

OUTCOMES
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PERFORMANCE

360°

Andrew Jackson
Head of Fixed Income

Opportunities beneath the surface

Hermes Fixed Income Quarterly Report
Q4 2019

For professional investors only

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HERMES
INVESTMENT MANAGEMENT



Andrew Jackson

Head of Fixed Income

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.

LESSONS FROM THE HUNDRED ACRE WOOD

An open mind will help navigate through any storms that lurk on the horizon.

Over the past few months I have travelled far and wide talking to fixed-income investors. Back home, it now seems like a good opportunity to pause and reflect.

In 360°, we try to give you our views on markets and avoid those that sound stale or just push the same ideas over and over again. Yet we also try to present a consistent approach in a language which grows in fluency and allows us to dig deeper at times.

This edition is one of those instances. We have taken a relatively unchanged macroeconomic backdrop as an opportunity to 'explode' some of our relative-value framework and more completely illustrate our approach to portfolio construction and management.

When reading any overarching market commentary that highlights favoured and out-of-favour areas, it is easy to assume that all portfolios focus on the top of the relative-value table and take nothing from the bottom.

By contrast, Hermes' approach means that each individual security has to fight for its place in a portfolio. Given that we run high-conviction portfolios with less than 150 positions across the whole product suite, we often see strategies that do not mirror the simplistic view we present here. For that reason, and others, we will start to introduce more nuance and detail over the coming quarters.

But before we do that, I want share with you my current top three non-financial books that I believe are relevant for the world of investment:

1. The Art of War, Sun Tzu
2. Fahrenheit 451, Ray Bradbury
3. The House at Pooh Corner, A. A. Milne

The first is a masterpiece. It is almost impossible to describe the clarity of thought, applicability to almost all aspects of life and insights it provides into strategy, planning and decision making, because every time I read it, I find new meaning. None of you will be surprised to see it listed, and there will be ample opportunities to come back to it in future editions of 360°.

Fahrenheit 451 was first published in 1953, but has never been more relevant. One rule of 360° is to avoid too much political commentary, so I won't say too much more. But as a fixed-income market practitioner who always wants to examine downside risk, Ray Bradbury certainly captures some of the trends faced by modern society, although one can wonder if it is easier to 'burn' a PDF or a book.

Most of you are probably surprised to see a 'children's story' on the list. This is because, like many great works of children's literature, A. A. Milne's book has at least two layers. For those of you who are Milne aficionados, I selected the second book because it includes the stories of Tigger, Kanga and Roo's arrival into the Hundred Acre Wood.

Most of you are scratching your heads by now. But fear not, all will become clear. On one of my recent trips I was invited to speak about a topic that I feel very passionately about to an audience of sophisticated investors: flexible credit and the benefits of a non-siloed approach. Speaking before me was a multi-asset strategist who was given the task of setting the market backdrop and pointing to some areas of risk and opportunity.

It would be unfair to focus too significantly on what was presented, but it can summarised as:

- Scene setting: the market is far too focused on the downside
- Opportunities: get long in anything you can, while you still can
- Risks: none

The views were supplemented by much charisma, an excellent rendition of a Rupert Brooke poem and the odd impeccably presented joke. Fortunately for me, there were many members of the audience happy to challenge some of the views expressed:

But what about the stage in the cycle, given that we still have very low growth and central banks are restarting quantitative easing (QE)?

Meh

But what about creeping leverage and the debt burden in markets?

Meh

Isn't \$17tn of negative-yielding assets a sign that something may be wrong?

Meh

So what happens if QE continues to fail?

Helicopter money

At this point, the speaker exits stage left with a flamboyant wave. He left an impression of a highly educated, articulate individual who is confident in his ability – and very credible.

I have seen – and indeed worked with – a number of people exactly like this. One of them was funny, educated and charismatic and had every single Icelandic bank in his portfolio just before they all went bankrupt. Many of his former colleagues remember him fondly, he now teaches the history of finance at one the world's best universities. His clients probably don't remember him fondly or place a high value on his ability to tell a joke, recall poetry or speak Latin.

Milne had a character in his stories with exactly this nature. Rabbit was intelligent, confident and a fabulous organiser. I am fairly sure his intentions were positive, but the amount of trust placed in him was inappropriate and turned out pretty badly for poor Piglet.



Asset management is a serious affair: managing money for our clients is something we take very seriously, and hearing people chuckle at the market participants that attempt to point to risk upsets me deeply.

Rabbit-like characters also bother me because they bring out my inner Eeyore, and that is something that I must fight as it betrays my personal bias. I am always striving to be more Pooh: open minded, inquisitive, listening, courageous and humble. That said, I would emphasise that I do see risks on the horizon. I place value on hedges and this shoulder-shrugging at the idea that helicopter money is the solution if QE fails is utterly terrifying.

But rather than just rant, I want to counter my natural inclination and list some opportunities, themes and strategies. Much of this you will see within the rest of 360°, particularly the relative-value section:

- We feel broadly wary and our positioning is on the cautious side. This is tempered by the fact that we see fixed income as a much more attractive asset class than many of its competitors.
- The distortions that we have examined in previous editions of 360° mean that opportunities lie below the surface, but the lack of convexity in liquid credit markets across the globe makes them fewer and further between.
- Our top-ranked picks on a relative-value basis are either high beta or low beta, and little of the middle ground ranks highly. Indeed, we feel that certain parts of this middling section may actually be opportune shorts.
- Central-bank technicals cannot be ignored and may provide a pricing floor for many of the more highly rated assets if a sell-off recurs.
- From a macroeconomic perspective, we still see clouds on the horizon and feel that markets are pricing in positive outcomes for most of the major obstacles on the horizon.

Our deep-dive in the relative-value section focuses on financials, a sector where we see the richest alpha. Indeed, we have generated meaningful alpha in this sub-asset class through instrument selection, seniority, instrument type, jurisdiction, industry and borrower selection. Filippo Alloatti, our financials analyst, can speak ad infinitum about this topic and certainly shares a number of characteristics with Owl from the Milne stories.

In closing, there is one final lesson to draw from the inhabitants of the Hundred Acre wood: the value of diversity. Critical thinking, managing unconscious bias, creativity and leadership all tend to flourish in a diverse and inclusive environment. Looking around the fixed-income team at Hermes, I can identify most of Milne's characters, including several Tiggers and a fair number of Piglets.

Central banks have ensured that there are few – if any – clouds in the sky at the moment. But it looks like they may be gathering on the horizon and while we continue to see opportunities, we will not ignore the fact that we are most likely closer to the end of the cycle than the beginning.

—

“If you know the enemy and know yourself, you need not fear the result of a hundred battles. If you know yourself but not the enemy, for every victory gained you will also suffer a defeat. If you know neither the enemy nor yourself, you will succumb in every battle.”

Sun Tzu, The Art of War



Relative value between asset classes

The divergence between different credit qualities widened over the third quarter, as investors gave the lower end a wide berth.

Dispersion in spreads between higher and lower-quality credit increased over the quarter. Looking solely at the headline figures, there was little movement in public-credit spreads. But this apparent calm masked some variation that was driven by investors avoiding the lowest-quality corporates and UK instruments.

CCC-rated global corporates widened by 313bps, while UK high-yield spreads rose by 35bps over the quarter. The rotation out of CCC-rated instruments prompted yield-hungry investors to move into B and BB-rated global corporates, which tightened by 48bps and 11bps respectively (see figure 1). This dispersion emphasised the need to take an active approach to credit selection.

Figure 1. Change in spreads over Q3 2019



In European collateralised-loan obligations (CLOs), primary-market transactions have been printing with higher margins on the senior AAA-rated tranches. As rates have gone further into negative territory, investors are benefiting from the EURIBOR* floors on CLO notes resulting in higher all-in coupons.

Like in previous quarters, observed spreads across private-credit exposures remained generally unmoved. The exceptions were UK and core infrastructure debt, which tightened considerably – by 165bps to 210bps on BB-rated loans and 30bps to 90bps on AA-rated loans.

Returns on European payment-in-kind junior loans to small and medium enterprises (SMEs) have increased by one percentage-point to 13% on an annualised basis, but there has been no movement in senior, unitranche or mezzanine SME loans.

*Euro Inter-bank Offered Rate



Figure 2. Our relative-value rankings as of Q3 2019

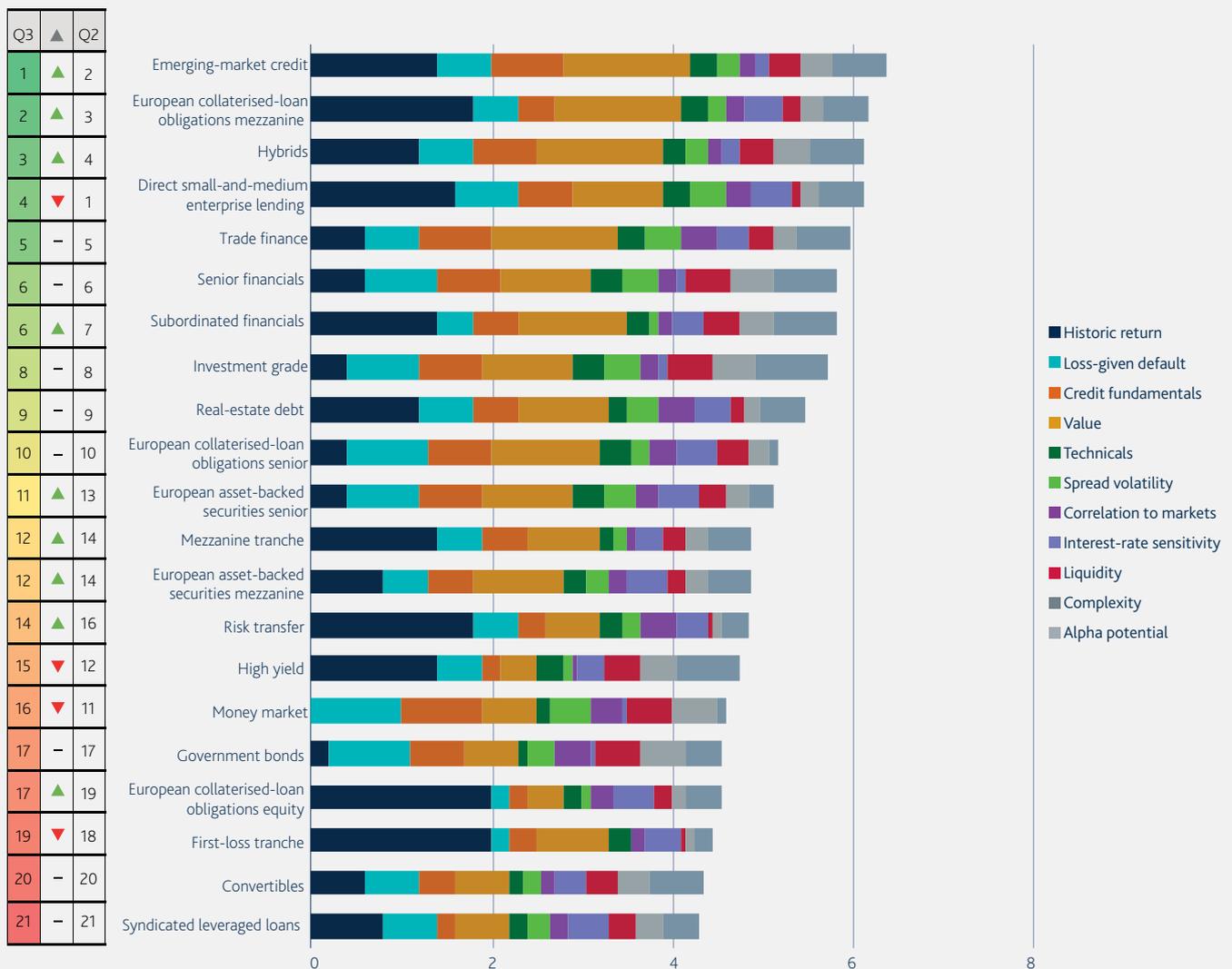


Figure 2 shows the Hermes Multi-Asset Credit relative-value framework at the end of September 2019, highlighting the quarter-on-quarter change in rankings. The key findings include:

- **Emerging-market credit** now leads the rankings, with improved value and technical scores. The credit class offers the combined benefits of liquidity and attractive yields, as investors reprice emerging-market risk.
- **Direct lending** fell from the top position to fourth place, as its value and alpha scores were downgraded in response to increased competition among lenders to win attractive deals. At Hermes, our exclusive origination arrangements with Europe's top-tier lenders mean we continue to benefit from a strong pipeline of deals. This allowed European CLO mezzanine and hybrids to take the second and third rankings respectively, despite no change in their factors scores over the quarter.
- The bottom half of the ranking was influenced by factor-score downgrades for a few exposures. **High yield** moved down from twelfth to fifteenth place, as tight spreads reduced value scores and increased volatility weighed on the spread-volatility factor score.

- **Money-market investments** moved down from eleventh to sixteenth place as its value score fell in response to the Federal Reserve's (Fed's) interest-rate cuts.

- **First loss and equity tranches** remain near the bottom of the ranking, as the risk of defaults increases with no commensurate pick-up in yield.

We use the relative-value framework as a guide when we construct multi-asset-credit portfolios. The aim is to construct a diversified portfolio that exploits attractive relative value but is also aligned with our views on risk appetite.

Our portfolios are positioned defensively at the moment, which means we use a barbell approach and combine higher-yielding exposures like CLO mezzanine and emerging-market credit with higher-quality defensive instruments like investment-grade corporates and structured credit.

Where we do seek credit risk, we continue to be selective. We invest in the areas we like and add convexity through options to provide tail-risk protection. If a shakedown does occur, our defensive positioning will allow us to opportunistically increase risk as assets are sold in large volumes.



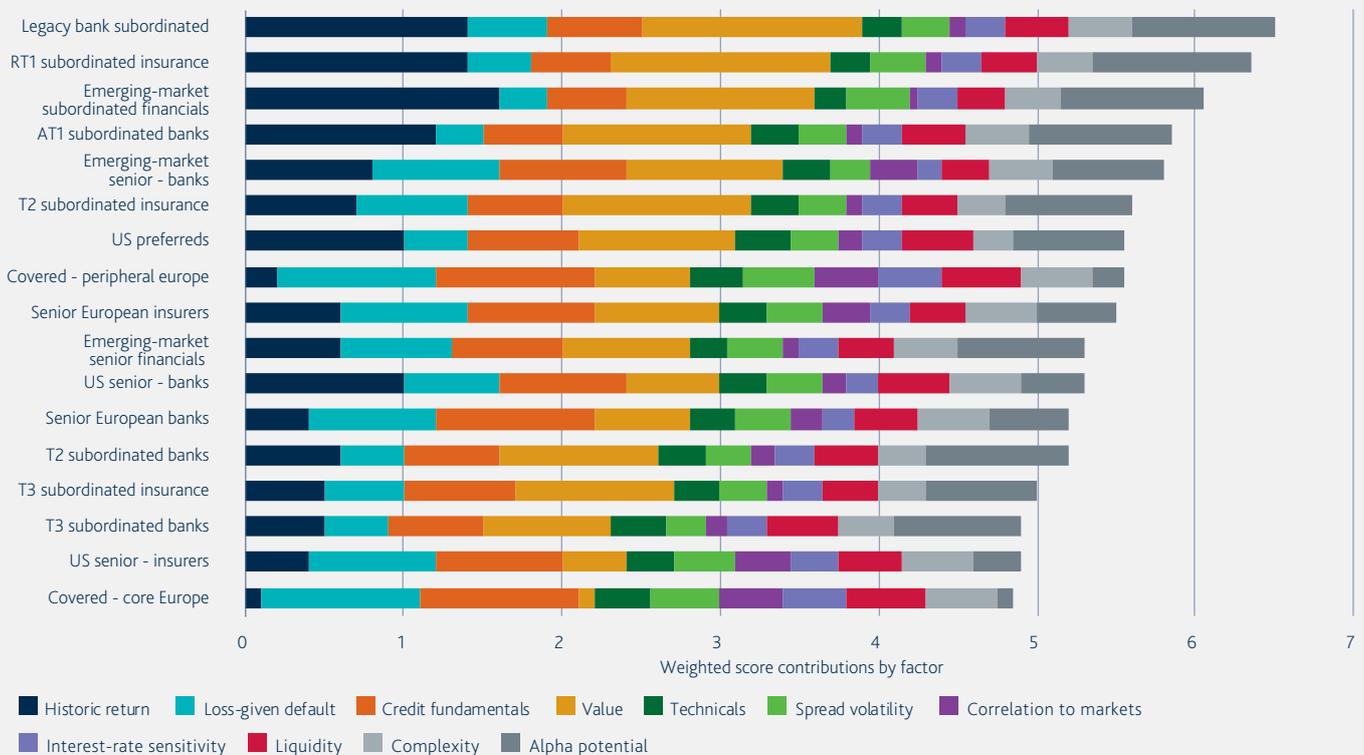
While our relative-value framework is a good way to compare broad credit-exposure types, as with any tool, it does not provide all the answers. There is a need to take a granular approach and appraise all the securities available, regardless of geography, sector, rating, position in the capital structure or maturity. We now consider the relative value within financials.

We like legacy subordinated securities the most, both in Europe and the US. This is because we are approaching the 2021 deadline, the end of the 'grandfathering' period, and banks need to improve their profitability. This can be done through liability management, by calling legacy deals, replacing the paper that is expensive and will no longer count as regulatory capital afterwards.

As for insurers, the RT1 (restricted T1) market is attractive and expanding. Over time, its premium over the equivalent T2 paper should be reduced, similar to the AT1-T2 compression observed in banks three years ago. While subordinated bank paper in emerging markets shows wide dispersion, it remains enticing from a valuation point of view both in relative and absolute terms.

Covered bonds are a very interesting asset class at this juncture. As 'excluded liability', they cannot absorb losses in resolution, and so virtually provide zero loss-given default. In a barbell type of strategy, we would play the 'spreadly' ones and avoid those with a negative yield. In September, Austrian Bawag, a bank, paid mid-swap rate +10bps for its inaugural 2029 covered bond, while Italian Monte dei Paschi paid mid-swap rate +125bps for a 2024 bond.

Figure 3. Going granular: relative value within financials



Source: Hermes, as at 30 September 2019.



Economic outlook

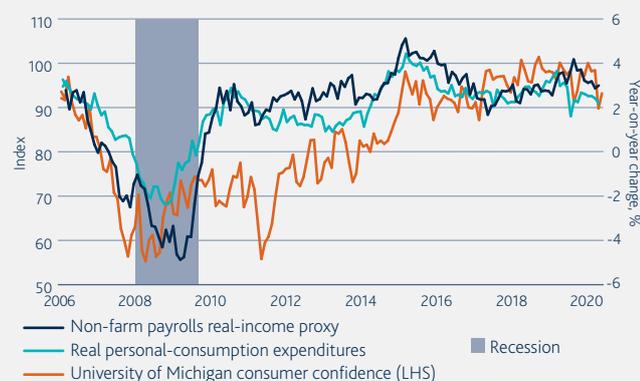
Labour markets have held up well in most countries, which has boosted consumption. But trade tensions mean the divergence between manufacturing and services activity has widened.

The global economy has slowed sharply over the last year and according to most estimates is on track to expand by less than 3% in 2019. This follows growth of 3.5% last year and almost 4% in 2017. Both surveys and hard data confirm that this subdued trend extended into the start of the fourth quarter, with the global composite Purchasing Managers' Index stabilising at roughly its lowest level in three years.

The services sector is still outperforming the manufacturing industry, which is contracting slightly across most countries. But the gap has fallen, which suggests that negative sentiment has started to spill over into the services sector. While manufacturing makes up a fairly small share of output in developed countries, it is cyclically sensitive and so tends to lead developments in the wider economy.

Consumer sectors tend to have been resilient, which is mainly a reflection of solid labour markets – unemployment rates are at multi-decade lows in Japan, the UK and US and have fallen back to pre-crisis levels in eurozone countries.

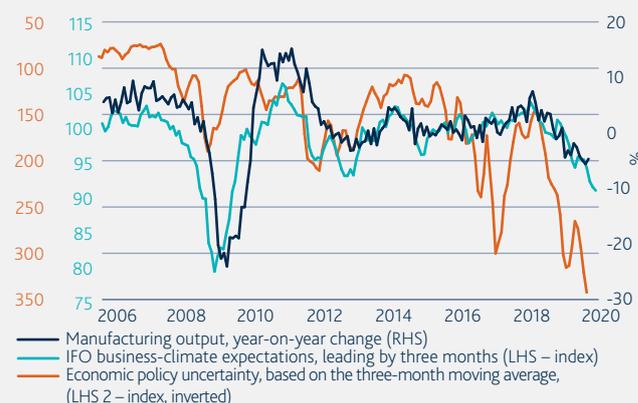
Figure 4. US consumption has held up



Source: Refinitiv, Bureau of Labour Statistics, Bureau of Economic Analysis, as at October 2019.

But industries that are more exposed to external demand have been hit by persistent trade-related uncertainty – Germany is one obvious casualty (see figure 5). While consumption has been solid in most countries, global trade recently grew at its slowest pace since early 2009.

Figure 5. The German manufacturing recession deepens



Source: Datastream Refinitiv, based on German Federal Statistical Office, www.PolicyUncertainty.com, as at October 2019

The current dichotomy is unlikely to be sustained and its trajectory will be determined by developments in trade talks and monetary and fiscal policy. The labour market's ability to withstand deteriorating corporate sentiment will be key, as it could act as a conduit of tensions from businesses to consumers.

Should the tariff spat evolve into an outright global trade war, the already weak global economy could fall into recession. While a thaw in tensions between the US and China has reignited hope a deal can be reached, any agreement is likely to be partial and temporary in nature. The US is also ratcheting up pressure on the European Union (EU) by threatening to impose tariffs on autos later this year.

Central banks have responded to increased uncertainty and subdued inflation expectations by easing monetary policy. The Fed slashed interest rates by 25bps in July, before cutting them again to 1.75%-2% in September. Although Chairman Jerome Powell defined the move as a mid-cycle adjustment, the door is open for more easing if necessary.

The ECB then delivered a hefty easing package at its September meeting, which included the resumption of monthly QE on an open-ended basis. But the effect of easing typically takes 18 months to flow into the real economy, meaning the package probably wouldn't be able to offset the effects of any escalation of trade tensions.

A decade of easing has also fuelled the debate on whether there should be a more active role for fiscal policy. While some – notably Mario Draghi, former ECB president – have called for more fiscal easing, political opposition means this is unlikely to be imminent.

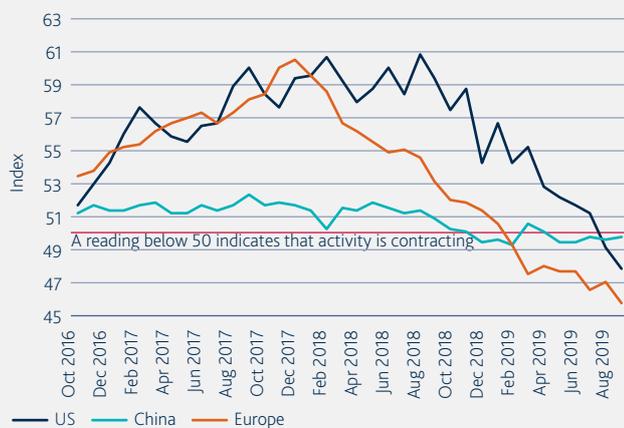


Credit fundamentals

Defaults have risen, particularly in sectors exposed to slowing growth. But in contrast to last year, BBB-rated credits no longer seem a source of anxiety.

The tension between a moderately deteriorating macroeconomic environment (see figure 6) and accommodative monetary policy continued into the third quarter. As we discuss in our economic outlook, this is likely to persist throughout the rest of the year.

Figure 6. Purchasing Managers' Index



Source: Bloomberg, as at October 2019.

While JP Morgan reckons that default rates should remain below their long-term average of 3% this year,¹ they could still rise in 2020. Moody's recent report² states that "As inferred from the statistical record, August's high-yield EDF metric of 4.59% favours an increase by the default rate from a recent 3% to 4% by May 2020. Nevertheless, it is possible that enough improvement in the outlooks for cash flows and pretax profits could prevent a significant widening by the high-yield bond spread."

At the same time, leverage in BBB-rated credit is improving. This low end of investment grade was the subject of acute concerns this time last year, but the de-risking that has taken place confirms that many companies do not want to even entertain the spectre of being downgraded to junk.

Taking these developments together – and staying mindful that the outcome of the trade war is as yet uncertain – we remain sceptical of chasing equity-like risk in credit markets over the next few months, unless valuations justify doing so.

Global credit is certainly not immune from these powerful trends. Leverage has deteriorated in some pockets of the market, resulting in higher default rates. This is not surprising, given that commercial and industrial lending activity has moderated (see figure 7). The trend was driven by defaults in the energy and basic-materials sectors, which are most directly exposed to a slowdown.

Figure 7. US commercial and industrial loans, year-on-year change



Source: US Federal Reserve Bank of St Louis, as at October 2019.

¹ 'Default Monitor: high yield and leveraged loan research', published by JP Morgan on 1 October 2019.

² 'Weekly market outlook: leading credit-risk indicator signals a rising default rate', published by Moody's on 5 September 2019.



ESG case study

The Sustainable Development Goals (SDGs) provide a universal lens through which to define non-financial impact. But proving and validating meaningful impact remains a challenge.

Credit investors have access to a wealth of environmental, social and governance (ESG) data. This offers an insight into how companies articulate the issues that they face, and shows how rigorously they act to manage them.

The use of this data has become so prevalent – and well-studied – that we have concluded that companies with strong ESG characteristics tend to have lower costs of capital. Indeed, our approach emphasises systemic analysis of ESG data to mitigate risks and leverage the connection to credit quality. This helps us identify investment opportunities that may arise from stronger ESG management.

But ESG data tell us far less about the additive impact that a company has on customers through products and services, or its positive social or environmental impact within communities, operating regions or the world. This is why we believe that the SDGs are instrumental. Put simply, the SDGs provide a universal lens through which investors, asset managers, companies and indeed all stakeholders can define and assess contributions to meaningful, non-financial impact.

These goals, developed through consensus-building with governments, multilateral organisations and the private sector, provide a vision of how we can safeguard the planetary environment we share while

addressing, in particular, unmet and underserved social needs. The 17 goals and 169 underlying targets provide a sophisticated map of outcomes which are quantifiable. This provides ripe ground for businesses to disclose robust, meaningful evidence on positive contributions, whilst leveraging what is effectively a blueprint for commercial opportunities.

Despite some 'rainbow washing' that we witnessed in early attempts to define corporate relevancy, the genuine application of SDGs is nascent and formidable work remains to be done. Measures of SDG achievement are complex, but we believe this is an important frontier for businesses to demonstrate contributions to society beyond financial value.

In some respects, the challenges of impact identification and quantification are not dissimilar to efforts and investments made in ESG reporting over the last decade. Hermes has embarked on several efforts to identify investable SDG themes, engage companies on SDG action and measurement and start investing in the SDGs through engagement-focused equity and credit fund strategies.

What have we learned so far?

A subset of SDG themes are directly investable	SDGs provide crucial context when companies weigh long-term opportunities and challenges	SDGs can be used to identify companies with greater potential for driving meaningful outcomes
<p>The complex, systemic nature of the SDGs means that driving impact is not an exact science and in some cases cannot be achieved through the direct action of one business. For many SDGs, policymaker and stakeholder action is also critical. But in the Hermes SDG Investing Taxonomy, we identify nine investment themes relevant to our portfolios. For example, the theme of <i>energy transition</i> could include companies which are focused on the development of renewables or energy-efficiency innovation, and which drive impact on several SDG targets.</p>	<p>Alongside dialogue on strategy, risk and capital allocation, the Hermes EOS stewardship team uses the SDGs as an engagement tool. In 2018, we linked over 900 company issues and engagement objectives to one or more of the SDGs. Dialogue on the SDGs has also opened the door to robust discussions with management teams, where we are able to ask deeper questions about company impact across value chains, product lifecycles and potentially with suppliers or customers.</p>	<p>In September 2019, Hermes, Federated Investors and UBS launched an SDG Engagement High Yield Credit fund. The philosophy is unique: to identify under-engaged companies where we have a hypothesis for considerable future contributions to the SDGs, and to use the fund as a platform for engagement and dialogue with boards and management for achieving these. In doing so, we believe these companies may also become more attractive credit investments in the longer term. The Hermes SDG Engagement Equity fund, rolled out in December 2017, has already provided a valuable proof-of-concept by proactively identifying opportunities for creating both impact and long-term value.</p>

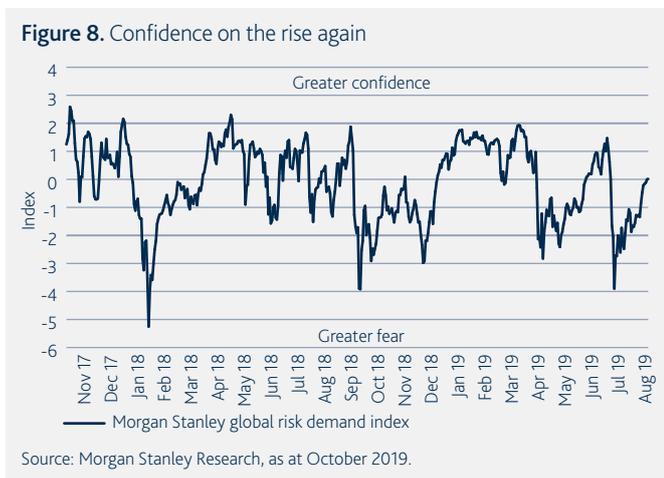


Valuations and technicals

The dovish turn of central banks throughout the world has boosted investor confidence and increased demand for spread products.

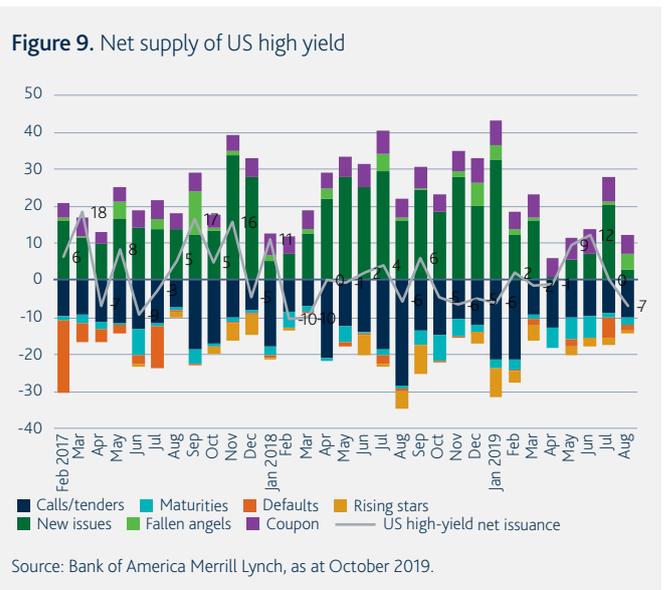
Sentiment

Investors faced an uncertain environment this summer, as data continued to show slowing activity. The Fed's July press conference also suggested that further monetary easing was not a certainty, but dependent on the trajectory of hard economic data. But despite this signal, central banks throughout the world continued to deliver stimulus. This eased investor concerns, supporting demand for risk assets.



Asset flows

The global low-yield environment means there is still strong demand for spread products. Investment-grade flows remain consistently positive in both the US and Europe, although high yield is slightly more volatile given the nature of the asset class. Within emerging markets, the stronger US dollar means that demand for hard currency remains higher than that for local currency. Inflows into leveraged loans in the US are still weak as a result of the ongoing easing cycle. Supply has been well digested, particularly in US high yield (see figure 9).



Valuations

The impressive rally since the start of the year has been driven by strong demand for spread products in the supportive monetary environment. But convexity remains an issue, particularly in the European high-yield market which is mostly trading above the next call (see figure 10). This limits the potential for investors to capture the upside and reinforces the need to reallocate capital into the US and emerging markets. It also supports strong demand for new issues, as asset allocators look to sell negatively convex positions.

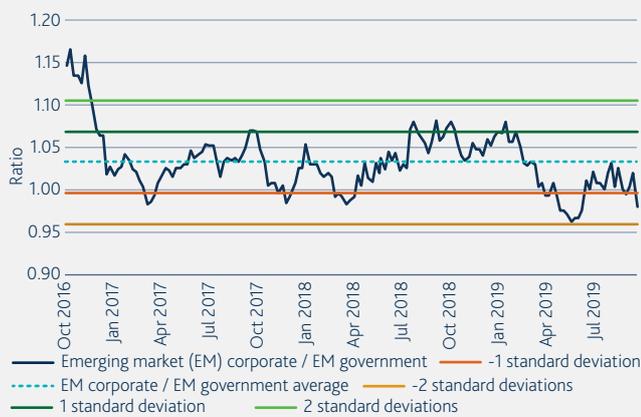


Public credit: relative value

Emerging-market sovereigns look attractive in the low-yield environment, while taking a position in longer-end high yield can help increase a portfolio's spread duration.

We have added to our emerging-market sovereign exposure at the expense of the region's corporates, which have performed particularly well in an environment where investors are hunting for yield. This more defensive positioning will let us switch from sovereigns back into corporates as the relationship normalises.

Figure 11. Corporates outperform sovereigns in emerging markets



Source: Hermes, as at October 2019.

Longer-end high yield is attractive on spread basis

Spread curves remain steep, particularly at the longer end where fallen angels often trade at very attractive levels in comparison to shorter-dated bonds. Taking a position in these securities that offer attractive total-return prospects presents an opportunity to increase a strategy's spread duration. This part of the market remains under-owned by the majority of investors.

Figure 12. Lengthening spread duration

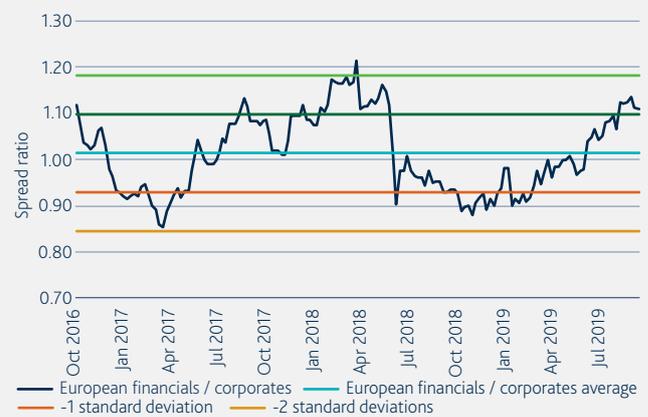


Source: Hermes, as at October 2019.

European financials present an opportunity

Unlike in the US, European financials have underperformed corporates recently and offer an attractive pick-up. Within Europe, we prefer subordinated financials like UK specialty insurance or legacy securities, which are due to be retired because of regulatory changes that are expected to take effect in the coming years. The resumption of QE in Europe will support demand for financials, and we expect this relationship to reverse.

Figure 13. European financials look attractive



Source: Hermes, as at October 2019.

Leveraged loans

Loan volumes declined in the third quarter, but lower margins could trigger a flurry of refinancing in the coming months.

The leveraged-loan market was characterised by declining yields and margins in the third quarter of 2019. Pricing tightened and the standard offer for B-rated credit is now EURIBOR +350, compared to +400 at the end of June. It also affected yield, which declined to 4.04% in the primary market⁵ from 4.14% and 4.43% at the end of the first and second quarters respectively.

All new deals in September came in tighter than initial price-talk, with an average cut of 29.2bps (including margin and original-issue discount). This was driven by strong demand and prints of new CLOs and the trend should be similar in the fourth quarter.

Figure 14. Yields and spreads trending down



Source: LCD, S&P Global Market Intelligence, as at October 2019.

Third-quarter loan volumes also fell to €16.4bn, down from €17.5bn in Q2 and €17.7bn in the first three months of the year. Year-to-date, loan volumes are 23% lower than in the same period of 2018. Having said that, the autumn pipeline is already full of mergers-and-acquisitions transactions and given the decrease in the margin, we are likely to see many opportunistic refinancings.

Supported by rising demand, the secondary market was very active. Accordingly, the average bid of LCD's European flow-name composite rose to 100.36 on 27 September, 264bps above its 2018 close. Similarly, the European Leveraged Loan Index's share of performing loans at or above par has climbed since the beginning of the year. More than 55% of loans were trading above par at the end of September, compared to 32.1% at the end of Q2 and 13.5% after the close of the first quarter.

Figure 15. Performing loans above par on the rise



Source: LCD, S&P Global Market Intelligence, as at October 2019.

New-issue leverage on a rolling three-month basis fell to 5.29x at the end of the third quarter, down from 5.31x in Q2 and 6.41x in the first three months of the year. The first-lien leverage also declined to 4.76x, in line with the fall from 5.08x to 4.9x over the first and second quarters. Both senior and total leverage are moving towards last year's close of 4.84x and 5.51x respectively, reducing the share of subordination.

¹ Rolling three months, ending 25 September for B-rated credit.



Structured securities

Asset-backed securities (ABS) primary activity continued to pick up the slack from a lacklustre first quarter with a surge of issuance over the summer.

The third quarter followed on from where Q2 left off, with a rush of ABS issuance throughout July and into August. This made up for the lack of activity in Q1 and was also a case of the market getting ahead of the traditional summer lull. The third quarter started with the busiest week of issuance year-to-date, although some of the larger deals in the UK that make up the distribution statistics were pre-placed with a small group or single investor.

The performance of UK and European ABS diverged over the third quarter. In the UK, spreads softened on the back of heavy supply and the pending Brexit showdown. But at the ECB's meeting at Sintra in June, Mario Draghi's signal that further easing was imminent resulted in tightening spreads across European asset classes, including ABS.

This tightening also changed the European CLO landscape. Following an August with no new issues, the spreads of AAA-rated instruments have tightened from around EURIBOR+115bps to the low 90s, recalibrating the arbitrage, or the difference between the cost of the liabilities and that of the underlying assets.

The improved arbitrage has made issuance more attractive and has also reinvigorated the refinance and reset market. In large part, this tightening of AAA spreads has resulted from the benefit they receive from having a EURIBOR element floored at zero in the face of rates that have gone more negative.

Rising uncertainty about Brexit and the resumption of QE in Europe means that UK ABS may be more volatile and could underperform their European counterparts and euro-denominated CLOs. In order to capture this performance, investors will need to sift through limited supply to source investment opportunities in the European space.

Figure 16. Heating up: distributed ABS issuance by month



Source: JP Morgan, as at October 2019.

Private debt: relative value

European direct lenders have recently focused on the large-cap market, but there are areas of value in UK small-to-medium enterprise (SME) lending.

While direct lenders are still increasing their market share in the European SME lending market, the rate of growth is slowing as banks become ever more active.

This competition from banks has resulted in increasing downward pressure on loan yields and has forced some direct lenders to widen their focus so they can deploy monies raised. We continue to see unitranche lenders compete on terms in order to write loans within their target returns, and recently some direct lenders have focused on the large-cap market where bigger loans can be made.

Within the large-cap leveraged-loan market, we are seeing more borrowers opt to use direct lending rather than syndicated loans. In turn, some investors now find that the SME direct-lending funds they are invested in are deployed within the large-cap segment in loans with more bond-like protection rights.

It is still our view that SME senior-secured loans, which benefit from strong equity buffers, offer the best risk-reward parameters. Low loan-to-value (LTV) ratios have become an essential equity buffer for investors in the event that enterprise values – currently at all-time highs – plunge in a future downturn. The smaller SME segment also provides more transparent loan structures in terms of EBITDA and leverage and traditional loan protections.

Senior-secured SME loan yields have been relatively stable in Europe, although loan yields have fallen a little in most continental jurisdictions. The UK is the exception, where the sterling premium continues to rise in response to political and economic uncertainty.

We think there are some pockets of real value in UK SME lending, especially in loans to non-cyclical companies that face limited risks from Brexit. The other value market is still Scandinavia, where stable companies offer healthy yields in a creditor-friendly legal environment.



Asset-based lending and real-estate debt

The UK real-estate market continues to suffer from Brexit-related uncertainty and declining retail values. But some sectors still offer opportunities.

The volume of UK commercial-property transactions came to £16.86bn in the first half of 2019, 40% lower than the year before. This decline was seen across all sectors and, from what we can see, has continued into the second half of the year. It is unlikely that full-year investment volumes will get anywhere close to the £56.75bn-worth of transactions undertaken in 2018.

Despite this, liquidity for commercial real-estate debt remains strong and competition fierce for prime, low-leverage transactions. Pricing at this end of the market, which is largely dominated by banks and insurers, has remained stable and in some cases contracted further.

We see more value in the more moderately geared part of the market, where loans typically represent 60% of the value of the underlying assets. Alternative lenders have traditionally operated here, and we have seen the occasional bank lender retreat to their core lending activities.

The total return for UK property in Q2 2019 was 0.5%. But the all-property return figure masks the wide disparity across commercial sectors. Office and industrial properties returned 0.9% and 1.7% respectively, while retail delivered a total return of -1.2%.

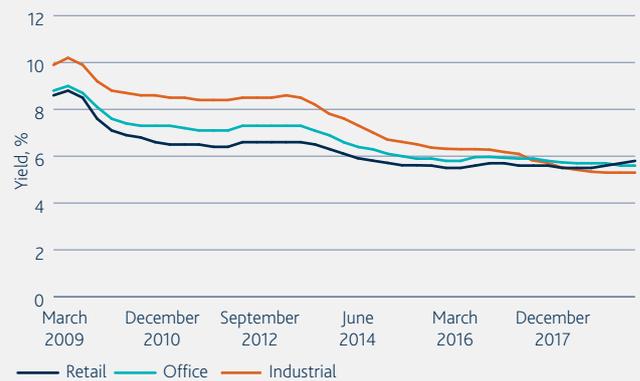
Retail values and rents continue to fall and the number of company voluntary arrangements in 2019 looks set to match those of the previous two years, with no end in sight for company failures and subsequent store closures. High-street retail and shopping centres have been the hardest hit, and there have been few transactions as a result. But amid this turmoil we still see pockets of value.

Retail warehouses in strong locations with long-term income from food and non-fashion operators could offer opportunities to investors, as could redevelopments of now-unviable city-centre shopping centres. The luxury end of retail also continues to perform well, buoyed by rising sales from growing Asian demand. As a result, lending in this market continues to look attractive.

The office market also still offers good risk-adjusted returns. While rental growth has softened over the course of the year, well-balanced supply and demand in most regional markets has supported a healthy leasing market. The increased supply of secondary office space could be one to watch over the next year, as the number of serviced-office operator failures increases.

Our final area of focus is the mainstream housing market. Despite the uncertainty surrounding Brexit, there is still a lack of quality affordable housing across the country. This is an issue that has tested governments for decades and is no closer to being resolved. Focused coordination with local stakeholders should be able to unlock investment opportunities in a variety of residential development projects.

Figure 17. Yields heading south



Source: MSCI Real Estate, as at 30 June 2019.

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