Credit Research
Macro

2019 Mid-Year Credit Outlook

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One step forward, two steps back. Central banks across the globe fold cards as markets reassess interest rate expectations amid a backdrop of slowing global growth and ongoing trade tensions.

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Executive summary

- Expectations for monetary policy have swung sharply to easing from tightening in the first half of 2019. Much of this stemmed from a wearying outlook for global growth on the back of heightened trade tensions and ongoing political risk. With the US, Europe and Japan all seemingly poised to respond to the softening outlook, monetary accommodation now appears increasingly in a race to the bottom, from already record (or near record) low levels.
- In Australia, on the back of a stubborn level of spare capacity within the labour market undermining wage and inflation growth, the Reserve Bank of Australia (RBA) cut interest rates in June and July, with markets pricing in a further rate cut by year-end. This would mark 2019 as the first time since 2012 has lowered the official cash rate three times or more in a calendar year.
- The Australian household sector is particularly soft. Stronger commodity prices and volumes have supported a record trade surplus, supporting the government's fiscal response (tax relief). Further fiscal measures may still be required. If unemployment and inflation doesn't respond positively, the RBA appears likely to cut rates again toward the end of 2019 or early 2020.
- While the US economy continues to track well on a number of fronts, markets are expecting with near certainty of a rate cut in July, with up to a further two expected toward the end of this year. We would regard any easing in monetary conditions as an attempt to maintain current momentum, rather than a sign that the economy was deteriorating materially. This is despite an inversion in the US government yield curve, which has historically foreshadowed a recession for the last 50 years.
- Bonds and equities have rallied strongly this year, buoyed by the expectation of a fresh round of monetary easing. Given the degree of downside expected by financial markets for the remainder of this year, risks could still surprise on the upside. A resolution in trade tensions between US and China or a resumption of stronger inflation would likely see a sharp repricing of interest rate risk, triggering a significant reversal in the recent bond rally.
- A more nuanced outcome, in our view, is that with the downside already expected by financial markets, periodical reversals should be expected, particularly if inflation surprises. Overall, however, we feel the rally in bonds has further to run this year in the Australia and the US, particularly at the shorter-end of the curve (less than five years).

2019 Mid-Year Credit Outlook

Global: Bonds and equities rally on monetary easing expectations

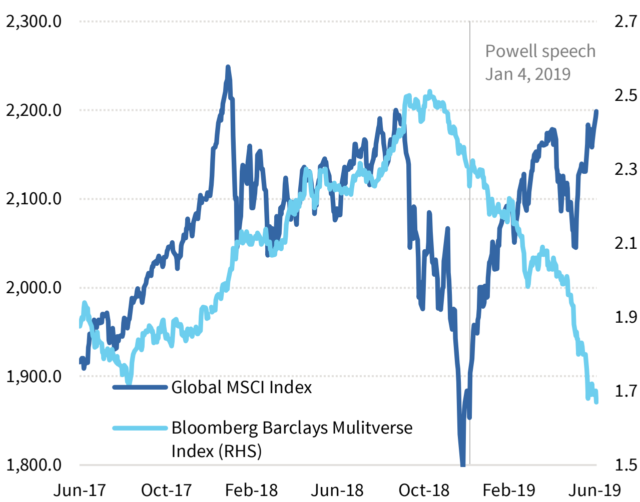
Late last year, we suggested uncertainty and volatility would feature prominently in 2019, carrying over a number of themes emerging in 2018. In the first half of 2019 (1H19), sentiment indeed shifted markedly. Much of this stemmed from a wearying outlook for global growth on the back of slowing corporate earnings and heightened trade tensions, amid concerns around the pace of monetary policy normalisation (most notably out of the United States). While expectations for monetary policy have swung sharply to easing from tightening, the outlook for global growth continues to be faced with headwinds. The International Monetary Fund (IMF) cut its outlook for global growth to 3.3% in 2019 earlier this year, the lowest level since the financial crisis. More than 80% of S&P 500 companies have cut profit outlooks for 2Q19, according to Bloomberg. Ongoing trade tensions and heightened political risk appear to be now having a tangible and negative effect on global trade, with indicators of global manufacturing contracting for the second straight month in June 2019 (see Figure 1), and at the fastest rate (of contraction) since 2012. With the US now experiencing its longest uninterrupted period of economic expansion, it's perhaps no surprise that recent data prints--manufacturing and inflation, most notably--have softened.

A deal between China and the US remains elusive, while China must also contend with the juxtaposition of a flagging domestic economy and a need to preserve financial stability. The US meanwhile has threatened the imposition of tariffs with other trading partners, including the European Union, Japan and Mexico. Britain appears to be making little progress toward a resolution to a problem it created, one way or another, and now without (the now) former Prime Minister May, with the uncertainty weighing on activity both domestically and within the European Union. Germany (the world's second largest exporter), like many countries, finds itself caught in the middle, with recent indicators of manufacturing output at multi-year lows. Germany's 10-year bond yield fell below zero percent for the first time since 2016, and has subsequently hit record lows. French 10-year bond yields recently turned negative for the first time in history.

Figure 1: Global Manufacturing PMI's (Index)

Source: Refinitiv (Reuters), JPMorgan, HIS Markit

Figure 2: Global MSCI (equities) v Multiverse (fixed income) (Index, YTW %)



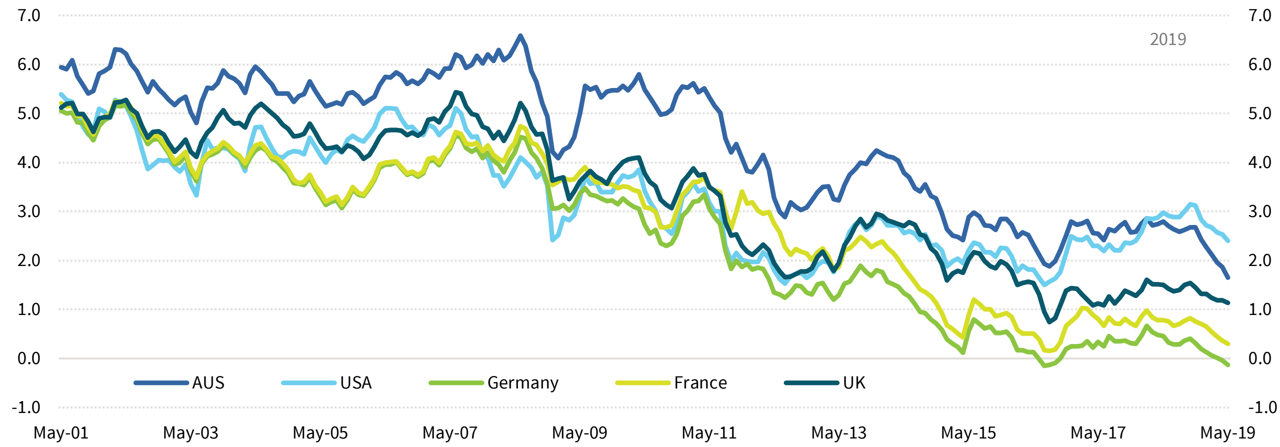
Source: Refinitiv (Reuters), Bloomberg, FIIG Securities

As global growth and interest rate expectations were pared back, bonds and equities rallied. A speech in January from US Federal Reserve (US Fed) Chair, Jerome Powell, signalling that the US Fed could pause interest rate increases triggered a broad-based repricing of interest rate expectations and a surge in the price of both bonds and equities (see Figure 2). Prices of stocks and bonds generally move in opposite directions. The rationale this time around, in our view, is that bond markets are pricing in lower rates as the growth outlook moderates (bond prices respond positively to falling yields, and vice versa); equity markets are also pricing in lower rates in an expectation that central banks will stimulate the economy before it materially weakens. At some point, one cohort of investors will turn out to be wrong.

2019 Mid-Year Credit Outlook

With the US government yield curve now firmly inverted, many are contending the US Federal Reserve tightened too aggressively; markets are currently pricing up to three rate cuts by year end. The nomination of Christine Lagarde to head the European Central Bank has been interpreted by markets as supportive to the extension of ultra-loose monetary policy in the Eurozone; 10-year yields in the core and much of the periphery of Europe are now trading in negative yields. Japan has also recently indicated it would "consider additional monetary easing without hesitation if inflation loses its momentum". With US President Donald Trump accusing both Europe and China of "big currency manipulation", and further reinforcing his views of that monetary policy settings are too tight by making two dovish nominations to the Federal Reserve Board, monetary accommodation now appears increasingly in a race to the bottom (see Figure 3), from already record (or near record) low levels.

Figure 3: 10-year (long-term) government bond yields (%)



Source: Federal Reserve Bank of St. Louis.

Risks could also surprise on the upside, however, given the degree of downside already expected by financial markets. The US economy continues to track relatively well, in our view. It's also questionable what benefit monetary easing in the US would achieve given the current settings do not yet appear to be an inhibitor to growth. Despite downward revisions to growth for 2019, global growth forecasts for 2020 remain largely unchanged, although some of this is presumably premised on a resolution of trade tensions--to one degree or another. China has recently stated that existing tariffs would have to be removed for any agreement to be reached. With campaigning in the US kicking off in the lead up to the presidential election in 2020, the likelihood of the incumbent US regime conceding ground on numerous trade fronts appears unlikely in the near term, in our view.

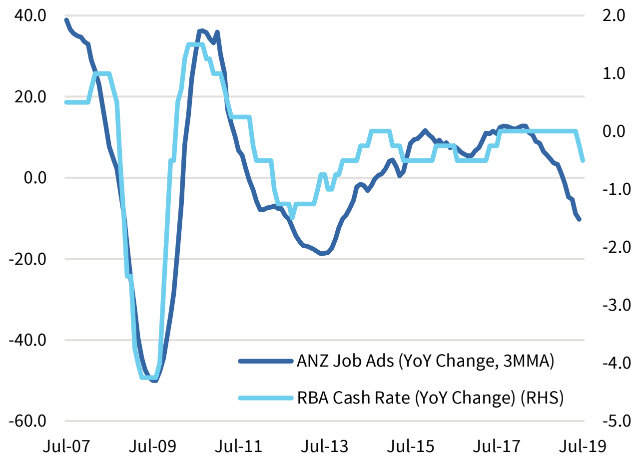
A resolution of trade tensions or, more pointedly, a resumption of stronger inflation indicators--actual or expected--would likely see a sharp repricing of interest rate risk, triggering a significant reversal in the recent bond rally (see Figure 2). Case in point: following a robust jobs report out of the US for the month of June, the US two-year yield rose 11bps, the most since the beginning of 2019. A more nuanced outcome, in our view, is that with the downside already expected by financial markets, periodical reversals should be expected, particularly if inflation surprises. Overall, however, we feel the global rally in bonds has further to run over a longer timeframe--particularly at the shorter-end of the curve (less than five years) if the US indeed embarks a fresh round of monetary easing (which would be received by markets as supportive to longer-term growth).

2019 Mid-Year Credit Outlook

Australia: RBA enters into easing cycle as unemployment turns and households retreat

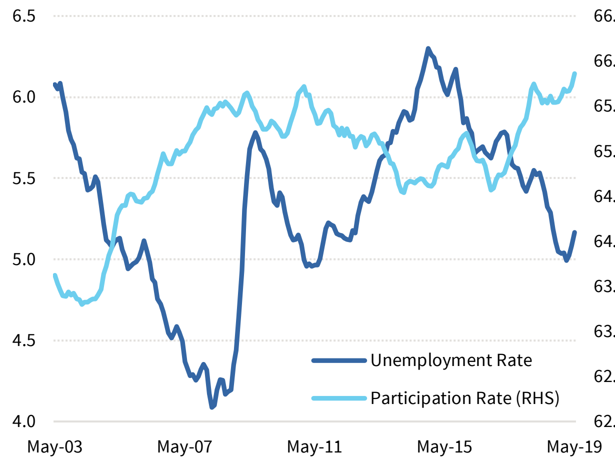
The first six months of 2019 saw the Reserve Bank of Australia (RBA) finally run out patience with spare capacity. It may also be running out effective measures to deal with it, too. With indications of spare capacity suggesting unemployment is set to shift higher in the near term (see Figure 4, 5, and 6), and inflation (including wages) likely to further underwhelm (see Figure 6 and 7), the RBA lowered the official cash rate by 25 basis points (bps) to 1.25% on 4 June 2019--the first time it has cut rates since August 2016--and by a further 25bps in the July meeting.

Figure 4: ANZ Job Ads v RBA Cash Rate (%, pts)



Source: Refinitiv (Reuters), JPMorgan

Figure 5: Unemployment v Participation Rate (%, %)



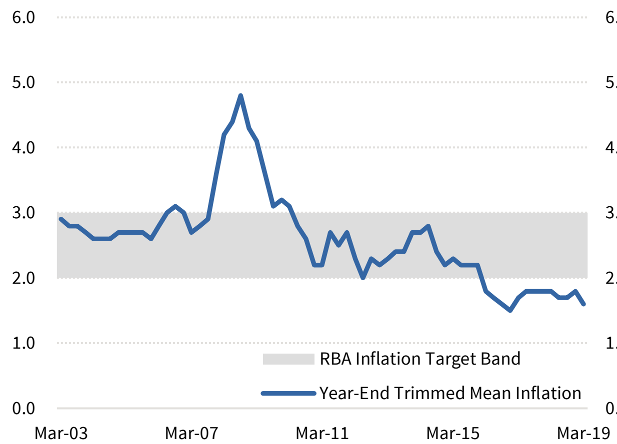
Source: ABS, FIIG Securities

Headline data on the strength of the labour market is mixed. While a further 100,000 (net) full time jobs have been added so far in 2019, the unemployment rate has edged higher to 5.2%, as the number of persons entering the workforce continues to reach record highs (see Figure 5). With job advertisements declining in recent months, and population growth strong, the likelihood of the RBA overcoming the issue of spare capacity in the near term appears unlikely. Recent improvements in the level of underemployed persons also appear to be levelling out, suggesting further upside in wage growth is unlikely (see Figure 6), at least in the near term.

Figure 6: Wage Price Index v Underemployment Rate (%, %)

Source: ABS, FIIG Securities

Figure 7: Inflation (%, %)



Source: RBA, FIIG Securities

2019 Mid-Year Credit Outlook

To illustrate this conundrum succinctly, the RBA recently noted its estimated rate of unemployment at which wages growth starts to pick up was revised lower to 4.5%, from 5.5% a few years ago. It is currently 5.2%, and appears to be heading higher.

GDP growth has slowed noticeably to 1.8%, the lowest growth rate since 2013. Growth forecasts for the remainder of the year have been revised lower, although the medium-term growth forecasts remain unchanged (see Figure 8). Given some of the assumptions underpinning those forecasts already appear optimistic, we wouldn't be surprised if further downward revisions materialise.

Figure 8: RBA Output Growth and Inflation Forecasts

	Year-ended					
	Dec 2018a	June 2019f	Dec 2019f	June 2020f	Dec 2020f	June 2021f
GDP Growth	2.3	1 3/4	2 3/4	2 3/4	2 3/4	2 3/4
(previous)	(2 3/4)	(2 1/2)	(3)	(2 3/4)	(2 3/4)	(2 3/4)
Unemployment Rate	5.0	5	5	5	5	4 3/4
(previous)		(5)	(5)	(5)	(4 3/4)	(4 3/4)
CPI Inflation	1.8	1 3/4	2	2	2	2
(previous)		(1 1/4)	(1 3/4)	(2)	(2 1/4)	(2 1/4)
Trimmed mean inflation	1.8	1 1/2	1 3/4	2	2	2
(previous)		(1 3/4)	(2)	(2)	(2 1/4)	(2 1/4)

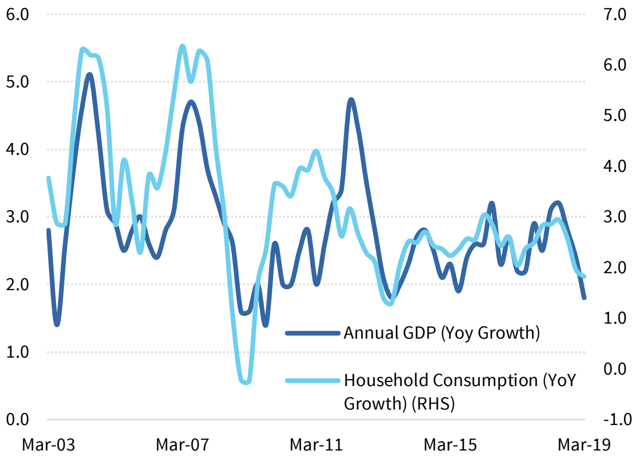
Source: RBA SoMP (May 2019)

For our mind, the Australian household sector appears particularly soft, with growth in household consumption--a key driver of economic growth as it makes up more than 55% of GDP (see Figure 9)--slowing further this year. Against a backdrop of record household debt, subdued wage growth, and falling house prices, the near-term prospects for the Australian household do not offer substantial upside, in our view.

As we explored in our recent update on Australia's housing market (link here), a fairly strong relationship exists between the movement in house prices and household consumption (see Figure 10). Against the backdrop of falling costs of credit and efforts by regulatory authorities to increase the flow of credit after a sustained period of tightening through 2018 and into 1H19, among other developments, we believe property prices are likely to stabilise and probably register a modest rise in 2H19. Coupled with forthcoming tax relief--see further below--we believe household consumption is likely to end the year on a firmer note. However, in the absence of stronger wage growth, while noting households appear to be in the process of unwinding a 10-year low in the household savings rate, we don't think the uplift will be particularly strong.

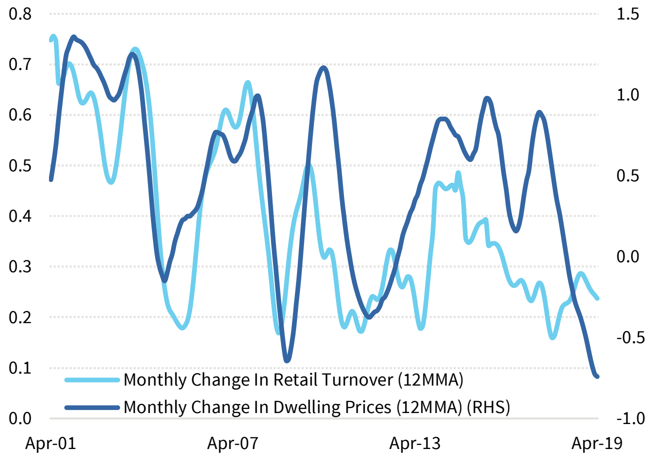
2019 Mid-Year Credit Outlook

Figure 9: Annual GDP v Household Consumption (%, %)



Source: ABS, FIIG Securities

Figure 10: Retail Trade v House Price Growth (%, %)

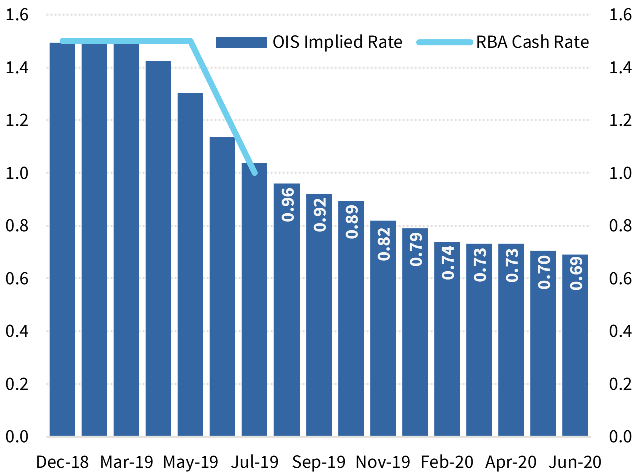


Source: CoreLogic, Bloomberg, ABS, FIIG Securities

Despite two interest rate cuts in June and July, markets are still pricing in a near certainty of a further rate cut by year-end (see Figure 11), which would make 2019 the first time since 2012 that the RBA has lowered the official cash rate three times or more in a calendar year. The government yield curve continues to tumble, although the slope has remained fairly constant this year (see Figure 12), suggesting markets are not overly surprised by the change in both short-term rates and the implications for the longer-term growth and inflation outlook. It did however narrow considerably toward the end of 2018 when markets were increasingly discounting the prospect of increasing interest rates while the domestic growth outlook deteriorated.

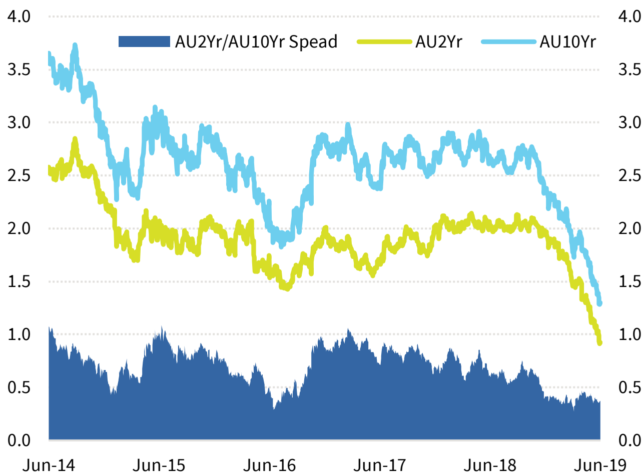
Some market participants have forecasted an even lower rate, while others have opined on the likelihood of quantitative easing. The RBA Governor, for his part, noted "it is not unreasonable to expect a lower cash rate". And while he ruled out the latter option of quantitative easing, it is worth remembering that the RBA began the year with an expectation that interest rates would rise in 2019.

Figure 11: OIS (Implied Rate) per RBA Meeting Date (%, %)



Source: Refinitiv (Reuters), ICAP, FIIG Securities

Figure 12: Australian Government Yield Curves (%, %)



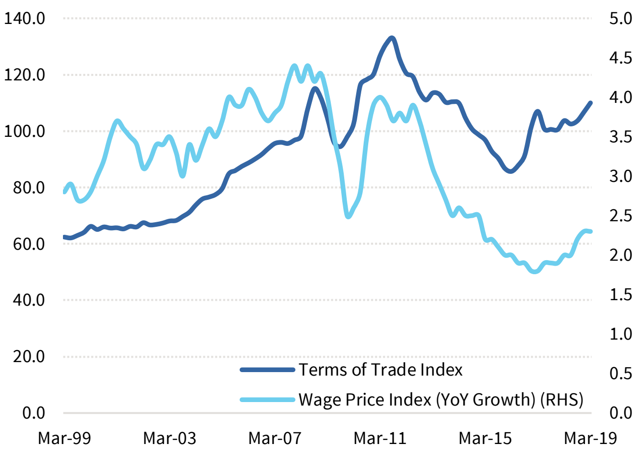
Source: Refinitiv (Reuters), FIIG Securities

2019 Mid-Year Credit Outlook

However, in a sign that the effectiveness of monetary stimulus may be increasingly subject to the law of diminishing returns--particularly as it is increasingly likely commercial banks are unlikely to pass on any future rate cut to borrowers in full, also discussed here--the RBA Governor implored a government response to address the deteriorating outlook for unemployment by identifying three actions it can take--fiscal support (tax cuts), infrastructure spending, and structural policy reform. While the RBA indicated a preference for the latter (structural policy response), the current government appears to presently favour the former (tax cuts) (see further below).

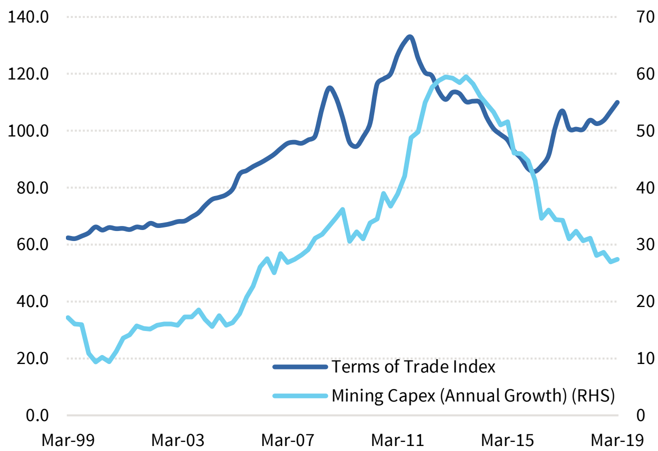
It is worth highlighting that outside of the household sector, public demand, both spending and investment, has been relatively strong and supportive of domestic growth. Public spending has been outgrowing household spending for four years running. Commodity volumes and prices (most notably, iron ore) have also strengthened this year, with Australia's trade surplus surging to a record AUD5.75billion in May. The latter is significant, as increasing terms of trade (the ratio of export prices to import prices) have at times supported higher wage growth (see Figure 13). However, given the increase in prices more recently have been due to disruptions in supply rather than a structural change in the outlook for iron ore (in particular), the increase in terms of trade hasn't corresponded with an increase in mining investments (see Figure 14), and flow-through to downstream and upstream industries. Relatedly, with some market participants arguing the strong uptick in iron ore prices no longer reflect market fundamentals, and Chinese steel demand expected to slow, the logical next step would be a price correction.

Figure 13: Terms of Trade v Wage Growth (Index, %)



Source: RBA, ABS, FIIG Securities

Figure 14: Terms of Trade v Mining Capex (Index, %)



Source: RBA, ABS, FIIG Securities

While there are clearly other factors behind the lack of growth in wages, it seems reasonable in our view to conclude that there is little reason to expect the recent lift in terms of trade to support materially stronger wage growth.

Rising prices for commodities do result in higher national income, which flows through to higher government revenue (in the form of increased tax receipts). Against the backdrop of a local currency content to sit around AUD0.70 (noting that commodities are priced in USD), the government appears emboldened to share the windfalls through personal income tax relief. However, with the bulk of the proposed tax relief not planned to come into effect until 2022-23 and 2024-25, further fiscal measures may be required in the interim to support stronger growth. We would put more weight on the probability of increased infrastructure spending rather than structural policy reform.

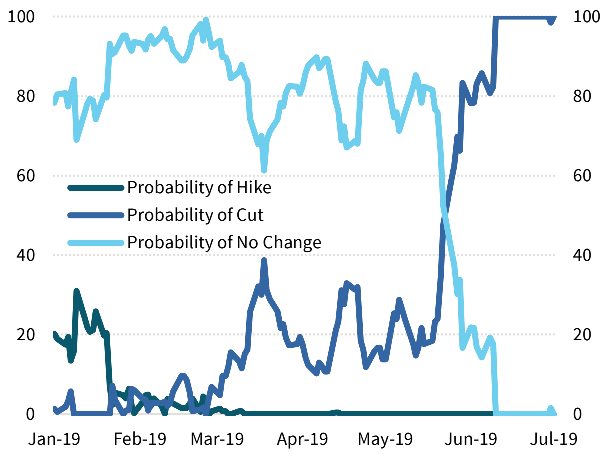
Tax cuts are likely to be more effective in terms of their flow through to consumer spending compared with lower mortgage rates; unless households elect to readjust their mortgage repayments, the amount they repay is unchanged--they simply pay off more of the principal. In any event, with the Australian household burdened by record levels of household debt, we can't help but feel any gains will be partly squirreled away or used to pay down debt.

2019 Mid-Year Credit Outlook

US: Yield curve inverts as the US Federal Reserve calls time on rate hikes

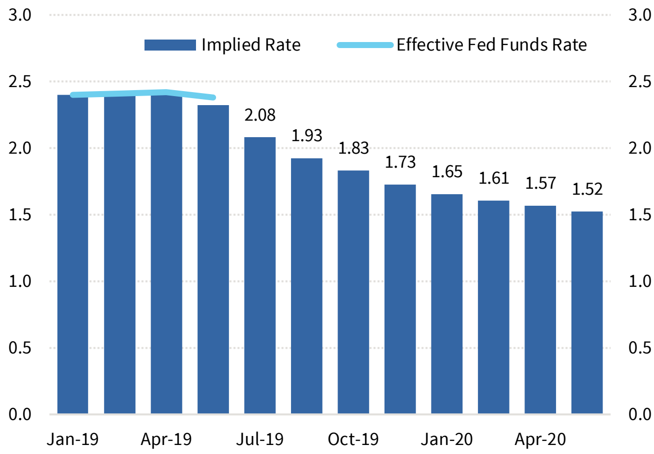
The outlook for US interest rates turned on a dime earlier this year. It remains to be seen whether the US Fed will follow suit and lower them to meet market expectations. Toward the end of 2018, the US Fed was predicting three rate hikes in 2019. It has since scaled back its projected interest rate hikes this year, whilst similarly signalling an end to its balance sheet reduction later this year. Markets are currently pricing in one rate cut by July (see Figure 15), with a further two by January 2020 (see Figure 16).

Figure 15: US Rate Cut probability at July Fed Meeting (%, %)



Source: Bloomberg

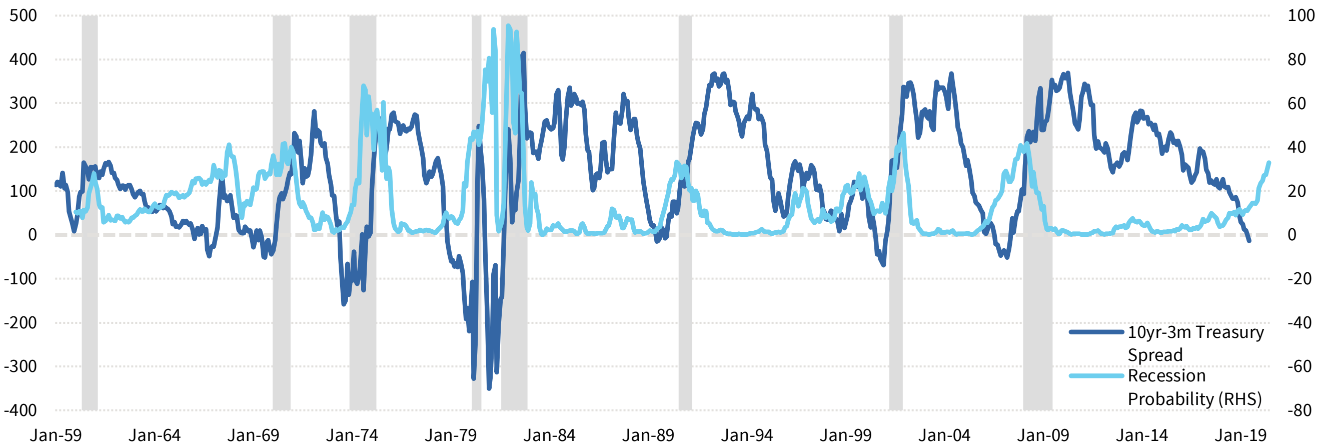
Figure 16: Effective Fed Funds Rate v Implied Rate (per Fed Meeting) (%, %)



Source: Refinitiv (Reuters), FIIG Securities

The prevailing view from markets that 'data dependent' monetary tightening would be a constraint on future economic growth saw the US government yield curve invert for the first time since 2007. The significance of this is not to be understated--the gap between ten-year and three-month yield curves has been negative before every US recession of the last 50 years, although lead times vary greatly. According to modelling by the New York Federal Reserve, based on the spread between the ten-year and three-month yield curves, there is a 33% chance of a US recession within the next 12 months, the highest level since 2008 (see Figure 17). The modelling is not without its detractors; given unprecedented levels of accommodative monetary policy post-financial crisis, including negative interest rates, historical observations may not be relevant this time around (noting earlier recessions were prior to the crisis in 2009).

Figure 17: US 10-year treasury spreads v recession probability (bps, %)



Source: Federal Reserve Bank of St. Louis, Federal Reserve Bank of New York, FIIG Securities. Note: Shaded area denotes recession periods.

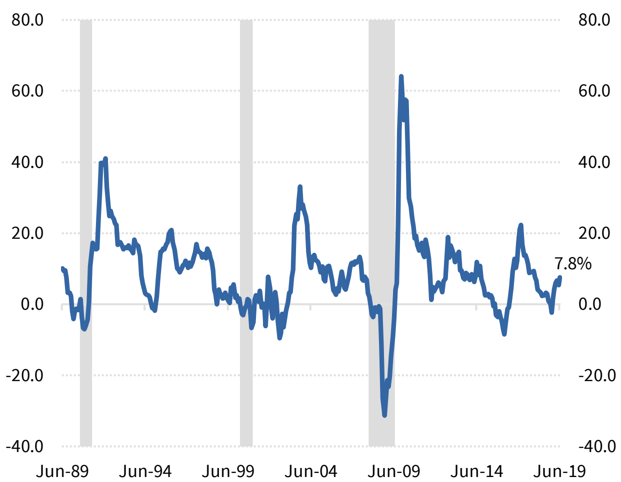
2019 Mid-Year Credit Outlook

Given the current phase of economic expansion is now the longest in history at ten years young, a slowdown should not be unanticipated, although we believe the likelihood of a recession emerging in this year is low. The US economy continues to track relatively well, with GDP above-trend at a touch above 3.0%. The US consumer remains upbeat; unemployment is at 3.70%, with job creation sound, as is wage growth. However, manufacturing, arguably at the coalface of trade tensions, has fallen noticeably this year, although it too has yet to move into an official contraction phase. On a similar vein, business investment has also slowed. The US Fed's preferred measure of inflation remains stubbornly below the 2.0% target at 1.60%, having only briefly touched 2.0% back in September 2018 (and again back in mid-2012). The five-year breakeven inflation--a market-based measure of expected inflation in five years--is around 1.50%. To the extent the current economic expansion does indeed slow, the US Fed is almost certain to cut rates, in our view, pushing out the chance of a recession in the near term (as implied by the shape of the yield curve).

The US Fed now finds itself at a difficult juncture, in our view. In light of still robust economic data, it would be well-justified to maintain a "wait and see" and "data dependent" approach, particularly as it regards recent inflationary softness as transitory. This would likely imply no cuts to rates in the near term. On the other hand, trade tensions pose a risk to the growth outlook, while the risk that inflation undershoots is not insurmountable, if the experience post-financial crisis is anything to go by. With markets pricing in an interest rate cut as a near certainty at its July meeting, we'd regard any easing in monetary conditions as an attempt to maintain current momentum, rather than a sign that the economy was deteriorating materially (in a similar justification to that adopted by the RBA here in Australia).

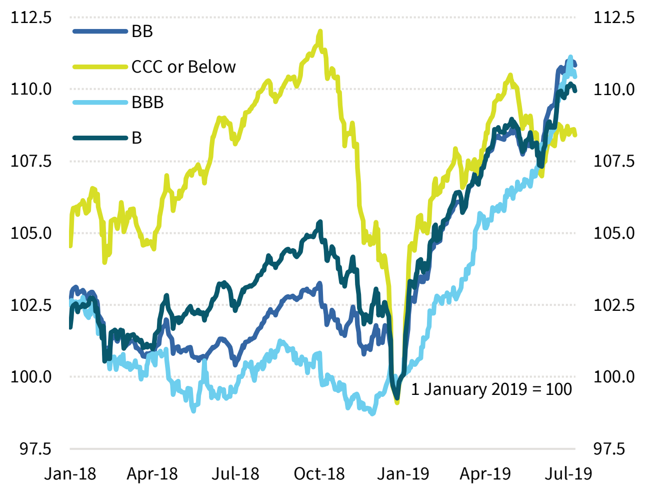
US high-yield debt has rallied strongly in response to the shift in interest rate expectations at the beginning of the year, with year-to-date total returns of close to 8.0% (or more than 16.0% on annualised terms) (see Figure 18 and 19). Spreads have moved materially lower (spreads, or yields, move in opposite directions to the price of bonds), with the spread between 'BBB' rated and 'BB' rated corporates tightening to just 80bps, down from around 160bps at the beginning of the year (and compared with an average of closer to 170bps over the last 20 years) (see Figure 20). Spreads between 'BBB' rated and 'B' rated corporates have tightened to a much lesser extent, as have the spreads between 'BB' and 'B' rated corporates. These movements in spreads suggest a confluence of investors seeking to shift up the yield curve in response to the economic outlook (by shifting from 'B' to 'BB') and, to a lesser extent, investors seeking greater yield (by shifting from 'BBB' to 'BB').

Figure 18: US HY total returns (%, %)



Source: Federal Reserve Bank of St. Louis, BofAML, FIIG Securities.
Note: Shaded area denotes recession periods.

Figure 19: US HY total returns by rating category (%, %)

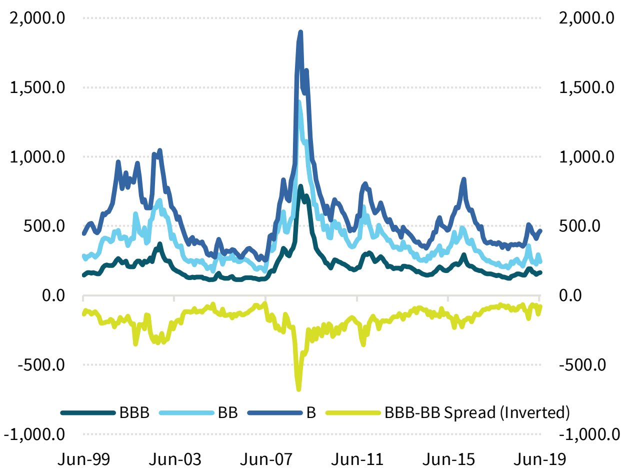


Source: Federal Reserve Bank of St. Louis, BofAML, FIIG Securities.

2019 Mid-Year Credit Outlook

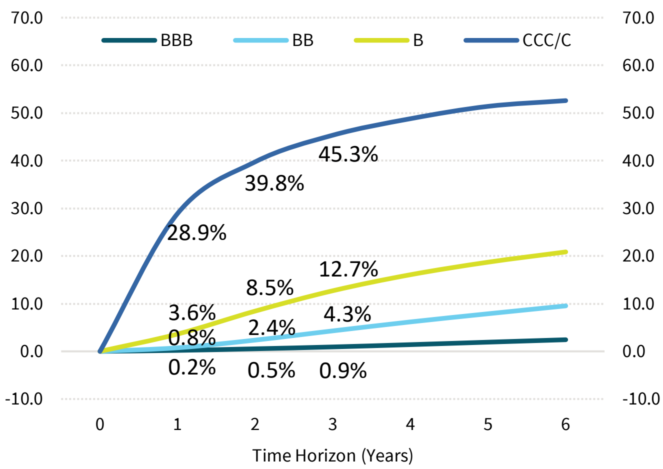
Any retracement in the bond rally is likely to be more acutely felt by high-yield bonds. Given the trade-off between total returns and default rates (see Figure 21), however, we'd expect the relative attractiveness of the 'BB' and 'BBB' corporates to be preserved, with any retracement to be relatively contained.

Figure 20: OAS Corporate Spreads (bps, bps)



Source: Federal Reserve Bank of St. Louis, BofAML, FIIG Securities.

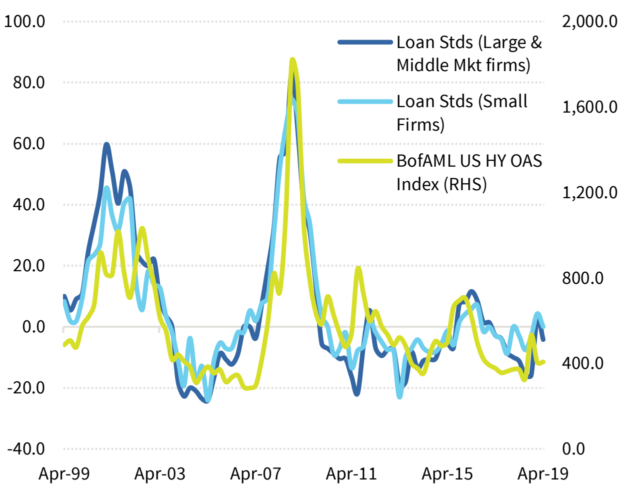
Figure 21: US corporate default rates by rating category (%, %)*



*Source: S&P Global. *Average cumulative default rates between 1981 and 2018.*

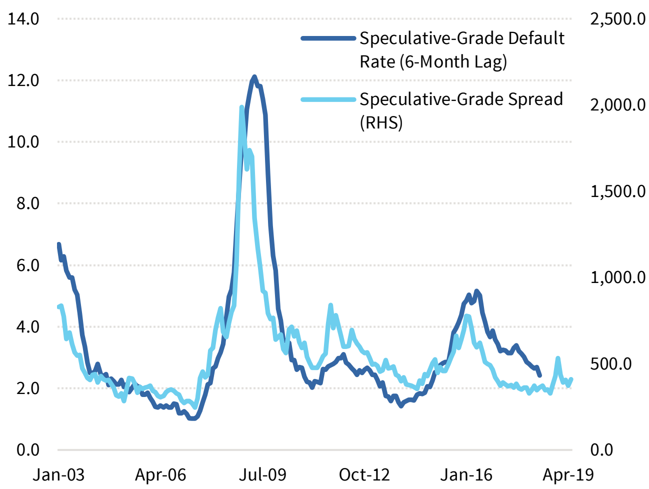
Lending conditions in the US have eased after tightening briefly at the back-end of 2018 (see Figure 22). While cheaper and less onerous financing conditions are positive and supportive of business investments, these trends can be worrying at times as they can indicate an imbalance in the risk-return equation. Looser financing terms and conditions mean that lenders are effectively accepting a greater share of the risk and, as evidenced by price tightening, this points to debt providers not being adequately paid for the risks they are taking. Indeed, and somewhat relatedly, according to credit rating agency S&P Global Ratings, nearly 90% of the USD1.1 trillion U.S. leveraged loan market is now covenant-lite (financing that is issued with fewer restrictions on the borrower and fewer protections for the lender), from closer to 80% back in 2018.

Figure 22: Bank Lending Standards v US HY Spreads (%, bps)



Source: Federal Reserve Bank of St. Louis, BofAML, FIIG Securities.

Figure 23: Speculative Default Rate v Spread (%, bps)

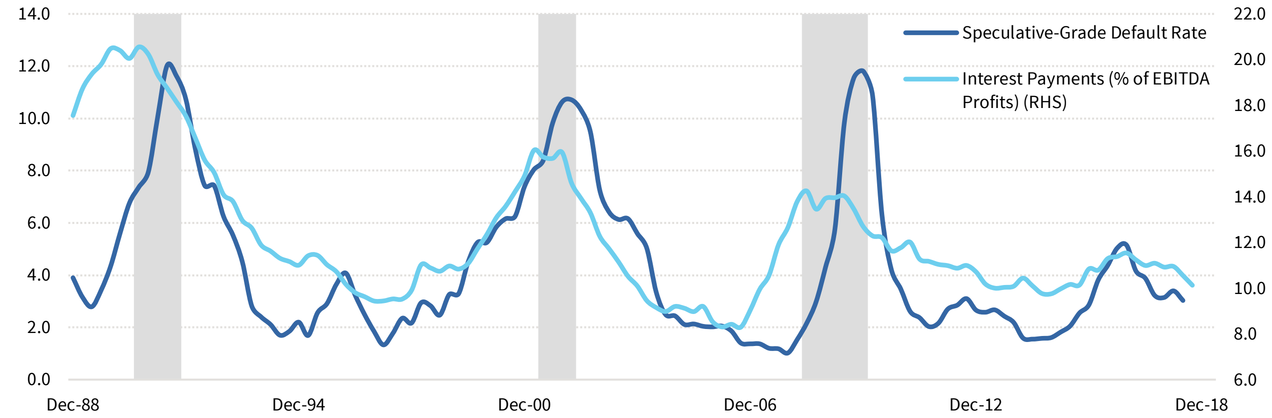


Source: S&P Global Fixed Income Research, BofAML, FIIG Securities

2019 Mid-Year Credit Outlook

With interest rate expectations now pointing to an easing in the near term, the risk of increased defaults within the US high yield sector appear contained, in our view (see Figure 23). Financing and operating conditions for US high-yield corporates remains favourable. If, however, the inversion in the yield curve does indeed foreshadow a recession, financing conditions will tighten and an increase in defaults will follow, albeit, with a lag of approximately six months (see Figure 24), and more likely within the 'CCC/C' and (to a lesser extent) 'B' rated corporates (see Figure 21).

Figure 24: Speculative Default Rate v Financing Costs (%, %)



Source: S&P Global Fixed Income Research, FIIG Securities. Note: Shaded area denotes recession periods.

2019 Mid-Year Credit Outlook

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