MAN GLG CIO COMMENTARY

THE WATCHWORDS FOR 2019: CAUTION, CLARITY AND CROSS-ASSET-CLASS VISIBILITY

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INTRODUCTION

In the wake of October's and November's turbulence, I was struck by the level of caution exhibited by the algorithms of quant-driven private wealth asset allocation strategies. Where the funds had scaled back equity holdings modestly in the wake of the volatility of January and early February, this most recent step downwards elicited intervention of an entirely more dramatic degree. Equity allocations were slashed to near minimum holdings by many models. The drawdown in the S&P 500 Index on each occasion was very similar – around 10% – but clearly, something else was spooking the algorithms this time around.

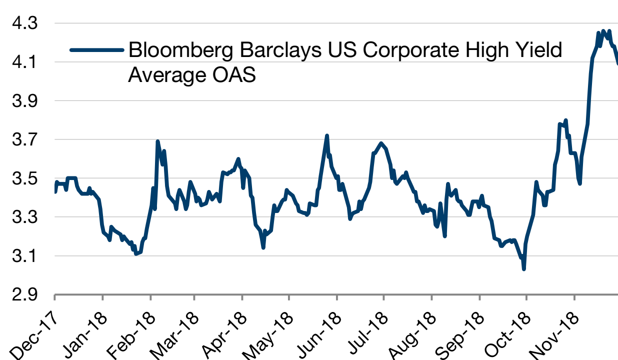
CREDIT: A CENTRAL STORY OF 2019

The difference was clear once you knew where to look: in credit.

Indeed, we believe that one of the central stories of 2019 will be the credit markets, with a particular focus on the extraordinary rise of low-investment grade-rated bonds.

Credit markets, particularly at the lower end of the quality spectrum, are exhibiting significant signs of stress, as depicted by the spreads for high-yield credit (Figure 1). Liquidity in credit has dried up. While there were yield-hungry buyers for even underperforming names in January and February, there is now almost no bid in the high-yield and crossover space. With regulatory changes meaning that banks are unable to warehouse bonds on-balance-sheet as they once did, the credit markets are enduring a difficult time from a trading perspective.

Figure 1. High-Yield Credit Spreads Gap Up



Source: Bloomberg; as of December 5, 2018.

However, we believe that this is not merely a technical phenomenon.

This begs the question: why aren't more equity-focused people talking about what's going on in credit? If credit is to be one of the driving factors of the next phase of the cycle, it still seems to be largely passing under the radar, in my view.

TRAINING IS KEY

This set me thinking about the difference between my own financial education and that of the current generation of graduates and trainee analysts. Any system, it strikes me, historically tends to move over time towards specialisation – and finance is no different. When I was learning the ropes of the markets in the 1990s, that education was spread across a variety of asset classes. It was partly a matter of allowing us to find our own particular preferences, but there was also appreciation that whatever specific securities you end up specialising in, there is much to be learnt from a more thorough knowledge of a company's capital structure.

With recognition that it is increasingly the case that early-career employees are placed into silos from which they rarely escape, Man GLG holds teach-ins for analysts and graduates every week. We begin with a general discussion about the markets and then zero in on some specific aspect of the financial world, often bringing in either an external or internal expert to instruct them. We've recently had talks on everything from forensic accounting to how sovereign credit ratings are calculated.

A month or two ago, before the sell-off in October, we held a teach-in on the relationship between credit spreads and equity volatility, looking at a number of case studies and thinking about how we would use this information better to inform our investment decisions, whatever our particular specialisations happened to be. So it was that our analysts, even those who don't deal with credit on a day-to-day basis, were able to immediately diagnose what was different and more troubling about this more recent negative price action.

BBB-RATED ISSUANCE: THE STRAW THAT FINALLY BREAKS THE BACK OF THIS BULL?

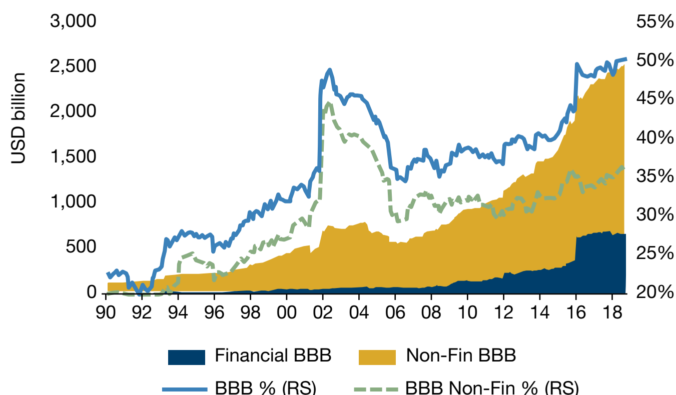
The fact that we wish to focus on credit markets – as we talk about our outlook for equity markets in the coming year – says something about the extent to which our attention has rounded on the asset class. If you are a regular reader of these commentaries, then you'll know that we have been carefully anatomising the various stages of the current bull market in equities, measuring fear against greed, strong earnings and fundamentals against a myriad of destabilising threats. It may be that credit, and particularly the astonishing bubble that has arisen in BBB-rated issuance, is the straw that finally breaks the back of this bull.

Every piece of regulation carries in its wake a host of unintended consequences. The beefing up of capital adequacy tests in the wake of the Great Financial Crisis meant that the investment grade designation came to carry more weight than ever before.

Companies recognised that there was a huge benefit to be gained by moving up the ratings matrix. As such, we have seen a ballooning of BBB-rated debt, which has risen to more than USD2.5 trillion outstanding in the US alone (as of October 5, 2018), according to Morgan Stanley[1]. This is a 227% increase since 2009 and represents 50% of the investment grade universe.

This explosion of BBB-rated debt was driven from both the supply and demand sides of the equation. Investors desperate for yield, but needing to place their money in non-junk-rated assets, necessarily sought the highest-paying securities in the credit universe. Some have already begun to speak of the BBB-bubble as the new sub-prime. If you remember the Jeremiahs in the lead-up to the 2008 crisis, the cry was always to look at where debt had become most heavily-concentrated. Back then it was in mortgages, particularly at the lower end of the credit spectrum. Just now, it's in BBB-rated debt, as Figure 2 demonstrates.

Figure 2. Investment-Grade BBBs Total USD 2.5 Trillion

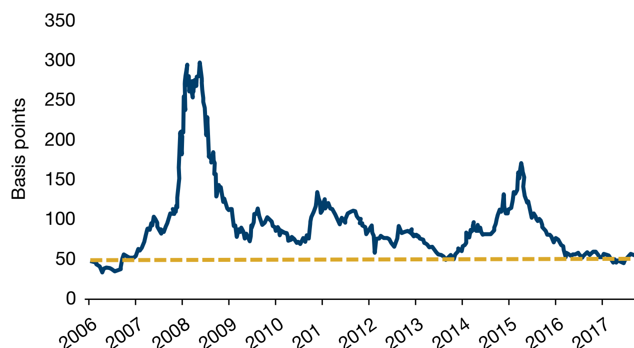


Source: Morgan Stanley Research, FTSE Fixed Income LLC; As of October 5, 2018.

Morgan Stanley analysts brought out a timely piece of research at the beginning of October: they too had read the runes of the credit markets, and were concerned. They pointed out that in the last three downgrade cycles (1989-91, 2000-03, and 2007-09), between 7% and 15% of the investment grade universe was downgraded to high-yield. Extrapolating these previous figures onto the current market, it would imply around USD350-750 billion of total downgrades in the coming years. That may even be an underestimate, though, given that such a significantly higher percentage of the market is currently rated BBB – more than 50% versus just over a quarter in the run-up to the 2000-03 cycle. This has prompted Morgan Stanley to estimate that downgrades in the coming year or two could breach the USD1- trillion mark.

While credit spreads have gapped out in recent weeks, investors are still not getting paid for the credit risk they're taking on (Figure 3).

Figure 3. BBB-A Industrial Spread



Source: Morgan Stanley Research, FTSE Fixed Income LLC; as of October 5, 2018.

The problem is that credit risk at its most basic – the risk of default – is outside the experience of all but the most long-toothed of market participants. Central bank intervention has been so pronounced and far-reaching over the past several decades that the default cycle has been all but eradicated. Eventually, the natural leverage cycle will need to re-establish itself. When it does, the BBB bubble seems likely to burst in our view. At that point, no one would be able to ignore the credit markets.

CONCLUSION

Before we wish you a restful festive period and a happy New Year, we should point out – cheerily – that we believe that October and November were a rehearsal for the general tone of markets in 2019. We would not rule out a relief rally in the coming weeks, but we believe that investor focus will be on an over-leveraged system and particularly on BBB-rated credit.

As a result, moving into the New Year, we want to urge significant caution when it comes to those companies that have taken on too much debt. The watchwords for 2019 are caution, clarity and cross-asset-class visibility. With that, I'd like to thank you for reading these musings over the course of the year, and look forward to seeing what challenges and opportunities the final year of the decade brings.

1. Morgan Stanley Research, The Nature of the BBBeast, October 5, 2018.

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Pierre-Henri Flamand is the Chief Investment Officer of Man GLG. He is responsible for investment performance across the firm's strategy range. Pierre-Henri joined Man GLG in June 2014. Prior to joining Man GLG, Pierre-Henri ran Edoma Capital Partners – a European-focused, event driven hedge fund. Before his role at Edoma, Pierre spent 15 years with Goldman Sachs where he ran the Principal Strategies Group. Pierre-Henri graduated from the Ecole Polytechnique, the Ecole Nationale de la Statistique et de l'Administration Economique and the Institut d'Etudes Politiques de Paris.

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1. Morgan Stanley Research, The Nature of the BBBeast, October 5, 2018.