Previously Investec
Asset Management

Credit Chronicle

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

2020: Quarter 3

Market review

We continued to see strong demand for credit for most of the third quarter as investors searched for yield and sentiment remained positive.

In what is typically a quiet month for credit markets, bond issuance volumes hit record highs in August as companies sought to take advantage of low borrowing costs, and this was met with strong investor demand fuelled by robust flows across most credit asset classes. Investors' increased appetite for risk pushed up Treasury yields while also boosting demand for high-yield bonds.

However, as the quarter progressed, headwinds grew: COVID-19 infection rates increased across much of Europe and the US as economies opened up; economic data was more muted relative to the strong May/June rebound; and political uncertainty rose due to the impending US elections. While this dampened the overall returns posted by high-yield bond markets, it also gave rise to some compelling relative-value opportunities in the high-yield market as we discuss in our Spotlight piece this quarter. Meanwhile, consistent investment-grade markets posted a significant tightening of spreads over the quarter, helping both US and European markets to deliver excess returns over government bonds.

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 teal)	● (light teal)
European high yield	● (red)	● (grey)	● (light teal)
US investment grade	● (orange)	● (light teal)	● (dark teal)
European investment grade	● (orange)	● (grey)	● (dark teal)
US loans	● (red)	● (light teal)	● (orange)
European loans	● (red)	● (light teal)	● (grey)
Bank capital	● (orange)	● (grey)	● (grey)
Corporate hybrids	● (orange)	● (grey)	● (grey)
EM corporate credit	● (orange)	● (grey)	● (light teal)
Short-duration high yield	● (red)	● (grey)	● (light teal)

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

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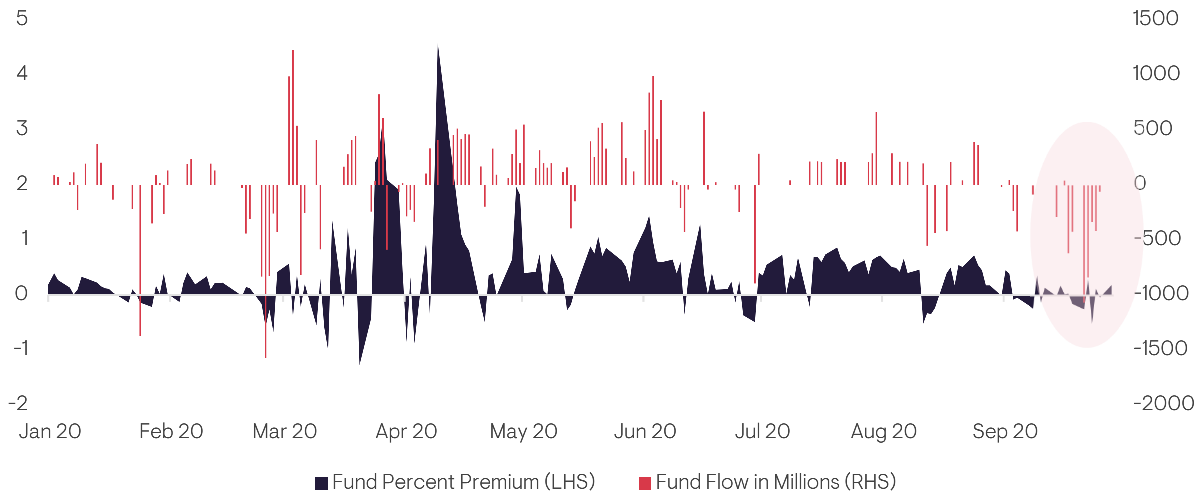
Credit spotlight

Opportunities arising from recent market volatility

Strong demand for yield continued to cause credit spreads to tighten for much of the third quarter. However, market volatility returned in September, beginning in the technology sector of the US equity market before making its way through to the credit market. Liquid credit markets were the first to be impacted as investors used portfolio products such as ETFs to de-risk. The largest US high-yield ETF recorded its third biggest weekly outflow ever in September, losing some $2.7 billion, as shown in Figure 1.

Fig 1. De-risking: US high-yield ETF flows



Source: Bloomberg, as at 28 September 2020.

ETF activity creates distortions

While ETFs only constitute c. 5% of the overall market size, they account for a far larger portion of secondary trading activity. To meet investors' outflows from ETFs in September, ETF providers typically sold the bigger and more liquid underlying bonds, causing these tranches to underperform by over 100 basis points, as shown in Figure 2. There is added pressure on secondary bonds when the ETF trades at a discount to underlying NAV, as ETF arbitrage causes some market participants to sell high yield bonds and buy the ETF.

Fig 2. Median Total Return by deal size (US$ millions) in September

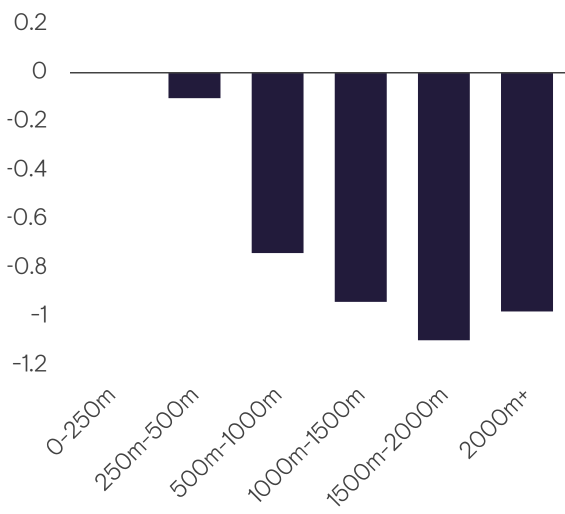
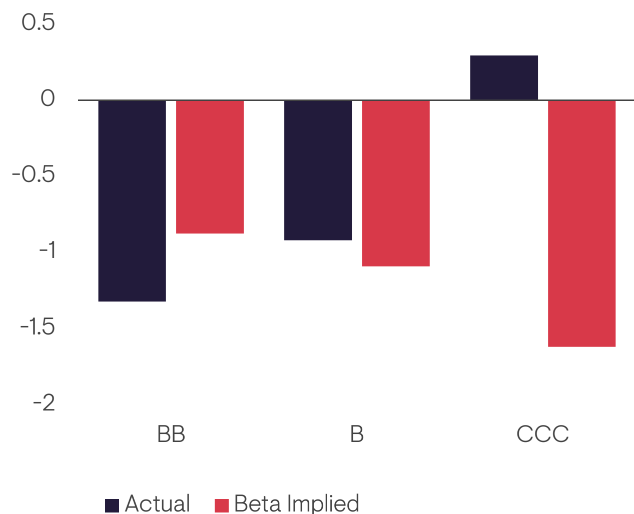


Fig 3. Return by rating category over September, %



Source: ICE BofA Index (HUCO and HWOC Index). Please see important information section for information on indices.

Historic market dislocation leaves BB rated bond valuations attractive

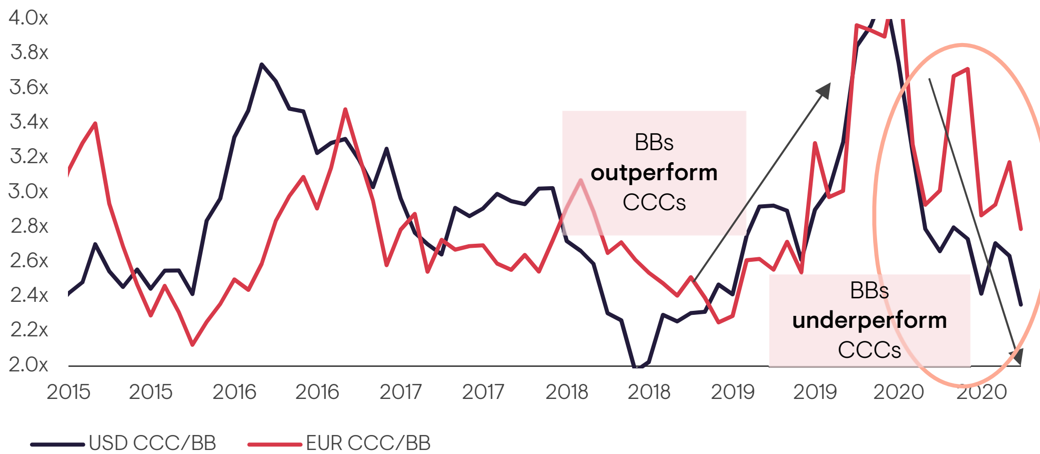
The liquidity related market technical phenomenon described above led to the underperformance of the BB segment of the US high-yield market in September, since this contains the most liquid/large cap names. This is shown in the 'actual' bars of Figure 3.

What is unusual is that this constituted a reversal of the market behaviour we would typically expect when there is a risk-off shift and equity market weakness, whereby lower-rated market segments would typically underperform. Given their higher credit quality, BB rated debt has historically had a beta to the US high-yield index of 0.8x but in this latest drawdown it was close to 1.3x. Figure 3 illustrates this starkly by including 'beta implied' returns – the returns investors would have seen based on historical relationships.

Risk/return profile of select BB names is compelling

We believe the recent underperformance of the more liquid and quality end of the market provides an attractive opportunity to capture excess spread without necessarily taking much default risk. At this stage in the cycle, we continue to remain highly selective, focusing on bonds issued by businesses with strong balance sheets and robust liquidity. From a longer-term perspective, BB rated bonds appear attractive relative to other high-yield market segments, particularly CCCs. The spread ratio between CCCs and BBs remains at historically compressed levels, despite the elevated default risk in the CCC rated part of the market, as shown in Figure 4.

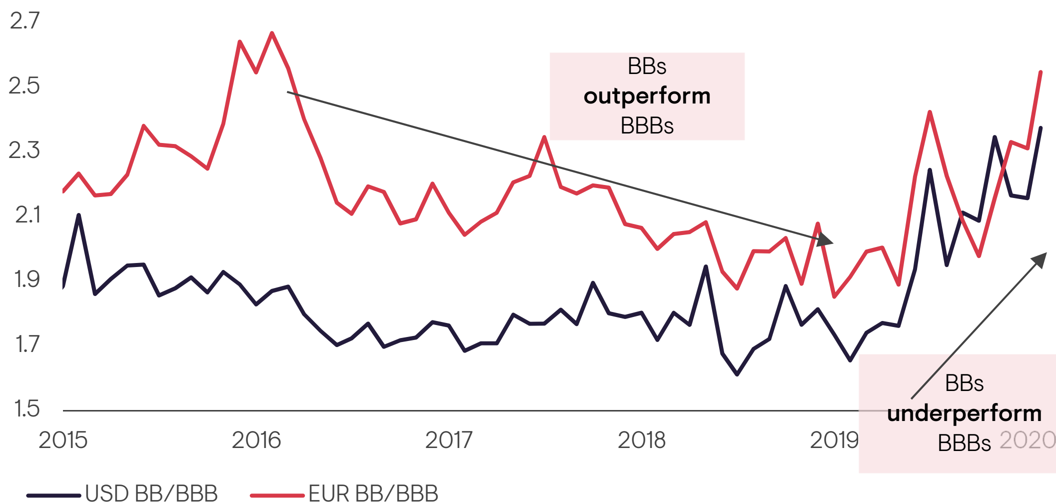
Fig 4. Credit spreads on BB rated bonds are now attractive relative to CCC rated



Source: ICE BoA Index (HWOC and GOBC Index). Based on median spreads to remove impact of constituent changes/outliers. Please see important information section for information on indices.

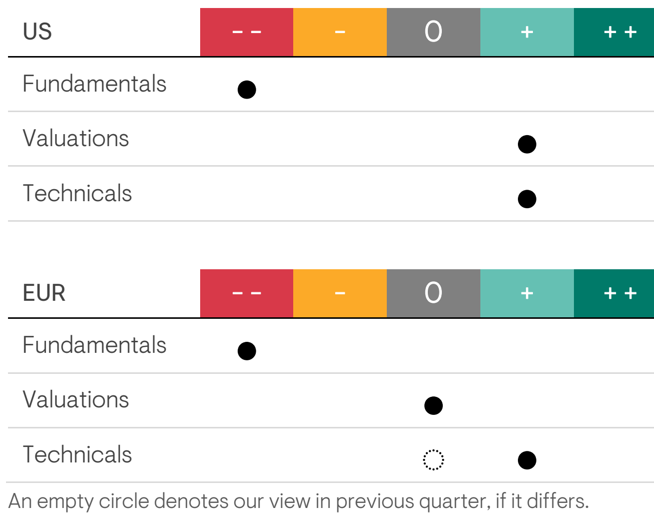
Viewed through a different lens, spreads on BB bonds have also underperformed the lower rated parts of investment-grade markets. The latest round of volatility has also made BBs historically cheap vs BBBs when compared on a spread ratio basis.

Fig 5. Credit spreads on BB rated bonds are attractive relative to BBB (investment-grade) rated



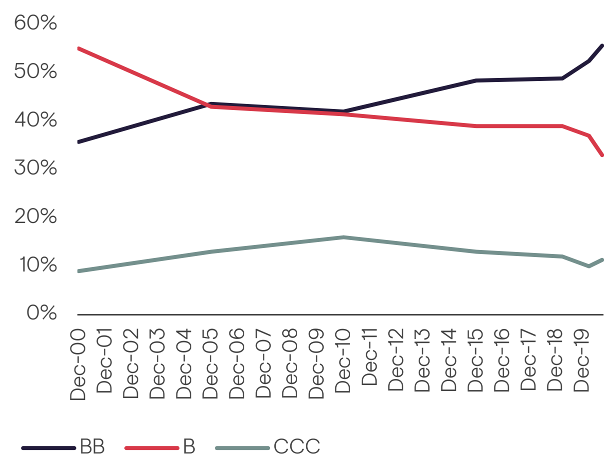
Source:. ICE BofA Index. Based on median spreads to remove impact of constituent changes/outliers. Please see important information section for information on indices.

Sector by sector



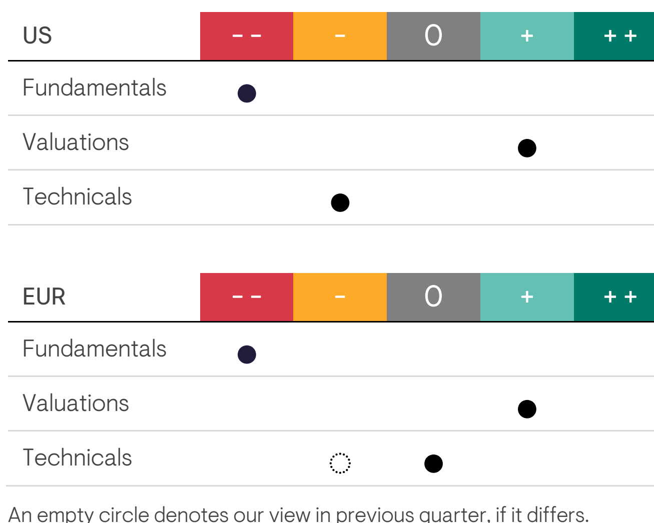
An empty circle denotes our view in previous quarter, if it differs.

US high-yield market make-up



Source: BofA as at September 2020.

As highlighted earlier, a continuing strong rally was followed by a modest correction in September. Uncertainty over the US election is particularly relevant for the high-yield market given the impact of tax policies on corporate capital allocation, and of regulatory policies on investment outcomes in the healthcare, energy and technology sectors. US defaults declined to a six-month low in September. In the downgrade and default cycle of recent months, large investment-grade issuers have fallen into the high-yield category and lower-rated high-yield issuers have defaulted and exited the index; the result a meaningful increase in overall credit quality. This is most notable in the US market, given its historically high exposure to the energy sector. As the chart above shows, the percentage of BB issuers in the US high-yield market is at historically high levels meaning credit spreads, which are now at their approximate long-term average levels, are compensating for a higher quality cohort of credit risk. While high-yield spreads have fallen meaningfully since their >1000bp peak of March and are now about 200bps wider than the January low, this does not necessarily translate into correlated outcomes in performance. This is because defaulted issuers exit the index at the end of every month and the resulting change in composition results in ever lower market spreads of the residual healthier credits, without providing incremental investment returns. Therefore, a passive investment in the high-yield market, especially lower-rated high yield, would not have generated returns near what the spread moves would imply. This underscores the importance of active credit selection in investing in the high yield market.



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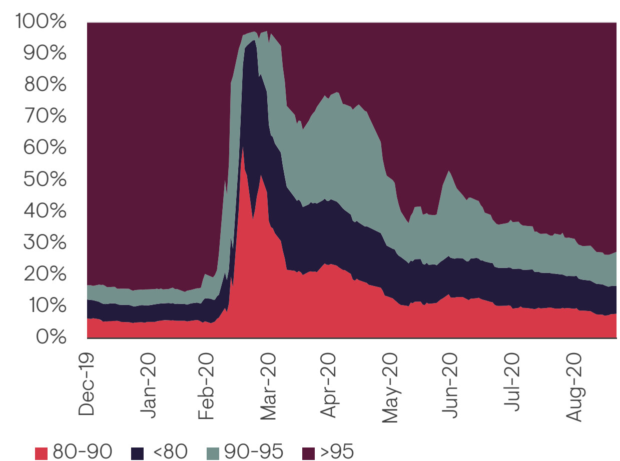
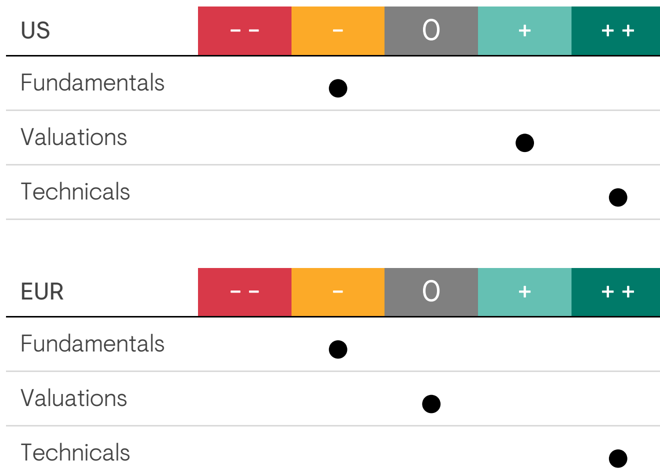
Share of loans in the secondary market



Source: Debtwire par, Markit as at September 2020.

It was another strong quarter for the loan markets, with both the US and European markets largely keeping pace with their traditionally higher beta high-yield cousins. Both markets saw a continued price recovery, as disappointing primary issuance through the first half of the quarter prompted loan managers to take a closer look at the secondary markets. This price recovery (illustrated above), has seen the proportion of loans priced at 95 or higher increase to just over 70% of the market, from 50% at the end of June, and 82% pre-COVID. Unlike most other credit markets, year-to-date new loan issuance has disappointed, with US institutional loan supply down 25% year-on-year. This has largely been driven by a significant reduction in M&A and leveraged buyout (LBO) funding, with LBO deal flow down 50% this year. With this subdued LBO issuance landscape, recent activity has been driven principally by refinancing and opportunistic dividend recapitalisations, although market forecasts for the rest of the year indicate only modest positive net loan issuance, which could provide a continued technical tailwind to loan markets.

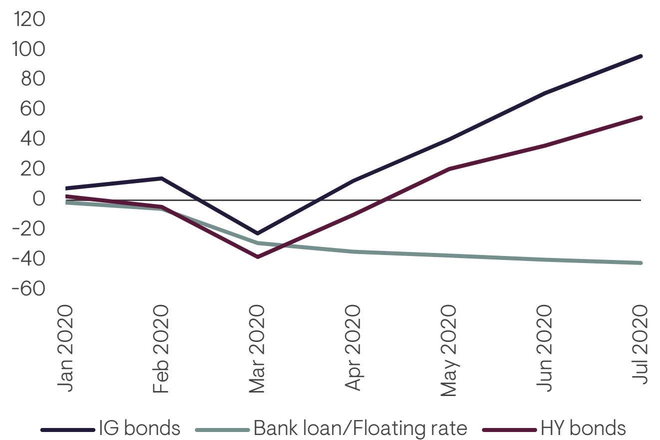


Investment grade

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

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

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



Source: Broadridge. Monthly data to end of July 2020.

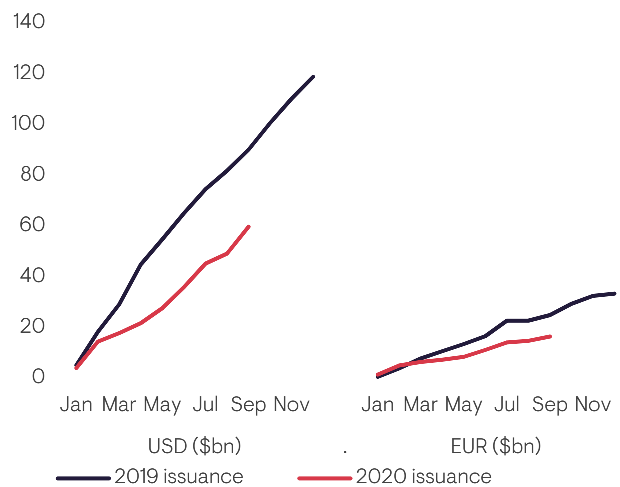
We continued to see strong demand for investment-grade credit over the quarter as investors searched for yield. This resulted in a consistent and significant tightening of spreads over the quarter, helping both US and European investment-grade markets to deliver excess returns over government bonds. Relatively lower new issuance volumes helped the European market outperform the US, where greater supply had a slight dampening effect on market prices. Relative currency strength also favoured European bonds. While we believe these trends will remain, the path is likely to be more volatile given the potential resumption of negative COVID-19 headlines and uncertainty around the forthcoming US election.

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.



Source: JP Morgan as at September 2020.

After a soft end to the second quarter, CLO spreads resumed their recovery through most of the third quarter, helped by the price recovery in the underlying leveraged loan markets. As with the loan market, a similar supportive supply technical exists in the CLO market, with the lack of loan availability limiting new issuance of CLOs. Supply is further constrained by the fact that CLO tranche spreads remain high relative to pre-COVID levels, keeping funding costs for new CLOs elevated, and making it challenging to produce attractive returns for CLO equity investors in new deals. CLO issuance is down 66% year to date in both Europe and the US, and although the pace of issuance is increasing again, full-year volumes look likely to finish much lower than in previous years. We think there are attractive opportunities in CLO mezzanine tranches, though while the technical backdrop is supportive, the outlook for loan fundamentals remains uncertain. Careful selection of portfolio and manager profiles remains important, and those managers best able to maintain the credit quality of their portfolios are likely to see outperformance of the CLO bonds backed by those portfolios.

Specialist credit

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

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

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

Short duration high yield	- -	-	0	+	+ +
Fundamentals	●				
Valuations			●		
Technicals			○	●	

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

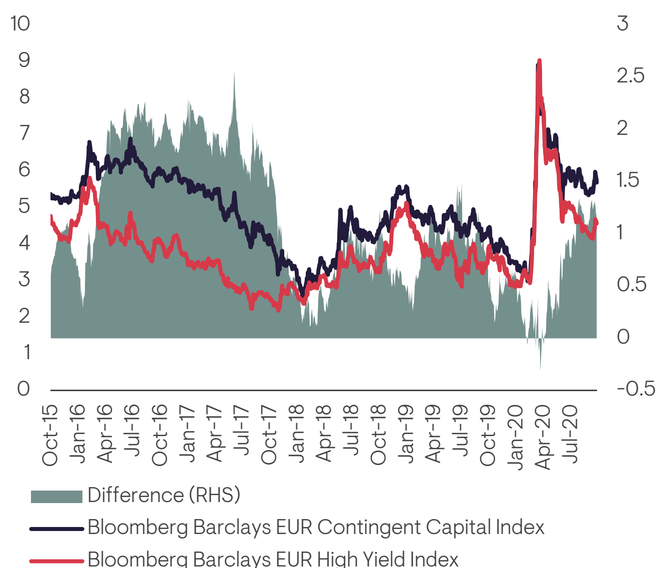
CoCos performed in-line with other high beta credit asset classes over the quarter, delivering 4.1%.

From a valuation perspective, CoCos offer over 100bp pickup vs European High Yield, which is above the 5-year average. Similarly, CoCos offer a substantial pickup relative to other parts of the bank capital structure, such as LT2 and Senior securities.

We believe at least part of this valuation pickup is justified. There is still a high degree of uncertainty about the path of loan losses over the coming years, particularly as government support mechanisms start to be withdrawn. We believe that COVID will have a more lasting impact on the banking sector compared to other sectors and volatility will likely remain high with several risk factors such as Brexit and US elections ahead.

However, we believe that select opportunities exist, particularly for higher quality banks and those with less exposed balance sheets. We believe the technical environment will remain reasonably supportive in this low-yield environment as CoCos offer a reasonable pick-up versus comparably rated asset classes.

CoCo's relative to European High Yield, %



Source: Bloomberg as at 28 September 2020.

Corporate hybrids underperformed other parts of credit in the quarter largely down to heavy supply. A large portion of this issuance has been from new sectors and first-time issuers. Corporate hybrid issuance has already matched the previous annual record set in 2015, despite having a quarter to go. The recent underperformance has now made corporate hybrid valuations closer to where we think they should be, particularly compared to senior spreads and also traditional high yield. We believe corporate hybrids remain attractive as they offer investors a reasonable yield pick-up without the same credit/default risk that is present in the traditional high yield market. We continue to prefer those issuers from stable sectors and where there is limited downgrade risk at the senior level.

Emerging market corporate credit: Returns remained robust in EM Credit, with High Yield marginally outperforming the Investment Grade portions of the market and all sector and regions producing a positive return. Much like developed markets after a strong July and August, there was a slight retracement in September as global sentiment turned and a number of country idiosyncratic headlines (e.g. Argentina FX policy) destabilised markets somewhat. Relative to the wobble in equities however EM Credit remained remarkably resilient. New issuance volume was high but well absorbed by the market, and broader investor demand remained robust given the continual search for resilient yield.

Credit market performance

	Q3 2020 Return (USD Hedged) %	YTD 2020 Return (USD Hedged) %	Yield-to-worst	Spread*	Duration
US high yield	4.7	-0.4	5.78	542	3.94
European high yield	2.9	-1.3	4.11	472	3.82
US investment grade	1.7	6.6	2.06	144	8.33
European investment grade	2.3	1.8	0.53	118	5.33
US loans	4.1	-0.7	6.0	574	0.3
European loans	2.9	-0.2	6.0	597	0.3
Short duration high yield	3.6	0.0	7.25	725	1.71
CoCo's	4.1	0.9	4.65	444	2.91
Emerging market corporate debt	2.7	3.1	3.89	357	5.19

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 September 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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