Gridlock or Goldilocks?

Is a Joe Biden presidency combined with a Republican-party controlled US Senate a "Goldilocks scenario" for credit markets? John Fekete, head of Crescent Capital Group's Capital Markets team, discusses the state of the US economy and the most likely future path for alternative credit.

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Q: What does a Biden win/Republican-controlled Senate mean for risk assets?

At this point it looks likely Republicans will retain a majority in the US Senate. Even if they lose both Georgia run-off elections in January they still will hold 50 seats, leaving the Democrats with a razor-thin margin, namely a 50-50 tie with the VP casting tiebreaking votes. With such a small margin it seems unlikely there would be consensus for sweeping legislative programs. That puts key Democratic policy actions like corporate and personal income tax increases and new financial, energy and pharmaceutical regulations on hold as Republicans would block these measures. This has been positive for risk assets, hence the significant equity and bond market rallies seen in the last two weeks.

Q: Where does that leave fiscal stimulus?

A "Blue Wave" or sweep by Democrats would have likely resulted in passage of a large economic recovery package in 1Q21, in the range of $2-3 trillion. That looks very unlikely in the context of a divided government. The Republican senate leader has suggested there is support for a much smaller, targeted recovery package under $1 trillion, but even that is not guaranteed as recent economic indicators like unemployment have been better than expected, removing some of the urgency and momentum.

Q: What do you expect from the Fed?

While the US economy shows signs of green shoots there remains a pretty big hole from which to dig out of. With the prospect of additional economic stimulus fading, that likely puts greater burden on the Fed to continue accommodative policies such as keeping rates at or near zero as well as continuing balance sheet expansion via bond purchases. The Fed's most recent senior loan officer survey indicated credit conditions are rapidly improving, with net tightening in standards dropping from 71.2% to 37.7%. We expect there may be some rate movement but nothing significant; rates look likely to remain low and range bound for some time.

Q: What sectors are you watching now?

Joe Biden's comments during the campaign suggest he will try to limit exploration and tighten regulation on the fossil fuel industry. However, if Republicans maintain control of the Senate, it would be difficult for the new administration to implement aggressive policies to hasten a transition to renewable and cleaner energy. Also, there is likely to be limited legislative restrictions on energy exploration and production, which is a positive for the sector. We think valuations and managements' conservative mindset toward capital allocation will be the dominant drivers of earnings performance in 2021.

We are also considering the outlook for trade tariffs. Export-centered businesses could see a boost from a less hawkish administration on trade tariffs, raising confidence in Emerging Market recovery prospects. While Joe Biden supports a tough stance toward China he will likely seek multilateral partnerships to address these issues. Positive vaccine news would also lead to stronger commodity prices and tourism recovery in many of these countries.

In the high yield market we see value in segments of the market hardest hit by Covid like aircraft lessors, hotels and casinos, and triple-C rated credits. We had largely avoided adding triple-C exposure but that segment now sticks out as historically cheap. At 1,126 basis points as of November 1 spreads are cheaper today than 70% of the time over the past quarter century. While this represents the lowest-quality segment of the market, default rates have stabilized and may be headed lower over the next 12 months, presenting a potential opportunity for investors. Conversely defense spending could be cut after a multi-year upcycle, adversely impacting suppliers and contractors.

Q: What's the outlook for credit right now?

We continue to believe central bank support underpins the US credit market, fueling demand for higher-yielding assets such as High Yield Bonds, Leveraged Loans and Structured Credit. Rates remain low globally further adding to the demand for these assets. High yield spreads are not especially tight, leaving room for compression as the recovery takes hold. In fact, the ICE BofA US High Yield index spread on November 1 was 535 basis points, 163 basis points higher than where we began the year (372 basis points) while our default expectations are lower today than they were in the first quarter. This is mainly because credit markets have been open to borrowers and the equity market has been supportive. There have been signs of consumer strength in segments of retail, autos and housing. Unemployment is another promising sign. The unemployment rate declined to 6.9% in October from over 14% in April. That's not too far above the historical average of 5.8% since 1948. If vaccines arrive on schedule the economy should be able to survive a deep recession without permanent scarring effects.

Q: What threats face the credit markets?

As Covid-19 case counts increase in the U.S. and Europe there will be significant focus on the timing and availability of vaccines. Daily infection rates and total hospitalizations are both approaching all-time highs as winter weather sets in and people spend more time indoors. The pace of the recovery could get worse before it gets better should mobility restrictions be re-introduced. While fiscal support has largely dried up weighing on consumption, economic growth is likely to reaccelerate in 2021 as mass immunizations boost hard-hit businesses like restaurants, airlines and entertainment. The more clarity on the vaccine timeline the better markets should be able to look through these risks.

Q: Given the political and virus-related uncertainty over the next few quarters what kind of strategy is best for liquid credit?

Recoveries rarely move in a straight line, so credit managers need to be nimble. It is important to be able to minimize credit losses and offer clients the ability to fully participate in the market recovery. We believe an all-weather credit strategy that can generate above-market returns with below-market volatility in both positive and negative credit market environments is best suited for the current environment.

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About Crescent

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