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It's a Recession -- Not the End of the World

Friday, November 21, 2008

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Non-investment grade bonds are pricing for default rates that aren't going to happen.

Given the continuing pall of extremely bearish economic and financial market sentiment, it might seem within the bounds of rational probability that the economy is in a downward spiral that will not bottom out before it degenerates into conditions that prevailed during the Great Depression (see "Vicious Cycle Visions" November 10, 2008). That is the message now being conveyed by the non-investment grade bond market, where spreads have blown out to all-time records of more than 1,900 bp, more than doubling since the intensification of credit market turmoil in mid September. All eyes are on risk now, not reward -- yet it is axiomatic that such a large risk premium promises to yield an extremely handsome return should the prevailing pessimism prove overdone.

Update to strategic view
US BONDS: Unless the economy is entering a complete breakdown on a par with the Great Depression, the surging spreads in the non-investment grade bond market have created a highly compelling value play. Yes, defaults will rise as this economic downturn plays out. But a recession is not the end of the world -- which is what this market is pricing for.
[see Investment Strategy Dashboard]

In the midst of the current market turbulence, marked by recurring episodes of outright panic, maintaining a sense of perspective on recent asset price movements might seem a challenging task. But in the case of the non-investment grade bond market at least, such perspective can offer revealing insight on the extent to which this rout appears to have gone too far. The current level of the non-investment grade spread implies a default rate approaching 20%. But consider that the peak default rate was 14% in 1936, in the heart of the Depression, when in some sense all bonds were junk bonds. In the post-Depression era, non-investment grade defaults reached highs of 12.4% in the early 1990s recession and 10.6% in the deflation-induced 2001 recession.

The current default rate of 2.8% is still well below the 4.4% long term average, as well as the 5% rate that the ratings agencies projected would prevail this year. No doubt, defaults will be on the rise during the current economic downturn. Moody's now forecasts the speculative-grade default rate rising to 10.4% in the next 12 months, up from the 7.9% it was predicting last month. But still, with a 20% implied default rate, the market would seem to have priced in a more than adequate cushion for just about any plausible eventuality.

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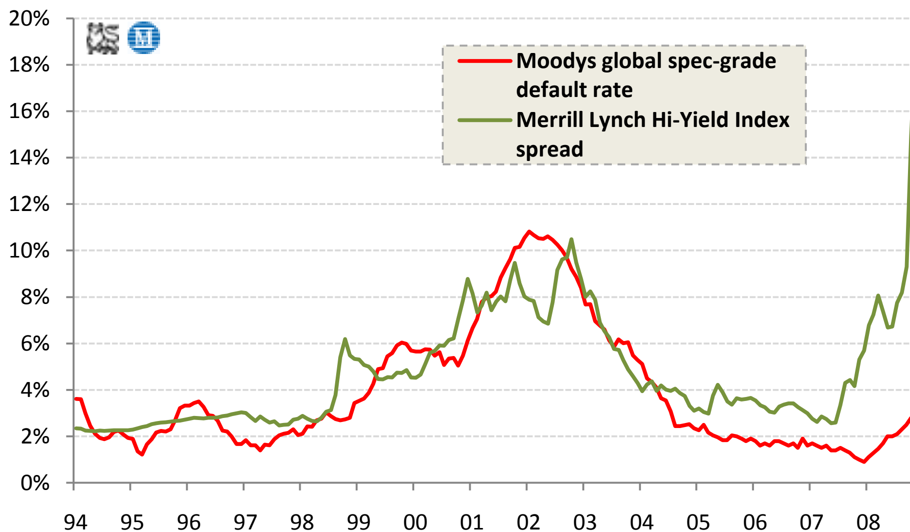

The chart at left provides some context on the degree to which the market has overshot the mark. For the most part, the yield spread moved in tight correspondence with the default rate, up until the onset of the credit crisis last year. The relationship plotted in the chart indicates that fair value for the spread, even if the default rate rises as abruptly as it's now forecast to, would be some 800 to 900 bp below its current level. Moreover, as the economy recovers, spreads should tighten further as the default rate declines.

It's true that the recent spread widening has been exaggerated to some extent by the flight-to-safety in Treasuries that has accompanied asset liquidation and the rush to liquidity. But at above 21%, the average non-investment grade yield is now about 300 bp higher than what had until recently stood as the previous record high, recorded in October 1990. And non-investment grade yields have also soared relative to investment grade corporate debt, even as those bonds have seen their spreads against Treasuries widen sharply. The spread against the five-year AA bond yield has widened by some 900 bp since mid-September, and now stands at more than 1,500 bp.

The non-investment grade market obviously is looking beyond the still relatively modest default rates projected for the next year, and pricing for a long-term economic decline with credit markets remaining frozen, and threatening the ability of even credit-worthy issuers to refinance their debt. The fear infecting the market is that this will not be a traditional two to four quarter recession but will be an extended self-feeding contraction that will eventually threaten systemic viability. Given the still highly fragile state of the financial system, that scenario cannot be dismissed as impossible. But we think it is highly improbable. Despite the renewed outbreak of market panic the past several days, we continue to see signs that a healing process is underway. The LIBOR-OIS spread, while still very wide relative to historic norms, has contracted by nearly 200 bp since the peak of the chaos last month. The TED spread is down nearly 250 bp, and two-year swap spreads -- at about 100 bp -- have fallen almost all the way back to their levels prior to the mid-September panic, down about 60 bp from their peak last month.

The revival of the economy could also come more quickly than is now widely considered likely -- in some sense a truism, considering the extent to which the conventional wisdom now regards such a thing as utterly unlikely. This recession is the result of the breakdown of confidence caused by this fall's near meltdown of the financial system. The downturn was not caused by too-tight monetary policy, or higher taxes, or restraints on global trade -- the restrictive policy moves that have caused all the other downturns in modern history, and all of which were at work at once in precipitating the Great Depression. This downturn was triggered by the exhaustion of an unsustainable housing and credit binge that had been triggered by monetary policy that was too easy, not too restrictive. The slowdown initially caused by that exhaustion

was aggravated into a sudden recession by the botched rescues of financial firms -- rescues that did more harm than good, creating perverse incentive dynamics that led to the destruction of capital markets rather than their protection (see "Death by Rescue" November 17, 2008). Those dynamics are to some extent emerging again this week as Citigroup comes under intense speculative attack. But the establishment of TARP's Capital Purchase Program, a true rescue offering banks capital on extraordinarily generous terms (see "At Last: A Bail-out That's a Bail-out" October 14, 2008) -- along with the explosive growth in the Fed's balance sheet and the variety of is liquidity facilities (see "Deflation Takes Center Stage" November 19, 2008) -- has probably ended the cycle of capital destruction that climaxed over the summer. This suggests the possibility that as the panic passes and confidence is restored, the economy could come back relatively quickly. Certainly, projecting recovery by the second half of next year is entirely plausible. As that prospect comes into clearer focus, relief from the extraordinary risk abhorrence that has captured the markets will finally be seen, with non-investment grade bonds being a major beneficiary.

In fact, as much as equities have been battered in this bear market and represent highly appealing value, we see non-investment grade bonds as being a competitive opportunity at this point. Currently, the S&P 500 is priced for a 58% decline in forward earnings. The non-investment grade bond market, though, is pricing economic destruction unseen since the Great Depression, when the economy shrank by nearly 30% in the first four years.

BOTTOM LINE: Unless the economy is entering a complete breakdown on a par with the Great Depression, the surging spreads in the non-investment grade bond market have created a highly compelling value play. Yes, defaults will rise as this economic downturn plays out. But a recession is not the end of the world -- which is what this market is pricing for.