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THE LIQUIDITY CRISIS IS DEAD. ALL HAIL THE SOLVENCY CRISIS.

John Leiper – Head of Portfolio Management – 15th May 2020

In response to the corona crisis, global central banks have unleashed a tidal wave of liquidity. This policy action has lifted all assets, which have floated higher on a sea of liquidity (full details in our blog: Economy ≠ Markets)

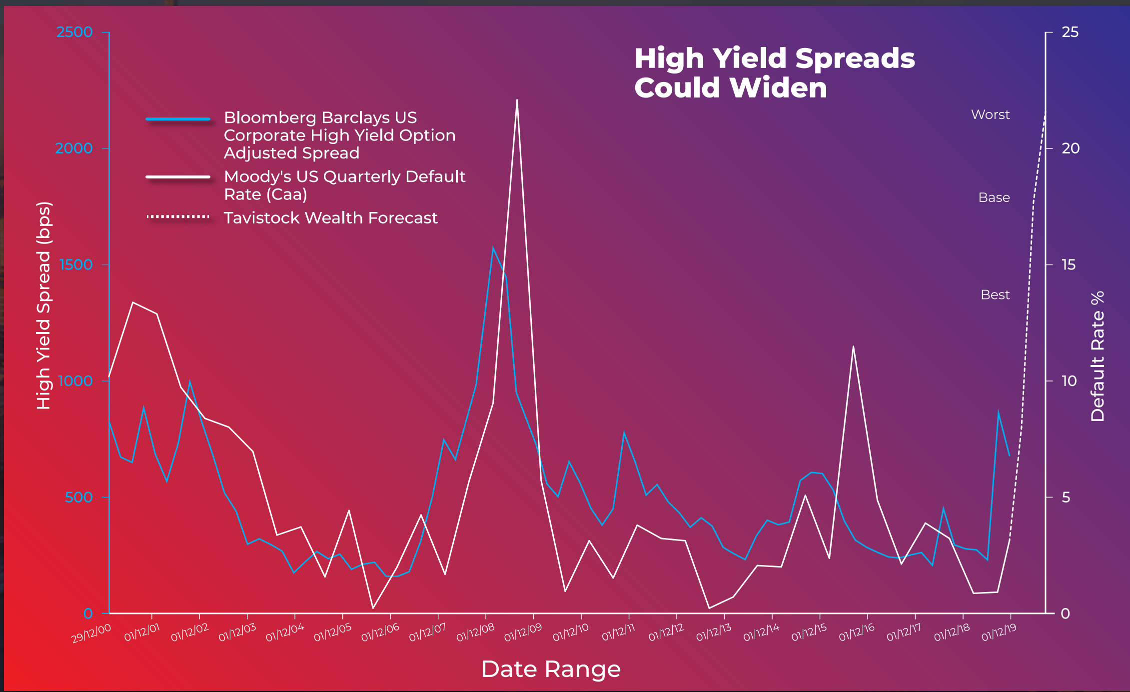
This week we concern ourselves with what happens when the tide turns...

Specifically, what if the sharp V-shaped recovery currently priced into markets does not materialise and the damage that is undoubtedly taking place to the economy takes years, not months, to recover?

The key issue is debt. Since 2008, global central banks have lowered interest rates so far that corporations have gorged on the cheap debt available. Total debt now stands at 322% of GDP. Since the financial crisis dollar-denominated corporate debt has more than doubled to $12 trillion. This is a demand shock on a global scale where the economy slows to a crawl, but the overhang of debt remains.

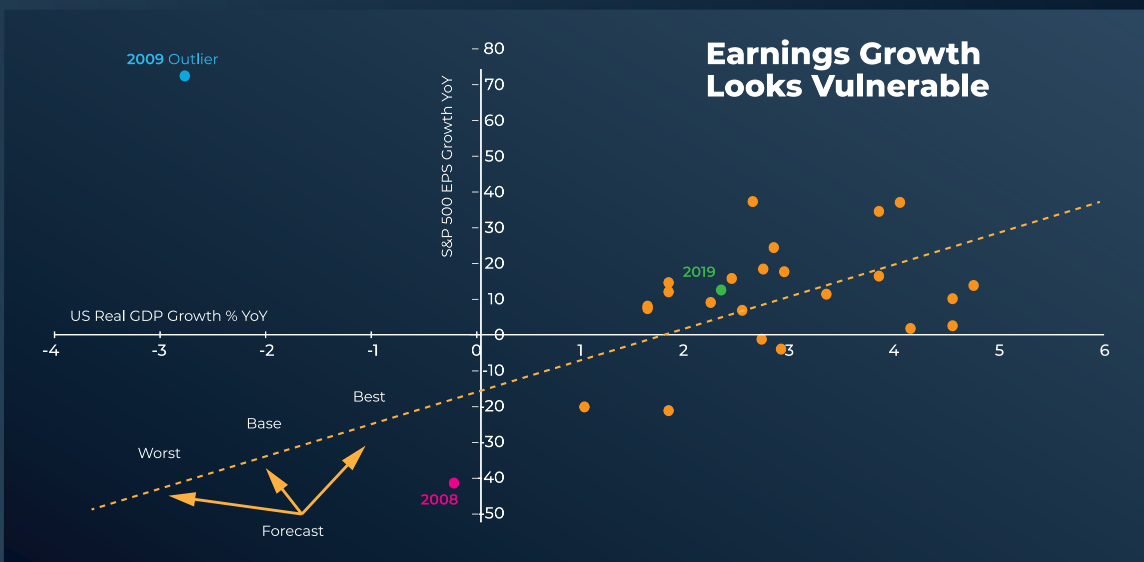
If debt-laden businesses cannot operate, as the coronavirus shuts borders and the population hunkers down, then many will struggle.

We are already seeing this play out. In the chart below, the number of credit rating downgrades has outnumbered upgrades over the last few months, according to data provided by the S&P credit rating agency for companies in the US high yield space. The ratio of net downgrades to total upgrades and downgrades is now near all-time lows. The high yield market will also need to absorb downgrades from investment grade debt, where the ratio is also at extreme levels.



Source of Data: Bloomberg, Tavistock Wealth, ESMA CEREP Statistics (https://cerep.esma.europa.eu/cerep-web/)
Date of data: Quarterly from 29/12/2000 – 10/05/2020

The 2008 crisis is now 12 years distant but it's effects still live with us today. This is partly due to the political decision to follow a path of economic austerity as well as wide spread revulsion over tax-payer bailouts. But it comes down to a system where you "socialise the losses and privatise the gains". There is less political capital to do so today. This time around, creditors will need to take a hit. This would involve large scale debt write-offs and years of ongoing negotiation and litigation. This is good news for bankruptcy lawyers, but little else. It's a similar story for equities which sit lower down the capital structure.Using data since 1994, forecasts for lower GDP growth point to a significant decline in US corporate earnings growth. This is consistent with the decline witnessed in 2008. Meanwhile, the multiple on which investors are willing to pay for these declining earnings is near a 20 year high. That looks like complacency.



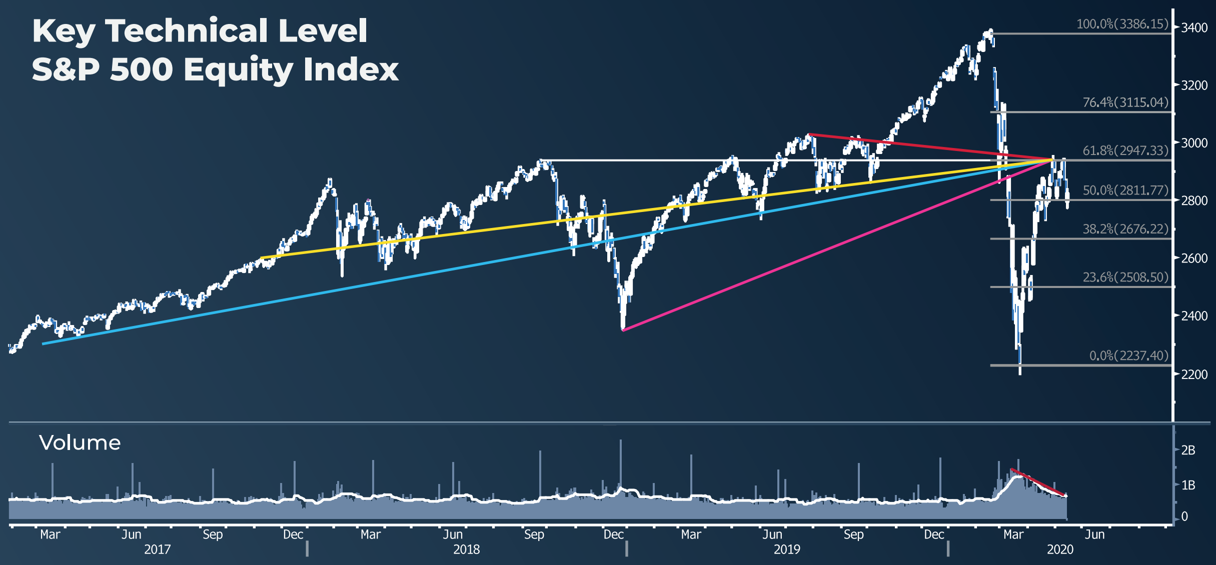
Source of Data: Bloomberg, Tavistock Wealth.
Date of data: 31/12/1994-31/12/2019

Our core concern is that markets are under-pricing solvency risk. The longer the virus continues unchallenged, and the economy remains impeded, the greater the probability that markets start to price this risk-in.

The portfolios remain liquid, highly diversified and defensively positioned. Within credit we are underweight high yield bonds as the market has failed to adequately price in both downgrade and default risk. On a relative basis we prefer US investment grade bonds, which will benefit from Fed purchases, but could still suffer from rising defaults.

Two weeks ago we reduced equities to underweight. We did so in the run-up to a key technical level on the S&P 500, at around 2,950 as shown by the red circle (details in blog here: From Liquidity to Solvency). Since then, that resistance level has held and at the time of writing the index has fallen approximately 6%.

The question is whether this level coincides with the market's collective perception of this crisis and whether or not that perception is about to morph from a crisis of liquidity to a crisis of insolvency.



Source of Data: Bloomberg, Tavistock Wealth.

Date of data: 10/02/2017 – 13/05/2020

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