Caron's Corner Transcript - 10.3.2022

The R.I.P. Cycle, Part 2: Credit Risk

- As we have discussed, Recession, Inflation and Policy risks form the R.I.P. Cycle. This is because Policy can either address Inflation <u>or</u> Recession risk - but not both - simultaneously. This amplifies the risk that a policy mistake that can have grave (RIP) consequences.

- The implication is that the Fed has to choose to fight inflation or recession risk. In this case, they are choosing to fight inflation, which increases recession risks.

- The linkage to credit risk is important, as credit risk increases and is highly correlated with the depth and breadth of a recession. This gets priced in the credit markets as higher default risk, which causes spreads to widen.

- The greater the number of rate hikes, and the greater the speed at which those hikes occur – both designed to lower inflation risks - the greater the risk of a deeper recession. The result is that default risks increase and spreads widen to price in a higher risk premia.

- In the end, we still advocate a balanced portfolio with a bias toward high quality and an average duration of 3-4 years.

Jim Caron: Well, the markets never ceased to amaze or disappoint, with more volatility ahead. So we're calling this the R.I.P. Cycle, part two. As you might recall in part one the R.I.P. Cycle is R for Recession, I for Inflation and P for Policy risk. And yes it's a full play on the more well-known R.I.P. as in "Rest in Peace," because mistakes made in the cycle might just be quite deadly.

When we look at the R.I.P. Cycle, there is policy risk because policy can either address inflation <u>or</u> recession risk, but it can't address both simultaneously, which amplifies the risk of a policy mistake that can have grave consequences. The implication is that the Fed has to choose to fight inflation or recession risk, and right now they are choosing to fight inflation as are most of the central banks around the world. But choosing to fight inflation increases the risk of recession, and this impacts the credit markets.

Now the credit markets are a very important part of this and it's critical to make a linkage to the credit market in this cycle, which is why we call this audio "The R.I.P Cycle, Part Two: Credit Risk." Why? Because credit risk increases and is highly correlated with the depth and breadth of recession. What gets priced into credit markets is higher default risk which widens spreads. The greater the number of rate hikes, and the faster the Fed hikes rates to address inflation risks, the more it increases the risk of a deeper recession. Default risk increases and spreads widen in order to price in higher risk premium. That's the linkage we have to make.

So we're morphing into this interest rate component of the risk with Fed hikes now into a credit and spread component. That's making this R.I.P. Cycle a little bit more intense. Many have called credit the “second shoe to drop” - and it feels like it's dropping right now, given that spreads have started to widen over the past week (based on the Bloomberg indices). The narrative all this year has been that the underperformance of bonds was really largely due to the rise in interest rates, and not a problem linked to fundamentals. However, now that credit spreads are widening, the narrative is starting to incorporate the rapid pace of rate hikes and the risk of the terminal rate. In fact, the policy rate may rise even higher than what the Fed told us a few weeks ago.

Now that's not our call, but that is a risk that's in the markets and it's certainly starting to weigh on credit. If the Fed hikes more aggressively than what currently has been priced, then it increases the odds of a deeper recession, which in turn increases credit risks through rising default rates and wider spreads. That's essentially what's being priced into the markets today. Now that's not all. It gets a little worse. Add to this liquidity related concerns, dealer balance sheets, year-end pressures and the like. All of these risks are further amplified to the point that markets have no choice but to embed more risk premium in today than what they had previously. That's what we're seeing as part of the stress in the markets.

But, if such a chain of events were to unfold with risk premium rising across all of these global assets, then interest rates in high quality bonds may actually start to fall. That's something that we have to account for as well, because the Fed will be more responsive to widening credit spreads and potential liquidity risks than they are to equity prices moving lower. Credit becomes a much more important part of the financial conditions framework. Wider spreads can occur for a period of time, then ultimately should bring rates lower, but, you know, clearly not under good circumstances. Essentially, this may cause the Fed to pause there hiking cycle, if not reverse it, depending on how bad things get. We need to watch closely as events unfold.

But the framework of the R.I.P. Cycle is useful reducing the complexity of the current market conditions and it can alert us as to when things change for the better or for the worse. We continue to advocate for a balanced portfolio with a bias towards high quality assets and an average to 3 to 4 years of duration. At this stage we're moving into a period where credit risk is starting to come under a little bit more stress, that spreads may widen. Now we don't think that they widen like a traditional recession might imply because we think that even if we do have a recession in the future, it's most likely a mild recession. Why? Well the jobs market is so strong and it's very hard to have a deep recession when you have such a strong jobs market. Spreads may widen at this stage of the cycle, but they probably don't reach historical levels as they normally would do because of the strength of the jobs market.

All that said this is a unique period of time. Credit spread is starting to participate more in some of the stresses and weakness in the market, and we have to keep a close eye on liquidity conditions as well. We still like our bar-bell approach where we want have short duration, floating rate type exposure on one side of the equation, but on the other a hedge against recession risk by owning higher quality, longer duration. The average duration of the portfolio in that 3 - 4 year area. I know we've talked about this before but I thought it was important to address the additional risk that's coming through in terms of credit risk.

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