For years, we have frequently been asked “How long can this economic expansion, and the attendant benign times in the high yield market, go on? Aren’t we overdue for a correction?” I have always disliked the implication that a recession is in any sense “correct” or that expansions have an intrinsically limited life…that they die of old age. They really end when a major (and randomly timed) exogenous event (like the oil shocks of the 1970s) occurs or when a large asset bubble bursts (like the tech and Internet stocks in the early 2000s, or subprime housing in 2007-2008), or when there is a major policy error by the monetary authorities (deflation during the Depression, or inflation in the 1970s, which resulted in Paul Volcker’s necessary but recession-inducing medicine in the early 80s). We have consistently responded that we see no major imbalances in the economy, and no major bubbles whose bursting would trigger a wealth effect driven decline in aggregate demand, and thus we have been believers in a long recovery which would get even longer.

Well, we are certainly in the midst of the granddaddy of all exogenous events. COVID-19 has devastated the world economy like nothing since the Second World War, and it has done it in a matter of weeks. It is a particularly difficult time to make any useful comments about the course of future events, and “this time it’s different” because the US economy was in quite good shape through the end of February. Yes, there were the warnings from various macroeconomists about greater leverage among corporations, consumers, and especially college graduates, and the bloated Federal deficit (economists are always in the warning business) but the real indicia of health – GDP, employment, wages, corporate profits, workforce participation – were all strong and either stable or improving, except for business investment, before COVID-19 shut the economy down in a matter of days.

Between February 28 and March 23, the high yield market fell by 18.66%, according to the Bloomberg Barclays index system. The leveraged loan market, according to the Credit Suisse Leveraged Loan index fell even more – by 19.09%. This is, by far, the worst three week period in history. All industries and all ratings had highly negative returns. Without question, the economy has suddenly entered a recession whose severity will likely be high but whose duration is unknowable. At times like this, I always quickly calculate what default rate is “baked into” a yield like today’s average promised yield of 11.7% in the high yield market (the yield per the Bloomberg Barclays index as of March 23). Over time, the high yield market has returned approximately 2.50% more than ten year Treasurys. With Treasurys at 0.5%, if an investor buying today earned a return of 3.00% on bonds held until maturity, he would earn that historical ex post risk premium. Using an average recovery rate of 40% when a bond defaults, the implied gross default rate is 14.50%. That is, that gross default rate would generate a net loss rate (after recoveries) of 8.7%, and 11.7% – 8.7% = 3.00% if the surviving bonds were held to maturity. Importantly, this breakeven default rate is both instantaneous and permanent - an extremely severe and prolonged credit disaster. Have we ever experienced a default calamity even close to this? Only for short periods, and only during the most severe recessions. According to JPMorgan, the three highest calendar year gross default rates have been 11.54% (1991), 10.89% (1990), and 10.27% (2009). The largest annual default rate over any five year period has been 7.86%. For context, the average default rate over the last ten years, including the commodities debacle of 2015 – 2016, was just 1.85%. So today’s pricing implies a permanent (that is, through maturity) eightfold increase in defaults.

So it is clear that in order for a buy-and-hold investor to earn a lower net risk premium than average by investing today, the next several years of default rates would have to be much, much greater than ever experienced before. We could repeat this analysis for all other periods of sudden spread widening, and we would always get the same result: on the way up, spreads always overshoot what history suggests is the very worst possible outcome by a substantial margin. In our business, we call this a buying opportunity – not just because bonds are cheaper than they were a month ago, but because of the forward-looking breakeven default analysis elucidated in the preceding paragraph. The only real question is whether an even better opportunity lies in the near future.

Historically, these buying opportunities do not last long, so trying to time a market bottom brings into the focus the risk of investing too late. In this vein, it is instructive to look at

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past recoveries, and how the market has moved up several months in advance of the end of recessions. After plunging over 15% in October 2008, the month after the bankruptcy of Lehman Brothers, the market rose over 5% just two months later in December…and proceeded to rise a stunning 58% (per the Bloomberg Barclays index) in 2009. The recession did not end until seven months after the massive rally began. After a steep drop in 1990, the market turned up five months before the recession ended in March 1991. During 2001, the market turned up in July, four months before the end of the recession. The terror attack of September 2001 interrupted its ascent for just a single month. Even the worst decline of all time, the 33% decline from late 2007 to late 2008, was fully recouped just ten months later. (Contrast this to recovery times in the equity market, which have averaged over 4 years in the last three recessions and have taken as long as 15 years in recessions which occurred before the high yield market existed.) The gist of this is that even if one misses the absolute bottom of the market and invests ahead of it, the likelihood of making good returns, and quickly, is very high…because when the high yield market recovers from a steep decline, it recovers fast.

In our experience, many investors wait for that unicorn moment when the risk is all gone and the juicy returns lie ahead. But a market which discounts the entire future, not just the next year, does not let that occur. An investor in the 2009 rally who waited until June (the end of the recession) to invest would have missed out on 62% of the market move. The huge return in 2009 happened during the wave of defaults in that recession, not after it.

Another way of looking at the present situation is to ask: what returns have historically been earned when investing at today’s credit spread of 1120bp, whether or not the market was at that time rising or falling? If we look at all monthly returns since 1986 in the Credit Suisse index system, there have been twelve months (out of 410) in which the market traded at a spread between 1000bp and 1500bp. That is to say, it did so rarely…just 3% of the time. Investors taking positions during those twelve months earned average subsequent one year returns of 38.42%, three year annualized returns of 21.05%, and five year annualized returns of 16.10%. There were no negative three year or five year returns, and a single example of a negative one year return (in the year which included both the 2000 telecom debacle and the September 2001 attacks). In order to get a more robust set of 84 observed entry points, we can increase the width of entry points to the range 700bp-1500bp; the average one year return across all of these observations is 16.30%, the average three year return 14.58%, and the average five year return is 8.65%.

We observe the dynamic of individual high yield securities overreacting to poor short term prospects as well. In general, industries respond in an intuitively sensible way to this shock. High-cost shale energy producers are hardest hit, because of both the direct effect of the virus (a decline in worldwide oil demand which could be as high as 8%) and the consequent collapse of the OPEC+ consensus on sharing output restrictions to prop up the cartel price. The constellation of travel-related industries – airlines, lodging, gaming, and restaurants – have all been hit harder than average, as these are ultimately discretionary goods which currently present a high risk of infection. Suppliers to Boeing have likewise suffered. Producers of essentials – food, supermarkets, healthcare, and utilities – have all have outperformed the index. But these dislocations create opportunities for those who know the companies best. For example, gas pipelines and the companies which rent the mammoth compressors which drive their throughput, although considered “energy issuers,” are not sensitive to oil prices. Their fortunes are governed by the volume of gas paying a fixed tariff merely for transporting it. The compressor does not care what the price of gas is, and as long as people heat their homes and use electric power generated by gas, total demand will not decline by more than 10 percent and almost all of that gas will be produced, compressed, and transported in the U.S. Yet we have found numerous opportunities to buy these issuers’ securities for prices between 40 and 60 when their bonds traded at par just three weeks ago. We believe there are similar opportunities in the aerospace industry, as well as in several consumer driven businesses whose securities have been driven below liquidation value. Even greater opportunities exist in the leveraged loan market, which uncharacteristically has declined just as much as the bond market. (In the last market downturn in 2015, loans’ greater seniority caused them to fall just 41% as far as bonds did.)

It is a valid criticism of the above historical analysis that, as we posited in the first paragraph, “this time is different.” Normal recessions have a certain pattern, as excesses in the economy are worked out, deleveraging takes place, monetary authorities inject liquidity, credit markets thaw, and animal spirits resume their path. What happens in the current unprecedented scenario, when the reason for the collapse in demand is simply the fear of getting sick, social shaming, or worse? Much as we dislike basing decisions on factors in which we have no expertise, every portfolio manager must implicitly or explicitly come to grips with the depth of the current recession, and whether the recovery will be strong or weak. The recovery from 2007 – 2008, for example was painfully slow, which is uncharacteristic for a recession with a financial origin. Will this recession be longer or shorter than in the past, and will the recovery be vigorous or tentative?

There are contrary views taken by very intelligent analysts about this question, and all of us are learning much more than we ever thought possible about public health, epidemiology, and the terrible tradeoffs that have to be made within the health care system. I am of the view that the recession will be short and sharp, and the recovery relatively quick. The $2 trillion government response focuses on businesses retaining their employees – that is, keeping in place the human capital that makes entrepreneurial small businesses (and large ones, too) productive. It is a liquidity bridge to the real answer, which is treatment or a vaccine or both. There is more intellectual firepower being urgently applied.
focused on this problem than any other in history – a global Manhattan Project, as it were. Tests of 65 drugs already approved for other uses (and thus known to be safe) are already under way. This is the only recession of our lifetimes which could be solved in a single moment by a scientific breakthrough. Once treatment is an option, the disease will become manageable with a few million doses, and the shutdown of the economy will not be needed if we follow the hygiene examples of other countries. Taiwan, South Korea, and Singapore, and possibly Japan, having learned the effectiveness of individual countermeasures during the SARS outbreak of 2002, are experiencing very low death rates. Notably, these neighboring countries, which all had multiple daily direct air connections from Wuhan during the crucial Lunar New Year in late January, have achieved this without the draconian isolation and economic shutdown regimen which less disciplined Western cultures have been forced to employ after missing early opportunities to check off the plague before its growth reached the exponential stage. There are cogent arguments to the contrary, made by scientists who are very expert, but it is notable that the lead author of the very influential Imperial College analysis which animated early policy moves in Europe has now reduced his estimates of ultimate deaths in the UK by 96 percent. Dr. Neil Ferguson did this in recognition of the effectiveness of the countermeasures being taken in his country, and a new and lower estimate of the case fatality rate. China and South Korea have largely controlled the virus and are carefully reopening their economies while trying to manage re-blooms of the virus, and if Italy and Spain can achieve this in the next month, or two or three, it will have been shown that even a locally very high infection rate can be managed in a rich Western country with fewer deaths than they suffer from normal influenza, which kills an average of about 300,000 people worldwide each year. I believe that within a year, a vaccine will exist even if it has not been fully mass-produced and distributed. Even if COVID-19 mutates and thereby becomes an annually recurring endemic infection requiring periodic immunization, by 2021 it will inflict less deaths than the average 36,000 Americans who die each year of influenza.

The underlying economy was healthy just a month ago. Small businesses will receive forgivable loans to keep their employees (and pay them). For those who become unemployed, a new Federal unemployment benefit of $600 per week will, when combined with State unemployment benefits, replace a remarkable 100% of wages for most workers for at least 13 weeks, after which renewal would be likely if needed. With people not forced to live off their savings or credit card debt, there is every reason to believe that there will be pent-up demand for recreation, travel, entertainment, and even new toys like cars and fashion. Housing prices, the largest assets on most families’ balance sheets, have not (yet) dropped as they did in 2008. Milton Friedman once invented the “permanent income hypothesis,” which posits that consumers base their spending on their expected incomes over their lifetimes, not their current incomes. Thus, we observe college students who are incurring massive debts continuing to buy tattoos and thousand dollar telephones. I expect that consumers will treat a once-in-a-lifetime interruption of their normal lives and spending patterns in the same way.

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The Bloomberg Barclays US Corporate High Yield Bond Index measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody’s, Fitch and S&P is Ba1/BB+/BB+. Bonds from issuers with an emerging markets country of risk, based on Barclays EM country definition, are excluded.
The Credit Suisse Leveraged Loan Index is designed to mirror the investable universe of the U.S. dollar denominated leveraged loan market. Investors cannot invest directly in an index.

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