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# *Right Fear…Wrong Monster*

As the Era of Accommodation draws to a close, concerns that had been rendered anachronistic for nine years have moved front and center. I'm talking *really* old fashioned stuff like, say, the cost of money. Suddenly… *there is one!* And it turns out investors are actually a fairly parsimonious group. **The prospect of a meaningful increase in rates is so troubling that nowadays even career stock-pickers can tell you where the 10-year Treasury closed to the nearest 100th decimal point.** While they remain confident that, with profits on track to post 18-20% gains this year and 12% next, there's plenty of room for rates to move higher before they become a problem for stocks, make no mistake. Everyone's on high alert. **With $1t in Treasury issuance coming, at the same time that the two principal purchasers** (Foreigners and the Fed) **are making for the exits, it's going to be a very delicate dance between earnings and interest rates.**

Again, the expectation on Wall Street is that the dance will be executed seamlessly and that the backup in rates won't step on earnings' toes. But there's real reason to doubt. I'll spare you another rant about the clear and mounting signs of consumer duress and why I believe that poses a threat to 2019 earnings assumptions. It's *interest rates* that I want to talk about today. **While I agree that higher rates pose a real risk for stocks, the fixation on the 10-year Treasury is totally misplaced**. As outlined in gory detail in January *"No Mr. Bond, I Expect You To Die"*, **the brunt of the pressure will be felt in the front end of the curve where all the issuance is …*and where all the foreign buying has taken place* (see addenda).**

Treasury Debt Issuance

| | As % Total |
|---|---|
| T-Bills | 76.3% |
| 2-9 year | 15.8 |
| 10 year+ | 4.7 |
| TIIPS+ FRNs | 3.2 |
| Total | 100% |

Facts all, which have acted as no impediment to continued spec selling. In fact, **if you want to blame anyone for the backup in Treasuries, blame hedge funds who have been shorting the 10-year in near-record fashion (see above).**

MacroMavens

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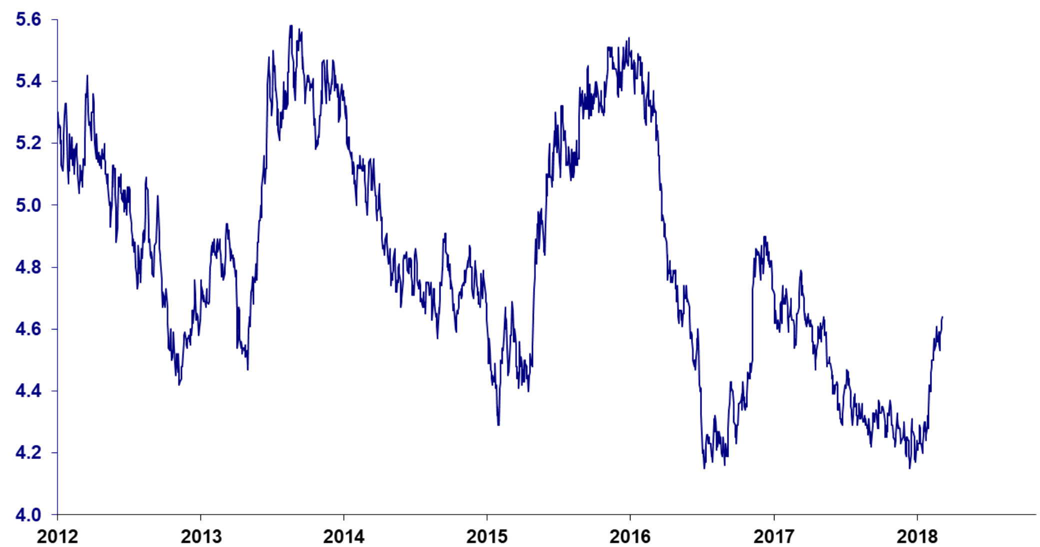
## Investment Grade Bond Yield




Lest that weren't reason enough to suspect we've seen the worst of the backup in rates already, there's the very real prospect, in my view, that growth falls short of lofty expectations and that a 'risk off' flight-to-safety bid sends long-dated Treasury yields lower. *Remember risk??* **While investors obsessively track each tick in the 10-year, they seem to have forgotten why they cared in the first place.** Presumably it's not because they were worried that fat and lazy government bureaucrats might FINALLY face a check on spending mountains of money they don't have.

*No.* **It's because the private sector—upon which the aforementioned earnings gains almost-entirely depend—would get whacked as well.** Were they to remember that, one presumes investors would be a little cagier about the interest rate-earnings dance. For, **after defying Fed tightening for the better part of 2 ¼ years, the corporate market is now turning tail.** *Here's a little secret:* **the Investment Grade (IG) market is actually one of the worst performing asset classes so far this year**, declining –2.8%, versus -1.9% for Treasuries, -1.6% for EM debt and a *gain* of +3.8% for the S&P.

*Wanna hear another secret??* **The supply-demand dynamics for corporates are every bit as challenging—if not more so—as they are for Treasuries.** This market, too, is **forecast to see a $1t in supply this year**. And, in contrast to 'high-quality' government debt, a quarter of that is coming from the guys at the very bottom of the barrel. So, **here again, we are totally reliant on a steady appetite for risk…**

DCM issuance volumes on USD market

| | Corporate bonds | | | | Financial bonds | | | | | SSA bonds | | | | | Total |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| In USD bn | Investment grade | High yield | Hybrids | Total | Covered bonds | Senior preferred | Senior HoldCo/ SNP | Hybrids | Total | US Treasury | Sovereign non-US | Agency non-US/ Supra | Local authorities | Total | Bonds |
| 2014 | 644 | 312 | 8 | **964** | 10 | 348 | 106 | 134 | **598** | 2 206 | 97 | 240 | 13 | **2 556** | **4 118** |
| 2015 | 787 | 262 | 8 | **1 057** | 22 | 318 | 144 | 122 | **605** | 2 123 | 84 | 244 | 13 | **2 464** | **4 126** |
| 2016 | 747 | 229 | 1 | **977** | 17 | 330 | 174 | 111 | **631** | 2 070 | 116 | 295 | 29 | **2 510** | **4 118** |
| 2017 Expected | 760 | 280 | 2 | **1 042** | 13 | 395 | 172 | 61 | **640** | 2 552 | 140 | 253 | 32 | **2 977** | **4 659** |
| 2018 Forecast | 750 | 250 | 3 | **1 003** | 15 | 403 | 197 | 70 | **685** | 2 635 | 128 | 270 | 24 | **3 057** | **4 745** |
| 2018 vs. 2017 | -1% | -11% | +50% | **-4%** | +20% | +2% | +15% | +15% | **+7%** | +3% | -8% | +7% | -25% | **+3%** | **+2%** |

*Source: SGCIB Analytics, Dealogic*

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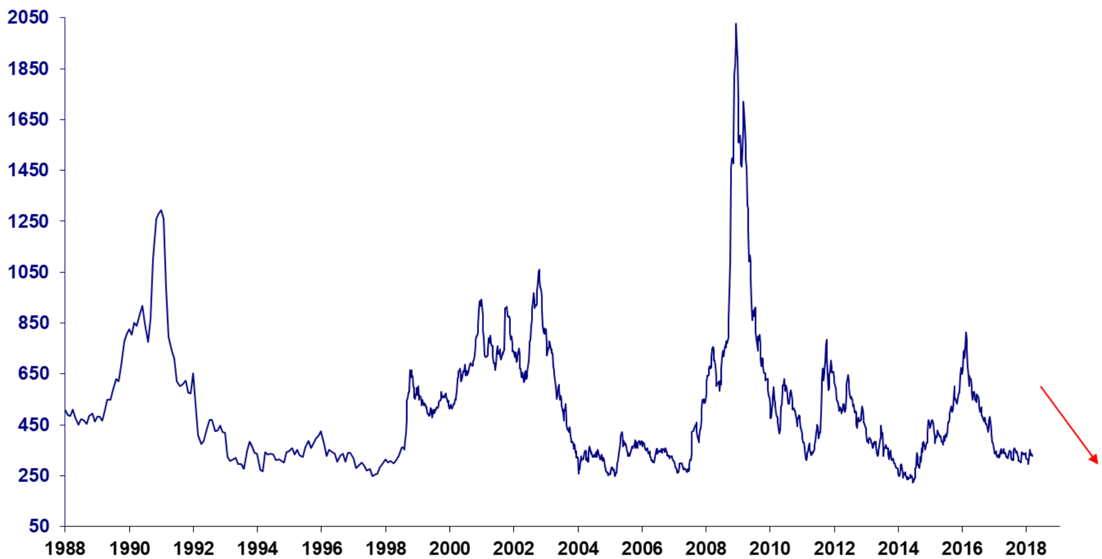
*Prod-to-Risk...*
**Junk Bond Spread over 10-Year Treasury**




That appetite, meanwhile, is being dulled by the very Fed tightening perceived to be *no problemo*. From its crisis peak, **the reward junk buyers are receiving for taking the riskiest of risks has collapsed from 2030bp to just 327bp.**

It has done so at the same time that **default risk is rising.** Whatever you think about the economic backdrop, **trying to borrow $250b at higher rates, is going to be challenging for these speculative grade companies, most of whom have no cash. Their woes will only be compounded by the limits on expensing of interest.**

| S&P 500 Companies by Mkt Cap | Cash & Cash Equiv's | % of Total Index Cash |
|---|---|---|
| Top 25 | 986 | 53% |
| Bottom 250 | 99 | 5 |
| Total | $1847b | 100% |
| Source=Bloomberg, S&P | | |

*I know. I'm SUCH a drama queen!* So, here's the take from the notoriously dispassionate folks at S&P: *"although the rise in corporate bond yields from September through December was modest, <u>we consider a sharper-than-expected rise in inflation or interest rates to be a potential risk for corporate funding,</u> especially for speculative-grade companies that have fewer sources of funding available."* That's downright hot-under-the-collar for these guys.

Still not enough to dent the allure of 'risk'? Alright. I'll pull out the big guns. **Let's take a look at those foreigners everyone's so worried about exiting the Treasury market…**

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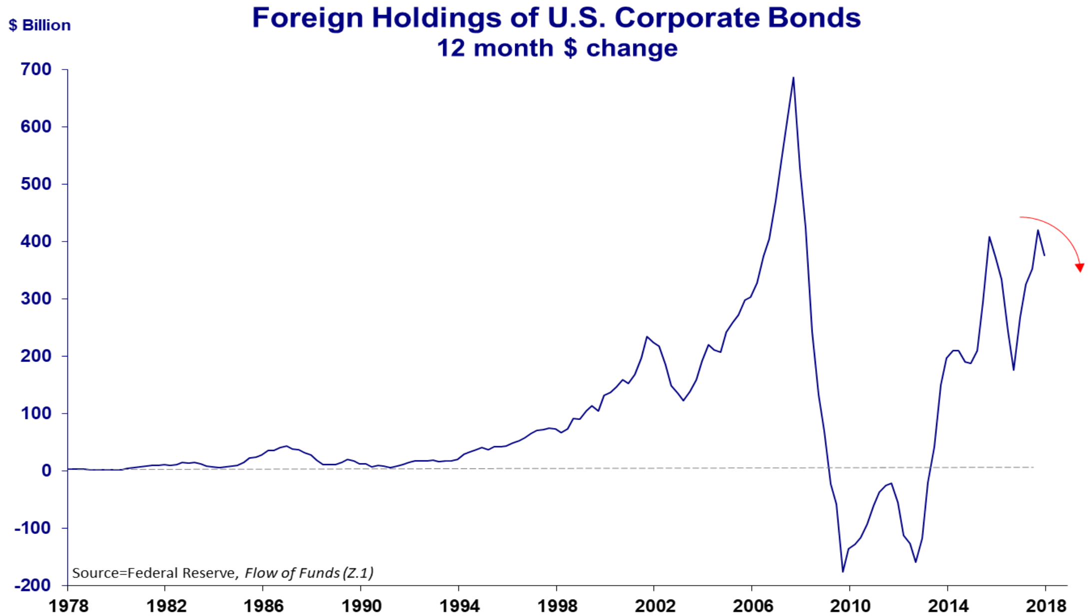


Turns out those same **foreigners have been YUGE buyers of our corporate bonds as well.** In fact, they have gone from owning 21% of the market in 2009, to **owning 30% today** (see addenda). As would necessarily be the case, that increase has been achieved on the back of sizeable annual purchases. In the Fed's *Flow of Funds* report, released last week, we find that **foreign buyers took down fully 54% of corporate debt issuance last year!**

Corporate Debt Purchases by Major Sector*

| | As % Total |
|---|---|
| Rest of World | $310b |
| Mutual Funds & ETFs | 272 |
| Insurers | 78 |
| Pensions | 40 |
| Households | -131 |
| Total Issuance | $577b |

Ominously, these purchases have slowed in the last 2 quarters.

**With deteriorating credit quality adding insult to the *declining dollar* and *trade war* injury** so widely cited as reasons to fret a foreign exodus from Treasuries, **the complacency around the corporate bond market seems dangerously mislaid.**

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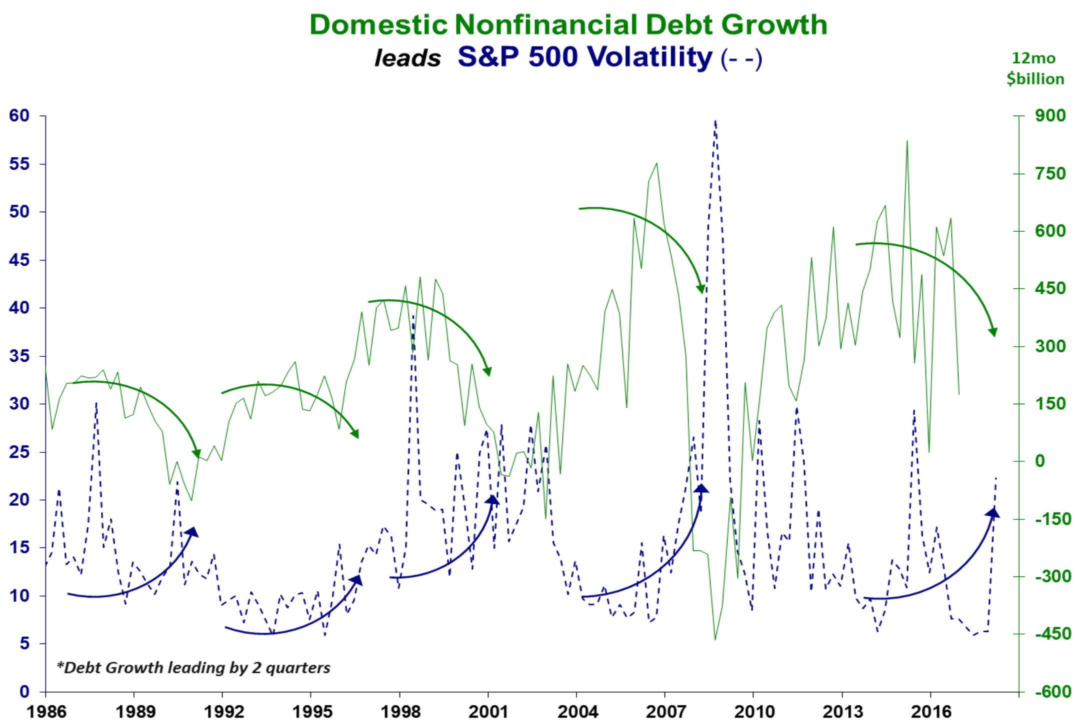


This is where I would normally pile on with astonishing tales of consumer credit doom—citing the perfect storm of rising debt service, stagnant wage growth and soaring food & energy costs as catalyst for higher delinquencies. But I promised to spare you this week. ☺

Fact is, there's plenty to worry about just on the corporate front. After all, **the corporate sector's ready access to cheap funds has been a major support under the stock market,** enabling all the aforementioned cash-poor companies to keep up in the competition to lavish money on shareholders via buybacks and dividends. Not surprisingly, given the backup in junk yields at the end of 2017, these same companies are now being priced-out of the market. Also courtesy of the Fed's *Flow of Funds* report comes the gory image above. **In the 4th quarter nonfinancial credit issuance collapsed from its $635b annual rate in the 3rd quarter to just $176b!** With rates having moved sharply higher in the 2 ½ months since, that trend has surely accelerated. Indeed, Bloomberg league tables put **y-t-d corporate issuance down -16% from the same period a year ago.**

**It's no mystery that volatility has ticked higher**. What IS a mystery is how long equities can go up (as they have so far in 2018) while the credit market goes down??

My guess is "not much longer", as the hand-wringing about rising yields and their implications for untenable finances shifts from K Street to Main Street.

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Maturity Distribution of Foreign Treasury Holdings

| 2016 | % of Foreign *Total* Holdings | Foreign *Central Bank* Holdings |
|---|---|---|
| 0-5 years | 64.2% | 67.1% |
| 5-10 years | 26.7 | 26.3 |
| 10+ years | 9.1 | 6.6 |
| Total | 100% | 100% |

Federal Reserve Treasury Holdings

| | $ | % |
|---|---|---|
| 0-1 year | $425b | 17.4% |
| 1-5 years | 1084 | 44.3 |
| 5-10 years | 317 | 13.0 |
| 10 year + | 621 | 25.4 |
| Total | $2447b | 100% |