2021 Credit Market Outlook

LIZ BOWYER: Hi Lotfi.

LOTFI KAROUI: Hi Liz, how are you?

LIZ BOWYER: Good thanks. Lotfi, you and your colleagues from Goldman Sachs Research have published your outlook for credit markets in 2021. With the prospect of a vaccine-led recovery, what do you think the impact will be on credit markets broadly?

LOTFI KAROUI: To a very large extent, that vaccine-led recovery is already priced in in credit markets. And so, across the board when you look at corporate bond spreads, we're very close to pre-pandemic levels. And even when you look at the primary market, the strong levels of activity that we've seen in the past couple of months suggest that investors' confidence vis-à-vis the durability of the recovery is quite strong.

From a performance standpoint for 2021, we're actually constructive on the asset class. Of course, returns will be lower relative to the stellar performance that we've seen since late March. And that's as reflection of valuation. You know, there's a limit to how much tighter spreads can go from here. But we nonetheless expect the asset class to deliver stable income to investors into 2021. The returns will be almost entirely driven by coupon income as opposed to price returns [PH]. But on a risk adjusted basis, those returns will be compelling to multi asset investors.

LIZ BOWYER: And what's driving that view?

LOTFI KAROUI: There are really two ingredients to that view. Number one, we do expect the strong economic recovery that is currently priced in to materialize into 2021. Of course as you said earlier, that is entirely predicated on the notion that the vaccine timeline is going to remain on track. And that we'll reach mass immunization probably by the end of 2021. That should allow a lot of pro cyclical sectors to recover, and also sectors that have been at the epicenter of the disruption caused by the COVID-19 pandemic.

The second ingredient is technical in nature. It is a reflection of the absolute low level of yields globally, which in our opinion should continue to stimulate demand for products that have a little bit of spread pick up. And certainly credit fits with that description today.

LIZ BOWYER: So, your research talks about investors wanting to move down in quality in the corporate bond market in 2021. Can you explain that?

LOTFI KAROUI: What we mean is that investors should try to maximize exposure to coupon income or carry as opposed to price returns. Practically speaking, that means a preference for high yield over investment grade. And then within the high yield market, it also means a preference for the low end of the quality spectrum, so CCC rated bonds relative to their DD rated peers [PH].

There are really three ingredients to that view. The first is, again, we do expect stronger growth will likely benefit weaker balance sheets and allow them to improve their fundamentals in 2021. So, for example, we're expecting a fairly benign backdrop in terms of the falls in the high [UNINTEL] market, or rating migrations in the low end of the quality spectrum in investment grade.

Number two, and like I said earlier, we think that [UNINTEL] motives will likely remain quite strong into 2021, which should incentives investors to seek income and move down in the quality spectrum. There are really two data points in my opinion that illustrate the strength for [UNINTEL] motives and the need for income among fixed income investors. The first one is a few weeks ago, for the first time ever, in real terms IG corporate bond yields turned negative. That means that investment grade rated borrowers are expected to be paid in real terms in order to borrow money today. So, on an inflation adjusted basis. And then the second data point that I think also illustrates how strong [UNINTEL] motives are is the fact that over 35 percent of the euro investment grade corporate bond market trades today with negative yields. Again, that's something that should incentivize investors to maximize income and move down in the quality spectrum.

Third ingredient to that view, which is related to the first one, but the lower you go in the quality spectrum in credit markets, the higher the sensitivity is to the vaccine timeline. Because the stronger the skew is towards some of the sectors that have been severely impacted by the sudden stop in the economy that we went through in the first half of the year. And so, energy is a good example in the high-end market in the US. Metals and mining is another one. Travel and leisure. Gaming. Et cetera.

LIZ BOWYER: Even with an economic recovery, there's still an expectation that borrowing rates will remain low for some time. What do you think that means for the US housing market, which has been surprisingly strong this year?

LOTFI KAROUI: Yeah, if you just looked at US housing market indicators in 2020, you would have never guessed that we went through a pretty severe downturn. The US housing market had a very strong year in 2020. And the best way we can describe 2021 is that we think that the market is going to transition from hot to warm.

There's really, again, two ingredients to that view. Supply and demand. On the supply side, we think that supply is going to remain very, very tight. You know, if you look at the inventory of homes for sales, where at actually multi decades low in the US. And that tailwind, I think, will remain in place into 2021. On the demand side, there's no doubt that the disruption that the COVID-19 pandemic imposed to the labor force, it basically forced a lot of people to work from home. Did stimulate a lot of demand into 2020. And so that tailwind will likely fade in 2021.

But we do see two structural factors that will remain in place and will, nonetheless, stimulate demand in, you know, next year. The first one is demographic forces. We do expect millennials to continue to increase their ownership share in the housing market. And then the second is the one you've just mentioned earlier, which is financing conditions or borrowing costs remain quite attractive for first time home buyers. But obviously, if you looked at 30-year mortgage rates we're basically at all time low levels. And that's a pretty significant tailwind to demand in our view.

LIZ BOWYER: Well, on a related note, consumer credit remains surprisingly strong in 2020, unlike in the financial crisis. Why do you think that is?

LOTFI KAROUI: Unlike the runup to the global financial crisis in 2008, US households went into this crisis into a position of strength. By and large households have done a very good job repairing their balance sheets after the global financial crisis. So, for example, if you looked at the ratio of debt to income it's been in a steady decline for pretty much the last decade. Having said that, as you say, US consumers did surprise to the [UNINTEL]. If you looked at delinquency rates in credit cards, auto loans, or even unsecured consumer loans, those are actually down on a year over year basis, which is quite remarkable considering the severity or the magnitude of the economic shock that we went through.

Now there are really two reasons for that. The first is the willingness of lenders to look through the shock and treat it as a transitory [UNINTEL]. And that allowed a lot of borrowers to enter forbearance programs. And that explains to some extent why delinquency rates did not pick up in this crisis. Number two is, of course, the powerfulness of the fiscal response. That allowed almost perfect income substitution for households. And it also greatly contributed to the resilience of US consumers and the fact that delinquencies didn't rise to the same levels that you typically see in an economic downturn.

LIZ BOWYER: So what's your outlook for consumer credit and delinquencies in 2021?

LOTFI KAROUI: There's some risk in the near term. A lot of the forces that allowed delinquencies to remain benign in 2020 are set to fade in 2021. So, fiscal support will be weaker. A lot of the forbearance programs that borrowers entered into in 2020 are set to expire in 2021. And then of course the current situation on the virus front continues to deteriorate. And that certainly poses a lot of risk in terms of potentially new business restrictions.

Beyond that and assuming the vaccine timeline remains on track, we do expect [UNINTEL] metrics to recover in the second half of 2021. And pretty much go back where they were in, you know, pre pandemic.

LIZ BOWYER: Thanks Lotfi.

LOTFI KAROUI: Thank you Liz.