Global Strategy

Is this the early stage of the US credit cycle? (Erratum)

Global Macro Strategy

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Are credit markets providing a strong signal of an early stage credit cycle?
Credit and macro clients are trying to understand whether they can rely on past early cycle templates for investing in a world of substantial uncertainty regarding the COVID-19 pandemic + record monetary & fiscal stimulus. We try to answer this question by tracking many of our favourite cycle indicators against past US early cycle recoveries, to see which are following the early-cycle script, and which are going off-message.

Our liquidity indicators are signalling an early cycle rebound ahead…
Our non-bank liquidity indicator, measuring business to business working capital financing & low-quality bond issuance, is improving more rapidly than after the financial crisis (Fig 2). Larger companies also have substantial access to capital markets (Figs 3/4), with US IG issuance up 71% & US spec-grade issuance up 26% YTD, which has led US corporate savings rates to near record highs. CCC-rated spreads are also compressing quickly relative to B-rated spreads, in a manner more consistent with a 2009 recovery, rather than the more sluggish 2001-2003 period (Fig 5). And $4.3tn of US money market fund assets are starting to decline, finding their way into riskier securities, consistent with early cycle recoveries back to 1991 (Figs 6/7).

… but our fundamental indicators are not yet following the script
Liquidity indicators provide a better tactical trading signal. But we must track fundamentals to ensure structural risks are being reduced as in most early cycle rebounds. At the moment, this is not evident. The Q2 Fed SLOS survey is one indicator not following the typical script yet, with 70% of banks tightening standards on fundamentally challenged SMEs in Q2 (Figs 8/9), with the Fed highlighting SMEs were restricted in drawing down credit lines during the COVID-19 pandemic. The shortfall in US economy wide earnings relative to debt growth is tracking below past early cycle recoveries since 1961 (Fig 10), and will require a fiscal stimulus + no winter flare-up of COVID-19 to get back to trend by Q2'21. Lastly, US permanent unemployment is rising at a steady pace over the past 6m in contrast to early cycle rebounds since '70 (Fig 11).

And the recent outperformance of equities over HY credit is also atypical
The S&P 500 has outperformed US HY by 12% over the last 12m. This is quite atypical; Fig 12 illustrates how US HY has always outperformed the S&P 500 in very early cycle recoveries since 1991. Today's strong equity outperformance is effectively another variant of the growth vs. value trade that refuses to break. But the substantial disconnect between stock returns of firms with low debt to EV vs. high debt to EV ratios (Fig 13) suggest speculative positioning issues have not been resolved.

Conclusion? Too early to say early cycle. But credit has liquidity support
Our liquidity indicators are signaling HY spreads will remain supported on a tactical basis. The portfolio rebalancing effect is not yet complete, and we remain comfortable allocating to BB credits, where solvency risk is low. In addition, our base case is that the liquidity cycle should be kept intact by accommodative Fed policy and a US fiscal stimulus package of ~$600bn - $1tn by Jan'21 at the latest. But our fundamental indicators are highlighting structural risks that remain stubbornly elevated. Hence, we aren't willing to reach too far down the capital structure into lower-quality leveraged loans. And we reiterate HY has better tactical risk-reward than large cap equities. HY still has significant upside if we enter into an early cycle recovery, but will still outperform equities if a late-stage focus on fundamentals returns, with Fed corporate purchases as a mitigating backstop.

This version corrects the incorrectly labelled X-axes on Figures 8 & 10.

Is this the early stage of the US credit cycle?

Are credit markets providing a strong signal of an early cycle recovery? This key question is being asked more frequently in client conversations over the past few months. Credit and multi-asset investors are trying to understand whether they can rely on past early cycle templates for tactical and strategic asset allocations, or whether the substantial uncertainty regarding the evolution of the COVID-19 pandemic + record monetary and fiscal stimulus are masking fundamental solvency concerns. The implications of where we are in the cycle has mattered for credit & equity returns historically. Figure 1 illustrates how S&P 500 futures returns and US high-yield excess returns have varied across regimes back to 1991, using our forward-looking UBS credit-based recession gauge as a rough proxy for dating where we were in the cycle.

Figure 1: S&P 500 Futures vs. US HY excess returns in various phases of the US credit cycle

UBS Credit Recession Probability	Avg. S&P 500 Futures Forward 12m Return	Avg. US HY Forward 12m Excess Return
0 to 20% (Early -> Mid Cycle)	18.1%	3.0%
20% to 40% (Mid -> Late Cycle)	12.9%	1.7%
40%+ (Late Cycle -> Recession)	-8.6%	-3.8%
40%+ to 20% (Recession -> Early Cycle)	2.8%	6.3%
20% to 0% (Early Cycle)	11.6%	5.4%

Source: Bloomberg Barclays Index Services Limited, Bloomberg, UBS

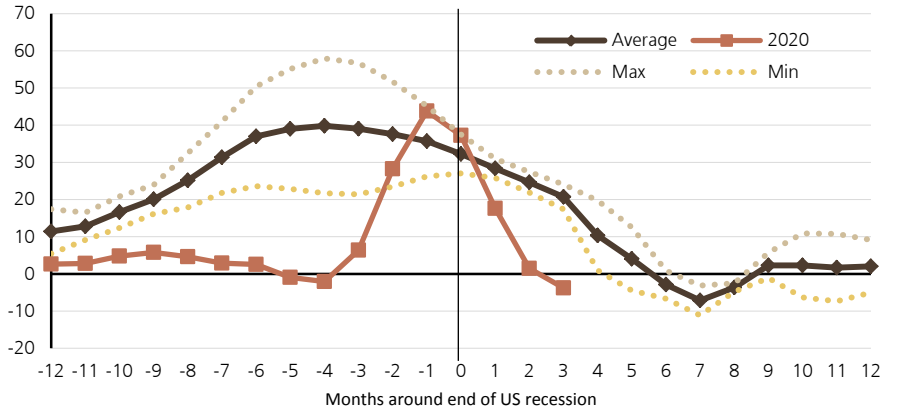
Currently, our model is still indicating we are in a recession. But there are two caveats. The most obvious is that our model utilizes GDP sourced data, and this will surely improve when Q3 US GDP data is released later this month. And second our model does run the near-term risk of failing to forecast future cycle turning points when the economic data is changing so rapidly (for example, our model failed to forecast the quick double dip recession of 1980-1981).

Hence, we look to answer this very difficult cycle question today by tracking many of our favorite credit cycle signals, plus a couple new indicators, in a more flexible way against past US early cycle recoveries, going back as far as 1961 in some cases where historical data is available. In our 9 "cycle charts" below, we assume that the most recent US recession ended in June 2020, when the US ISM crossed the 50 mark denoting expansion. We then analyze the trajectory of our cycle indicators to assess if they are behaving in a manner consistent with a US early-cycle recovery from June onwards, or if they are going off-message.

Our liquidity indicators are signalling an early cycle rebound ahead…

Our non-bank liquidity indicator, measuring trends in timely business to business working capital financing conditions and low-quality HY bond issuance (B & CCC rated), is one of our top indicators for assessing the health of the credit cycle on a tactical basis. Our framework for viewing the credit cycle does focus to a large extent on the supply side, as we believe the retrenchment of lenders from extending new credit is a reliable leading indicator of future refinancing risks for borrowers. The results below highlight that the 2020 recovery in non-bank liquidity has been rapid, much stronger than what was experienced after the 2001 & 2008 recessions, and providing a good positive signal for tactical credit returns through year-end (Figure 2).

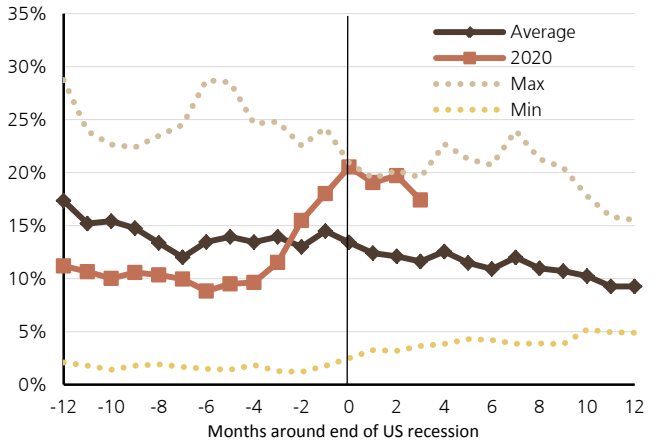
Figure 2: UBS non-bank liquidity indicator: Current vs. Past US Recessions (0 = END of US recession, lower numbers = net easing)



Source: Bloomberg, S&P LCD, UBS estimates

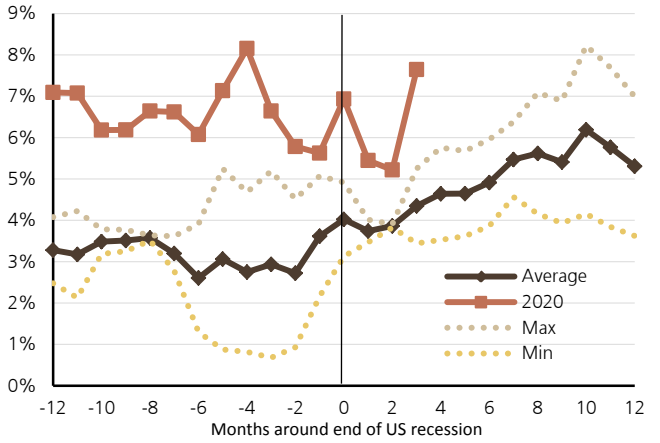
The results above are mirrored below in US corporate issuance trends YTD. US IG issuance is up 71% YTD, US spec-grade issuance (HY bonds + loans) is up 26% YTD, and lower-quality US spec-grade issuance (B & CCC rated bonds & loans) is up 43% YTD. As Figures 3 & 4 highlight, rolling 6m issuance trends in US IG & B+CCC rated US spec-grade credit markets (as a % of respective market AUM) are generally following past early cycle templates, albeit on the high end historically. However, this is not overly concerning to us, given high levels of issuance have taken place in the context of Fed corporate purchases, the tremendous uncertainty unleashed by the COVID-19 pandemic, and seasonally high issuance that occurs ahead of US elections. In addition, 2020's issuance totals have allowed US corporates to radically boost corporate savings rate to near record highs and at levels close to their more conservative EU counterparts. We expect capital markets to remain open, but the pace of issuance to decline from here with US IG and US HY issuance finishing 2020 up 65% & 60% YTD, given high savings rates and a decline in uncertainty after the US election in November.

Figure 3: Trailing 6m USD IG Issuance % AUM: Current vs. Past US Recessions (0 = END of US recession)



Source: S&P LCD, UBS

Figure 4: Trailing 6m B + CCC HY & LL Issuance % AUM: Current vs. Past US Recessions (0 = END of US recession)

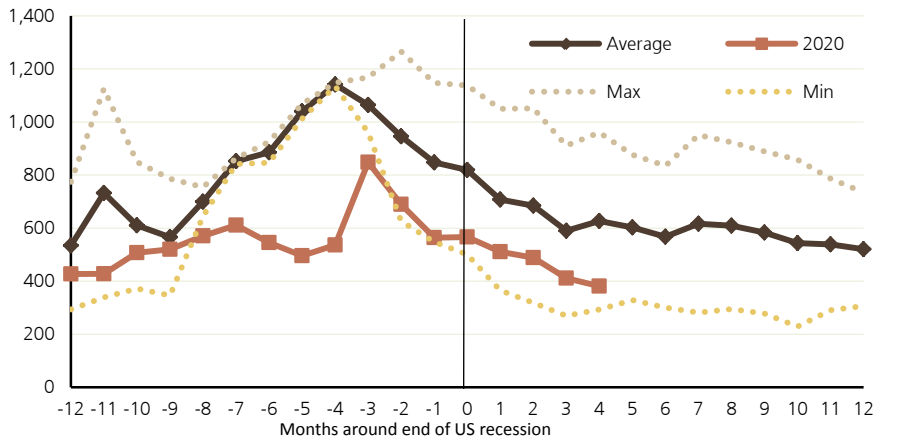


Source: S&P LCD, UBS

Is this liquidity filtering itself down into CCC-rated spreads, the weakest links of credit with the highest probability of default? We believe it is. As our cycle chart below indicates, CCC-B rated spread differentials (381bps) are compressing in line with the 2009 post GFC rebound rather than the more protracted 2001-2003 early

cycle recovery period where CCC – B rated spread differentials remained stubbornly above 800bps amidst a weak environment for both equity & credit markets.

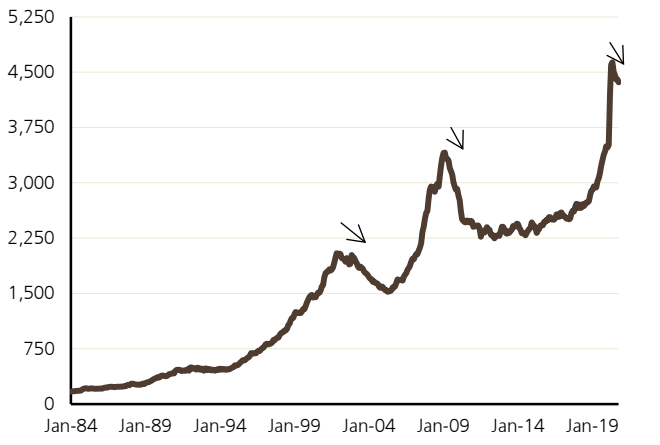
Figure 5: US CCC - B Spread Differential: Current vs. Past US Recessions (0 = END of US recession)



Source: Bloomberg Barclays Index Services Limited, UBS

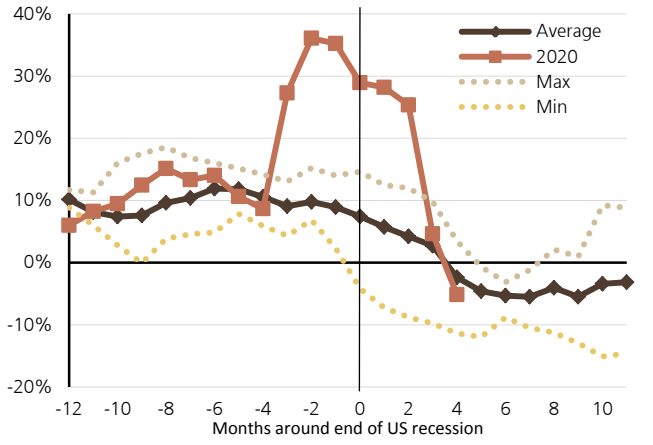
Lastly, one indicator we have spent more time focusing on for the better part of 2020 is the trajectory in US money market fund assets, given the ability of this indicator to verify early cycle recoveries in the past (Figure 6). We believe this can be a useful indicator, because if Fed monetary policy is effective, it should improve growth/inflation expectations and steepen Treasury yield curves, leading to money market fund outflows that chase better returns in equities and longer-duration fixed income. As Figure 7 below highlights, that is what is occurring at the moment, with declining money market fund assets over the last 6m consistent with past early cycle trends.

Figure 6: US Money Market Fund Assets ($bn)



Source: Haver, UBS

Figure 7: 6m % change in US Money Market Fund Assets: Current vs. Past US Recessions (0 = END of US recession)



Source: Haver, UBS

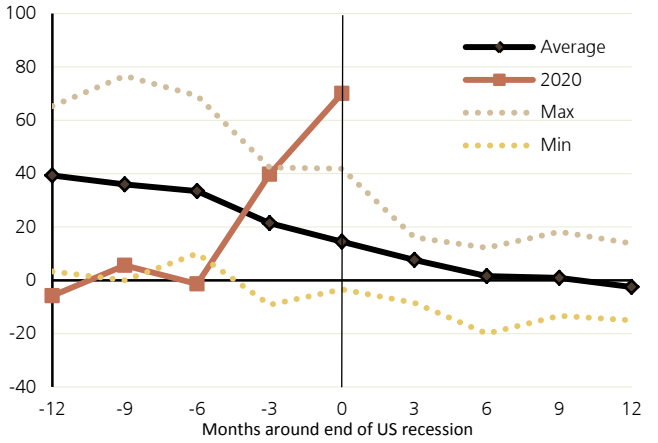
But fundamental indicators, particularly for SMEs, are producing mixed messages on the health of the cycle.

We generally put more weight on liquidity indicators for our tactical views. However, we still need to track fundamentals to ensure liquidity is flowing through the US economy in an effective way to reduce structural credit risks. At the

moment, the jury is still out on this development, particularly for SMEs and companies not able to access capital markets. The Q2 Fed SLOS survey is one indicator not following the typical script, at least not yet, with 70% of banks tightening lending standards on small firm business loans in Q2. This number should realistically be at +10%, if not 0%, by year-end if we are experiencing a more sustainable recovery ahead (Figure 8).

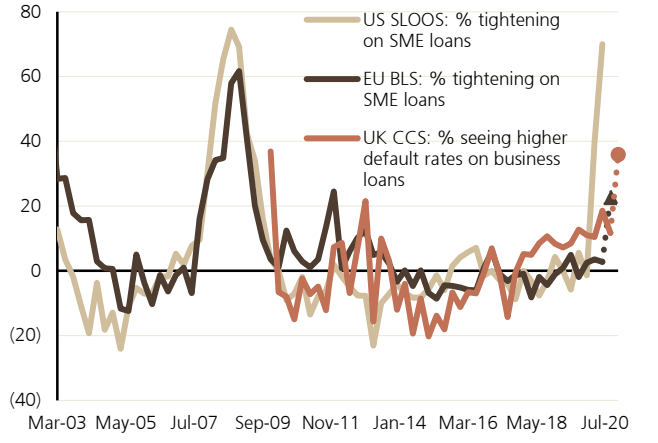
But we do have our concerns here, particularly with the Fed recently commenting the ability of small firms to draw down their credit lines during the COVID-19 pandemic was limited, even in the most COVID-19 exposed industries, in a total contrast vs. larger COVID-19 exposed companies that were able to access substantial liquidity. In addition, the forecast from EU banks that they expected to tighten lending standards on SMEs in Q3 & the prediction of UK banks in the latest BOE credit conditions survey that UK corporate defaults would rise substantially in Q4 point to potential delayed effects from the COVID-19 economic shock on future credit risk that should be monitored (Figure 9).

Figure 8: Fed SLOOS Survey: % of banks tightening on small business C&I loan standards: Current vs. Past US Recessions (0 = END of US recession)



Source: Bloomberg, UBS

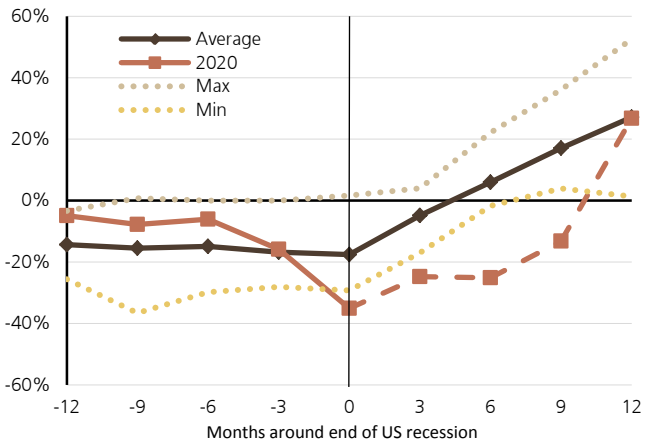
Figure 9: % of US/EU banks tightening lending standards (US/EU) & seeing higher defaults (UK) on business loans (dashed lines = EU/UK bank predictions for Q3/Q4'20)



Source: Bloomberg, ECB, BoE, UBS estimates

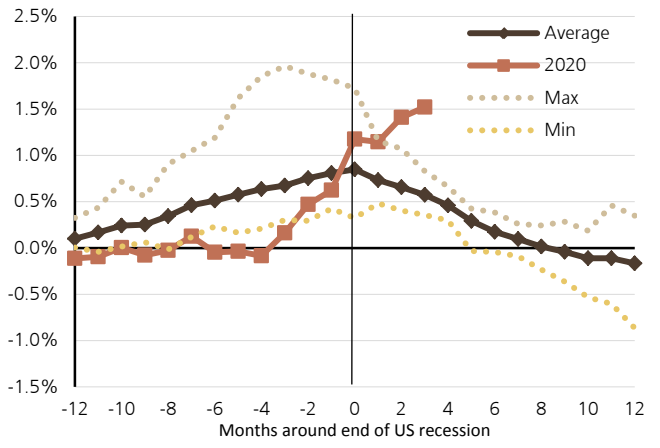
We should also not underestimate the damage done to corporate fundamentals through the COVID-19 pandemic, particularly when broadening our lens to look at smaller companies throughout the US economy. One indicator we have used in the past to assess fundamental risks is the Y-Y change in US non-financial + rest of world corporate earnings growth (from the US GDP report) vs. the Y-Y change in US debt growth (from the Fed Flow of Funds). This indicator has unsurprisingly collapsed through the COVID-19 pandemic to –35%. And while it is now rebounding, it is likely to remain more subdued than in early cycle recoveries since 1961 (Figure 10). One key reason for this is that our US economists still expect US real GDP to be declining on a Y/Y basis through Q1'21, given a lack of pre-election US fiscal stimulus (our base case). And on the debt side of the equation, while debt growth will slow in the future, we have not cleared out the excesses of the past cycle through a sufficient de-leveraging to create the declines in debt growth typically experienced during past recessions. We only forecast getting back to trend by Q2'21, when our assumptions of a US fiscal stimulus package of $600bn to $1trillion plus no second COVID-19 wave would allow earnings growth to exceed debt growth once again.

Figure 10: US Economy Wide Earnings - US Debt Growth (Y/Y): Current vs. Past US Recessions (0 = END of US recession, dashed 2020 lines = UBS projections)



Source: BEA, UBS

Figure 11: 6m Change in US Permanent Unemployment Rate: Current vs. Past US Recessions (0 = END of US recession)



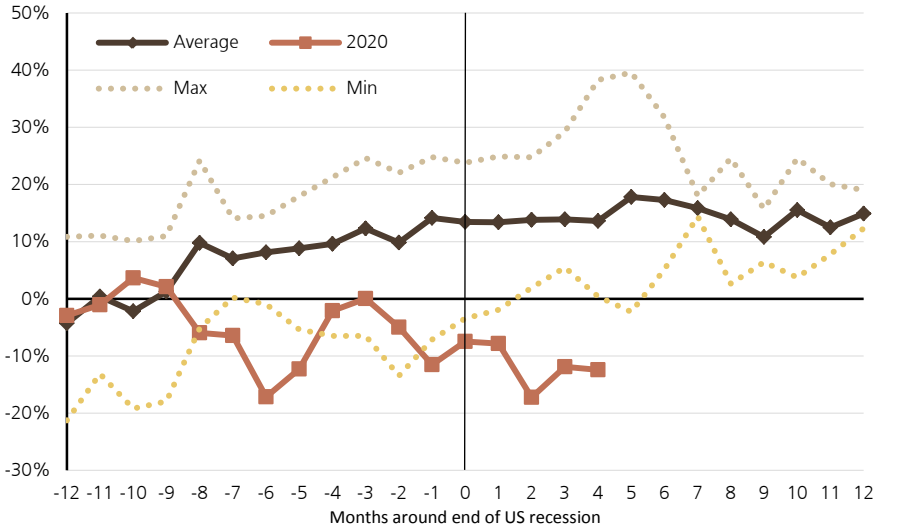
Source: Bloomberg, UBS

In addition, given client interest & our US economists view that the durability of the economic recovery will depend on the labor market, we are tracking trends in US permanent unemployment rates (the % of the labour force unemployed, not on temporary layoff) and how this is faring relative to past cycles. While unemployment is clearly a lagging indicator, the current cycle still has permanent unemployment rising at a steady rate over the past 6m, whereas most early cycle recoveries back to 1970 would have seen a levelling off by now, with outright declines expected 8 months after past recessions ended (Figure 11). If we are to follow the early cycle template, we should expect a much slower increase to an outright stabilization in permanent unemployment rates by Jan '21.

The recent outperformance of equities over HY credit is also atypical

From a multi-asset perspective, regular readers are aware that we track performance in equity markets, particularly for lower-quality companies with high debt to EV ratios, to inform our view of the prevalence of structural credit default risks. While credit markets have rebounded strongly from the worst days of the pandemic, high-yield credit total returns over the last 12m (4.4%) are still trailing that of the S&P 500 (16.8%) by a substantial margin, in a very atypical fashion for an early cycle recovery (Figure 12). Generally, we think credit markets should outperform equities in the very early stage of the cycle coming out of a recession; high carry + falling priced-in default rates provide a powerful tailwind to credit returns, while equity rallies generally take time to emerge given a wash-out of speculative positioning.

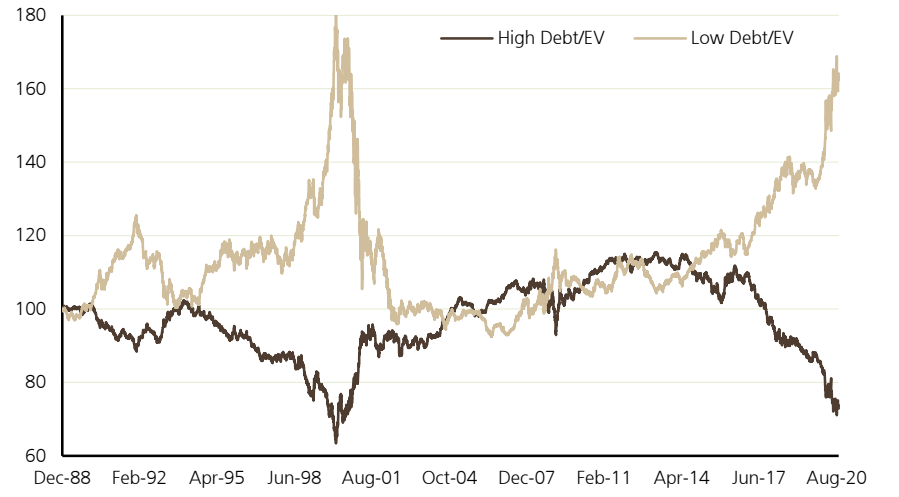
Figure 12: US HY - S&P 500 Total Returns (Y/Y): Current vs. Past US Recessions (0 = END of US recession).



Source: Bloomberg Barclays Index Services Limited, UBS

The outperformance of equity over credit during the last 12m is actually quite divorced from most early cycle recoveries, and is effectively another manifestation of the growth vs. value trade in our view. Or perhaps put slightly differently, the outperformance of low debt to EV vs. high debt to EV stocks. Figure 13 below highlights this picture quite starkly thanks to our UBS Quantitative Strategy Team, with low debt to EV stocks vastly outperforming the Russell 3000 index, while high debt to EV stocks have underperformed, particularly since June of 2019. To us, an early cycle recovery would be most vindicated with HY returns besting equities over the next 3-6m, along with a sector rotation within equities toward relative outperformance of high debt to EV stocks.

Figure 13: Stocks with high debt to EV ratios continue to relatively underperform in contrast to most early cycle recoveries. (Relative performance to Russell 3000 index, Dec 31 1988 = 100)



Source: UBS Global Quantitative Research

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