In credit: our latest views

Investment review and outlook from Investec's developed market credit team
2019: Quarter 4

Market review

The closing quarter of 2019 did not disappoint, with most credit markets again posting strong returns. Factors helping markets end the year on a high note included: macro data painting a picture of stabilising global growth; positive progress towards a US-China trade deal; and reassuring comments from increasingly accommodative central banks. This helped investors to lay aside fears of an imminent recession and reach for risk.

The fabled 'Santa rally' came early, with credit investors joining in with the broad shift in momentum. The rally touched many parts of the credit market; even riskier segments – such as CCC rated credit – regained some lost ground, having lagged earlier in the year. That said, significant dispersion remains, as we discuss below.

The European Central Bank resumed quantitative easing, re-launching its corporate bond buying programme with initial purchases that were well ahead of market forecasts. We believe this could act as a tailwind for European credit markets in the year ahead.

The issuance rate of credit was fairly robust across the board, as companies looked to lock in finance at enticingly low yields.

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	🟢	🔴	🟢
European high yield	🟢	🟠	🟢
US investment grade	🟢	🟠	🟢
European investment grade	🟢	⚪	🟢
US loans	⚪	🟢	🟠
European loans	⚪	🟢	⚪
Bank capital	🟢	⚪	🟩
Corporate hybrids	🟢	🟠	⚪
EM corporate credit	🟢	🟠	🟢
Short-duration high yield	🟢	🔴	⚪

Key: Worst ← 🔴 🟠 ⚪ 🟢 🟩 → Best

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Credit focus: quarterly reflections

Hidden dispersion and what it means for credit investors

Dispersion of returns has been a key theme across a number of credit markets, including bonds, loans and structured credit, as illustrated by the chart below.

While the higher-rated part of the credit market has rallied (spreads have compressed), certain sectors in the lowest-rated parts of the credit market saw spreads widen over 2019. This has created a bifurcated market.

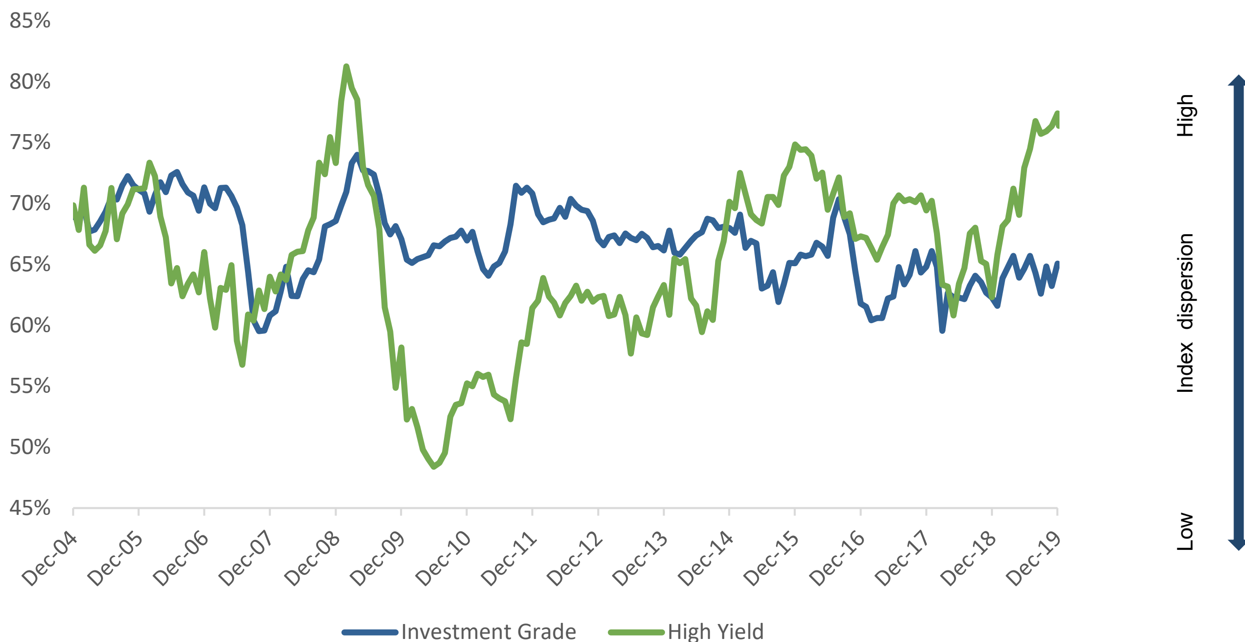
To observe the level of credit spreads at the aggregate index level would mean missing the full picture. There is now a significant divergence between the valuations of high- and low-quality credit: credit spreads are tightening towards all-time lows in highly rated segments of the market, but they remain in-line with historical averages in low-rated parts of the market. We believe a combination of cyclical and secular factors are behind this dynamic:

- Low government bond yields are continuing to fuel demand for the higher-rated parts of the credit market, which offer higher yields relative to government bonds
- In contrast, the softer growth environment seen in much of 2019 made investors cautious of debt issued by riskier, cyclical companies
- Some sectors continue to face secular headwinds. For example, persistently high operating costs continue to weigh on the energy sector, while the growth of e-commerce is an ongoing challenge for traditional (bricks and mortar) retailers.

With the growth backdrop set to improve in 2020 and technicals (supply/demand dynamics) to remain supportive, we expect dispersion to partially normalise from these extreme levels. Indeed, we have started to see this in recent weeks, with lower-rated segments outperforming. However, we believe the growth backdrop is unlikely to be strong enough to reverse all the underperformance we saw in 2019, particularly as many of the factors holding back some sectors are secular in nature.

We believe elevated dispersion will continue to create significant dislocations and mispricing in the market, which is ultimately beneficial for active managers. Selecting the right names to invest in will be critical in this environment, given the need to untangle the structural vs. cyclical challenges impacting businesses.

Credit spread dispersion within indices has risen again



For further information on indices, please see the important information section.

Source: ICE BofAML Indices, Investment Grade = G0BC, High Yield = HW0C. Dispersion is measured as the % of bonds trading at more than +/ 25% relative to the index spread. As at 31 December 2019.

> Dispersion creates alpha opportunities for bottom-up investors – we believe it will be an important driver of returns in 2020

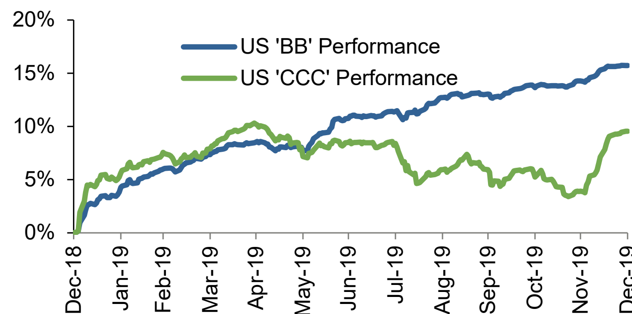
Sector by sector

HIGH YIELD

US	- -	-	0	+	+ +
Fundamentals				● (green)	
Valuations	● (red)				
Technicals				● (green)	

EUR	- -	-	0	+	+ +
Fundamentals				● (green)	
Valuations		● (amber)			
Technicals				● (green)	

Performance of BB and CCC rated credit



Past performance is not a reliable indicator of future results, losses may be made.
Source: Bank of America/Merrill Lynch. BB: BofAML US BB Corporates. CCC: BofAML US CCC Corporates. As at 31 Dec 2019.

A strong December helped a solid fourth quarter to cap a strong year for high-yield credit.

In the US, December saw a particularly strong rally within the CCC rated sub-set, ending a sustained period of underperformance for that part of the market. Improved macro, trade and oil market dynamics over the quarter pushed credit spreads tighter across the board, with the spreads of higher quality high yield edging ever closer to post crisis tights. These tighter valuations are arguably underpinned by reasonably robust fundamentals, with default rates remaining below long-term averages and the immediate outlook set to remain benign. Furthermore, the dovish Federal Reserve continues to provide a tailwind (boosting demand for higher-yielding credit), as do supply constraints resulting from many ‘rising stars’ moving out of the high-yield and into the investment-grade market.

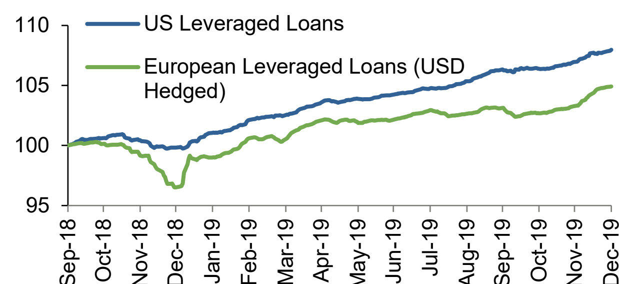
European market returns were also strong, with the European Central Bank’s corporate bond purchases offsetting slightly weaker fundamentals. The European high-yield credit market underperformed the US by around 3% on an absolute basis, but excess returns were similar (in local currency terms) highlighting the impact of falling US interest rates on credit market total returns. European valuations are also quite elevated, but not as close to post-2007 highs as the US market. Central bank activity remains a driving force for credit markets globally, so it’s a key area for investors to watch.

GLOBAL LOANS

US	- -	-	0	+	+ +
Fundamentals			● (grey)		
Valuations				● (green)	
Technicals		● (amber)			

EUR	- -	-	0	+	+ +
Fundamentals			● (grey)		
Valuations				● (green)	
Technicals			● (grey)		

Cumulative total returns



Past performance is not a reliable indicator of future results, losses may be made.
Source for European series: S&P/LSTA European All Loans USD Total Return Hedged Index. US series: S&P/LSTA Leveraged Loan Total Return Index. 30 Sept 2018 to 31 Dec 2019.

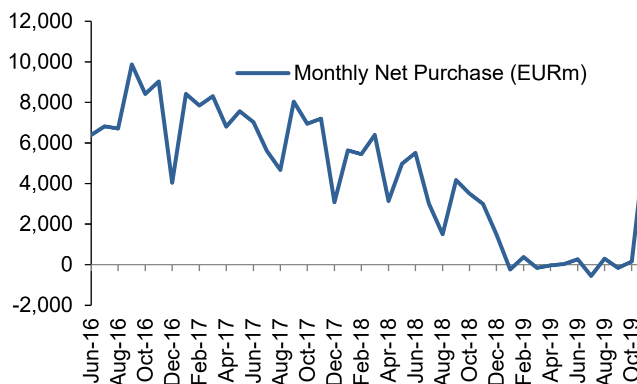
The US leveraged loan market participated well in the fourth-quarter rally, comfortably outperforming its European counterpart and recouping some of the previous quarter’s underperformance. General loan market fundamentals remain relatively weak. A slight rise in defaults and a continued weakening of the downgrade/upgrade ratio were among factors weighing on the market. There was also more muted demand from CLO investors for lower-rated leveraged loans. However, we still find some attractive segments in US and European markets. A price recovery in some assets that had been particularly under pressure earlier in the year drove the performance of the loan market higher. However, price dispersion in loan markets remains relatively high. Coupled with the limited appetite for underperforming/vulnerable issuers, this means credit selection remains key in this market. While loan fund flows remained negative, the continued healthy rate of issuance of CLOs in both the US and Europe helped to absorb the reasonably robust issuance of loans during the quarter.

INVESTMENT GRADE

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

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

ECB corporate sector purchase programme, EUR mn



Source: Bloomberg. ECB Corporate Sector Purchase Programme (CSPP) Monthly Net Purchases. June 2016 to November 2019.

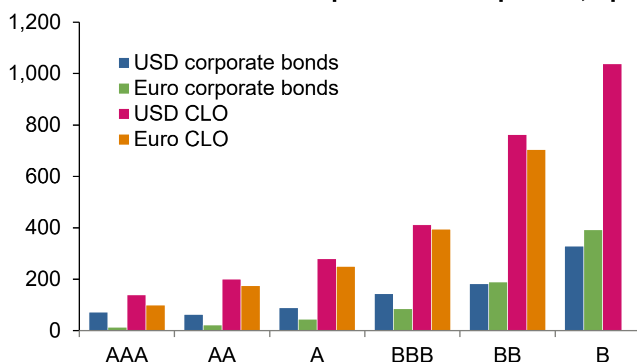
Investment-grade bonds didn't quite keep up with broader credit market gains, as rising government bond yields in Europe and the US weighed on total returns. However, a meaningful tightening of credit spreads helped corporate bonds outperform their sovereign counterparts and deliver positive excess returns in the quarter. Unsurprisingly, given the increased appetite for risk, BBB rated credit outperformed markets with a single A rating or higher. Less predictable was the outperformance of US credit over European, given the European Central Bank's resumption of its corporate bond purchase programme shown in the chart. But this is explained by the US market having a longer spread duration than Europe (i.e. spread tightening having a more pronounced positive effect on US bond prices). The US market also had some catching up to do, as European market spreads tightened significantly more than US in the middle part of the year. Both markets are now making strides towards the tight credit spreads seen in early 2018.

STRUCTURED CREDIT

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

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

USD and Euro CLO and corporate bond spreads, bps



Source: CLO spreads and primary spreads from JP Morgan. Corporate bond spreads are from ICE BofAML sub-indices: ER00 = ICE BofAML Euro Corporate Index. HE00 = ICE BofAML Euro High Yield Index. C0A0 = ICE BofAML US Corporate Index. H0A0 = ICE BofAML US High Yield Index. As at December 2019.

The improvement in market sentiment took longer to make an impact on the CLO market than other credit markets. Concerns that had pushed CLO spreads wider in the third quarter – weakening loan fundamentals and a higher downgrade/upgrade ratio – lingered, particularly in lower-rated US CLO tranches. However, from mid-November, CLOs joined in the broader market rally, albeit with spreads generally not managing to fall below the tight levels seen in May.

Higher-rated CLO tranches continued to perform defensively, offering high carry but minimal volatility, and we think they still offer attractive risk-return characteristics relative to other parts of the credit market. Taking into account the embedded Euribor floors in European CLOs (which effectively set Euribor at a minimum of 0%) and current currency swap levels, we continue to think European CLOs offer better value than US CLOs on the whole. However, rising interest rates over the fourth quarter have caused those embedded Euribor floors to lose some of their value. With loan fundamentals weakening and dispersion rising, we also expect to see more appealing opportunities emerge in lower-rated tranches in the year ahead.

Specialist credit

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

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

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

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

Source: Investec Asset Management. For illustrative purposes only.

The **Bank capital** market – consisting of securities commonly referred to as Contingent Convertibles (CoCos) – continued its strong run in the fourth quarter, comfortably outperforming other credit markets once again. While we do not expect a repeat of the annual returns seen in 2019, we believe there are still pockets of opportunity within the asset class.

From a fundamental perspective, we expect banks to remain creditor-friendly as regulatory uncertainty should encourage them to maintain or even grow their capital buffers. And while valuations are clearly less attractive than a year ago, they still look reasonable when compared with other asset classes, particularly the now-expensive US bank preference share market.

From a technical perspective, we expect the supply of CoCos to be manageable (i.e. at levels that can be absorbed easily by investor demand); after several years of issuance being relatively high, many of the larger banks have now reached a steady state level of Additional Tier 1 Capital (AT1) in their capital structure.

Selection will, however, remain key in 2020 – at both an issuer and security level. We believe many in the market have become relatively complacent around extension risk, with limited differentiation between high coupon debt and low coupon debt. We plan to focus our investments in stronger structures, with higher coupons and lower duration.

Corporate hybrids also finished on a strong note in the fourth quarter. Similar to bank capital, corporate hybrids have been one of the main beneficiaries of investors' search for yield. Fundamentals in this asset class remain healthy as the majority of these issuers are from stable sectors with strong balance sheets. We believe valuation is the main obstacle for this sector going forward. Spreads have compressed relative to a number of comparable asset classes, including traditional investment-grade as well as BB rated high-yield bonds.

Emerging market credit experienced outcomes similar to those seen in developed markets, driven by stable fundamentals and lower interest rates. A further similarity with developed markets is in asset valuations, which are looking increasingly expensive considered in the context of their historical ranges. However, we think that fundamental resilience across a large swath of EM regions justifies a positive view on the asset class, with pockets of value offering potential upside opportunities for investors who are selective in their approach. Importantly, China continues to provide support for the credit market in its attempt to manage a steady decline in growth, and EM credit defaults remain manageable at historically low levels.

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.

Rising star: a high yield issuer that has subsequently had its credit rating upgraded to investment grade.

Santa rally: an effect that often sees markets rally in the run up to the Christmas period.

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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