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TRANSCRIPT

Credit Markets Snapshot: Apocalypse Not Quite Now

*Featuring**: Hamed Faquiryan**, Vice President, MSCI Research*

Adam Bass (00:03):

This is MSCI Perspectives, your source for weekly research insights as investors respond to the COVID-19 pandemic. I'm your host, Adam Bass, and today is August 27, 2020. This week, credit markets then and now. While we haven't returned to pre-COVID conditions, the difference between markets today and how their condition less than six months ago is as stark as, well, as stark as things looked back then. To get the full story, we spoke with Hamed Faquiryan, Vice President on MSCI's multi-asset class research team.

Adam Bass (00:42):

Hamed, Thank you so much for joining us.

Hamed Faquiryan (00:44):

Sure. It's a pleasure to be here.

Adam Bass (00:47):

Usually when someone doesn't know where to start a story, the advice is often start at the beginning. Today, I'd like to go against that advice and start at the end of our story so, in broad strokes, can you describe what the credit markets look like today?

Hamed Faquiryan (01:05):

Sure. Credit markets have pulled back from the brink. I think we were really staring into an abyss there in late March and early April. Today, what we see is very, very different from that, where what we're seeing is what classically looks like the beginning of a new credit cycle as opposed to the end of one or the precipice of one ending. We see elevated risk premia in certain credit markets where the very real shock that we experienced from the COVID crisis is going to have long-lasting effects.

Hamed Faquiryan (01:43):

Think airlines, any live events company and stuff like that where there is going to be a reallocation of risk premia based on the reality on the ground. Defaults are elevated and we don't see a sign of them really pulling back in terms of real bankruptcies in the real economy. What we do see is a rather placid credit market where things are priced at elevated spreads relative to the pre-COVID reality, but things aren't falling apart in the manner of free-fall that we were witnessing in March and April. That's a very different story than a full on financial panic.

Adam Bass (02:23):

Exactly. That's why it's so important and why I wanted to start where we are now because, as you mentioned, when coronavirus hit the world it hit the markets really hard and nobody knew where it was going to stop. At this point, I'd like to plot our path back to today starting from last spring, which I don't know about you but feels like it was so long ago to me, back to March. What did we see from the markets then? What were investors concerned about?

Hamed Faquiryan (02:55):

I agree. I feel like this year has been a decade long so I fully agree with that. I think it's actually instructive to give the context of where we were in March, which is all time highs for the stock market, really compressed spreads in the credit markets, meaning that credit was expensive. There was a sense of everything is so expensive any disturbance might be amplified in a way that would be really surprising to the market, and I think that's exactly what happened basically.

Hamed Faquiryan (03:24):

Then the shock, I think, ended up being much, much larger than anyone really anticipated. Because everyone had paid a premium to be in the position they were and had no real conception of what the post-COVID crisis would look like, I think there was a dash to liquidity. To be honest, what we saw in the investment grade market was such extreme selling pressure to the extent that I don't think anything in the data actually comes even close to what we saw in terms of the spread blow-outs that we saw in March and April, and that's including the 2008 financial crisis. The speed of this thing is unprecedented and the speed of the subsequent reversal is also unprecedented.

Adam Bass (04:07):

I'm curious. Did it need to be an external shock or was it truly end of cycle behavior where the model is showing some type of negative reaction if COVID or some other shock didn't happen?

Hamed Faquiryan (04:25):

Yeah. I think that was probably the mean forecast, was that we'd have maybe defaults in a particular market. One thing that happened in the energy markets that maybe antedated the COVID crisis by just a little bit was the plunge in oil prices and oil price war between Russia and Saudi Arabia, which had broad implications. I think that is something that was more forecastable in the sense of there'll be a shock and maybe a bunch of defaults in a particular part of the credit markets, and then this would mean a little bit of elevation in spreads. I don't think that was thought of as something that could affect double A, IG spreads for a completely unexposed sector to the energy markets.

Adam Bass (05:11):

Exactly, exactly. Picking up the story there, when you were looking ahead through the models in March, what story were they telling?

Hamed Faquiryan (05:22):

Okay, so the amount of issuance in the corporate debt markets was really on a tear for years and years. Folks were keeping an eye on, throughout 17, 18, into 20, was that the riskiest part of the investment grades credit band was expanding at a much faster rate than everything else. If there was a recession, maybe you'd see a lot of downgrades within the ... This is the triple B segment, and if you have a lot of downgrades in that segment that means all that paper gets dumped onto the high yield market.

Hamed Faquiryan (05:58):

There were questions about what happens in that scenario where there might be a bunch of managers who need to dump that paper because their mandates say investment grade only or their benchmarks are to investment grade bonds only. The questions arose, if there is a coordinated selling event within the investment grade market, can the high yield market absorb the sheer quantity of paper that would be dumped onto it and would investment grade managers suffer a coordinated loss because everyone's selling at the same time?

Adam Bass (06:29):

Then like the cavalry coming up over the hill, the Central Banks step in.

Hamed Faquiryan (06:34):

Yeah. Okay, so I was an intern at Merrill Lynch in 2008. The 2008 financial crisis in a lot of ways was an inflection point in Central Bank policymaking. Reflecting on what happened in 2008 and the alternative monetary policy tools that were unveiled then, that stuff took years and years to think hard about and then actually implement. When I compare what happened in March, you can basically take all the lessons of the global financial crisis and all the policies that either organically or externally were thought of and created, all that stuff took years and years to implement over the global financial crisis and all of it was implemented within weeks, in March.

Hamed Faquiryan (07:27):

I think the evidence is fairly clear that risk premia in the credit markets were extraordinarily elevated and the credibility of the Central Bank to backstop all of its debt really pulled us back from the brink.

Adam Bass (07:43):

Which brings us right back to today. What are investors concerned about today and what stressors are you seeing on the markets that investors should probably keep an eye on?

Hamed Faquiryan (07:55):

I think there is a multiplicity of shapes being bandied about in terms of what the recovery will look like. You have the V-shaped, the U-shaped, [inaudible 00:08:06] shaped. I think what we're seeing is something akin to a K-shape. What we're seeing today is elevated risk premia relative to the pre-COVID times, but a dramatic recovery along the axis of companies which aren't exposed to the most deleterious effects of the crisis, and then a halting of recovery in those sectors which are.

Hamed Faquiryan (08:31):

I think what the credit markets right now are pricing in is that the industries that aren't exposed to the virus are as safe as they were pre-crisis, more or less. At the same time, we're seeing record issuance by companies which are perceived as super safe. Your Googles and your Microsofts might be able to issue more debt than they've ever been able to issue and investors are clamoring for it because it's companies which are extremely safe.

Hamed Faquiryan (08:59):

Whereas in, I think if you're an airline company or maybe a tourism company, I think there your fortunes are still pretty dire. The question becomes, can those companies which are heavily exposed ride out the wave until something approximating normalcy returns?

Adam Bass (09:20):

It sounds like, unlike in March, the market is functioning pretty much like it should?

Hamed Faquiryan (09:28):

More or less, yeah, I think so.

Adam Bass (09:30):

Now throughout this interview you've been speaking, Hamed, with the perspective of a seasoned professional, but you mentioned being an intern at Merrill Lynch back in 2008. I'm curious what were you thinking coming into the industry at that time?

Hamed Faquiryan (09:46):

Okay. My first day at Merrill Lynch was the day that Lehman declared bankruptcy and the night before at midnight Merrill Lynch was sold to Bank of America. My first day was you go upstairs, say hello, and then you call to an all hands. The all hands is basically about whether or not everyone in that room will be fired. I'm an intern so I have the disadvantage of being useless but the advantage of being costless so I was just a witness to this world historical event.

Hamed Faquiryan (10:20):

The anxiety and excitement that was in the air at that time was fascinating because the stakes for me were extremely low. Now that I am an adult attached to the industry with all of the obligations and responsibilities that adulthood comes, you might have a bead of sweat running down your forehead.

Adam Bass (10:39):

Well, thank you so much again for joining us, Hamed. This was a great conversation and we'd love to have you back again to see where we are perhaps six months from now.

Hamed Faquiryan (10:49):

Thanks a lot, Adam, I appreciate it.

Adam Bass (10:52):

That's all for this week. Thanks to Hamed and all of you for joining us. Remember, it takes just a moment to subscribe to the podcast, leave a comment or share with a friend. Until next week, I'm your host, Adam Bass, and this is MSCI Perspectives. Stay safe everyone.

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