Risk Building in the Financial Markets is Not Being Priced Properly

By

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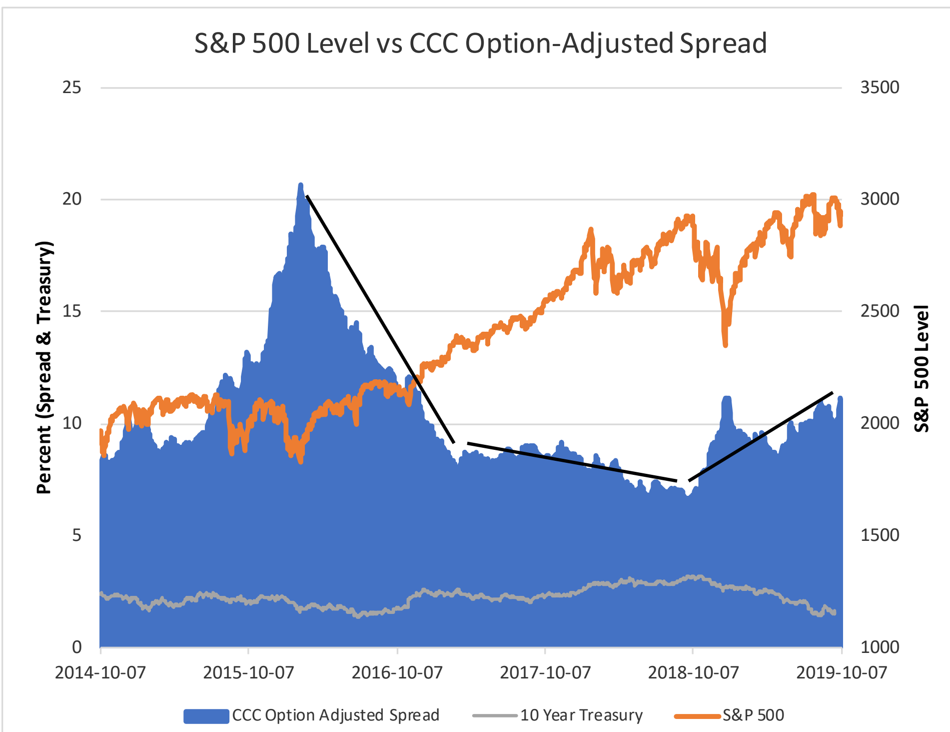
The focus on Fed policy and whether short rates are higher than long rates as an indicator of future recession is overdone. The real key to understanding movements in the financial markets is being able to evaluate changes in financial risk and whether these changes are priced into asset valuations. Axiom's analysis of both the public and private equity markets indicate that there is a growing financial risk that has not been priced by market participants. Movements in credit risk tell us a great deal about the pricing of risk in the financial markets, and the CCC credit spread is a prime indicator of whether overall risk is increasing or not. The chart below indicates that credit risk is rising, and the public equity market has not caught up.



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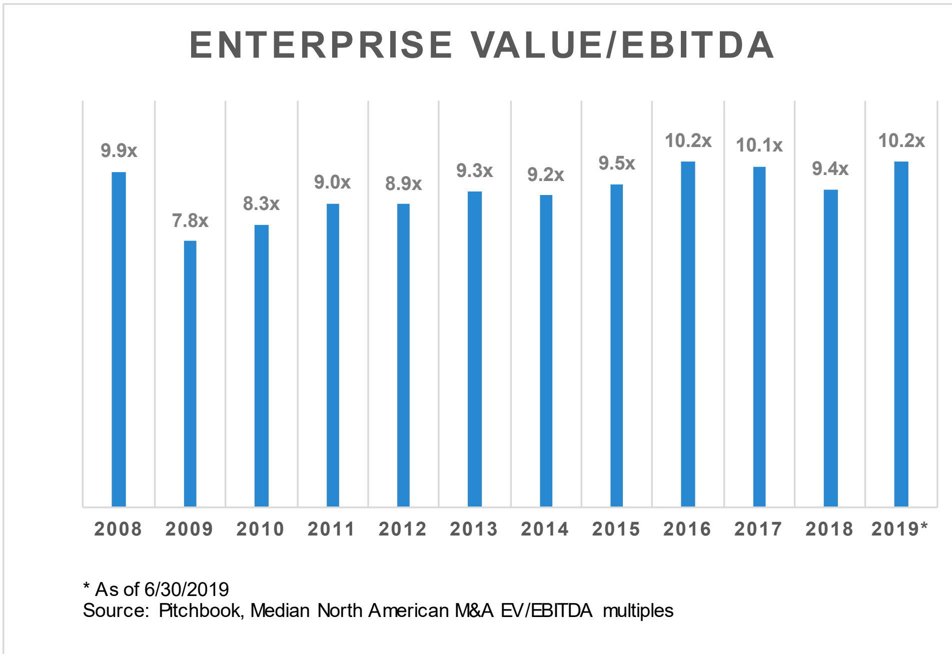
The CCC spread, as measured by the ICE BofAML US High Yield CCC or Below Option-Adjusted Spread, has increased from a low of 669 basis points in 2018 to a high of1065 basis points in 2019. This is an increase of 400 basis points. The Treasury ten-year rate declined over the same period by about 160 basis points. The result is that the cost of capital actually rose while asset prices have either increased marginally- the S&P 500 shown above- or as in the case of private equity multiples have actually expanded as shown below.



All of this suggests that private equity deals and the public equity markets have not priced in the risk buildup. In the private equity case, some of the mispricing is technical in that private equity funds have a great deal of dry powder and the banks are willing lenders. But with a weaker global economy deals will begin to fail, exits will be more difficult, and multiples will shrink. Timing of course is everything.

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