HOW DOES LOW FOR LONG IMPACT CREDIT RISK PREMIUMS

BY ANTJE BERNDT AND JEAN HELWEGE

DISCUSSION BY ROBIN GREENWOOD
SEPTEMBER 2018
Central Question

- Many people believe that the Fed’s extended period of QE and low short rate have induced risk taking by financial market participants
- Can we detect this in the pricing of corporate credit?
- This paper
  - Persuasively shows that credit risk premia are not at disturbing levels compared to historical experience
    - Compares CDS spreads to measures of expected default to estimate premia
    - Shows that credit risk premia did not move much with QE announcements
- My comments today
  - Overall, I found the evidence on pricing to be persuasive, and it moved my priors on this topic
  - However, evidence on prices needs to be evaluated in conjunction with quantities
  - It still seems likely that we are sitting on a tinderbox
  - There is lots of great material in the paper, I will only touch on a few points
Junk Bonds Are Booming, But So Are Hedges Against Them

By Dani Burger
July 13, 2018, 7:38 AM EDT  Up

Bad boom
Credit booms marked by a rising share of default bonds were followed by lower economic growth over the following three to four years. (percentage points of GDP)

Barrons: Where the Bond Market's Next Big Problem Could Start
by Viro J. Ranarven
Aug. 17, 2018 4:03 p.m. ET

After the extraordinary rise in U.S. corporate borrowing in recent years, the investment-grade bond market resembles a forest, littered with kindling and vulnerable to a lightning strike. And this sector—not high-yield or junk debt—may be where the next market conflagration starts.
CREDIT SPREADS

Corporate Yield Spreads, Various (%)

BBB OAS  High Yield OAS  BAA Spread to 10y  AAA Spread to 10y
Main Approach

• Credit Risk Premium = Credit Spread – Expected Default*Recovery
• Credit spread obtained from CDS Prices
• Clearly, results depend on Expected default model
  • In general, with any structural model, more faith in estimates of changes than in levels

• Then analyze:
  • Event studies of QE dates
  • Time series
FOR COMPARISON

• Gilchrist and Zakrajsek (various years) have a competing measure, based on bond prices
ISSUES WITH THE APPROACH (1)

- Using the CDS spread implicitly takes a view on
  - Integration of the cash and CDS markets
  - Where the credit risk premium comes from
    - Expectations/Sentiment/Reaching for yield
    - Risk aversion
  - Whether taking CDS spread or bond spread as the measure of risk-neutral probability depends on what were the non-fundamental forces. For example, during the crisis
    - On the bond side, there were forced deleveraging by bond holders and breakdown of repo market which made financing bond purchases by arbitrageurs harder.
    - On the CDS side, there were perceived counterpart risk in CDS contracts, since CDS contracts were written by banks. The demand for CDS protection is probably less because of possible defaults by banks.
    - Hard to tell whether the bond spread or CDS spread is a better measure of market implied risk-neutral expectation
      - I am persuaded by the evidence, but can the authors make a case?
CDS BOND BASIS

Bond spread much wider than CDS

Tight basis today
ISSUES WITH THE APPROACH (2)

• How directly do we think is the link between changes in short rates and reaching for yields (levels, changes)
• Some evidence that reaching for yield is immediate
  • Hanson, Lucca, Wright (2018), SR>LR
• Intuition suggests might play out over a longer horizon
• My favored account of the credit cycle
  • Fed lowers rates
  • This induces reach-for-yield behavior
  • In the short-run, this lowers risk of high yield credits, making them appear safe ex post
  • An expectations cycle kicks in, further reducing credit “risk premia”
• Much like output-inflation cycle, there are variable leads and lags here, making measurement difficult
  • This gives me some license as a discussant
Event Study Evidence (3)

Paper finds very little movement around QE Announcement Dates.
### Table 1. Interest Rate Changes around Baseline and Extended Event Set Announcements

<table>
<thead>
<tr>
<th>Date</th>
<th>Event</th>
<th>2y UST</th>
<th>10y UST</th>
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**Baseline Event Set**

Baseline Set + All FOMC

**Cumulative Change:**
11/24/08 to 3/31/2010

<table>
<thead>
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<th>Std Dev of Daily Changes: 11/24/08 to 3/31/10</th>
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</table>

* Included in the baseline event set.

bTwo-day change for agency MBS on March 18, 2009 due to a Bloomberg data error.
But horizon matters

Aggregate responses for Federal Reserve QE announcements

Source: Mamaysky 2018
ISSUES WITH EVENT STUDY ANALYSIS

• Assumes perfect integration of credit/CDS/ Treasury markets at all horizons
  • Greenwood, Hanson, Liao (2018) suggest unrealistic
• Correcting for impact that QE has on actual default probability is fraught with difficulty, making changes in both credit spreads and CDS prices hard to evaluate
ISSUES WITH THE APPROACH (4)

- The paper is solely concerned with prices, but a financial stability assessment would also consider:
  - Non-price features of the debt
    - Becker and Ivashina (2018), cov-lite etc
  - Quantities
    - Greenwood and Hanson (2013), Baron and Xiong (2017)
Cov-Lite Share

Becker and Ivashina 2018
CREDIT GROWTH

Corporate Debt and Loans/GDP
Loan Officer Survey
ISSUANCE
THE BBB SHARE TINDERBOX
WHERE DOES THIS LEAVE US

• The pricing evidence that Berndt and Helwege present suggests that pricing is much like any other credit boom, and not as extreme as the last one
• But all of this needs to be caveated with
  • High credit growth overall
  • Other estimates of credit risk premia suggest the market is bullish
  • Need to have greater clarity as to whether CDS is the right place to study risk premia
  • Combination of high growth and pretty low spreads suggests that a credit correction will produce a garden variety credit crunch, but most likely nothing like 2008
• In my opinion, this is a fruitful area of research, and more explorations such as Berndt and Helwege present should be done