Eye on the Credit Markets: Regulation & Tapering

Bloomberg

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The worldwide credit markets were impacted by a confluence of factors in 2013, as the global economy continued to slowly regain its footing. Among those influences, two garnered particular attention as the year progressed: the uncertainty surrounding the U.S. Federal Reserve's tapering of its bond-buying program; and the impact that global banking regulation has had on the issuance of debt and the availability of derivatives data. Both issues will continue to drive markets in 2014.

A Reduction in Stimulus

The Fed began its third round of quantitative easing in September 2012, buying $40 billion in mortgage-backed securities on a monthly basis, in addition to $45 billion in Treasuries under Operation Twist. On May 22, 2013, when Ben Bernanke first mentioned the eventual reduction of its bond buying campaign, stocks plunged and Treasury yields climbed. How and when that $85 billion in stimulus would be reduced was a question that faced markets for the better part of the year.

"Probably the most common question we get asked by our client base is, 'How do you expect the credit market to perform in a Fed tapering scenario,'" said Sivan Mahadevan, head of U.S. Credit Strategy and Global Credit Derivatives Strategy at Morgan Stanley, on November 21.

On Dec. 18, the Fed announced that it would reduce its purchases by $10 billion a month—$5 billion in MBS and $5 billion in Treasuries—in January, but that short-term interest rates would continue to hold steady after the U.S. passed the 6.5% unemployment rate previously cited. How imminent additional reductions are, and how that tapering affects the credit markets, are developments that will be watched in the coming months.

"Janet Yellen, the incoming Fed Chairman, has argued that the economy is still operating far below potential, and the unemployment rate remains too high," noted Seth Rooder, Global Credit Derivatives Product Manager for Bloomberg. That may point to a more gradual reduction in stimulus.

Federal Shutdown

The central bank wasn't the only part of the U.S. government whose action—or inaction—weighed on the markets in 2013. The federal government shut down for 16 days in October when the House and Senate were unable to reach a budget agreement. If not for an eleventh-hour deal that raised the debt ceiling, the U.S. would have entered a technical default on Oct. 17.

However, while the debt ceiling threat had the potential to severely disrupt markets, the market largely shrugged it off, as few investors believed that the government would choose to default.

"The disruption was localized in Treasury bills and near-term maturities," said Rooder. "The real disruption was at the very short end of the curve, which quickly normalized after the temporary measure was passed."

The government averted the possibility of another shutdown in 2014 by reaching a bipartisan budget agreement in mid-December. But the debt limit will need to be raised again before Feb. 7, raising the potential for default if a compromise cannot be reached.

"Perhaps the most dangerous thing about even a technical default on short-dated Treasuries is that these instruments form the basis for the repo markets and short-term funding," noted Rooder. "Any disruption there could be very damaging to financial markets as a whole."

"Furthermore," he added, "many trading and order management systems simply weren't set up to handle a Treasury default, so an event could prove a calamity just from a technical perspective."

Cautious Credit Investors

The equity markets were largely unaffected by tapering fears and reached new highs in 2013, due in part to a long series of corporate earnings reports that exceeded expectations. But credit markets also enjoyed a substantial and prolonged rally. As of late November, Markit's CDX North American Investment Grade index was 35 basis points tighter over the last 12 months, and Markit's CDX North American High Yield index was 200 basis points tighter. Still, credit investors have exercised a bit more caution, with growth in the investment grade and high-yield indices stalling.

Based on Morgan Stanley's valuation frameworks, investment-grade U.S. credit is near fair value, though somewhat tight, according to Mahadevan. The bank's year-end forecast calls for a base-case spread of 137 basis points, with bull and bear cases of 92 bps and 176 bps, respectively. U.S. investment grade may have the "strongest hands" of the credit markets, said Mahadevan, because the participants include both total return-based investors and asset liability investors—pension funds and insurance companies.

"We see less of the asset liability audience in markets like high yield and even municipals," he said. "I think those markets are much more dependent on total return flows, they're much more dependent on retail flows. We feel investment grade is perhaps a bit more balanced."

Cash credit behaved similarly to credit derivatives over 2013, with indices recovering from the May sell-off. After falling out of favor in the wake of the financial crisis, the leveraged loan market roared back to life in 2012, and 2013 saw the market continue to build on that performance.

Issuance Boom

Favorable conditions across the credit markets led to a boom in issuance activity in 2013. As of Nov. 21, it was on track to be the highest-issuance year since 2009, with $1.1 trillion in investment-grade issuance and $340 billion in high-yield debt. In the leveraged loan market, issuance appears poised to set a new record—and, at $900 billion as of late November, has eclipsed high-yield issuance by nearly three times.

Looking at total loan issuance, $1.2 trillion of syndicated signed loans have been issued over the past year, with some $32 billion left in the pipeline. And issuance has handily outpaced maturities and redemptions, meaning that firms are adding supply to the market and relying more on the asset class for financing.

However, the aggregate strength in issuance masks a countertrend: net issuance in the financial sector, which grew rapidly from 2000 through 2006, before collapsing after the final crisis. "Since then," said Rooder, "financials issuance has been much more moderate, oscillating between net redemptions and net issuance, and certainly not approaching anything near pre-crisis levels."

Changing Banks

Banks have undergone considerable transformation since the financial crisis, as they have faced stricter regulatory capital requirements and a greater need to hold tier-one capital, and have had to work to de-risk their balance sheets.

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Tapering's effects on the credit markets will be closely watched in the coming months.

The DTCC's Swap Data Repository—essentially a consolidated tape for derivatives—represents the first time that the market has had post-trade transparency.

This phenomenon can be seen in narrowing spreads between financial and non-financial CDS. "It's been a post-crisis theme," said Rooder, "and the dynamic continues as banks are increasingly seen as less risky from a credit perspective."

The changes have also introduced challenges for investors. "If you're trying to figure out where bank spreads should be, where senior spreads should be relative to subordinate spreads, you really can't use history as a guide," explained Mahadevan. "We've gone through so much change that in many ways you need almost a new kind of framework."

Based on the application of two different techniques to valuing bank capital structure—one a Merton model-type approach, the other a securitization framework that uses correlation models—Morgan Stanley finds the current senior spreads for banks to be reasonable, though the subordinate spreads feel "a little bit tight," according to Mahadevan.

New Data

From a transparency perspective, regulatory mandates have had significant benefits. 2013 was a big year for implementation of the Dodd-Frank Act, which has put a great deal of new data in the hands of investors.

Under Dodd-Frank, mandatory clearing of over-the-counter derivatives through central counterparties was phased in throughout 2013, beginning with swap dealers, major swap participants and active funds in March. Swap execution facilities launched on Nov. 1, and all trading is expected to be conducted on the platforms beginning during the first quarter of 2014.

At the start of 2013, the Depository Trust & Clearing Corp. began publically disseminating reported trades through its Swap Data Repository, which is essentially a consolidated tape for derivatives and represents the first time that the market has had post-trade transparency. Bloomberg is making the data available to users through its SDR <GO>.

"The trades must be reported as soon as technologically practicable, which means a delay of under 15 minutes, though frequently it's under five minutes," noted Rooder. The trades are displayed on the SDR <GO> screen as they come through, "along with the price, volume, time of execution, and whether it was cleared or un-cleared. You can also do things with this information such as show the aggregate amount of volume traded for a given product over the day or over a certain timeframe."

Bloomberg is also utilizing the DTCC-disseminated data for its SDRV screen, which gives users real-time awareness of liquidity in the context of recent trading volumes and trends. And historical data allows users to track and compare trading volumes over time for different instruments. "If market participants had this information when the 'London whale' trades were occurring, it would have immediately flagged the unusual trading volumes that were going through on some of the off-the-run IG indices. And that information would have been available in real time," suggested Rooder.

With tapering underway, and regulatory pressure continuing to drive the markets—in both surprising and predictable ways—additional transparency could only help in the coming year.

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