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Previously Investec
Asset Management

Credit Chronicle

Investment review and outlook from Ninety One's Developed Market Credit team

2020: Quarter 2

Market review

Investors witnessed a dramatic shift in credit markets in the second quarter, with an impressive rally continuing the rollercoaster start to the year. This was a very welcome development, albeit taking many in the market by surprise with its magnitude and speed.

The gradual reopening of global economies, tentative positive news flow around potential COVID-19 treatments, together with the unprecedented levels of fiscal and monetary support from global policymakers, all helped markets to edge higher week after week, with extraordinary policy measures also helping to restore market mechanics. Despite some minor wobbles towards the end of the quarter as secondary spikes in coronavirus cases occurred, markets remained largely resilient as the quarter drew to a close.

As the quarter progressed and market functionality resumed, significant opportunities arose for investors seeking to capitalise on both attractive outright spread levels, but also on compelling relative-value positioning across different regions and credit-market subsets. The scale of the moves in markets also meant that this relative-value equation between different markets has been continually evolving, providing great opportunities for flexible investors with a broad opportunity set.

Current snapshot

We believe that credit markets are driven by three Compelling Forces and that a careful assessment of each of these is essential for exploiting evolving market inefficiencies and building a robust credit portfolio. Here's our current view:

Compelling force	**Fundamentals** Fundamental strength	**Valuations** Attractiveness of valuations	**Technicals** Supply/demand dynamics
US high yield	● (red)	● (light green)	● (light green)
European high yield	● (red)	● (grey)	● (grey)
US investment grade	● (orange)	● (light green)	● (dark green)
European investment grade	● (orange)	● (grey)	● (dark green)
US loans	● (red)	● (light green)	● (orange)
European loans	● (red)	● (light green)	● (orange)
Bank capital	● (orange)	● (grey)	● (grey)
Corporate hybrids	● (orange)	● (grey)	● (grey)
EM corporate credit	● (orange)	● (light green)	● (light green)
Short-duration high yield	● (red)	● (grey)	● (grey)

Key: Worst ← ● (red) ● (orange) ● (grey) ● (light green) ● (dark green) → Best

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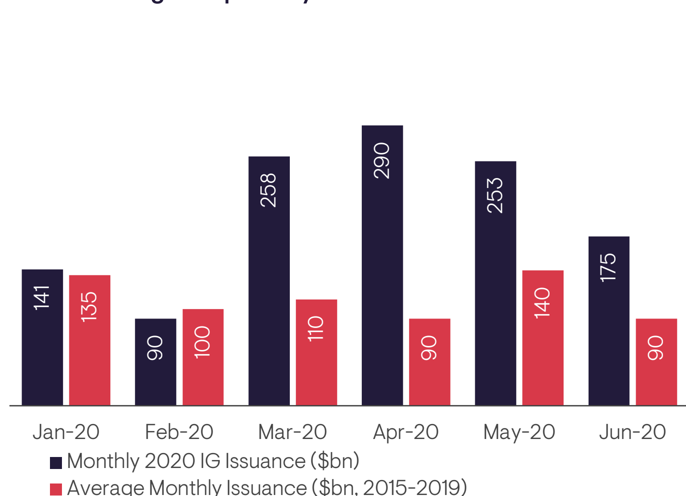
Credit spotlight

Credit market reversal: speed and magnitude of rally surprises many investors

The remarkable second quarter rally probably came as a surprise for many credit investors, both in terms of its speed and magnitude. Not least because it was also accompanied by a huge supply of bonds, in what could easily be described as a hyperactive new issue market.

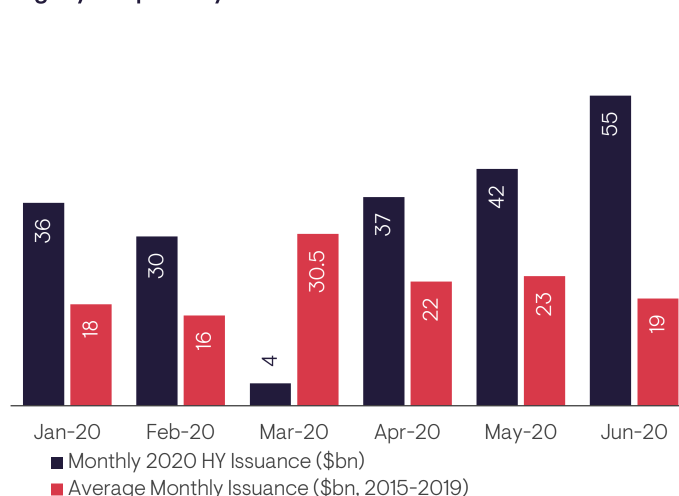
This surge in issuance makes complete sense from the perspective of companies navigating the current environment. As economic growth has slowed dramatically and the world has entered an era of heightened uncertainty, one thing has become more important than anything else – liquidity. For a company that stops generating revenues from one day to the next, the biggest determinant of whether the business has a future when the world reopens is if it has enough liquidity to create a bridge to the other side. As such, if there is liquidity available in the market and it also comes at a cheap price, then it makes sense to go and get as much as you can. This is reflected in the new issue market volumes in both high-yield and investment-grade markets, which is significantly above long-run monthly averages.

Investment-grade primary market issuance



Source: Credit Suisse, as at June 2020.

High-yield primary market issuance



Source: Credit Suisse, as at June 2020

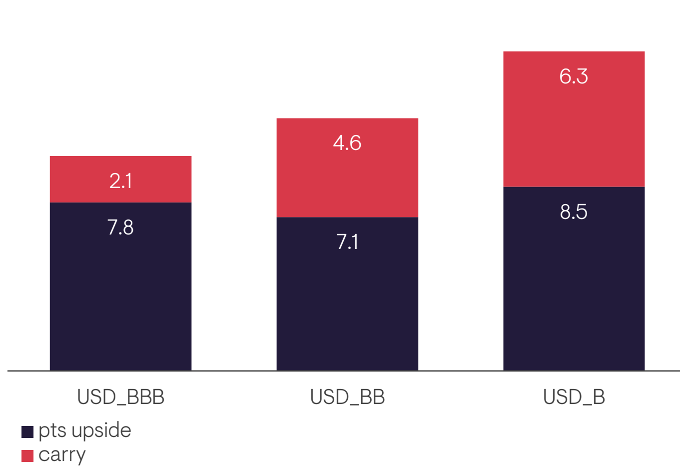
In this context of record supply volumes, it was surprising just how much credit markets still managed to rally. Traditional economic theory would dictate that a spike in supply should put downwards pressure on prices. However, matching this supply we saw a second quarter surge of inflows into both high-yield and investment-grade credit funds, tipping the balance in favour of further spread tightening. To an extent the mass inflows are understandable, reflecting a search for yield among investors when the last remaining positive interest rate bastion (the US) turns into a low-yield realm. Add to that policy moves by both the US Federal Reserve and the ECB, both of which are now active buyers of corporate bonds, and the result was a steady grind tighter of credit spreads through the quarter.

This leaves investors questioning how to deal with the credit market going forward. Now that spreads have rallied, is the only option for investors looking for good return potential to explore further down the credit rating curve? And what if this rally later proves to have been overdone and we see a correction at some point?

To address these questions, we draw your attention to one of the interesting nuances in credit markets: high-yield bonds have typically embedded call features in their structure, whereas investment-grade bonds do not and are a bullet structure. As we explain below, this leads us to believe that a number of investment-grade rated issuers currently offer a much more attractive upside potential/downside risk ratio than high-yield issuers.

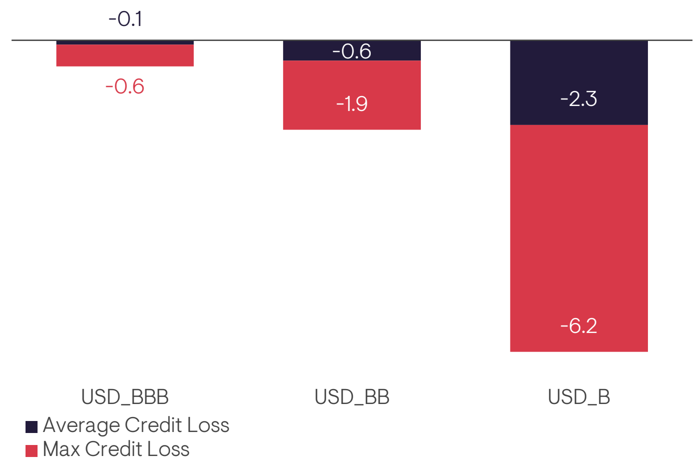
Given the embedded call feature in high-yield there is an essential limit to the potential upside, the point at which it is no longer economical to own the bond, because it is trading to a call-date which lies significantly earlier than the bond's final maturity. Or differently put, as high-yield bond prices go up, typically their spread-duration gets lower as the probability of the bond being called and repaid early by the issuer becomes higher. That means that in the case of a callable high-yield bond, a tightening of e.g. 50 basis points is likely to lead to less price appreciation than a smaller spread tightening on a non-callable investment-grade bond. At the same time there is still substantially greater credit risk, given the lower credit quality of the issuers and thus a higher susceptibility to the economic environment. Therefore, if one compares the return potential in US BBB rated bonds (i.e. investment grade) under a scenario where they return to their year-to-date spread tights, the potential capital appreciation is very comparable with that of BB/B rated bonds if they also were to return to their year-to-date tights. The total return in high yield might still be a little higher due to the higher carry, but in our opinion, investors should be getting compensated more than just carry for the incremental credit risk in the current environment. This is best illustrated by looking at the downside potential for each of these markets, where, unsurprisingly, average credit loss increases as the credit quality lowers. As a result, we think a number of BBB rated issuers currently offer a much more attractive upside/downside skew than that of BB/B High Yield issuers. The charts below help to visualise this.

Little differentiation in upside remaining



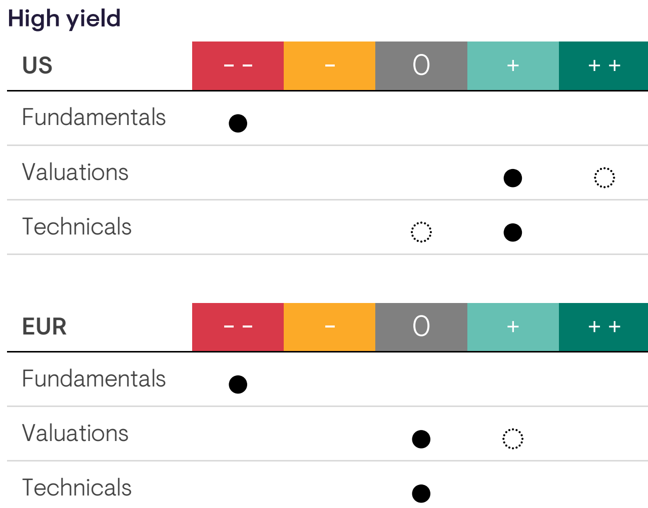
Source: Bloomberg as at 23 June 2020. Based on median bond spread for each bucket. Points upside represents the expected price appreciation assuming bonds return to their spread tights for investment grade or for bonds to go back to their highs in price for high yield.

Despite substantial difference in credit risk



Source: Bloomberg as at 23 June 2020. Based on Moody's long term default studies considering annual credit loss from 1983-2019.

Sector by sector



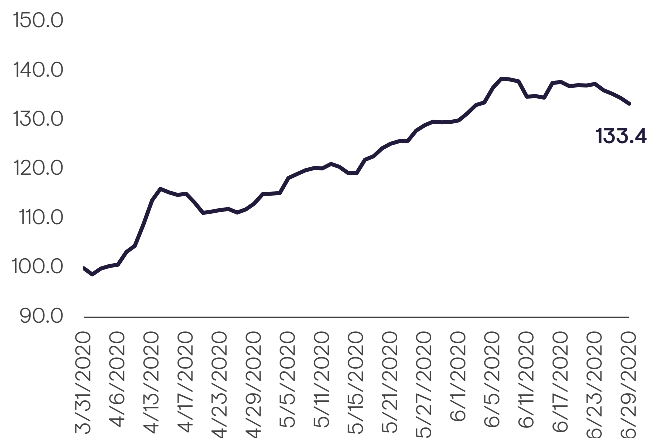
High yield

US	- -	-	0	+	+ +
Fundamentals	●				
Valuations				●	◌
Technicals			◌	●	

EUR	- -	-	0	+	+ +
Fundamentals	●				
Valuations			●	◌	
Technicals			●		

An empty circle denotes our view in previous quarter, if it differs.

Energy sector total return index, rebased to 100

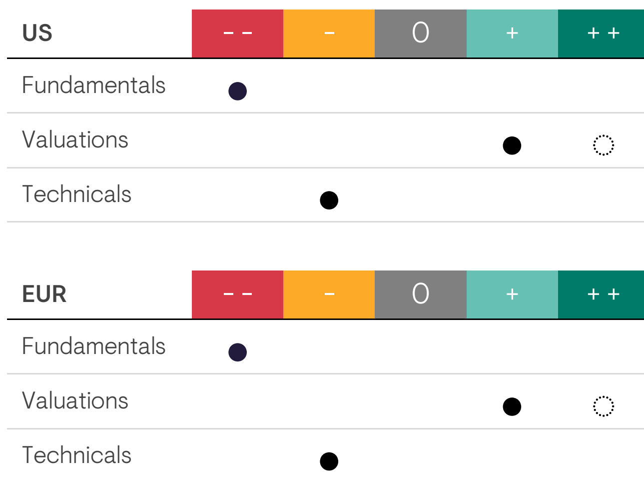


Source: ICE Data Indices. H0EN index.

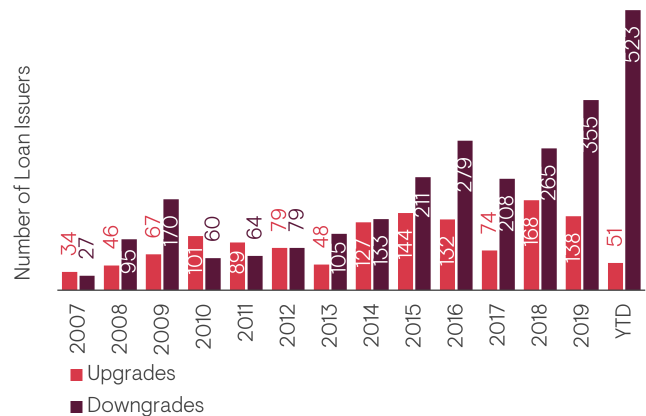
Second-quarter performance in the high yield market was impressive and the market recovered much of its first quarter losses. The Fed's entry into the market has had a meaningful impact on investors' risk appetite and willingness to underwrite a sharp recovery in underlying economic fundamentals. US and European markets rallied aggressively, with Europe outperforming slightly. An interesting aspect of the first-quarter sell-off is the return of the energy sector as the gorilla in the room impacting asset class returns. Net of recent fallen-angel and default activity, energy now sits atop all sectors at 12.5% of the global high yield index. Considering the average spread by sector, at 930bps energy is punching well above its weight relative to the rest of the market ex-energy at 595bps. Energy-sector concentration has also seen a notable change post sell-off with the sector now dominated by large capital structures, mostly fallen angels which have replaced the smaller, independent producers and service firms that used to drive sector performance. As of June 30, Pemex, Petrobras and Occidental Petroleum are three of the largest five issuers in the index, representing 4.5% of the asset class, and a third of the sector[1]. US high-yield energy was the best performing sector of the quarter generating a 33% total return. However, given the 45% loss through mid-March, investors who have held positions all year are still nursing a total return loss of almost 20%.

[1] This is not a buy, sell or hold recommendation for any particular security.

Developed Market Credit Indicator: Credit Chronicle

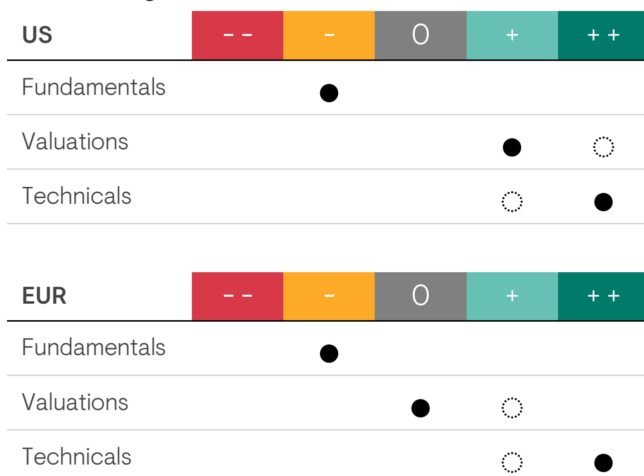


An empty circle denotes our view in previous quarter, if it differs.



Source: JP Morgan as at June 2020.

After a particularly difficult start to the year, loan markets rebounded in style in the second quarter, outpacing their high-yield peers in both the US and Europe. European loans were the standout performer, with strong gains across all rating categories. Interestingly, loan markets were one of the few credit asset classes not to benefit at all from fund flows through the quarter, with a continued drip of mutual funds outflows outweighing any positive impact from CLO formation. As an offsetting positive dynamic, it was also one of the few markets where new issue volumes have remained particularly subdued, in the US and Europe. Other notable developments include an unsurprising increase in the default rate on US loans, at 3.0% it is now the highest since 2012/2013. Recovery rates have also declined to a stark 43%, and while we have seen a degradation in documentation and security packages, we believe there is significant sampling element to that number, and we'd expect it to trend higher as the default cycle matures. Rating agencies have also been particularly busy within the loan market and we saw a record number of downgrades within the US loan market over the quarter. This trend, and specifically the downgrades to CCC rated securities and resultant pressure on CLO holders, is one to watch in the year ahead.



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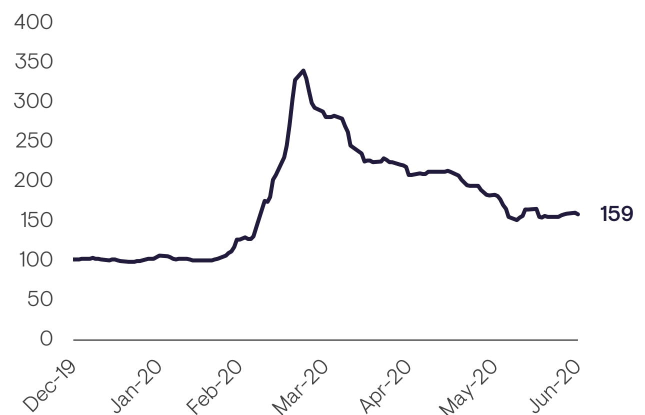


Source: Bank of America/Merrill Lynch. ICE BofA 15+ Year US Corporate Index.

The rally in investment-grade debt started in the last 10 days of March, after the Fed intervened in the market, and extended all the way to the end of the second quarter. For US investment-grade bonds, the cash price for the market had recovered to more or-less pre-COVID levels by the end of second quarter, driven by a combination of the significant boost from a collapse in Treasuries along with steady spread tightening through the period. Looking at it specifically from a spread perspective, credit spreads at the end of the second quarter were still wider than they were pre-COVID in both European and US markets, with both having another 50-75bps of tightening room before they reach that level. Over the quarter we saw an outperformance of the US over European markets, which was not surprising given the US underperformed in the March sell-off. We have also seen an abatement in the rapid downgrades experienced in late March and early April, with a gradual moderation in the trend through the quarter. With the Fed and the ECB both buying investment-grade corporate bonds and continued strong inflows into these at investors search for yield, the technical backdrop for investment-grade credit feels supportive of a continued grind tighter in credit spreads. We highlighted last quarter how compelling the opportunity for investment-grade credit was then, and while the opportunity now is not as pronounced, we continue to think that investment-grade debt is a very attractive space within the credit market to seek to generate further capital appreciation in a very defensive manner.

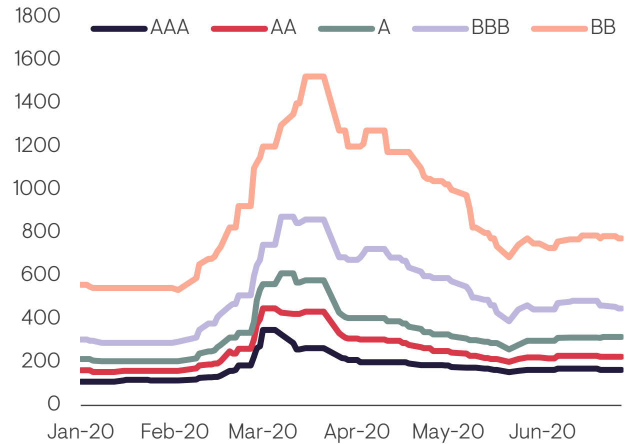
Structured credit

Senior CLO's (AAA/AA)	- -	-	0	+	+ +
Fundamentals		●			
Valuations				●	
Technicals			●		

Mezzanine CLO's (A-BB)	- -	-	0	+	+ +
Fundamentals	●				
Valuations				●	
Technicals		○	●		

An empty circle denotes our view in previous quarter, if it differs.

European CLO spreads (bp)



Source: Citi.

The second quarter recovery in CLO pricing was swifter for the more senior tranches, where we think investors' liquidity needs – rather than credit concerns – were the key driver of price weakness. Prompt central bank action to address this liquidity stress therefore helped drive a reasonably quick recovery for these tranches.

For lower-rated tranches, fears of rating downgrades, interest deferrals, and even ultimate principal losses for the most junior tranches, all combined to keep spreads wider for longer. The risk of a wave of potential downgrades to non-investment grade seemed to drive a notable gap between single A and BBB spreads in April for example, as shown in the chart.

As the pace of rating downgrades on the underlying loans slowed and broader market risk sentiment improved, lower rated CLO tranches eventually joined the recovery, with spread tightening accelerating in late May and early June. Low primary market supply volumes for CLOs helped create a supportive technical backdrop, as did large amounts of cash reportedly being raised to target lower rated CLO debt and equity tranches.

Specialist credit

Bank capital	- -	-	0	+	+ +
Fundamentals		●			
Valuations			●	○	
Technicals			●		

EM Corporate Credit	- -	-	0	+	+ +
Fundamentals		●			
Valuations				●	
Technicals			○	●	

Corporate hybrids	- -	-	0	+	+ +
Fundamentals		●			
Valuations			●	○	
Technicals			●		

Short duration HY	- -	-	0	+	+ +
Fundamentals	●				
Valuations			●	○	
Technicals			●		

An empty circle denotes our view in previous quarter, if it differs.

Bank capital: CoCos continued their recovery from late in the first quarter, driven by a combination of coordinated central bank action, strong fiscal responses as well as investor flows, with the second quarter return the strongest on record. While the sell-off into March was indiscriminate there has been more variation in the recovery, as expected. This is in evidence in the relative performance of CoCos by issuer year In general, the older vintages tend to have stronger structural features such as higher coupons and higher back-end spreads.

Valuations of CoCos continue to look reasonably attractive from a medium-term perspective, but less attractive on a relative-value basis compared with comparable asset classes such as corporate high yield and even parts of the investment-grade market. Fundamentals are expected to deteriorate further in the coming quarters, although government guarantee schemes and other fiscal support have helped to contain loan losses for now. Technicals have improved since March, although they have been tested by

several new deals recently. We note that supply from banks across the capital structure is up year on year. That said CoCo issuance itself remains slightly down year on year, with most issuance so far being used to re-finance existing securities.

Naturally the rally over the past quarter has made the asset class less attractively valued but we believe there are still select opportunities from higher-quality issuers, which have significant capital buffers in place to withstand further shocks.

Corporate hybrids were one of the sectors fastest to recover, particularly those that carried investment-grade ratings. We believe this was driven by increases in central bank purchases by the ECB and the Fed pushing investors into the subordinated parts of well-known investment-grade credits.

That said, as the market has rallied corporate hybrids have looked less compelling on a relative value basis, particularly when we compare them to the corresponding senior bonds. From a fundamental perspective we are comfortable with the sector noting that many of the issuers carry an investment-grade rating, have significant scale and are typically from more stable sectors such as telecoms. Technicals weakened somewhat in the quarter driven by a pickup in supply. There were deals from debut hybrid issuers, using the corporate hybrid market to protect their senior ratings.

Given compressed valuations in the market, we believe selectivity is key. We find value in hybrids from stable sectors and issuers with significant scale and flexibility to weather the virus. We prefer hybrids with stronger structures, in the form of higher back-end spreads which we believe will be more defensive in the event of another downturn.

Emerging market corporate credit: Emerging market corporate debt posted a strong quarter, broadly in line with Developed Market Credit. High yield outperformed Investment Grade as risk assets rallied with the Oil & Gas, Metals & Mining and Industrial sectors posting the strongest returns, bouncing back from the March lows. Whilst the market has rallied spreads still remain wide of those in developed markets on a comparable rating basis as the fiscal and monetary tailwind hasn't been as strong. There continues to be a strong demand from investors for EM assets in the global hunt for yield, particularly in the IG space. New issuance has also been strong (although less so the DM) whilst being well absorbed by the market. Fundamentals will remain under pressure given the impact on leverage of the extended economic shutdown, although EM corporates have shown an ability to work through these types of environments before.

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Credit market performance

	Q2 2020 Return (USD Hedged) %	YTD 2020 Return (USD Hedged) %	Yield-to-worst	Spread*	Duration
US high yield	9.5	-4.8	6.9	645	4.2
European high yield	11.6	-4.2	4.6	521	3.9
US investment grade	9.3	4.8	2.2	160	8.2
European investment grade	5.3	-0.5	0.9	148	5.4
US Loans	9.7	-4.6	7.1	690*	0.3
European Loans	13.6	-3.0	6.5	652*	0.3
Short duration high yield	9.9	-3.5	8.4	838	1.8
CoCo's	14.2	-3.1	5.0	472	2.7
Emerging market corporate debt	9.1	0.3	4.4	403	5.1

Past performance is not a reliable indicator of future results, losses may be made.

Please see important information section for information on indices.

*Libor OAS spread.

Sources: US high yield = BofA US High Yield (HUC0); European high yield = BofA EUR High Yield (HE00); US investment grade = BofA US Investment Grade (C0A0); European investment grade = BofA EUR Investment Grade (ER00); US Loans = S&P/LSTA Leverage Loan Index; European EUR Loans = S&P/LSTA European Leverage Loan Index; Short Duration High Yield = BofA 1-3yr Global High Yield (H1WN); CoCo's = BofA Contingent Capital Index (COCO); EMCD = BofA Emerging Corporate (EMCB). All as at 30 June 2020.

Glossary

Alpha: outperformance of a reference index or market through an investment manager's active investment decisions.

Bank capital: additional capital held by banks to absorb losses under duress. Cheaper and quicker for banks to issue than equity. Helps banks to improve their capital ratios.

Bank preference securities: issued by banks to meet their required capital ratios. These have characteristics of both equities and bonds. The securities are perpetual (with call features), pay dividends, and are subordinated relative to other forms of debt.

Callable bonds: bonds that can be redeemed by the issuer prior to the maturity date of the bonds. The issuer may look to issue new bonds at a lower coupon.

Carry: the net-of-cost return earned by owning a security – a 'carry trade' might involve borrowing at a low interest rate to invest in a security offering a higher interest rate to earn the additional 'carry'.

CLO: collateralised loan obligations are bonds that are backed by pools of (typically sub-investment grade) corporate loans. Several bonds of varying risk and return characteristics are usually issued against each pool of loans. Lower-risk, 'senior' tranches have higher priority claims on the cash flows from the loans but offer a lower yield than the lower-rated 'junior' tranches, which are the first to suffer losses if the underlying loans underperform.

Corporate hybrids: subordinated debt of Investment-grade issuers. They combine characteristics of bonds (payment of coupon) and of equities (no maturity date or very long maturities) and are typically rated a few notches lower than the same issuers' senior debt. Usually callable by the issuer five or 10 years after issue

Coupon: the regular interest payments a bondholder receives from the issuer of the bond.

Credit rating: a score awarded by an independent rating agency to indicate the financial strength of the issuer of a bond, and the potential for it to default on interest and principal payments. The top credit rating is 'AAA'. The lowest rating to be considered 'investment grade' is 'BBB'. Below 'BBB', bonds are termed 'sub-investment grade' or 'high yield'. The higher the credit rating of the issuer of the bond, the higher the 'quality' of the bond.

Credit spread: the difference between the yield offered by a corporate bond and the yield offered by a sovereign (government) bond of an equivalent maturity. This is the reward the investor gets in return for taking on a greater level risk than they would if they just invested in the sovereign bond.

Credit risk: see *Default risk*.

Currency swap: a swap is an agreement between investors to exchange future cashflows, such as interest payments. In a currency swap, the parties to the agreement exchange future cash flows of different currencies

Default risk: the risk that the issuer of a bond may not be able to meet interest payments or repay the money it has borrowed. The lower the credit rating of the issuer, the greater the risk of it defaulting on its debt and the greater the risk of the investor suffering an investment loss.

Duration: a measure of how much a change in interest rate will impact a security's market value. There is an inverse relationship between interest rates and bond prices.

Emerging market credit: bonds issued by companies from emerging markets (e.g. China, Brazil). Can be rated high yield or investment grade. Largely US dollar-denominated, although a small local currency corporate bond market exists.

Excess return: the total return of the bond minus the return attributable to changes in underlying treasury yields of an equivalent maturity.

Extension risk: the risk that the bond issuer will seek to delay when it pays back the amount it has borrowed from bondholders.

Fallen angel: an investment-grade bond issuer that has subsequently had its debt downgraded to a high-yield credit rating.

Floating-rate notes: the floating nature of coupon provides protection in a rising interest rate environment. Issued by both investment-grade and high-yield borrowers. These are typically shorter duration (up to five 5 years).

Interest rate risk: see *Duration* above.

Leveraged loans: loans that are structured, arranged and administered by at least one commercial or investment bank. Typically issued to support a merger or acquisition or to finance company growth. Sub-investment-grade rated. Typically, the coupon is a floating rate rather than fixed.

Maturity: The date the issuer will repay the bondholder.

Subordinated debt: debt that is repaid only after other debt has been repaid (i.e. comes further down in the order of priority for repayments) in the event of the issuer of the debt falling into financial difficulties.

Synthetics: highly liquid financial instruments that artificially simulate other credit market investments. Instruments can be related to a single corporate, or to a whole credit index. Allows for efficient implementation and hedging.

Total return: the investment return on a bond which takes into account a change in credit spread and a change in the yield of the underlying treasury of an equivalent maturity.

Yield: the return investors earn for owning a bond to maturity. This is a function of the price paid for the bond, the coupon, and the time to maturity.

General risks

The value of investments, and any income generated from them, can fall as well as rise. Where charges are taken from capital, this may constrain future growth.

Past performance is not a reliable indicator of future results. If any currency differs from the investor's home currency, returns may increase or decrease as a result of currency fluctuations.

Specific Risk(s)

Default: There is a risk that the issuers of fixed income investments (e.g. bonds) may not be able to meet interest payments nor repay the money they have borrowed. The worse the credit quality of the issuer, the greater the risk of default and therefore investment loss. **Derivatives:** The use of derivatives may increase overall risk by magnifying the effect of both gains and losses leading to large changes in value and potentially large financial loss. A counterparty to a derivative transaction may fail to meet its obligations which may also lead to a financial loss. **Interest rate:** The value of fixed income investments (e.g. bonds) tends to decrease when interest rates rise. **Liquidity:** There may be insufficient buyers or sellers of particular investments giving rise to delays in trading and being able to make settlements, and/or large fluctuations in value. This may lead to larger financial losses than might be anticipated. **Loans:** The specific collateral used to secure a loan may decline in value or become illiquid, which would adversely affect the loan’s value. Many loans are not actively traded, which may impair the ability of the Portfolio to realise full value in the event of the need to liquidate such assets.

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Additional information on our investment strategies can be provided on request.

Investment Process

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