June 2020

Give the Fed Credit!

What's driving credit markets?

Driven by the continued level of uncertainty of the COVID-19 pandemic, global financial markets have been highly volatile and while more recently have become calmer, remain in a state of flux. Prospects for a vaccine coming to market sooner than expected and lockdowns ending, versus increasing contagion rates, rising deaths and risks of a second wave of infection, seem to be the main driver of financial market direction. While credit markets haven't been immune, on the whole they have displayed more stability than equities. Credit spreads have generally moved wider and liquidity has been challenged, in some countries more than others.

Although credit markets have received support from Central Banks that have introduced new programs to either buy corporate bonds directly (Fed, ECB and the BoE) or allow some corporate bonds to be repo-eligible collateral (the RBA), there has nevertheless been considerable stress and investment grade credit spreads are generally 50 to 150 basis points wider today than at the end of February, when the crisis began.

In order to assess whether this repricing presents an opportunity or a risk, it is critical to understand if these changes are mainly driven by technical or fundamental factors. Unsurprisingly in the short term technicals have been the driving factor for credit spread widening. Initially investor demand for cash, given the flight to quality, led to indiscriminate selling of risk assets including credit. More recently the markets are now giving way to optimism, fuelled by political will and Central Bank support initiatives. Whilst underlying corporate fundamentals have taken a back seat so far, historical experience suggests that in the medium- to long-term, fundamentals such as leverage, interest coverage and access to cash will regain their position as the most important variable in driving credit spreads.

Have credit fundamentals changed over the last few months?

With a higher degree of uncertainty about future earnings, investors are right to remain cautious. Most sectors and businesses are suffering from, and will continue to see, a reduction in revenue and profitability. But of more importance for credit fundamentals is the accompanying impact on free cash flow. Companies will try to reduce cash burn as much as possible by reducing, or extending out, capital expenditure and reining in variable costs.

As positive cashflow becomes harder to generate and leverage increases, it is important to focus on a company's liquidity position – a key indicator as to whether or not it will be able to survive the downturn. How much cash does it have on hand? Does it have access to credit lines or a revolving credit facility? Are corporate bond markets open for new deals? In answering these questions, it is important to make sure that these credit facilities are committed; if they are not, then it is all too easy for a bank to renege on these 'commitments' in times of stress. Companies in stress will often draw down on these lines and despite the negative carry will choose to hold the cash on the balance sheet. That way, management can guarantee that it can access the liquidity and buy itself time for demand to recover.

Credit market issuers have become somewhat polarised into the 'haves' and 'have nots'. Higher quality, investment grade companies have a better chance of weathering the storm given their access to cash on hand, bank credit lines and capital markets (equity and/or credit); for the latter, the US primary debt market has seen a record amount of issuance over the last few months, dominated by strong investment grade companies. For example, Oracle issued

USD20bn of debt in March, some of which was 20 years in maturity. Smaller, more indebted and lower rated companies will likely struggle, as they have fewer and less well-resourced levers to pull.

Given this last credit cycle was one of the longest on record with almost unlimited access to liquidity, some companies will now struggle to refinance and stay solvent. So not only will there be more credit rating downgrades, but also an increase in defaults. However, defaults, consistent with history, will remain concentrated on already lower-rated, high yield companies.

In order to mitigate these negative factors, portfolios should be diversified and consist of more highly rated, short-dated bonds, as we have maintained for some time.

What are the rating agencies saying about downgrades?

As the current crisis can easily be viewed as an abnormally large negative shock, should a raft of rating downgrades be expected? Moody's recently published a report that analysed movements in ratings since 1920, which considers other economic recessions, shocks, and includes the Great Depression of 1929. The report emphasises that while softer than expected revenue and free cash flow will impact credit quality, rating agencies do attempt to rate through the credit cycle and capture lasting changes in credit quality; for those companies that had an historic rating change (either an upgrade or downgrade) Moody's examined more than 100 years of data and noted it only reversed a rating change about 3% of the time within one year and only 20% after five years.

The report also states *"Net downgrades rise in credit downturns, but only by a small amount. This is unsurprising as deteriorating financial and economic conditions are a key indication that aggregate default risks are rising. However, the degree of downgrades is relatively limited, particularly for higher-rated issuers that should be more robust in the face of normal cyclical developments. During the past three credit downturns, on average ratings have only declined by around half a notch."*

Nevertheless, we do expect the COVID-19 crisis to result in more BBB bonds transitioning to high yield compared to history given that the BBB segment has exceeded 50% of US investment grade, from ~35% over the last decade, as a result of 'financial engineering', and many are currently on negative watch. In our experience bonds that go from investment grade to high yield can fall ~10% in price, so single name issuer selection remains crucial.

What are the rating agencies saying about defaults?

Before talking about defaults, it is worth stressing that most of the data examines just the high yield universe – those bonds rated BB+/Ba1/BB+ (S&P/Moody's/Fitch) and below – as there are too few investment grade defaults to allow meaningful analysis.

For example, S&P's average one-year default rate for a BBB- (the lowest investment grade rated) corporate over the last 40 years is just 0.2%, with a high of 1.4% in 1983. The long-term, annual high yield default rate is about 4% and in February 2020 it was 3.1%. The current COVID-19 crisis is expected to drive a rise in high yield default rates. Moody's expects its baseline default forecast for high yield to be 13.4% at the end 2020 and to increase to 14.4% by the end of March 2021.

S&P is forecasting the trailing 12-month default rate for US high yield bonds to jump to 10% by the end of December 2020, from 3.1% in December 2019. This assumes that there will be a global recession this year. This increase is partly driven by the fact that the percentage of issuers with a B or lower rating stood at an all-time high of just more than 30%. S&P noted, *"The current recession in the US this year is coming at a time when the speculative-grade market is historically vulnerable to a liquidity freeze or an earnings drop."* The energy and retail sectors are expected to drive these defaults.

Concluding, as with previous crises we expect heightened default risk to remain more or less fully contained within the sub-investment grade universe, and specifically sectors such as energy, leisure, gaming and retail. Minimising or avoiding these areas remains key.

Is this current crisis the same as the GFC?

This COVID-19 driven economic downturn is different to the GFC, as the financial sector is not the source. The initial impact will be felt more broadly across the corporate sector compared to the financial sector. The severity of the crisis will depend on the individual sector, varying from those heavily impacted (travel, leisure, energy, luxury products), to those less so (food, consumer staples, infrastructure, agriculture, pharmaceuticals, technology).

Whereas in the GFC when pure corporate credits were generally preferred over financial credit, the current crisis sees the reverse as true. Since the GFC, through various new regulations, banks have been forced to substantially increase their loss-absorbing capital bases and should be well set to survive. They are also less geared and hold more liquid assets. Banks will obviously be impacted by credit losses in their corporate, property and personal loan books but well managed ones are expected to have sufficient capital to take those hits.

One fortunate advantage of having stronger banks this time around is that they are more willing to extend credit to sound corporates, even those in more volatile sectors.

What are the technical factors that are driving the market at the moment?

After examining credit fundamentals, it is equally, and possibly more important to understand some of the technical factors that can drive the markets in the short-term.

Early in the crisis there was considerable investor uncertainty which manifested in increased volatility in financial markets. Investors reduced risk across all asset classes and also within asset classes. That led to selling of riskier assets, and a move into more defensive, stable assets, be that cash or higher-rated credits. As a result, with limited liquidity and few buyers, most asset prices moved lower.

Then, and since, governments, regulatory authorities and Central Banks have been proactive in attempting to support global economies and financial markets. There have been several initiatives that have been supportive to credit markets.

On 18 March 2020, the ECB announced its EUR750bn Pandemic Emergency Purchase Programme (PEPP). Initially, purchases will be conducted through to the end of 2020 and will include all the asset categories eligible under the existing asset purchase programme. ECB President, Christine Lagarde said, *"Extraordinary times require extraordinary action… …there are no limits to our commitment to the Euro. We are determined to use the full potential of our tools, within our mandate."*

On 19 March 2020, the Bank of England's (BoE) Monetary Policy Committee judged that an increase of its Corporate Bond Purchase Scheme – previously launched in August 2016 – was warranted. It voted unanimously to increase the BoE's holdings of UK government bonds and more importantly, sterling, non-financial, investment grade corporate bonds by GBP200bn to a total of GBP645bn. As such, the

BoE intends to purchase at least GBP10bn of eligible sterling, non-financial, corporate bonds in the coming months, taking the stock of purchased corporate bonds to at least GBP20bn.

On 23 March, the Federal Reserve (Fed) announced their plans to purchase corporate bonds for the first time, followed by statements to include high yield bonds as part of the program. Post these announcements, US high yield BBs rallied and recouped more than half their losses before any bonds were ultimately purchased by the Fed on 12 May.

Domestically, the RBA has allowed some corporate bonds to be repo-eligible if they possess a minimum credit rating of BBB-. It is worth noting that as with all debt securities, the RBA must approve them first.

In addition, the AOFM has been given the authority to administer the government's $15bn Structured Finance Support Fund (SFSF). Via the SFSF, the AOFM has provided support to issuers and the securitized markets by buying primary and secondary ABS and MBS bonds.

Given this extraordinary support from Central Banks and show of additional firepower if needed, technical factors are currently overwhelming pure credit fundamentals. Credit investors have gained comfort that there is a potential 'buyer of last resort', and credit spreads have since narrowed from their peak crisis wides.

What are the main takeaways and where are the opportunities?

The global financial outlook is still uncertain, and it is easy to make the argument that the risk to reward profile of equities is becoming more skewed to the downside. As such, we remain attentive to the possibility of further bouts of volatility, bringing with it corporate spread widening.

As revenue, earnings and cashflow diminish, credit fundamentals for certain specific pockets of the market and individual companies will also deteriorate. The pace of credit rating downgrades will inevitably increase and although defaults will inevitably rise, they should continue to be largely contained to sub-investment grade issuers, and therefore be more than manageable within a broad, diversified, high-quality credit portfolio. Furthermore, the wider spreads on corporate bonds now offer investors the opportunity to benefit from higher returns. To capture these opportunities, issuer selection and differentiation have become increasingly important.

All said, the persistent and co-ordinated efforts by global Central Banks to inject confidence and stability back in the system by supporting credit should not be undervalued. Almost universally, central banks telegraph that they will continue to do whatever it takes. As such, at this juncture, we believe investors should be comfortable adding some credit risk; not universally but in a highly targeted and specific fashion, while still mindful and remaining alert to the ongoing uncertainty and sporadic bouts of future volatility.

Within our remit, we firmly believe that more resilient opportunities in credit are most likely to be found in higher-quality, shorter-dated, investment grade issues, with a continuing preference for financial sector bonds and corporate sectors with defensive attributes. We also expect to take advantage of opportunities in the more liquid jurisdictions such as the US, which continue to have a higher degree of support from the Fed, versus other Central Banks.