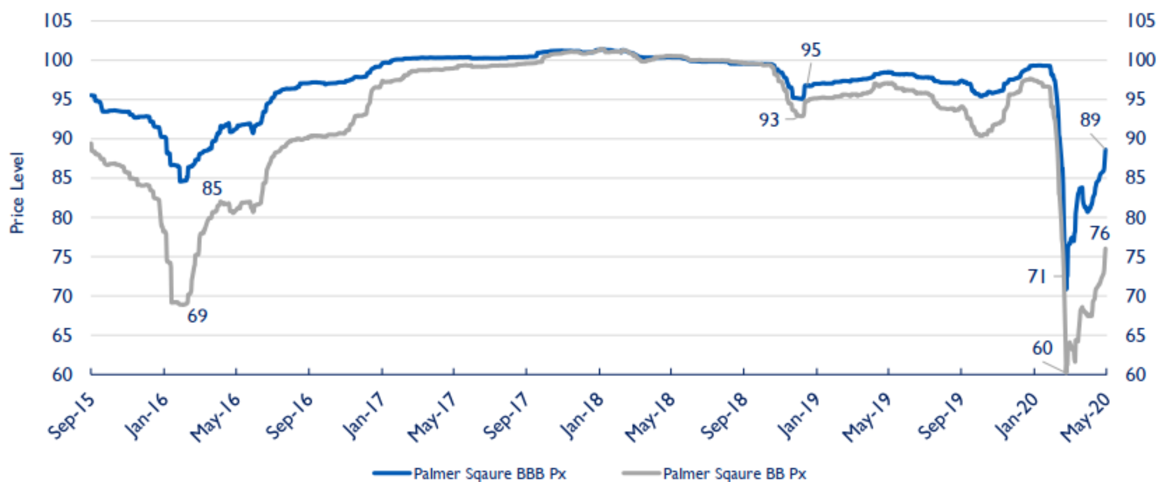


Source: Guggenheim Investments, Moodys

Higher rated senior debt CLO tranches have further room to recover

When bond markets collapsed in March 2020, CLO markets were hit even harder. The highest quality markets (i.e. AAA, AA, A tranches) have almost fully rebounded, whereas the mezzanine tranches (i.e. BBB/BB) have only partially recovered from their lows and offer significant value vs. the "common" BBB/BB single bond market. However, specific expertise and experience is required to filter out the highest quality tranches in these sectors.

Price development of BBB and BB tranches



Source: Palmer Square

Should corporate default rates not exceed the levels of 2008, the price recovery in selective BB/BBB tranches has further room to run as the chart above does illustrate.

AAA to A-rated CLO bonds can withstand a severe economic crisis

Highest quality CLO tranches suffered lower defaults vs. the "normal" bond market. For example, AAA or AA rated CLOs have never experienced a single default and BB rated CLOs have a much better "track record" than their counterpart - single B rated bonds.

Moody's CLO Tranche Defaults vs. Corporate Default History (Cumulative)

	U.S. CLO Default Rate	Total Tranches	Defaulted Tranches	U.S. Corporate Default Rate		
	1993 – 2018	1993-2018	1993-2018	5 Year	10 Year	15 Year
AAA	0.00%	3,833	0	0.1%	0.1%	0.1%
AA	0.00%	1,961	0	0.3%	0.8%	1.3%
A	0.08%	1,816	1	0.8%	2.2%	3.6%
BBB	**0.63%**	**1,791**	**24**	**1.5%**	**3.3%**	**5.7%**
BB	**1.10%**	**1,477**	**26**	**7.9%**	**15.1%**	**20.8%**
B	1.20%	358	4	20.3%	33.6%	41.6%
Total	**0.31%**	**11,236**	**55**			

Source: Moody's, CIFC

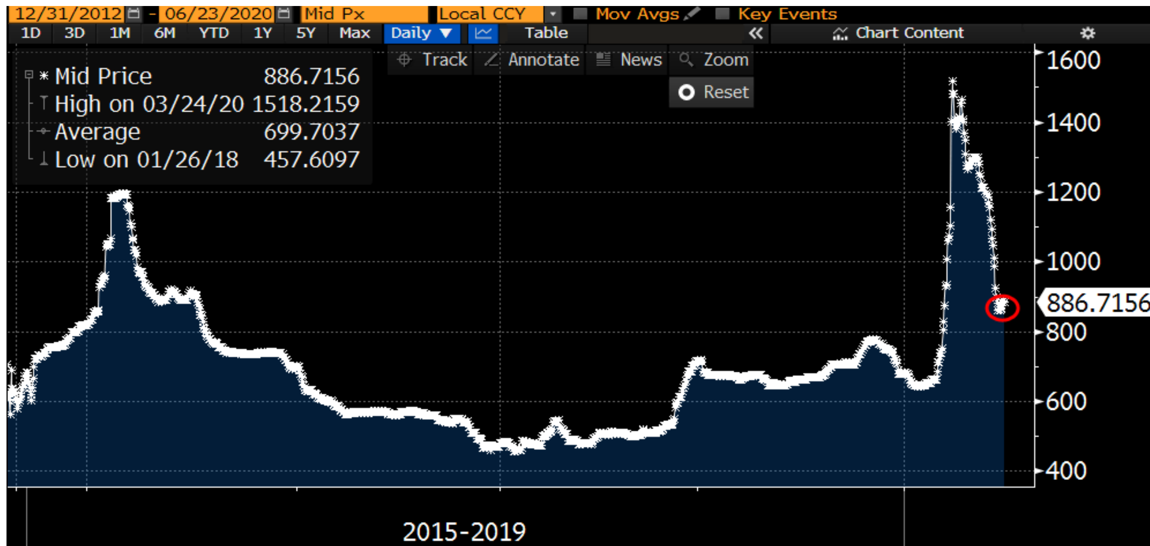
Highest rated tranches benefit from large subordination (~35%) and actively managed portfolios.

BBB/BB tranches have been more resilient than BBB/BB rated single bonds.

Key risk: Cumulative defaults surpass within a short period of time a certain threshold so that equity tranches don't absorb all default losses anymore.

CLOs experienced severe drawdowns in March and depending on an investor's default outlook, selective BB/BBB tranches offer attractive value even if we faced slightly higher default rates as experienced in the great financial crisis in 2008. The chart below illustrates the historical spread level of BB rated bonds since the end of 2012. At a current yield of 886 bps p.a. (+4% vs. an average BB 7 year single bond), the income generation is high and the outlook for price appreciation is still appealing should default rates not surpass the levels experienced in the GFC.

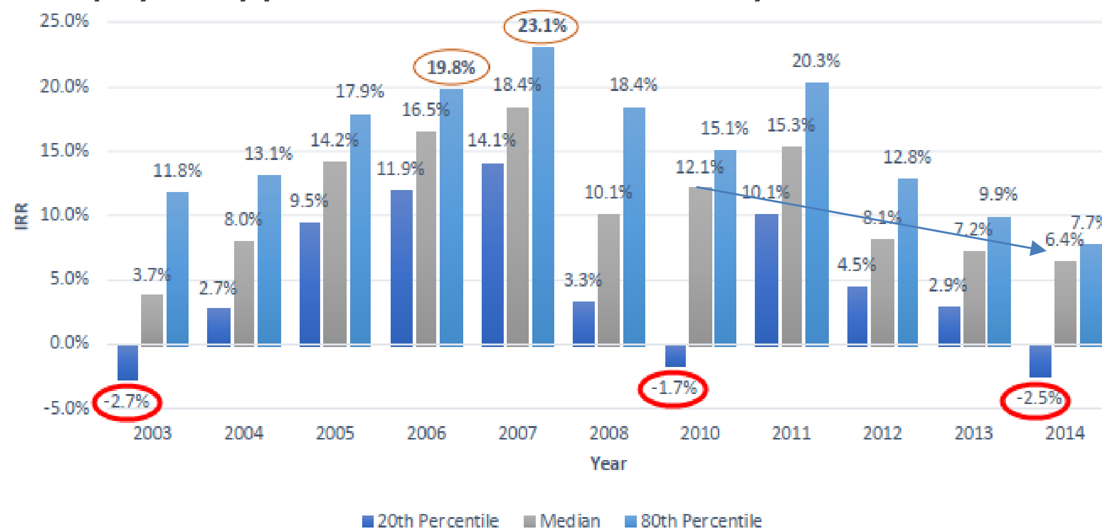
Yield in CLO BBs (Discount Margin)



Source: Bloomberg, Palmer Square, Alpinum IM

Equity tranches are the riskiest CLO exposure and are faced with significant losses in case default rates surpass a certain level. Such investments are only suitable for experienced investors with a very high risk tolerance. After the market sell-off in March/April, valuations are at depressed levels, but in case the crisis is going to worsen, significant losses could still occur despite you are now able to buy these papers at low valuations. What weighs also negative for these highest risk papers is the fact that the majority (>80%) of the loans, which serve as collateral for the investors, are described as "Cov-lite" (loan issued with fewer protections for the lender). Nevertheless, historical analysis suggests that good selection skills can lead to outsized returns.

CLO Equity IRR by year of issue – Terminated deals only



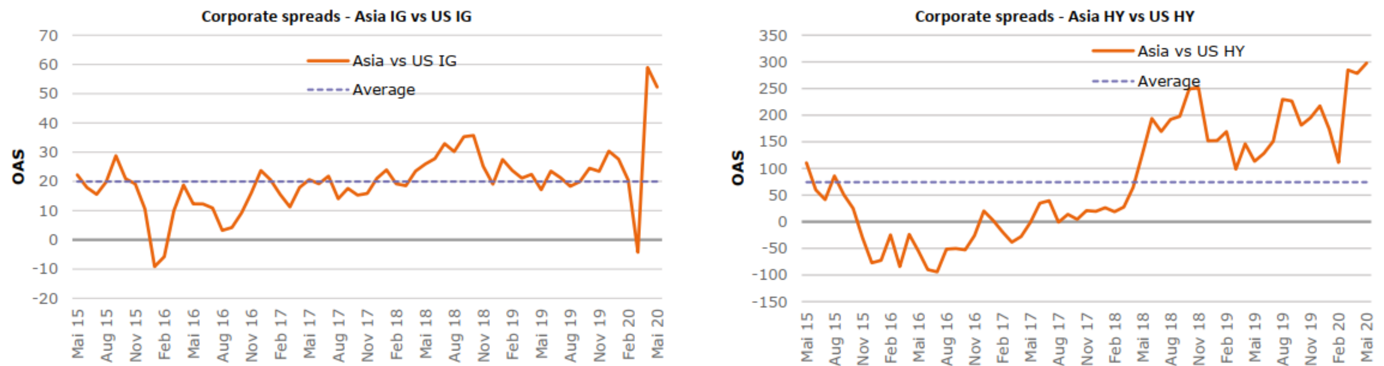
Historical returns have been double digit on average, but decelerating in recent years.

Selection for quality is a key return driver, even more now, when corporate default rates rise.

Source: Wells Fargo, JPM, Alpinum IM

Asian Bonds trade at Premium vs. U.S.

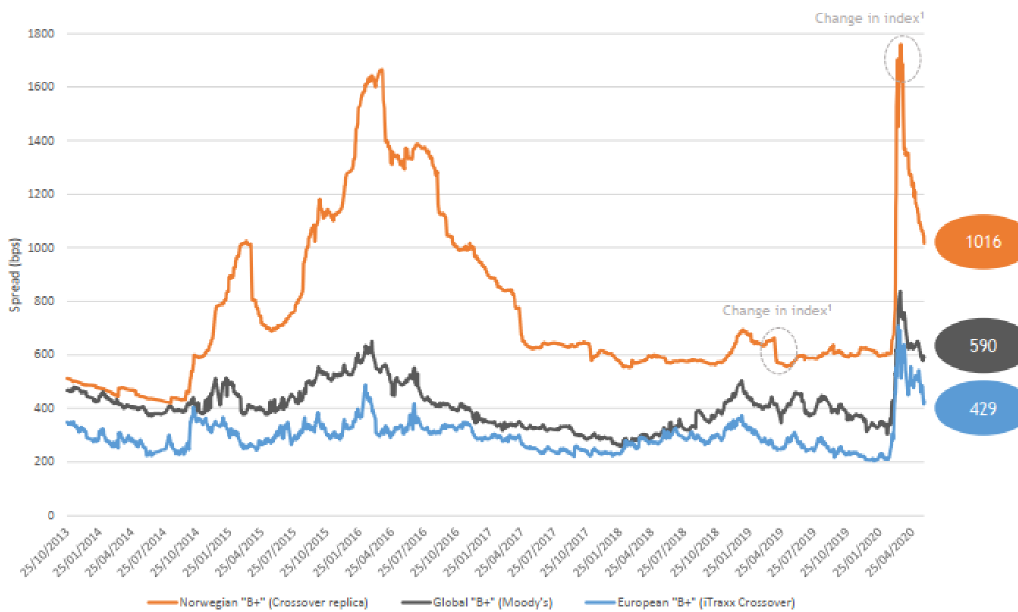
Asian investment grade and high yield bonds trade at significant higher spread levels as compared to the U.S. Hence, from an investment standpoint, this market offers significant relative value.



Source: Barclays, NN, Alpinum IM

At the moment, Asian high yield spreads trade almost 300 bps wider as compared to the U.S. although, the default outlook for Asia is much more favorable as compared to the U.S. With respect to investment grade bonds, the spread duration risk is much lower in Asia with currently 4.8 years as compared to the U.S. with 7.9 years.

Norwegian High Yield B+ Market trades at Premium vs. International markets



Source: Sparebank 1 Markets, end of May; (1): Some distressed issuers left index/new issuers added

Scandinavian bonds were hit very hard by the liquidity crisis as the market is narrower as compared to continental Europe or the UK. In addition, the Norwegian high yield market took a hit due to its structural large weight in the energy and shipping sector. So far, the rebound in Norway has been less pronounced vs. the international markets, which leaves plenty of room for active bond pickers to identify undervalued bonds with significant additional yield.

An opportune time to look into Credit Investments

With interest rates at all-time low levels, yield seeking investors are forced to look beyond the obvious. After the recent sell-off, there exists a wide range of sectors offering more attractive income sources as compared to US Treasuries. Please see below the historical development of the yield of US 10 Year notes: It has never been lower.

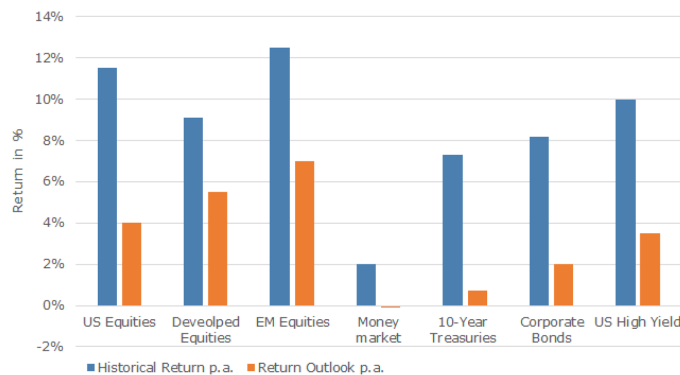
Source: Tradingeconomics.com, U.S. Department of the treasury, Alpinum IM

Current yield is at 0.7% p.a. and break even inflation at 1.4%, what leads to a real negative rate of -0.7% when holding 10 year UST bonds.

Outlook

Investors face difficult times to generate attractive returns as past returns will not act as a good proxy for future returns as interest rates trade at historical low levels and many equity markets have strongly rebounded and show again high P/E ratios.

Outlook: 10 Year Return Expectations



Source: BCA, Alpinum IM

With a 5 or 10-year investment horizon, an investor needs to be realistic in the expected return or cash flow generation. The history will not simply repeat itself.

The truth is that investors need to downsize future return expectations.

As the table above demonstrates a "plain vanilla" portfolio will not achieve similar returns as in the past. An investor needs either to adjust his return expectations or increase the risk budget and/or tap different (additional) fields of yield and return generation.

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