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360°

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Head of Fixed Income

Where next after the market's fall and rise?

Hermes Fixed Income Quarterly Report
Q2 2019

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HERMES
INVESTMENT MANAGEMENT

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As Head of Fixed Income, Andrew leads the strategic development of Hermes' credit, asset-based lending and direct lending investment teams, and its multi-asset credit offering.

RUDE AWAKENING FOR SLEEPWALKING CREDIT MARKETS

A reveille has been sounded in markets that are now experiencing feverish activity as half a decade of torpor gives way to volatility. Glib explanations for the panicked stampede of the recent sell-off – and subsequent rebound – mask the importance of properly calibrated defensive and flexible portfolio strategies.

Of bear traps and rabbits caught in the headlights

I apologise that the introduction to this issue of *360°* is longer than normal, but the additional commentary is warranted given the rise in volatility across markets which appeared to have been in a near-permanent state of slumber over the last five years.

There are three things that I would highlight as notable about the fourth quarter of 2018 and the first quarter of 2019. The first is the sheer ferocity of both the downward plunge and the subsequent recovery. The second is the fact that so many people were shocked by this turbulence after such an extended period of dead calm. The last is the remarkable symmetry between the two quarters.

Figure 1. Symmetrical rebound in iTraxx Crossover spreads: Q4 2018 and Q1 2019

Source: Hermes, Bloomberg as at 29 March 2019.

With regard to that last observation, it should be said that credit markets rarely behave in this fashion. When confronted with such conditions, we, as credit-market participants, tend to behave like startled rabbits on the side of the road at night after a sports car has passed. The initial shock is rapid and severe; the recovery is slow and timid. The response conformed to the classic sustained and linear pattern of a credit sell-off, resulting in an overshoot.

At the nadir of the sell-off, we definitely got the sense that the classic triple whammy of weakening fundamentals (in terms of macroeconomic numbers), worsening technicals (in terms of flows) and poor performance (given that so many investors had chased returns going into the fourth quarter) had created ideal panic conditions.

Take a look at significant shocks in the past and you will see that it typically takes far longer for credit markets to return to normal than it does for the sell-off to occur. This poses questions as to why this time was different and whether there is anything that we can learn from the aberration. Undoubtedly, we have been conditioned to buy dips by the market's repeated attempts to trap bears, which we discussed at some length in the last issue of *360°*. We also had a very convenient narrative that explained, after the fact, why the events of the fourth quarter of 2018 occurred, along with a simple-to-grasp explanation for the remedy in the form of the Federal Reserve's (Fed's) pivot on quantitative tightening.

We believe that market participants' memories are getting shorter and shorter: they fear the cost of hedges and defensive strategies more than they do sell-offs.

Good yield hunting

If we consider the pace of the rally in credit as an abnormal characteristic of the V-shaped recovery, then it's also clear that the vast swathes of negative-yielding fixed-income assets (over $10tn at the time of writing) make short squeezes and the hunt for yield particularly punitive. Echoing the last observation about the hunt for yield, one does get the real sense that market participants (including credit-market participants) have fully participated – or perhaps even taken a levered exposure – to the drawdown and have then under-participated in the subsequent rally. We have certainly observed this in the relative performance of some of our competitors, which have not had the benefit of either defensive portfolios or a defensive strategy going into the fourth quarter of 2018.

We believe that market participants' memories are getting shorter and shorter: they fear the cost of hedges and defensive strategies more than they do sell-offs. We fear that this is becoming increasingly inconsistent with the desire of end-investors for a more defensive mindset. We are convinced that flexibility and pragmatism will be the watchwords for fixed-income markets in the medium term.

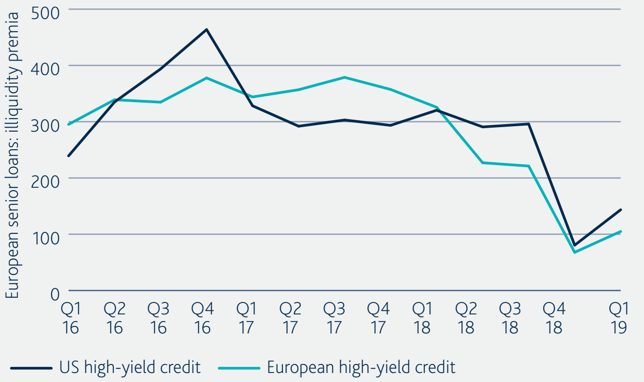
All of the above relates entirely to what we have seen in the liquid parts of the market. As the largest and the most visible part of our market, it is naturally the easiest on which to comment. One very important subtext that we would draw to our readers' attention is the differential between these markets and the illiquid parts of the fixed-income universe. The illiquidity premium is a topic that we discuss regularly, both internally and externally. Indeed, we will be writing about this fascinating topic in months to come. Our view has been that some parts of the less-liquid universe exhibit a premium, on a fairly consistent basis, for investors capable of accessing them (although we also believe that the opposite is true for some parts of these markets).

No such thing as a free liquid lunch

At the end of the fourth quarter of 2018, however, we think that the illiquidity premium was close to zero. As liquid markets sold off in October and November, they barely acknowledged this retrenching. We are in the fortunate position to be able to observe this in action. By December, we were certainly seeing those less-liquid markets noticing the travails elsewhere. But, rather than retrenching, those markets merely shut down early for the year – only to re-open in mid-January at the same levels at which they had closed before Christmas.

Given that these less-liquid assets behave according to a discontinuous function (or stepwise function), we feel it is important to emphasise that there would come a point at which a retrenchment would occur if liquid markets continued to move. We do not adhere to the view that these assets are materially less volatile. In fact, when a retrenchment occurs with respect to these assets, it is often a huge surprise to investors who have become convinced that these assets don't move.

Figure 2. Our illiquidity premia assumptions for direct lending v high-yield credit



Source: Hermes as at 31 March 2019.

This phenomenon is one that we have seen over and over again in these markets. You will see from our relative-value framework (see p.4) that we saw greater value in the most liquid parts of fixed-income universe at the end of fourth quarter than at the end of the third quarter. We now see that theme reversing so that, once again, our ideal client portfolios show greater allocations to strategies such as direct lending. One exception to this broad trend is that we still see little value in syndicated leveraged loans. More on this, perhaps, next quarter.

The triumph of experience over hope

In summary then, we believe that the last six months have been an almost perfect advertisement for our investment approach. We avoid silos, encouraging investors to be flexible and consistent. Our attitude to risk is predicated on the idea that things will not be different this time. Our positioning is always long-term and, wherever possible, we aim to be ready for, and capitalise on, the panic of others.

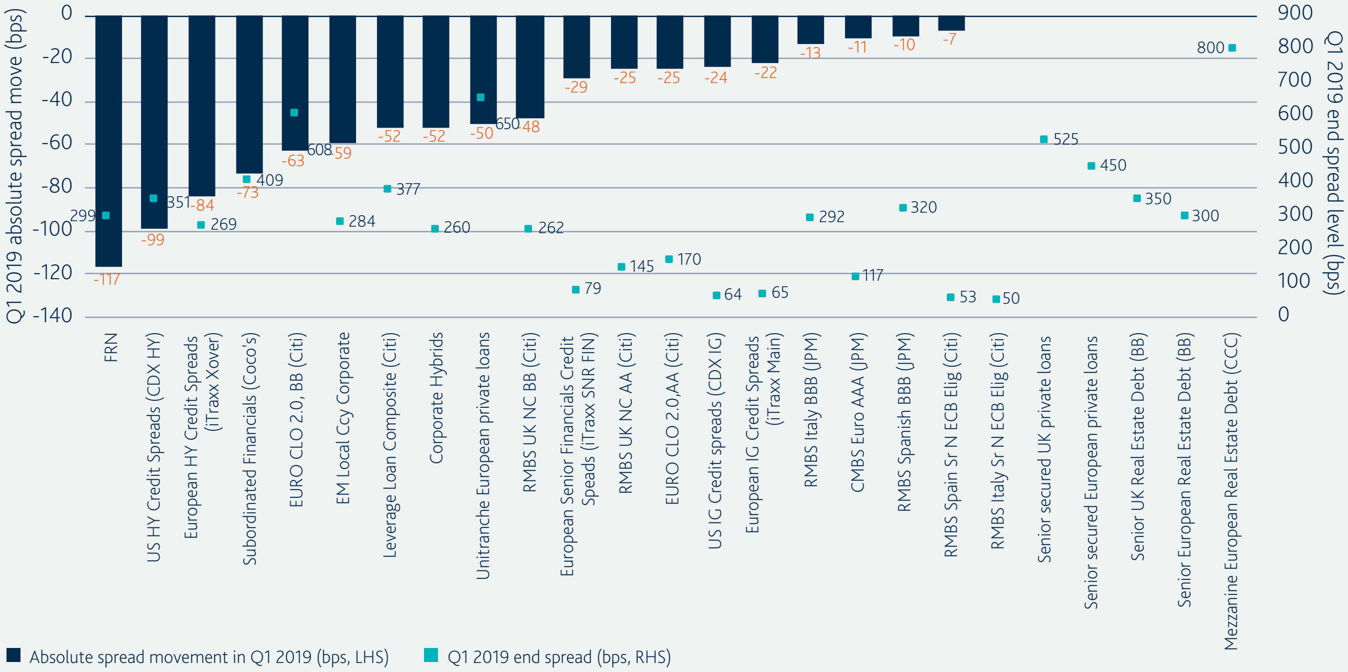
A few other observations from the past quarter:

- Brexit is not only in shambles but has confounded all expectations of how intransigent and dogmatic politicians can be. It still throws up real risk and uncertainty, but our view is that UK-exposed positions currently tend to be good value on an expectations-adjusted basis.
- We still see lots of tail risk caused by protectionism. In fact, apart from climate change, we see this as the major medium-term risk for markets.
- Collateralised loan obligation (CLO) managers are clearing their warehouses and bringing deals to the market despite the lack of attractive arbitrage opportunities between assets and liabilities, as liabilities have widened to a greater extent than the underlying loans despite loosening credit conditions. The resulting squeeze on equity returns makes the current CLO equity vintage seem poor value, in our opinion.

Relative value between asset classes

Market sentiment has improved after the fourth quarter sell-off and spreads are tightening. Senior loans have benefited from increased illiquidity premia while repriced US Treasuries have driven an ominous inversion of the yield curve.

Figure 3. Illiquidity premia reemerge as public credit tightens over the quarter



Source: Hermes, Bloomberg, Citi and JP Morgan as at 31 March 2019.

In the first quarter, public credit markets reversed part of the fourth quarter sell-off as market sentiment improved for several compelling reasons: the Fed changed its guidance on monetary policy, optimism increased over US-China trade talks and the oil price recovered. High yield led the rebound with US CCC spreads tightening by 170bps while the broad index also moved 120bps lower. This trend was echoed in the European high-yield market with CCCs shifting down 135bps versus 115bps for the broad index. A similar extent of tightening was observed for subordinated financials (75bps), emerging market (EM) credit (60bps) and leveraged loans (50bps).

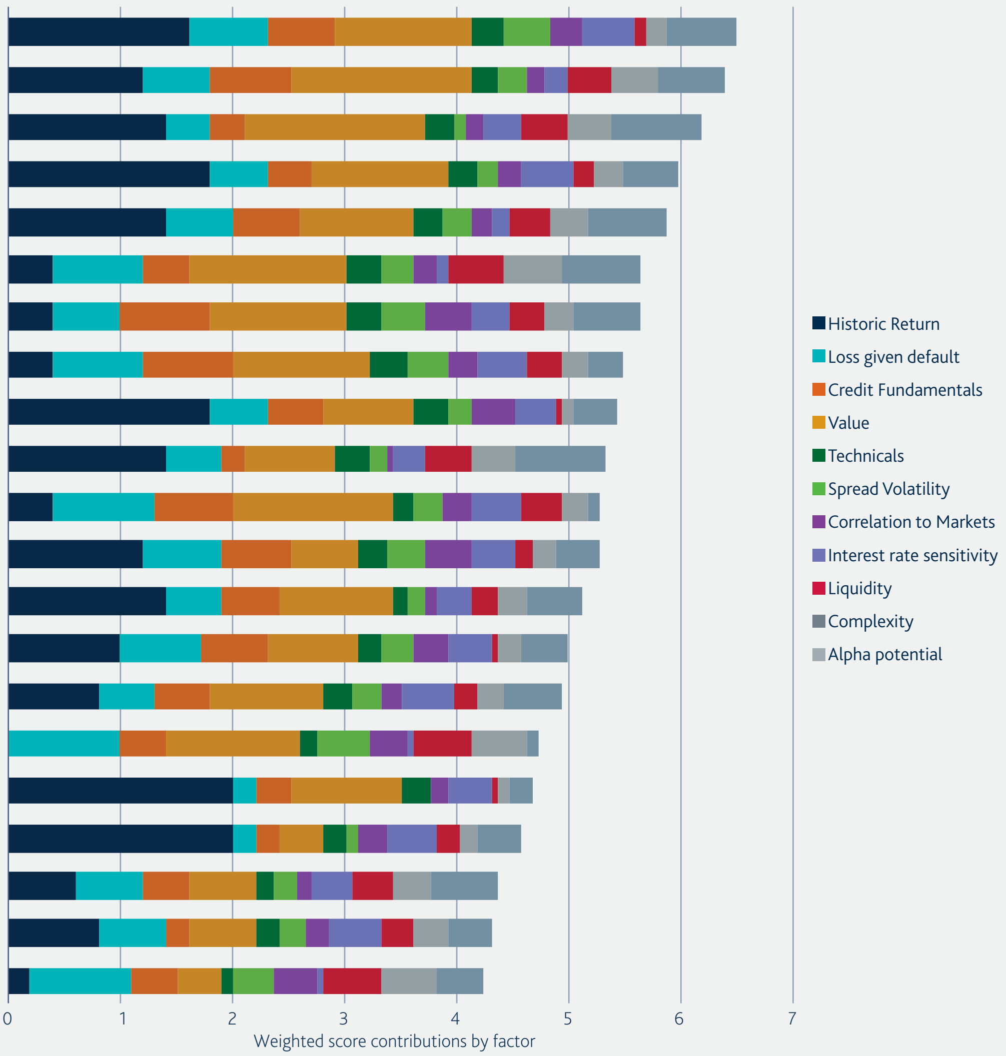
In the structured credit market, asset-backed securities (ABS) tightened across the board in the first quarter due to a lack of primary supply following new securitisation regulations but UK ABS showed more value relative to European ABS. In the CLO market, investment-grade tranches have seen little movement over the quarter in the primary market while sub-investment grade tranches have tightened, but to a much lesser extent than high-yield instruments, especially in percentage terms given their wider spreads.

Private-credit spreads mostly avoided the sell-off in the fourth quarter of 2018 and remained broadly stable in the first quarter of 2019. The exceptions were a tightening among unitranche middle-market loans and in segments of the UK real-estate-debt market. The general resilience among private-debt spreads saw the reemergence of the illiquidity premium.

These moves in relative spreads were the primary influence on the new rankings in our relative-value framework at the end of the quarter. See figure 4 for some of the key changes described underneath.

Figure 4. Our relative-value rankings as of Q1 2019

Q1	▲	Q4	
1	▲	3	Direct SME Lending
2	▼	1	Hybrids
3	▲	4	Subordinated Financials
4	▲	6	Europe CLO Mezz
4	▼	2	EMCredit
6	▲	7	Investment Grade
6	▼	5	Trade Finance
8	▲	10	Europe ABS Snr
9	▲	11	Risk Transfer
10	▼	9	High Yield
11	▲	13	Europe CLO Snr
12	▼	8	RE Debt
13	▼	12	Tranches
14	–	14	Impact Lending
15	–	15	Europe ABS Mezz
16	▲	21	Money Market
17	–	17	First Loss
18	▼	16	Europe CLO Equity
19	▲	20	Convertibles
20	▼	19	Syndicated Leveraged Loans
21	▼	18	Government Bonds



Source: Hermes as at 31 March 2019.

Direct lending tops the rankings as the illiquidity premia increased following the fourth quarter. The asset class offers good relative value coupled with low default rates. Hybrids, subordinated financials and EM credit spreads continue to offer the best value in public-credit markets. Although, with spreads generally tightening, they are less attractive than they were at the beginning of the year. Subordinated financials move up to third place, reflecting the very attractive relative value that we see in certain pockets of the market, such as UK insurers.

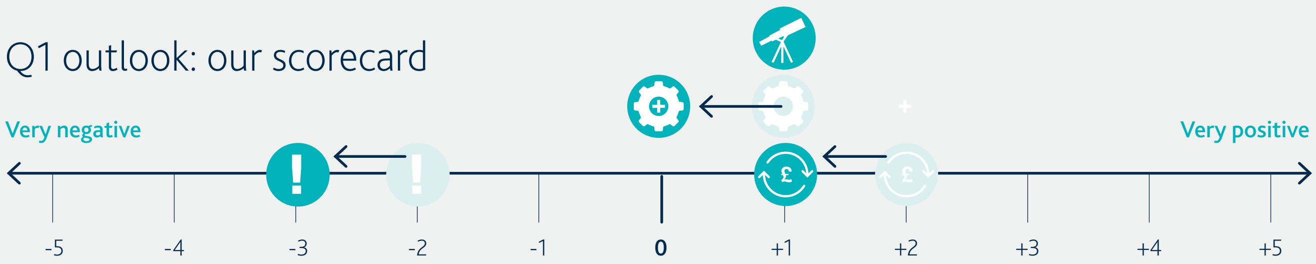
European CLO mezzanine tranches climb to fourth place, given their greater attractiveness on a risk-adjusted basis. Tranches rated BB and B offer attractive spreads versus similarly rated European corporates, with BBs paying 605bps versus 295bps and Bs delivering 885bps versus 550 bps respectively. Their low expected default rates and current good liquidity ensures that they can be readily traded.

Real-estate debt moves down the ranking because certain segments, such as UK BBB-equivalent senior loans, have become increasingly attractive to banks, whose appetite is driving down spreads. This makes it even more important to source assets where the banks do not compete to find better value.

Government bonds have slid to the bottom of the table as their value scores have been downgraded. Yields moved lower following a rally in the asset class attributed to weakening global economic data, the halting of the Fed's tightening cycle and the pricing-in of rate cuts this year. This repricing of US Treasuries caused an inverted yield curve, which many believe signals a recession within two years. Money-market instruments moved up from the bottom of the rankings to 15th place; they currently offer attractive relative value for those taking a bearish view given the tightening spreads in high-quality corporate credit.

While many view the inverted yield curve as a warning signal, others are convinced that 'this time, it is different'. Given the uncertainty as to when this credit cycle will end, we aim to maximise returns while reducing downside risk: we continue to select areas of credit risk we like while adding convexity to our multi-asset credit (MAC) portfolios. Our MAC portfolios have benefited from an allocation to credit-index option payers as, not only have they profited as markets sold off, they also gave us the conviction to maintain risk throughout the fourth quarter. This allowed us to top up in areas of value and to participate fully in the subsequent first quarter rally.

Q1 outlook: our scorecard



Economic outlook

- **Remained at +1**

Credit fundamentals

- **Declined to zero from +1**

Valuations and technicals

- **Declined to +1 from +2**

Tail risks

- **Declined to -3 from -2**
- Inverted US yield curve could be a warning signal for the next recession
- Protectionism could stymie growth if the US's trade disputes with China and Europe are not resolved
- Continued uncertainty about Brexit while a 'no deal' outcome remains a possibility
- Rise of populism in European Parliamentary elections

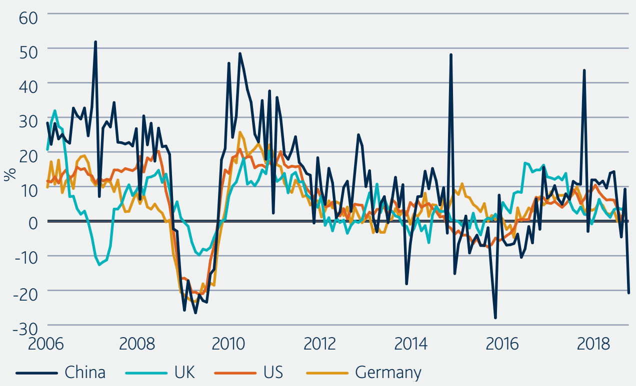
Contents

Economic outlook

Global growth should stabilise at lower rates in the middle of the year, helped by accommodative policies. But the balance of risks will remain skewed to the downside.

Economic growth slowed down further in the first quarter of 2019, primarily as a result of weaker global trade (see figure 5 below) and a deterioration in manufacturing activity.

Figure 5. Global trade continued to slow down at the turn of the year



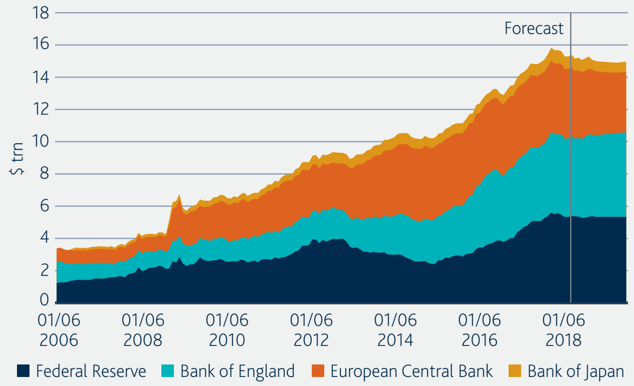
Source: Reuters Datastream, based on national sources, as at January 2019.

The global composite Purchasing Managers' Index (PMI) has shown tentative signs of stabilisation in recent months, reflecting improvements in the larger services sector. However, the more cyclically sensitive manufacturing sector remained under pressure, probably reflecting the lagged impact from tighter global financial conditions last year and lingering uncertainty concerning international trade policies. The manufacturing PMI came in at 50.6 in March, its lowest level since June 2016, indicating that manufacturing activity has virtually stagnated.

Geographically, weakness has been concentrated in Europe and China. However, US data has also shown some cracks, pointing to growth moderating from the sustained growth rate of about 3% in 2018. The US slowdown will become more pronounced in the figures for the second quarter of 2018, when the boost from past fiscal measures is set to fade.

Going forward, global growth is likely to stabilise around the middle of the year, reflecting the lagged impact from the more accommodative monetary policy stance most central banks adopted early in the year, following the Fed's lead. In January, the Fed announced a pause in its hiking cycle, adopting a new mantra of patience and data-dependency. In March, the Fed confirmed that it expects rates to be on hold in 2019. In addition, the central bank announced an adjustment to its balance sheet run-off, implying that the balance sheet will stabilise at a high level of about $3.75tn in September this year (see figure 6).

Figure 6. For major central banks, balance sheets are stabilising at elevated levels



Source: Hermes Investment Management, based on Reuters Datastream, ECB, Fed, BoE, BoJ as at December 2019.

In addition, the Chinese economy has already showed some signs of stabilisation, in response to the fiscal and monetary stimulus that has been provided since the middle of last year, and that should continue. As the current round of Chinese stimulus is more measured and targeted than previous episodes, external spillovers should be limited but nonetheless helpful.

Global growth in 2019 overall should stabilise at lower rates of about 3%, compared to 3.75 % in the previous two years. The outlook for 2020 is more uncertain. The persistence of low interest rates and accommodative policies has increased financial imbalances, with stretched asset valuations in some markets and high debt levels in both the private and public sectors. More importantly, the main risk that could scupper the global economy is a potential reescalation of protectionist tensions.

A trade deal between the US and China seems to be within reach but it is not a certainty. The two countries seem to be in agreement on many crucial issues, including the rebalancing of trade flows, foreign-exchange stability and, to some extent, the protection of intellectual property, but the main sticking point appears to be the enforcement mechanism. From a broader perspective, my view is that even if a trade deal is reached in the short term, it will be fragile and temporary, as it is unlikely to address the underlying structural issues. Indeed, the confrontation between the two countries ultimately concerns technological dominance, and it will likely persist in the medium term, resulting in repeated escalations of trade tensions.

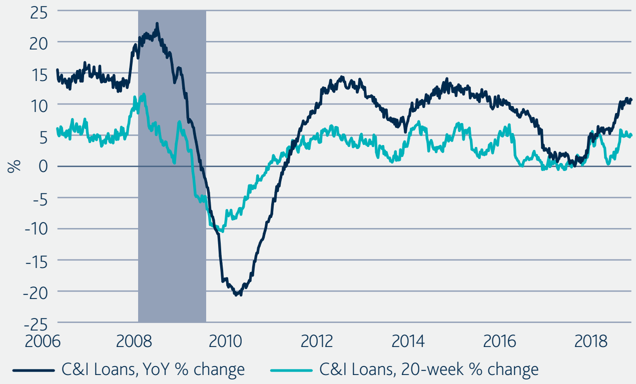
Credit fundamentals

The boost from the latest 'Fed put' may be abating but a slower growth environment is generally supportive of credit.

As we have discussed in the last few editions of *360°*, earnings growth has indeed decelerated (see figure 7). The US numbers are more robust than we would have expected – particularly in the energy sector – albeit they are slowing down after the turbo-charge given last year by the Republican-controlled government's stunningly supportive fiscal policies. Looking across Europe and the US, it looks like peak earnings occurred in the third quarter, as we had speculated.

But what are the portents? In the last issue we noted our concerns about the outlook for corporate fundamentals, although our fears were mitigated to some degree by strong liquidity. Credit markets did reopen in the first quarter of 2019 after a very tough fourth quarter of 2018 (albeit at a more modest pace than in the same period a year earlier, especially in the case of Financials). The so-called Fed put likely had a large part to play in this. Moreover, as shown in Figure 8, the growth in commercial bank lending has picked up meaningfully following the

Figure 8. Corporate lending is on the rise



Source: Thomson Reuters as at March 2019.

Figure 7. Earnings growth among US and European corporates

Bloomberg European 500

Sector (GICS)	EPS Q1 18	Q2 18	Q3 18	Q4 18	Q1 19	Sales Q1 18	Q2 18	Q3 18	Q4 18	Q1 19
All Securities	16.75%	1.25%	10.60%	10.21%	-4.36%	8.41%	1.98%	5.18%	4.65%	2.65%
Energy	101.87%	32.02%	49.02%	58.13%	28.56%	23.52%	18.65%	29.09%	30.33%	16.67%
Materials	62.09%	16.80%	13.98%	-5.53%	-26.97%	24.70%	1.79%	4.31%	-9.19%	-15.16%
Industrials	-1.45%	1.90%	-5.24%	0.52%	5.36%	8.19%	2.28%	4.61%	6.35%	5.84%
Consumer Discretionary	30.49%	-1.73%	11.55%	-0.06%	-26.47%	7.75%	3.36%	3.70%	1.94%	2.21%
Consumer Staples	54.80%	-0.51%	3.44%	-11.60%	3.00%	11.73%	-0.26%	3.18%	-0.58%	-3.12%
Health Care	-1.93%	-5.95%	-5.63%	0.48%	8.76%	-3.22%	-6.80%	-2.99%	3.92%	12.52%
Financials	-4.61%	-7.26%	11.36%	12.25%	-19.23%	1.36%	-3.41%	-0.69%	-1.30%	-0.89%
Information Technology	20.61%	10.95%	2.39%	9.68%	3.77%	3.38%	-0.06%	4.51%	6.72%	7.78%
Communication Services	33.09%	5.74%	11.49%	1.79%	-16.41%	-0.02%	-3.18%	-3.00%	-2.53%	-0.34%
Utilities	52.14%	-6.17%	12.63%	-6.13%	23.15%	2.29%	-3.36%	-3.77%	-2.74%	-5.68%
Real Estate	-18.62%	35.56%	14.41%	36.30%	-18.07%	-20.74%	-1.19%	-4.09%	10.78%	35.02%

S&P 500

Sector (GICS)	EPS Q1 18	Q2 18	Q3 18	Q4 18	Q1 19	Sales Q1 18	Q2 18	Q3 18	Q4 18	Q1 19
All Securities	15.00%	22.60%	24.24%	23.82%	11.22%	8.18%	8.22%	9.26%	8.06%	5.76%
Energy	54.11%	61.39%	98.61%	98.64%	99.94%	20.95%	12.78%	21.68%	19.51%	11.21%
Materials	42.08%	31.85%	43.81%	28.34%	1.38%	13.56%	11.73%	16.32%	10.71%	2.65%
Industrials	6.37%	24.71%	16.94%	16.90%	17.05%	8.50%	10.30%	9.54%	6.72%	6.37%
Consumer Discretionary	11.91%	16.20%	18.77%	24.52%	13.10%	7.75%	7.93%	8.91%	8.18%	5.09%
Consumer Staples	7.84%	9.76%	11.14%	9.72%	3.80%	4.64%	4.85%	4.08%	2.27%	1.00%
Health Care	8.72%	14.63%	13.28%	14.66%	11.13%	6.74%	7.76%	7.79%	7.33%	9.01%
Financials	13.68%	26.82%	22.87%	30.51%	2.59%	3.17%	2.94%	5.96%	4.62%	3.95%
Information Technology	20.29%	25.92%	31.82%	21.71%	2.35%	11.61%	12.89%	12.18%	10.13%	0.48%
Communication Services	19.28%	24.55%	37.02%	27.44%	22.53%	7.65%	10.28%	9.51%	12.62%	13.68%
Utilities	19.08%	15.44%	11.58%	14.79%	-0.08%	3.53%	3.68%	0.41%	1.63%	2.05%
Real Estate	10.20%	8.22%	6.63%	8.89%	10.07%	8.16%	14.59%	13.48%	13.09%	12.83%

Source: Bloomberg as at April 2019.

nadir in the third quarter of 2018, when fears abounded that rate hikes would bring forward the end of this long credit cycle. Lending in commercial and industrial loans rebounded in line with the more dovish stance of the Fed (and other central banks).

While we do not want to read too much into the negative foreshadowing implied by the inversion of the US yield curve (for the first time since 2007) and the negative 10-year Bund, we do not see any reason to be overly bullish on the upside risk of corporate fundamental support of weaker credits. A number of factors preclude this: global PMIs; global debt growth (both corporate and government); deceleration in earnings growth; a pick-up in auto-loan delinquency rates; a modest rise in default rates; and the rapid move in valuations. However, even if slow growth may not be supportive of equity-like credit risk, it is supportive of credit in general. This is where we will continue to look for opportunities in global credit.

ESG case study: General Motors v Ford

One of the most famous lines in business history was attributed to the President of General Motors (GM) in 1953, when Charles Wilson is reputed to have said: "What's good for our country is good for General Motors".

A similar symbiotic relationship would appear to hold in terms of the automotive giant's governance and debt profile. "What's good for General Motors' ESG rating is good for its credit performance" would be the modern version of Wilson's epigram.

It is our view that companies with stronger ESG practices benefit from tighter credit spreads than those with lower QESG scores. We believe this is the case in the automobile industry original equipment manufacturer market too.

In the US auto industry, we therefore tend to favour GM over its major Detroit-based rival, Ford, and hold its credit in our portfolio. GM's five-year credit default swap (CDS) has outperformed Ford's since early 2018.

GM has recovered from bankruptcy in 2009 to become an investment-grade company, and now has a deeper exposure to progressive motoring trends and stronger geographical diversification than Ford.

It has demonstrated the benefits of ESG differentiation, especially in terms of its robust governance and focus on sustainability through investment in electric vehicles (EVs). It already has a mass-market EV, the Chevy Bolt, on the road, which was the second-most-popular EV in the US behind Tesla in 2017.

The company's robust governance extends to its strong balance sheet, which it has worked hard to repair since the financial crisis by reducing structural operating costs and improving its credit metrics.

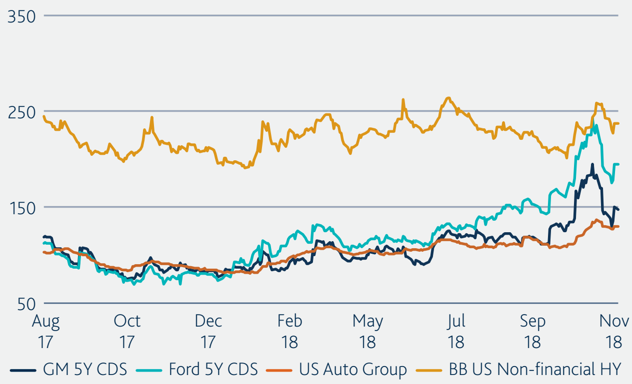
GM also has a more robust market position in China than Ford and has exited its weak European operations (having sold Opel to Peugeot in 2017). In China, GM has a very strong offering and positioning, with good coverage across all major cities. The opportunities are excellent with China poised to fuel EV growth globally. The market has the potential to grow to 30m units.

In contrast, Ford seems to be in GM's rear-view mirror. While its new CEO announced a significant boost in EV investment at the Detroit Auto Show last year, we still need to see how Ford delivers on this promise given its limited experience in producing EVs. Ford also remains exposed to the challenged EU market and has a weaker foothold in China.

It is possible that GM's outperformance against its peers in terms of financial returns, product pipeline, and EV and autonomous vehicle (AV) investments, is linked to the effectiveness of the company's board. GM highlighted that it has a very strong, diverse and engaged board, which helps to implement the right strategy. The company believes that it needs to lead disruption rather than be disrupted and is committed to an all-EV future.

Overall, we see GM as having a superior long-term strategy and commitment to future mobility. This has the potential to deliver attractive returns for credit investors and sustainable growth for the company itself.

Figure 9. GM has the inside track over Ford



Source: Bloomberg and Bank of America Merrill Lynch as at 12 November 2018.

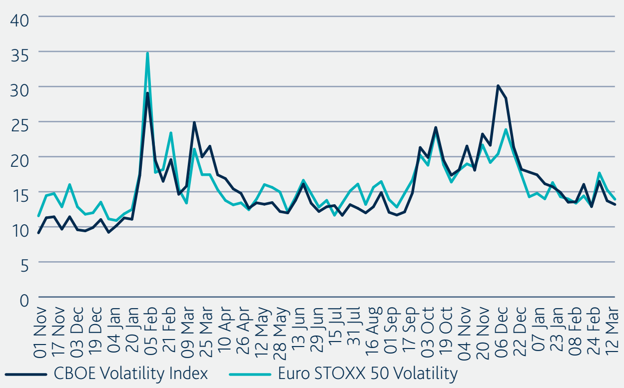
Valuations and technicals

Improving global indicators and progress on trade talks are driving demand for credit, with Europe recovering after prolonged weakness.

Sentiment

A more accommodative monetary policy environment globally, combined with progress on US-China trade talks and improving macro indicators, supported an environment of low volatility and strong demand for credit in the quarter. Sentiment was supported by lower-than-expected new issuance in the market.

Figure 10. Volatility levels remain subdued in the US and Europe

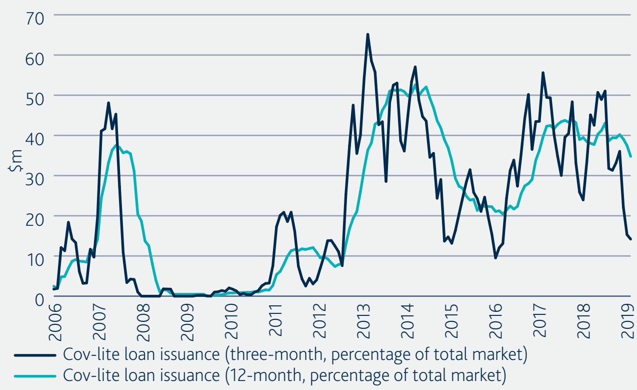


Source Bloomberg as of 31 March 2019.

Asset flows

The first quarter saw strong inflows into credit markets across the board, with the exception of the US leveraged loans space, which continues to struggle due to a combination of the lower-for-longer interest rate environment, the suppressed LIBOR, and the market's focus on the weak fundamentals that prevail in that part of the universe. One of the most interesting developments is the start of inflows into the European credit space after a long period of weakness. This is being driven by the superior value offered by European credit and the improvement of economic indicators for this quarter.

Figure 11. US leveraged-loan issuance has continued to slide



Source: Bank of America Merrill Lynch as at February 2019.

Valuations

Performance in credit markets has been very strong over the first quarter with the majority of the returns so far driven by capital appreciation. Looking ahead, there is still convexity in the market as the percentage of the market trading above call is well below previous highs and the average cash price remains below par.

Figure 12. High-yield bonds are trading below par, supporting convexity in the market

Source Bloomberg as of 31 March 2019.

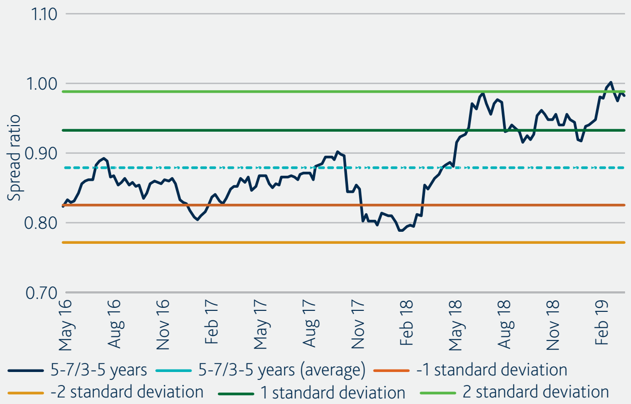
Public credit: relative value

The Brexit-battered sterling market remains unloved but lower oil volatility could reenergise the sluggish energy sector.

Unlike rate curves, spread curves remain steep

Strong demand for front-end maturities are also evident in the high-yield space, where the five-to-seven-year point is trading two standard deviations cheaper than three-to-five years. It remains critical to be positioned at the right point on the credit curve to optimise the roll-down and the total return potential of the portfolio.

Figure 13. The front end of the high-yield curve is in strong demand

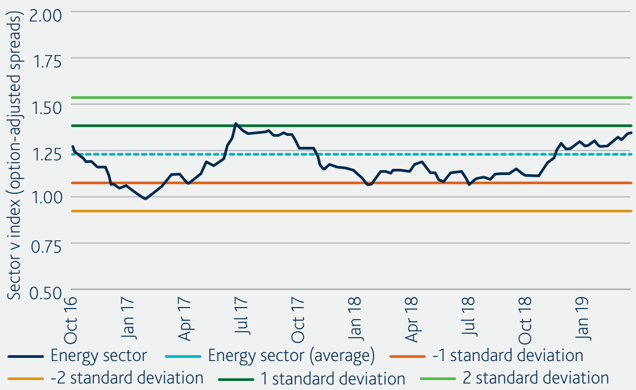


Source Bloomberg as of 21 March 2019.

Energy underperforms

The sector may present attractive opportunities in the next quarter if it continues to lag the rest of the market, as it has done during this quarter. In an environment of lower oil prices and FX volatility, there are issuers that are well-positioned given the renewed focus on cash generation versus production growth.

Figure 14. Switched-on investors can find opportunities in the lagging energy sector

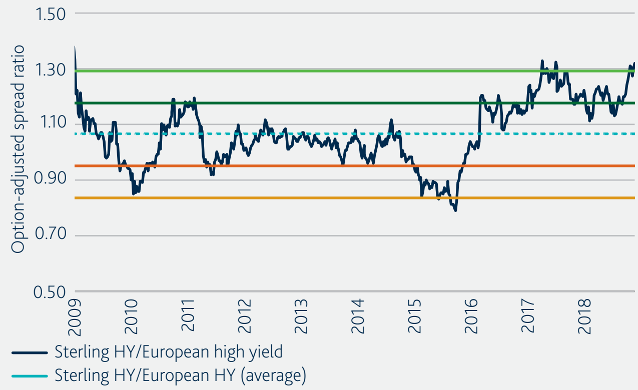


Source: Bloomberg as at March 2019

Tarnished sterling

The sterling market is suffering from Brexit fatigue, although selective opportunities are present. For example, we like the speciality insurance sector, where the low cash prices and attractive yields on offer are hard to resist. The space remains under-covered and under-appreciated by the market.

Figure 15. The beleaguered sterling high-yield market



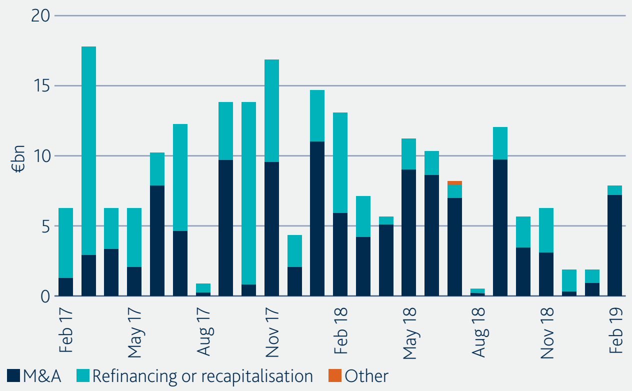
Source Bloomberg as of 21 March 2019.

Leveraged loans

Secondary markets in Europe picked up the slack from lacklustre new issuance, while mid-sized deals were notable by their absence as billion-euro-plus deals dominated.

After a strong sell-off at the end of 2018, the leveraged loan market rebounded in both Europe and the US. At the end of the first quarter of 2019, the S&P European Leveraged Loan Price Index traded at 97.97, up from 97.33 at year-end 2018 but still far from its peak of 99.64, reached in January 2018. Similarly, the S&P LSTA (the price index tracking the US market) increased from 93.82 to 96.64 over the first quarter although this too was well below the 2018 peak of 98.72, which it attained in February. This offers investors potential room for yield.

Figure 16. Bouncing back from the Q4 2018 sell off



Source: LCD as at February 2019.

In Europe, activity was mainly driven by a strong rally in the secondary market as new issuance remained disappointing: loan volume was €9.6bn in the first quarter of 2019 versus €28.1bn in the same period last year. The refinancing wave which occurred in 2017-2018 pushed existing maturities to 2024-2025 at lower spreads, leading to the relative dearth of deals that aren't leveraged buyouts in the current market.

In the year to date, 23% of institutional tranches have been sized at more than €1bn (excluding add-ons). Additionally, with the exception of the Ceva Sante €2bn term loan B (TLB) jumbo deal, most transactions over €1bn have been used to back buyouts. As a result, while the 23% share for the €1bn-plus club is at a 10-year peak, it is based on just five loans. Moreover, there is a lack of mid-sized deals in the current market, with only three TLBs sized between €500m and under €1bn, down from an average of 10 deals per quarter in the previous two years.

In terms of pricing, the March 2019 average spread is 406bps, up from 376bps in December 2018, reflecting the volatility and lack of liquidity in the market.

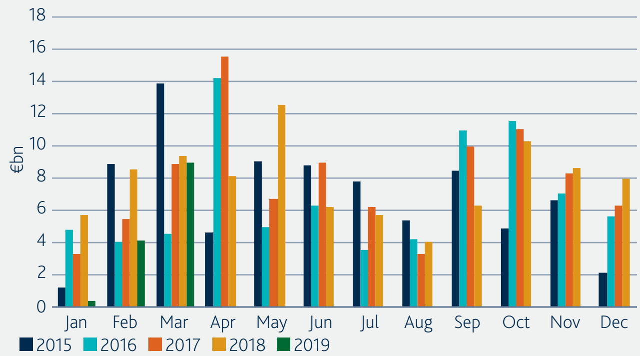
Structured credit

New Year's Day brought compliance headaches for issuers as the fresh regulations went live despite being incomplete. The lull in the ABS market contrasted with record levels of activity in the CLO market as warehouses were cleared out.

The first day of January 2019 saw the implementation of the Securitisation Regulation – a new set of rules that govern the securitisation market, applicable to ABS as well as CLOs. Despite going live at the beginning of the year, the final formats of a number of aspects of the new regulation have not been completed. This has placed the onus on the ABS and CLO markets to work out how to comply with the regulation while continuing to operate during this period of limbo.

The result has been an extremely quiet pipeline for ABS with volume only really picking up towards the very end of the quarter. The focus for ABS investors was therefore on the secondary market. Spreads slowly tightened over the quarter following the widening during the fourth quarter of 2018 although the spread movements have been muted compared to the wider credit markets.

Figure 17. ABS issuance by month, 2015-2019



Source: J.P. Morgan International ABS and CB Research as at March 2019.

Meanwhile, in stark contrast to the lack of primary supply in the ABS market, CLOs have continued to print as managers and arrangers clear out the warehouses that they had open. Market conditions were not conducive in the fourth quarter of 2018 so the pent-up supply has resulted in the first quarter of 2019 setting a new issuance record for the opening quarter of any year. In total, 16 European CLO deals printed, amounting to €6.9bn of supply. In the face of such high supply, levels have been soft across the capital stack, putting pressure on the arbitrage (the cost of the liability stack versus how much the underlying assets are paying). The consensus appears to be that, while CLO bond spreads remain at these wider levels without a corresponding widening in the underlying assets, fewer warehouses have been opened and new-issue CLO supply could quieten over the course of 2019.

Private debt: relative value

European direct lenders are increasingly aggressive and now have the large-cap market in their sights. Pockets of value can still be found in the smaller mid-cap sector, and in Scandinavia.

Although there has been an increased focus from the press on the aggressive nature of large-cap leveraged loans, this seems to have had little effect on the ability of direct lenders to small- and medium-sized enterprises to raise funds. As a result, the liquidity available to direct lenders remains high and competition for transactions is aggressive. This continues to be centred on loan structures and lender protection rights, but increasingly we are seeing direct lenders providing bigger loans and therefore competing in the large cap market. This is increasing the degree of differentiation between direct lenders.

In an aggressive environment, Hermes feels that senior-secured loans benefit from strong equity buffers, which are important at a time when corporate enterprise values (EVs) are high. Both mezzanine and unitranche loans are priced aggressively when compared to the last few years, and prices have continued to tighten while senior-secured loans have remained relatively stable. In the last quarter, there was little change in average European yields on senior-secured loans, even if there were some changes in country-specific markets due to issues like reduced transaction flow and increased penetration by some direct lenders.

We believe that value is still available in the smaller mid-cap sector, where loans are more likely to provide strong protection rights and yields, and where competition is weaker. In geographic terms, we see Scandinavia as offering the most value due to the quality of the loans on offer and the pricing available, with Denmark and Finland being the most attractive markets. Germany, which has seen increasing levels of competition, remains a challenging market: value remains in the smaller mid-cap range where fewer funds can compete owing to language barriers. As such, off-market transactions can be attractive. The UK market remains slow due to uncertainty about Brexit, but the few transactions that occur in the non-cyclical sectors tend to be very competitive, especially if they are protected from Brexit risk. Yields and terms are therefore aggressive for those transactions. France remains the market with the strongest growth in penetration by direct lenders, meaning that there is increasingly little value thanks to a combination of very competitive transactions and the risks associated with lending in a weaker legal environment.

Asset-based lending and real-estate debt

Real-estate markets continue to tread water as uncertainty about Brexit persists and margins remain tight. But innovative disruptors in the flexible and co-working sector are creating exciting, if risky, opportunities in prime office locations.

Uncertainty over Brexit caused the real-estate-debt market to move slowly over the last quarter, with investors and borrowers cautious about making large investments. However, where opportunities are available, we have yet to see significant movements in margins. The exception is the troubled retail property market, where opportunistic investors aiming to turn around distressed assets are encountering higher margins, due to the perceived increased risk.

This quarter, however, we want to focus on the disrupting effect of co-working on the office market. The rapid growth of flexible offices has been a dominant trend in the commercial real-estate sector in recent years. They are typically a blend of small private spaces and public areas designed to encourage a sense of community among occupiers.

The leading operator, WeWork, has become the largest private-sector occupier of office space in central London and Manhattan in the eight years since it was founded. The firm, which we do not have exposure to in our real-estate-debt capability, rents large expanses of floorspace from landlords, fits them out and charges clients a membership fee starting at a few hundred dollars a month. For users, signing a lease is extremely quick and deposits can be paid by credit card. Space is ready to be occupied immediately.

These operators have increased the average number of workers in office buildings from one person per 200 square feet to one person per 60-80 square feet. This has increased worker density by more than 100%, with no apparent effect on demand. Research suggests that employees are happier in co-working environments. In addition, these offices are cheaper for their employers.

However, a closer look at WeWork's innovative approach reveals a significant mismatch between its own lease liabilities and the revenues it generates from members. Leases are typically 15 years in duration, standard for a Central London office building, with no more than 7% expiring each year. However, WeWork members need to give only one month's notice before vacating. Typical occupancy terms range from a few months to a few years.

WeWork has devised ways to tackle this mismatch. Leases are held in special-purpose entities for each property, insulating the parent company from idiosyncratic failures. This shifts the risk of failure to the landlord. However, the firm is increasingly using revenue-sharing leases, in which they pay landlords a proportion of their turnover. This is effective in a strong business environment, but in a downturn it leaves WeWork's landlords exposed to losses if, or when, co-working tenants cannot pay rent.

We would be wary of the right of WeWork's tenants to serve only one-month notice before vacating, as a rapid succession of departures could lead to negative cash flow very quickly. Anecdotally, few lenders in the US will finance a building where WeWork represents more than 50% of the rent roll. However, in the UK, lenders have priced debt against central-London offices that are let to WeWork at approximately 250bps over LIBOR. Given the risk involved, this pricing is not attractive.

A more attractive structure for lenders would be one in which the co-working space provider was the property owner. This changes the risk profile of a fall in occupancy. The co-working operator then becomes the borrower and the loan is serviced by the cashflows received directly from members.

We have advanced loans to an operator that leases office space on short-term licences. The properties are less glamorous than WeWork's Manhattan and Central London buildings and the tenants use the space both as workshops and offices. However, there is no reason that the successful aspects of the WeWork model – such as the environments it creates and the efficiency of space – could not be applied to this simpler and more sustainable ownership model, which is far more attractive at current debt market pricing.

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HERMES INVESTMENT MANAGEMENT

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Our goal is to help people invest better, retire better and create a better society for all.

Our investment solutions include:

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Infrastructure, private debt, private equity, commercial and residential real estate

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Asia, global emerging markets, Europe, US, global, small and mid-cap and impact

Credit
Absolute return, global high yield, multi strategy, global investment grade, unconstrained, real estate debt and direct lending

Stewardship
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