SAXO GROUP

Welcome to credit implosion week

By Steen Jakobsen | March 9, 2020

- Two weeks ago we had **Global Policy Panic**
- Last week it was **Global Policy Angst**
- **Global Credit Implosion** week is next.

We at Saxo Bank has long argued that as negative and sad the Corona virus is the **real impact** comes from global supply breakdown which has received a one-two hook to the jaws from first US vs. China trade war and now a total lock-down of significant parts of global supply chain as in China, Japan, South Korea, plus now increasingly Europe and the US as well.

The average SME or non-listed companies operates with maximum three-month of liquidity as we are now more than two month past the initial break-out in China and six week in rest of world, we entering a very difficult time for these companies. They in turn will make the bank's NPL, non-performing loans, explode, and at a time where global bank suffers from flat yield curves and in the case of Japan and Europe also negative interest rates. The bank system is again under stress and a stress from mainly structural and external factors (negative yield + flat yield & breakdown of supply chains)

This is bad enough, but then late Friday this headline hit the wires:

Politics

Putin Dumps MBS to Start a War on America's Shale Oil Industry

By Ilya Arkhipov, Will Kennedy, Olga Tanas, and Grant Smith
7 March 2020, 18:27 CET

- Russia's refusal to budge shocked markets and ministers alike
- Saudi prince warned other ministers they would regret decision

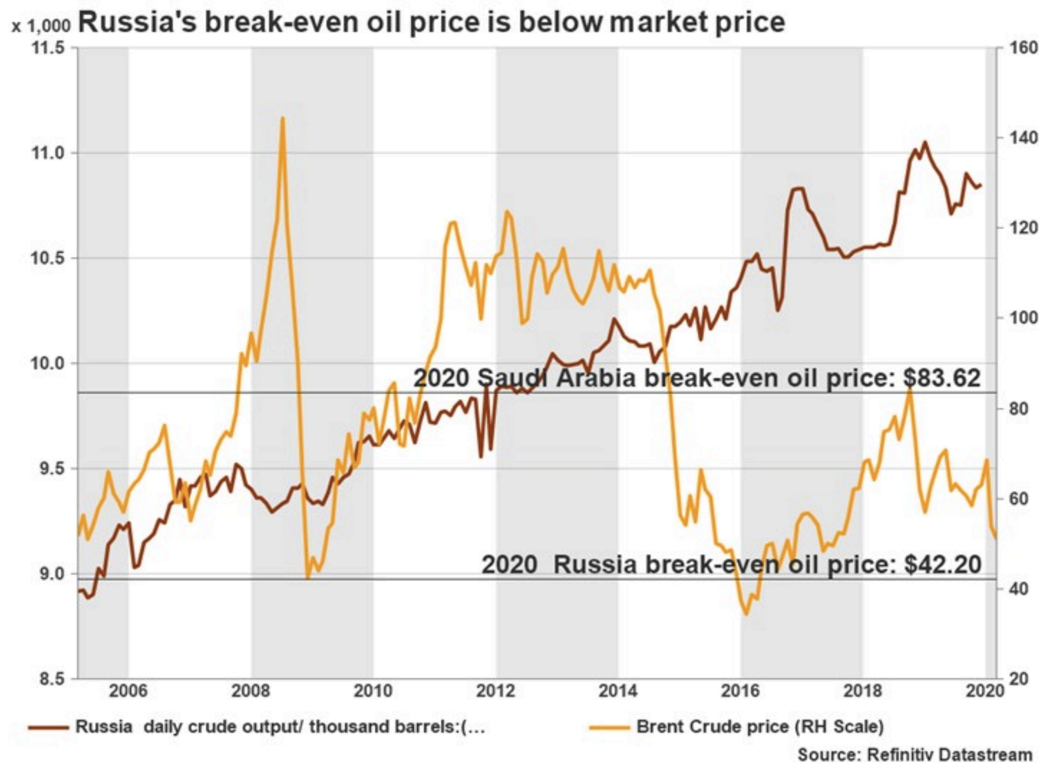
https://www.bloomberg.com/news/articles/2020-03-07/putin-dumps-mbs-to-start-a-war-on-america-s-shale-oil-industry

Oil prices dropped 10% on Friday:

Source: Saxo Bank

The reason for Russia gambit is two fold:

1. It's a major pay-back from 1986-89 where Saudi egged on the US pumped oil to destroy the former USSR - something Putin and Russia has never forgotten.
2. It's a frontal attack on US shale industry which has totally destroyed OPEC+ pricing power and in the process Russia has significant lower extraction prices than Saudi Arabia and most of OPEC:



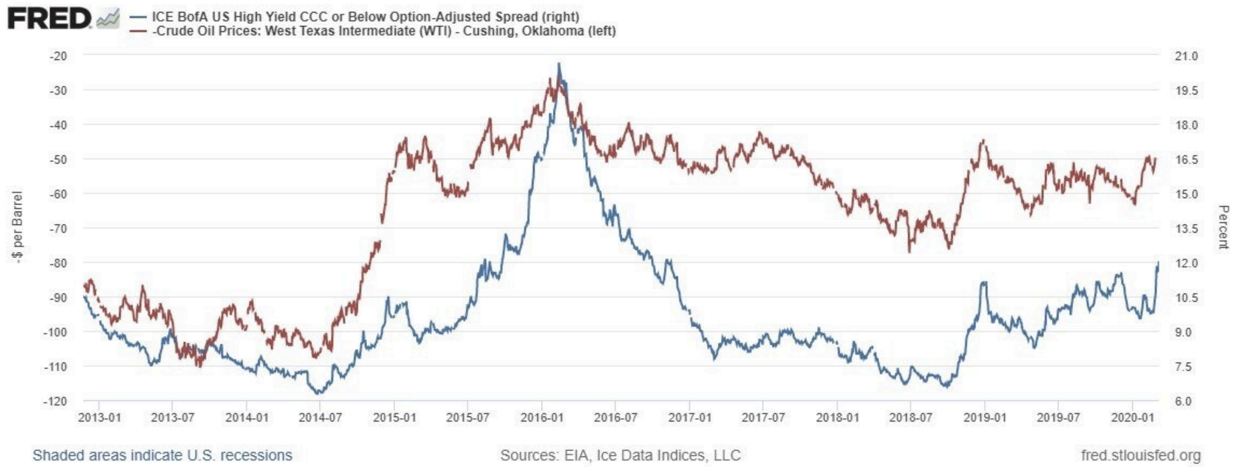
Why is this relevant? Cheaper oil is good "nes pas?" - No, because energy companies and in particular energy companies with exposure to shale is under severe pressures.

One of my pet theories remains that energy prices is **always a major part of crisis in macro.** Or put differently: Most crises start with either a too high or too low oil prices.

When prices are too high: It's a tax on consumption - Don't forget that 50% of all things you have done today involves accessing electricity one way or the other - hence prices being too high is massive additional tax on consumption.

When prices are too low: It becomes a credit event, as energy sector is extremely capital intensive and it's the single most leveraged part of a **CREDIT BOND market**. Here is chart of CCC - junk bond - courtesy of St. Lois Fred:

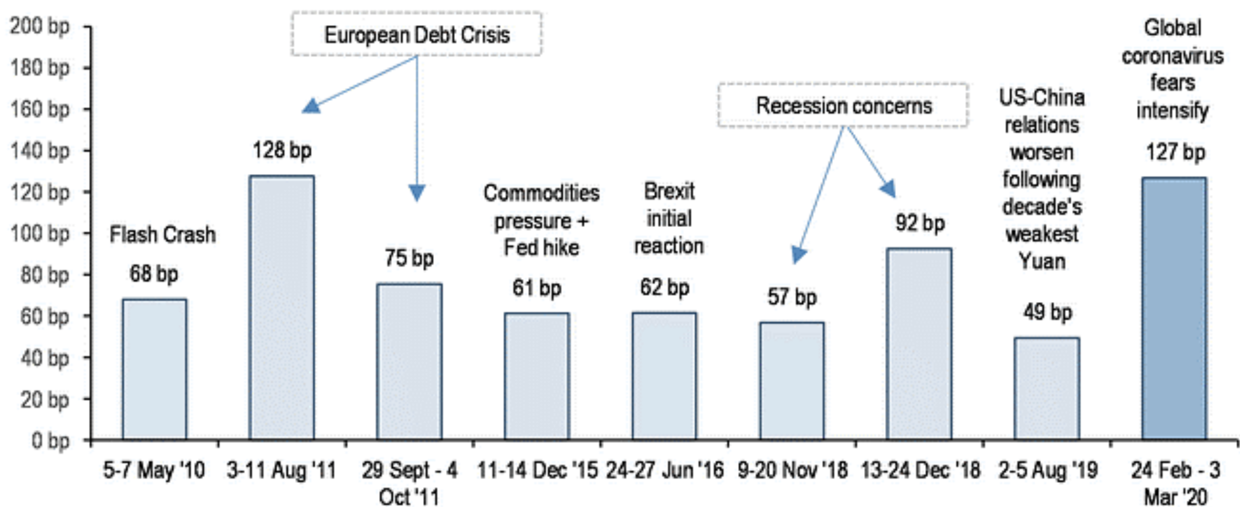
NOTE: Oil prices is INVERTED – ie. when RED line is high – the price of oil is extremely low



The correlation is pretty clear for everyone to observe – the spike in the last two week is yet to spill-over fully to IG – Investment grade, but its only matter of time as:

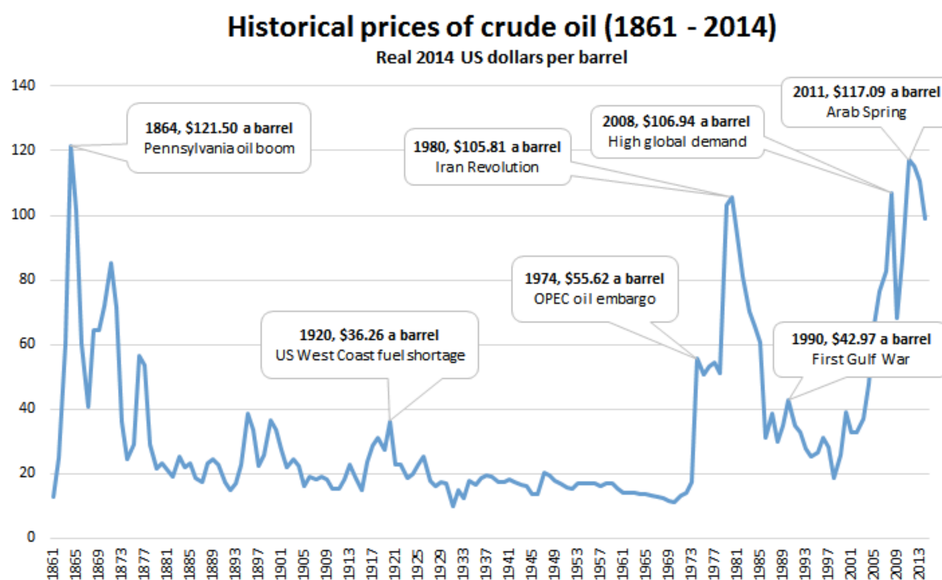
The early move in credit crisis comes from **most leveraged & most capital incentive names**, when they start to fall, lenders, mainly banks, retract overall lending and becomes defensive. Furthermore than US benchmark yield, government bonds, outperforms as they did last week, the spreads vs. credit simply can't follow due to liquidity constraints in corporate bond markets. There was several major credit bonds last week without a bid!

Overall this overview from JP Morgan gives an excellent insight into moves in High Yield credit spreads relative to prior macro crisis'



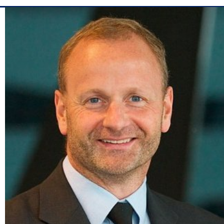
Comment: This is biggest move since 2010 – and it's barely been notice by market.

Finally, here is BP history of prices since 1861 – when dad was young.....



Conclusion

- We are in for an EXTREMELY volatile week. Remember to adjust your positioning down! You should be trading at least 50% of the nominal size you do during calmer markets.
- Use gold and commodities as hedge
- Remain long volatility – now mainly in FX: Long JPY and CHF calls.
- We will this week publish our **what to buy** when this is over basket of stocks. The strategy here is to make mechanical model for getting back into the market. Peter Garnry will lead this effort. Remember when tings looks the darkest sunset is around the corner, but having said that the 15% we have seen so far in no where close to REAL RISK as of now. We see 32% overall downside as **fair value** based on our WTI crude analogy, but markets can get oversold. That's clearly not the case now. BTD mentality is still rich and cycles likes this don't end quietly. Just saying.



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