Authers' Note: Precarious credit markets

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Welcome to Authers' Note, in which I will attempt to provide some context and analysis on the world of investment each day, and provide you with a handy guide to the best coverage on offer, both here in the FT and elsewhere. All feedback is welcome, particularly of the constructive variety, as we try to get this right. (Email to authersnote@ft.com).

The 10-year Treasury yield continues to hover just below the level of 3 per cent which is now touted as a "line in the sand" before higher rates tip over into problems for other markets.

The last big event before next week's debut FOMC press conference for the new Fed chairman, Jay Powell, will come on Tuesday morning with the publication of the latest CPI figures for the US. If consensus estimates are right, they will continue to show that inflation is a fear rather than any kind of accomplished fact: according to Bloomberg, expectations are for 2.2 per cent headline inflation (it was higher than that 12 months ago), and "core" inflation, excluding fuel and food, of 1.8 per cent. As the Fed's long-term target is 2 per cent, there would be little here to be worried about.

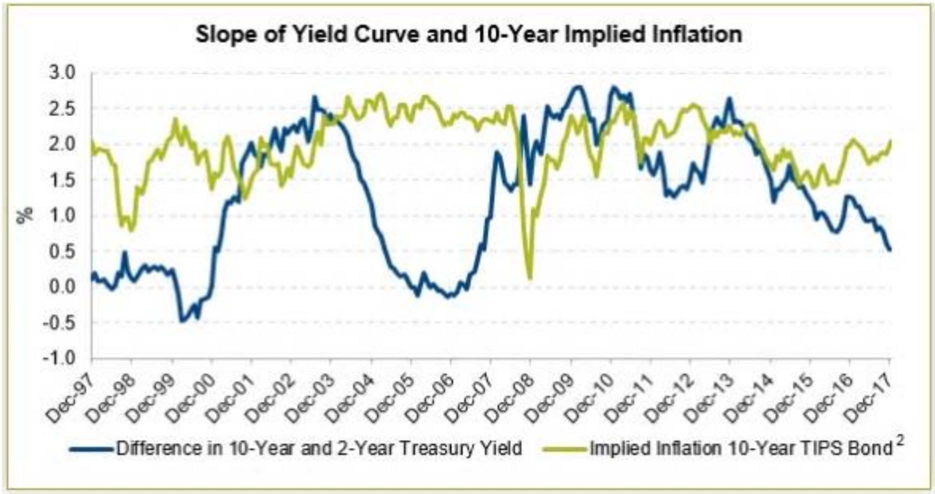
However, expectations of such calm and anchored inflation do create the opportunity for that much more of an adverse reaction if inflation comes in hotter than expected.

Also, there are signs of inconsistencies within the bond market. It is not just a question of the market as a whole being expensive after years of central bank intervention; it also seems as though the risks of both rising interest rates and rising defaults are being underpriced.

This comes from a note from Tom Atteberry, who runs the FPA New Income Fund, pointing out that both intermediate-term bonds, which are barely yielding any more than short-term bonds, and "high-yield" bonds, which are barely yielding more than higher quality bonds, are repaying investors very little for taking extra risk.

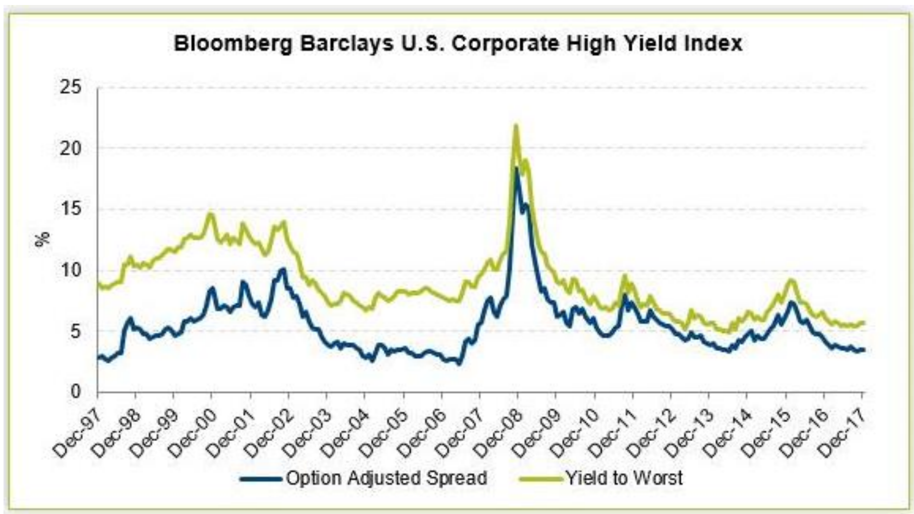
This is how he explains the problem with interest rate risk:

The following graph shows the spread in yields between the two- and ten-year Treasury bond (in blue) and what the market expects inflation to be (in green). The spread between the two- and ten-year Treasury bond is one way of measuring how worried investors are about future inflation and/or rising interest rates. Over the past twenty years, there have only been three instances when the spread has been this low: right before the 2001 and 2007-2009 recessions, and today.



The logic of such a flat yield curve is that investors are braced for deflation, and yet the yield curve has flattened as inflation breakevens have risen.

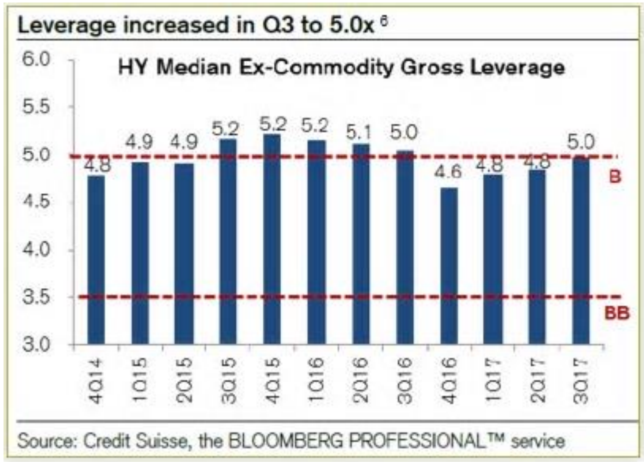
Meanwhile, when it comes to credit risk, high-yield bonds carry close to a record low yield, in absolute terms or compared to Treasuries:



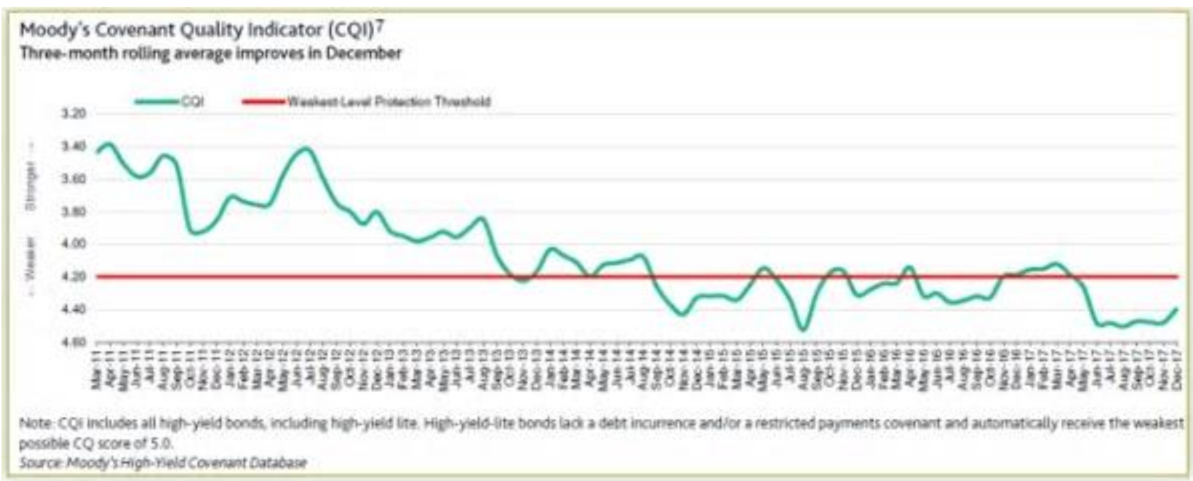
This is not a good sign if you currently hold high-yield bonds:

Over the past twenty years, there has only been one other time when the yield-to-worst [the lowest possible yield that can be received on a bond without the issuer actually defaulting] has been lower than today's ~5.8% yield, when yields dipped below 5.3% in 2013. The high-yield market went on to post a 10%+ drawdown over the next two years, while the broader bond market was down less than 5%.

These numbers might make sense, Tom concedes, if leverage were reducing, bringing default risk down with it. But this is what is happening to leverage of US high-yield bond issuers:



So the sector is as leveraged as ever. Alternatively, covenant quality might be improving, meaning investors would be able to retrieve more in the case of default. Except it isn't:



The US fixed income has found its way to a very precarious place. It will be interesting to see how it navigates the next year — and that in turn will provide great lessons for credit markets in Europe, where the retreat from QE still lies in the future.

Netflix Flicks

Ostensibly this was rather a dull day on Wall Street, with the S&P 500 closing marginally down. But on a closer look, something interesting was shifting. Some of the recent leaders have suddenly moved into reverse. Both Netflix and Boeing appear in the list of the worst performing 10 stocks in the S&P.

This is how Netflix has performed compared to the markets as a whole since the beginning of last year.

And this is Boeing:

The correction of last month mysteriously failed to correct the leaders of the market, and instead saw continued dramatic outperformance by tech and particularly the "Fangs" — a group that includes Facebook, Amazon, Apple, Google and Netflix, which benefit in particular from the growth in internet commerce. It also saw Boeing, a continuing huge market darling, notch great outperformance.

It is possible that Boeing, which is a buyer of metals such as aluminium, has been harmed by nerves about the application of tariffs on metals. Netflix, however, is intriguing. If any stock anywhere appears to be in a bubble, it is Netflix. This is how it has performed compared to the other Fangs (measured by the NYSE FANG+ index) since the beginning of last year:

What can possibly justify such growth? Little or nothing in the company's actual accounts, it would appear. And as it is reaching saturation in the US, and facing hefty competition from some rivals with very deep pockets, such as fellow Fangs Apple, Google and Amazon, it is unclear why it is being priced on the assumption that it will instead leave all the other Fangs in the dust.

Dan McCrum wrote this beautiful piece on the bear case for Netflix on Friday for FT Alphaville. I commend it to your attention. One choice passage:

Today, the numbers represent boundless optimism: a dozen times the $12bn of revenues reported last year, 120 times the profits it is expected to generate in this one. Fast forward, and estimates from analysts prepared to put a finger in the air for 2021 average out to forecast revenues of $27bn.

Are they, and the market, wrong?

Maybe it would be easier to share that confidence if Reed Hastings submitted to the sort of quarterly conference call suffered by less exalted chief executives, where questions from the crowd are allowed. The company prefers to pre-record polite conversation with chosen analysts.

It might be easier to believe in the growth story if 48m American households weren't already signed up for the delights of Stranger Things, and marketing spend wasn't growing faster than sales. It will jump to $2bn this year, from $1.3bn in 2017, which suggests winning customers is getting harder even if, like Netflix, we believe 700m households around the world are potential customers.

Buying into the dream would be easier if the company weren't also competing with Amazon, HBO and, in the not too distant future, Disney.

It is possible that Dan's note in itself had some effect on the market (although sadly I fear FT journalism rarely has quite that kind of market-moving effect). But there were some other interesting developments. An Apple executive said at the SXSW conference that his company was unlikely to buy Netflix. If investors were buying Netflix in the hope of being taken out by Apple, then, they will be disappointed. Then there was this tweet from Andrew Left of Citron Research, known for aggressive calls to short stock, suggesting that Netflix could safely be sold down to $300. It had opened at $331 today, so this was not his most aggressive attack:

And if we look at activity on the short side, it does look as though investors are beginning to think that Netflix can safely be shorted from its current level, after short interest had dwindled to almost nothing. This chart comes from S3 Analytics:

That would be just as well, because those short Netflix have suffered grievously over the last year. This report also comes from S3 Analytics, which monitors short positions:

Short sellers are up $209 million today in mark-to-market profits, putting a slight dent in their $2.95 billion of year-to-date mark to market losses incurred as of last Friday. Shorts are now *down $2.74 billion for the year, down -50.17%. This follows a $1.78 billion mark-to-market loss in 2017, down -41%, when average short exposure was $4.4 billion.*

. . . While Andrew Left was partially correct when he mentioned that NFLX "short interest at 10 year low", its 20.6 million shares shorted is actually the lowest level of shares shorted since June of 2002, two months after its IPO. NFLX $ short interest is now $6.8 billion, an increase of 63% for the year and the highest level of short exposure in the stock's history. In actuality, the main reason shorts have been buying to cover their outstanding short shares was because NFLX's stock price kept rising and they needed to trim their shares shorted to remain within their dollar risk limits.

It is far too soon to call a top in Netflix. But the run over the last 12 months, and particularly since the turn of the year, seems senseless. It is speculative excess that needs to end. And when the Netflix bubble does at last start to burst, it will look a lot like the activity of the last two days.

John Blockchainiver

Bitcoin is less in the news this year, even though it is far cheaper than it was before Christmas. It has halved since that extraordinary high. It remains more than 600 per cent above its level of 12 months ago, however, so the excitement remains intense — and the potential downside is great.

So it is good that fellow Englishman in New York John Oliver has broadcast this glorious summary of the dangers of pump and dump schemes in cryptocurrencies. It is very good and very funny (although beware that there are a few unbleeped four-letter words).