Mommy, Where Do Credit Losses Come From?

It is impossible to watch some smaller banks getting lined up like dominos and not wonder about credit or bond losses.

It is also impossible to watch the debt ceiling debate play out and not wonder about credit and bond losses.

As I've been thinking about that, two long-running themes keep popping into my head. I'm not sure how to tie them together, but something is telling me that it is at least important to get these two thoughts off of my chest.

- **To begin with, far more credit losses occur from forced selling than default.**

It has been a long time since I dragged that line out, but this is incredibly important to think about right now.

Far More Credit Losses Occur From Forced Selling Than Default

You could go to great lengths to avoid defaults completely (only buy AAA 1-month paper, for example). But even running a "normal" portfolio, default risk tends to be manageable. For all the handwringing about the size of the BBB bond market, it is still rare to see an entity default a few years after it becomes BBB. Even struggling companies that lose their BBB rating tend to have lots of levers to pull (tightening the belt, raising secured funding, etc.). They have plenty of room to operate, and in many cases return to investment grade. Growing up in the high yield space, my view is that BB is "money good", so why worry about BBB? **But I digress, the point of this is to quickly highlight how easy it is to avoid losses from default.**

What is incredibly difficult to stop is losses from forced selling.

The forced selling tends to be generated by one or two problems (or a combination of the two things).

- **Far too much exposure to an individual asset or type of asset.**
    - Risk management wakes up one day and questions why they own so much of a single asset or asset class. Given human nature, **you rarely come to this revelation when that asset (or asset class) is performing well.** It is usually something going wrong that attracts the attention of people to the exposure. Some may identify the risk sooner than others and sell close to par, but others won't be so lucky. If one manager selling reduces the price and attracts attention, it will force others (who are often in similar circumstances) to decide what to do.
    - It may be prudent to sell some of your position (say at a 5% loss) and if you do that often enough or in big enough sizes, the losses from this type of selling can outweigh any real default risk.
    - **This is the more benign of the two reasons.**
- **Leveraged positions**. **Mismanaged leverage is the root cause of exponentially more credit losses than default**. Recent examples highlight the obvious nature of this – **banks being forced to sell Treasuries, which had absolutely zero credit risk.**
    - What concerns me here is that once one person is selling/pushing on prices, it can bring out the next wave of sellers. These entities might have had their leverage better

managed, but they are triggered by the forced selling of another entity (or even the perception that forced selling is necessary). Super Senior Corporate Synthetic CDO tranches sold at fire sale prices during Great Financial Crisis. This was "better than AAA" risk and if memory serves me correctly, they were trading at 20 points up front (AAA CLO tranches were trading at prices below 80). Yet, what was the total amount of credit losses realized on either AAA CLOs (not market value deals, which had their own embedded leverage) or Super Senior Corporate Synthetic CDOs? ZERO. Absolutely no credit losses were associated with any of those structures, yet price action in those markets quite literally contributed to firms going out of business.

- Yes, bond markets are big and liquid, but **when the risk shifts from assessment of default risk to forced selling risk, things get dangerous.**
- **Rising interest rates have not helped in this respect**. There are so many Treasuries, corporate bonds, and mortgages trading well below par that rates alone are contributing to this overall risk.

So, regarding this market, I'm really thinking more about the risk of forced selling than I am about default risk, because **far more credit losses come from forced selling than default.**

A Financial Crisis Starts with "Safe" Assets

This is a topic that I dredge up with regularity.

The argument is, basically, that **it is something that is deemed "safe"**, however:

- It grows to unreasonably large positions in portfolios.
- Gets leveraged to a high degree.

The two things that cause forced selling tend to be concentrated in and around "safe" assets.

When I read articles about various risks in the bond market, they are almost always about things that even today are considered "safe" assets! The last time I read a report about losses in "private credit" (a boogeyman crowd favorite late last year) was before the issues facing Silicon Valley Bank surfaced.

Not a Fully Formed Thought, But…

I'm not any more bearish this morning than I was at 3:30pm ET yesterday after Powell's press conference – One and Donish, but I'm getting there.

Will Treasuries Rally if "We" Default?

I am concerned that the debt ceiling debate will lead to a "failure to pay" event in the Treasury market (call it a 10% probability).

Let's think about a T-Bill that doesn't get paid. It expires (say August 3rd) and doesn't get paid. On August 2nd, it will have traded at 99.9 something, and should be 100 on the 3rd. I suspect that the secondary market price on the 3rd will be very close to par, and by the 5th or 6th, if the failure to pay event is ongoing, it will trade above 100 because people will price in par plus accrued interest.

There might be some blips around the time of default, but I'd buy any bonds that weren't paid at maturity at "par plus accrued". Why not? You will receive the money.

NRSROs will likely rush to downgrade Treasuries (and potentially some debt linked to the credit

worthiness of the U.S. Treasury), but will they sell off?

How many forced sellers does a downgrade or default create?

I'm trying to get a better answer on that question, **but my initial indications is that it won't create a wave of forced selling**.

In many bond mandates that I've seen, the position size of Treasuries (and often Agencies) is precisely described. Corporate bond mandates typically have some rules that are affected by ratings, but that doesn't seem true regarding sovereign (or agency) debt.

There will be some **immediate implications** from a failure to pay event:

- **Lots of end of the world headlines for sure.**
- Some initial selling pressure, probably followed by buying as a "flight to safety" trade occurs on the back of that level of government dysfunctionality. The dysfunctionality will create economic risk which will make Treasuries (ironically) more interesting than prior to the credit event.
- Anyone who bought U.S. CDS will make about 30 points up front. Not because anything changed in the creditworthiness of the U.S., but because a credit event will have been triggered allowing the cheapest to deliver option to kick in. There are plenty of bonds trading around 70 cents on the dollar because of the vicious rise in yields.
- Equities and risk assets should do poorly and I would not be in a rush to buy the dip.

There will be some **longer-term implications** from a failure to pay:

- Less trust in the U.S. political system (partly domestically, but far more globally). The "heh, its messy, but it works better than anything else" will be questioned yet again by our counterparties.
- The erosion of confidence in the U.S. dollar will continue and China will solidify more and more trading agreements directly in Yuan (see world wide web vs dark web analogy). Countries will be even less interested in buying Treasuries.
- Over time, I expect that our borrowing costs will rise relative to other nations, but would buy any Treasury dip in the hours and days following any credit event.

So, a default would be bad, but I'm not sure that it would show up where people expect it to.

Two Crazy Ideas in One Day is Enough

I cannot quite tie a full narrative around the "where do bond losses come from" question, but increasingly I have the inkling that the narrative is bad.

Having said all that, while I'm still -4 on a scale of -10 to +10 on equities, **I am more bearish than I had been on credit spreads.** Call it a -1 before today, but it is moving down to a -4 to join equities as equally at risk here.

Re-reading this rant, I am now 100% certain that my vacation is just a distant memory as the anger is back (Not Angry Enough to Write).

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