

A photograph of a rocky coastline with tide pools and starfish. The scene is captured from a low angle, looking down into a tide pool. The water is dark blue, and the rocks are covered in various types of seaweed and coral. Several starfish are visible, including a large orange one in the foreground and a smaller red one to its right. The overall atmosphere is serene and natural.

360°

Seeking riches with the tide far out

Andrew Jackson
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Andrew Jackson Head of Fixed Income

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

Commentary

Rock pooling: finding value with the tide far out

"I wish it need not have happened in my time," said Frodo. "So do I," said Gandalf, "and so do all who live to see such times. But that is not for them to decide. All we have to decide is what to do with the time that is given us."

J.R.R Tolkein – *The Fellowship of the Ring*

Those of you with a similar literary education to mine will immediately recognise this quote. Putting the formality of the language to one side, you would also be forgiven for thinking it was a conversation between a portfolio manager forced to invest in negative-yielding assets and an asset allocator tasked with making money while investing in supposedly zero-risk assets.

The conversation could equally have been between a central-bank governor and a political leader. We certainly live in the most unusual period I have experienced throughout my career, both in terms of financial markets and geopolitics.

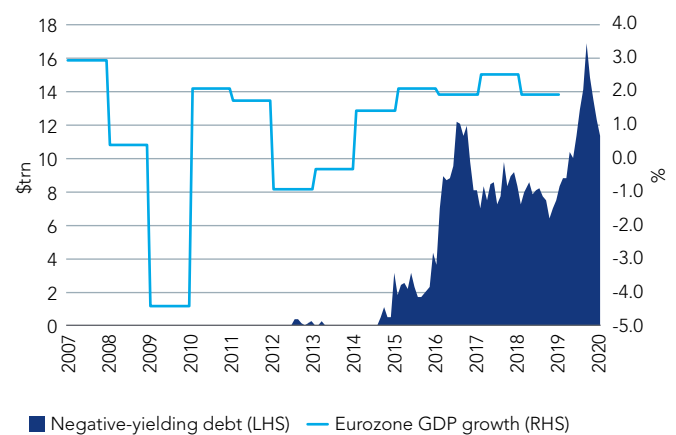
Of course, none of this means that it will meaningfully change in the short term. We may indeed be establishing a new normal in terms of the influence of central banks on markets and the use and impact of interest rates. It certainly seems very hard to see a scenario in which interest rates and central-bank balance sheets return to pre-financial-crisis levels, even in the medium term.

As we attempted to emphasise in the last edition of *360°*, we find ourselves in the most unusual of predicaments. Only a fool (there are several out there) would argue that all is good with the global economy or geopolitics. Historical precedents are being broken and unpredictability seems to be testing credulity.

Meanwhile, markets are at all-time highs, credit markets at all-time tights and the cost of borrowing as cheap as it has ever been. To use the analogy of a spring, it seems likely that when the unwind occurs, the more compressed the spring is the more violent it will be.

I have been using the spring example for some time. While it has some merit – given it takes more energy to further compress the spring, and a spring can also become weak over time – there are some elements that don't necessarily follow.

Figure 1. European negative-yielding assets



Source: Bloomberg, Eurostat, as at 31st December 2019.

It is important to emphasise that corporate treasurers and home owners around the world are being entirely rational in refinancing and extending their borrowing. There are also real signs of rationality in the functioning of credit markets: performance of CCC-rated credits in 2019 relative to BBs is probably the best example.

To be clear, I am not saying that pockets of the market are not over-levered, or the covenants are where we would like to see them. I am merely reflecting that the market is not assuming that nothing will ever default ever again or that house prices can only ever go up (views that existed in 2006).

We have repeatedly pointed to interest coverage and affordability ratios in a rising-borrowing-cost environment as dynamics that can mitigate the risk of a market meltdown. The much-discussed leverage in debt markets is hard to ignore, but other than central banks themselves, it is hard to spot the weak points.



And so, I find myself in a situation where I may appear to be slightly less contrarian than at many times in my career. I'm not proud of that. Choosing to lend to higher-quality corporates for longer, rather than lend to lower-quality corporates at a traditional tenor, has become consensus. Disliking the syndicated leverage-loan market throughout almost all of 2019 was also consensus. Being bullish in the first quarter of 2019 was not consensus, but being cautiously bullish now probably is.

When a portfolio manager has delivered an outstanding year of performance, the temptation is always to revert to the market, benchmark or consensus. This is because we tend to look at markets through a lens that is coloured by the strategists who espouse mean reversion and history. This is despite having far too little data for this to be a successful scientific approach, and despite it never having saved them before.

For these reasons and others, I want to share a new analogy with you.

We are beach combers searching for value in what the sea offers us. The tide flows in and out, and each wave is different, but there is a pattern to observe. The tide comes in and out regularly. But the extent of the tide also gets higher and lower over a longer time period.

We find ourselves where the tides are all out, and even when the waves briefly wash in, we have to walk further and search harder to find what we seek. Right now, the tide is far out and most of the rock pools are empty and the sea life been fished to extinction – there are certainly no gems left in the rock pools close to the coast.

So, we find ourselves out in the more distant, deeper pools, plunging our arms deep into the water and under rocks and into crevices. Often there will be nothing, occasionally we will be nipped by a crab, but there will also be times when we find a rare and valuable gem.

Among the things we are attracted to right now are parts of the leveraged-loan market that we have been averse to for so long, elements of the unloved energy sector, and in the deeper pools we also like the mezzanine and junior parts of the structured-credit market. In the darkest, deepest crevices we have also seen the glister of a regulatory capital trade or two that looks like it may offer value. But until we have examined it more closely, we will avoid definitive judgement.

We are active managers, and are philosophically sceptical about taking a passive approach to many parts of our asset class. There is little doubt that as an aid to execution, risk management and even perhaps liquidity management, some of the technology that has been developed in the name of the passive management of fixed income is a useful tool for market participants.

But if there is a time for active management and a time for passive management, now is the time for active. Risks are hard to identify but are obviously present, and value is incredibly hard to discern in a market that began the 2020s with a near-insatiable appetite for risk.

Reflecting on our analogy, consider this: a passive beachcomber walks blindly up and down the beach collecting anything that is left on the drift line, whether it be flotsam and jetsam. We eschew this approach in search of value, but are cognisant of the risk that as the tide turns we need to be very risk aware.

It may be stretching the analogy too far, but we are also aware that we have a responsibility as a leader in environmental, social and governance (ESG) integration to help deal with the less palatable items we find on the beach, and to educate others about the impact of these pollutants.

Last year was a very important year for our Fixed Income team in this respect, and we are excited about the short-term future ahead of us. There are more publications to reference than we could reasonably do here – as well as an ESG-focused episode of the *Delta* podcast that we published at the end of last year – but please do reach out to the team if you wish to discuss this or any other topic. There are very few things we enjoy more than discussing how investment managers are beginning to have a positive impact on the world we live in.

The technicals that face the market as we enter 2020 look very different than they did a year ago. Our risk appetite is much lower than it was then, and we see a higher chance of markets widening moderately – albeit mitigated by the knowledge that central banks around the world appear to be reacting as much to markets as to longer-term macroeconomic trends.

Central-bank support, coupled with investors waiting to top up on risk in the event of a moderate sell-off, makes the probability of a larger widening of spreads less likely than it was at the beginning of last year. Attempting to guess either when or why the market will turn is fruitless and futile, but as we've discussed several times already in previous issues, our approach at times like this is to dedicate almost all of our time and attention to capturing the most attractive relative value among securities.

Providing themes and easy-to-digest anecdotes becomes harder at times like this, but it fits with our philosophy and process incredibly well, reinforcing the need to be active. Listeners to *Delta* gained the opportunity in the first episode of 2020 to hear our credit analysts' expectations for the weeks, months and year ahead as well as a snapshot of their current views.

In closing, it's important to be mindful of the fact that when the tide rushes out beyond where its ever gone previously, it may be a sign that a very large wave is coming and that we should watch the horizon, ready to get back to safety.



Relative value between asset classes

Credit markets tightened in 2019 as investors turned to credit in search of yield in the face of greater uncertainty and slowing growth.

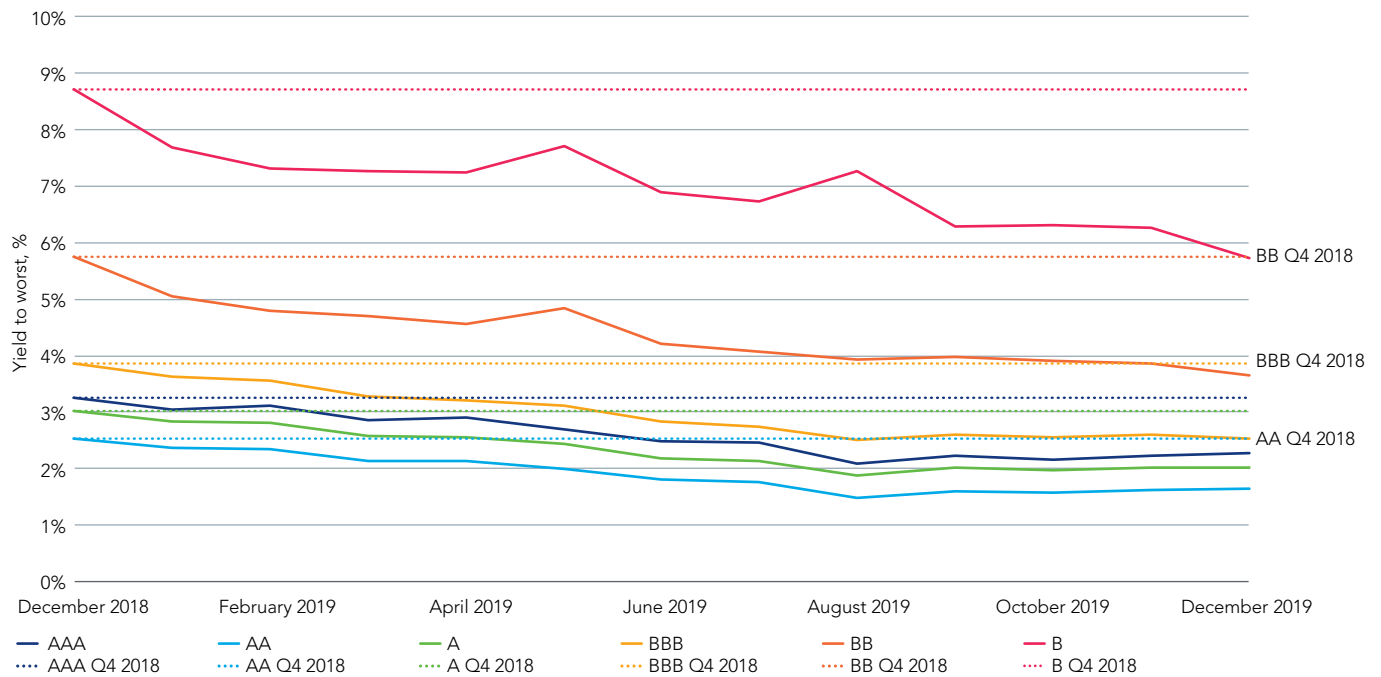
It was a strong start to the year for public credit, as the global high-yield index generated total returns of 11.68% and the corporate index delivered 10.75%. Following the selloff in the fourth quarter of 2018, spread levels recovered and returns were boosted by looser monetary policy.

With the exception of CCC-rated credits, all other parts of the market tightened over the year as investors favoured quality in the face of slowing growth and trade-related uncertainty. Although diminishing trade tensions helped CCC-rated yields fall by 1.5% over December, at the end of the year they were 0.9 points wider than at the start.

By the end of the year investment-grade and high-yield credit were trading at the tightest levels in five years, with respective yields of 2.2% and 5.2% and spreads of 102bps and 375bps. It seems very unlikely that last year's strong performance will be repeated without an unanticipated boost from rates.

Figure 2 shows corporate-credit yields for different ratings bands. We can see that BB-rated credits now yield less than BBB-rated ones did at the start of the year, while BBB-rated yields are lower than A- and AA-rated credits were in January. Investors now expect to take on more credit risk in order to capture yields seen last year.

Figure 2. Global corporates: yield to worst by credit rating



Source: Federated Hermes, Bloomberg as at 31 December 2019.

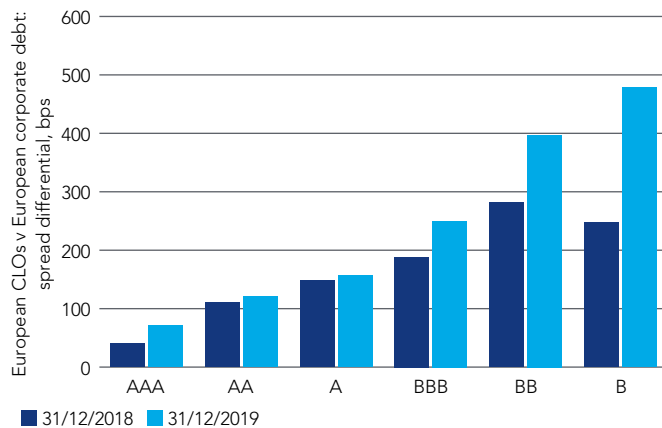
Leveraged-loan spreads have recovered since investors started to shun the asset class, which prompted spreads to widen in the first half of the year. European leveraged loan spreads have since tightened by 15bps to 373bps, and by 8bps to 372bps in the US. Leveraged loans are now on par with global high yield – where spreads are 375bps – but rank more senior in the capital structure.

Both asset-backed securities (ABSs) and collateralised-loan obligations (CLOs) moved tighter over the year, but less so than corporates of the same rating. Asset purchases by the European Central Bank (ECB) then prompted European ABS spreads to return to the tight levels last seen before the final quarter of 2018.

Figure 3 compares the difference in spread between European CLOs (which are not part of the ECB's purchase program) and corporates of the same rating. In many cases, the pick-up in spread from investing in CLOs rather than corporates increased, as the move in CLO spreads lagged that of corporates. In 2020, it seems that CLO investors will be better rewarded for credit risk, while yields should improve in response to the zero-LIBOR floors.



Figure 3. Increase in spread differentials between European CLOs and equivalent-rated European corporate debt

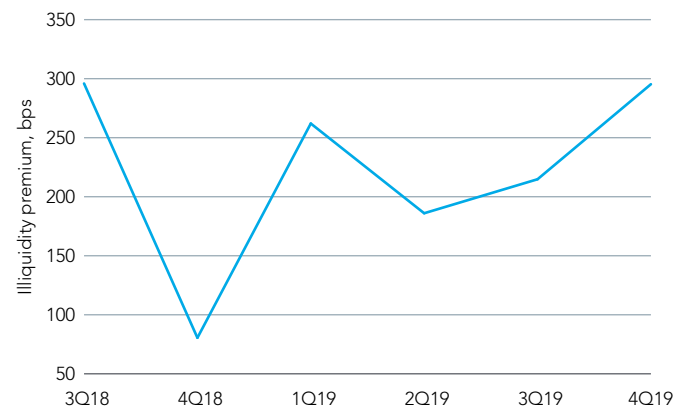


Source: Federated Hermes, Bloomberg and Citi, as at 31 December 2019.

Private credit continues to be relatively unmoved by public-credit spreads and we observed declining spreads for infrastructure debt, trade finance and real-estate debt. The core part of the real-estate market – ranked BB to BBB – tightened by 50bps in the fourth quarter, to a respective 275bps and 350bps. However, spreads of senior-secured middle-market direct lending are similar to those at the start of the year: 525bps in the UK and 475bps in northern Europe.

Following the Q4 2018 sell-off in public credit, the illiquidity premium shrank at the start of the year. But after a year of little movement in spreads, we have seen the premium re-emerge. Figure 4 illustrates our proprietary calculation of the illiquidity premium for European middle-market direct lending versus US high yield. [To read more, see the second instalment of our two-part paper on the illiquidity premium.¹](#)

Figure 4. Return of the illiquidity premium in direct lending



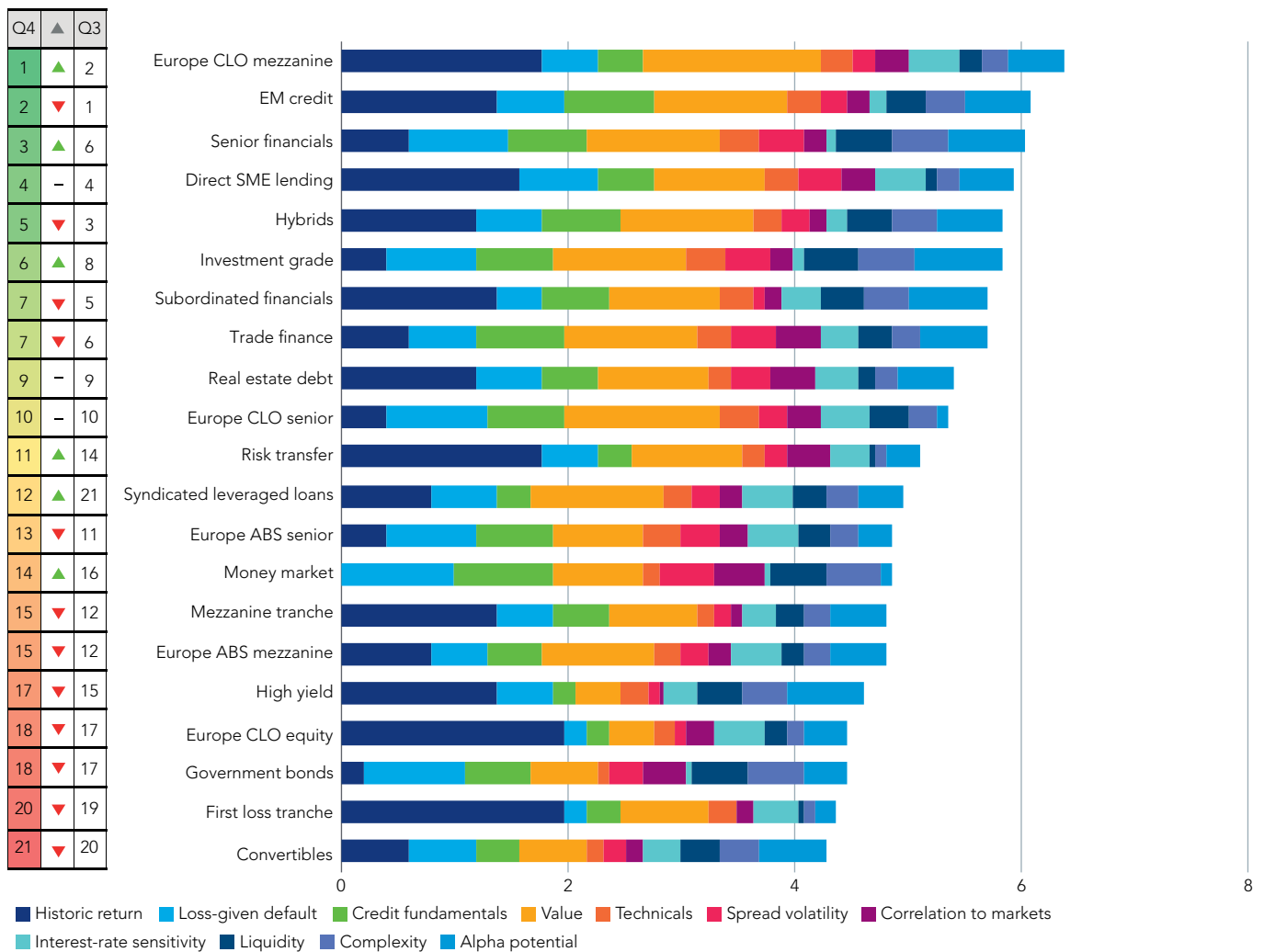
Source: Federated Hermes as at 31 December 2019.

Figure 5 shows our Multi-Asset Credit relative-value framework at the end of December 2019, highlighting the quarter-on-quarter change in rankings.

¹ 'Harnessing the illiquidity premium: managing liquidity risk in multi-asset credit portfolios,' by Khalid Khan. Published by the international business of Federated Hermes in Q4 2019.



Figure 5. Our relative-value framework, Q4 2019



Source: Federated Hermes, Bloomberg and Citi as of 31 December 2019.

The key themes that have influenced the ranking changes include:

- **Europe CLO mezzanine** moved from second to first place. The asset class currently offers even more attractive relative value than other similarly rated exposures. Contagion from a spate of US high-yield defaults meant that the spreads of the lowest-rated tranches moved out in October and November, before recovering in December. For investors who can handle additional illiquidity and volatility, CLO mezzanine tranches (BBB, BB and B) offer an attractive pick-up in yield versus corporate bonds with the same rating.
- **High yield** has moved from 15th to 17th place. With tight spreads, BB-rated credits now only provide an extra 98bps of spread over those rated BBB. High yield also looks less attractive than higher quality liquid credit exposures like **senior financials** (which moved up to third place) and **investment grade** (which moved up to sixth). These two also scored higher on fundamentals, loss given default and spread volatility. The relative attractiveness of higher quality credit means that **hybrids** and **subordinated financials** have moved down, although we still think they offer value.
- **Leveraged loans** hovered near the bottom for most of the year after suffering large outflows in response to tighter monetary policy from the Federal Reserve (Fed). The asset

class benefited from the Fed's dovish turn and has moved from the bottom of the rankings to 12th. It now stands above high yield on the basis that it offers similar levels of spread but with more security. Given that many high-yield issues are priced above par, leveraged loans also offer better convexity in many cases.

- **Direct lending** remains in fourth position. Private-credit spreads have not tightened as much as public-credit exposures and continue to offer an illiquidity premium, as well as stronger documentation than public-credit markets. **Trade finance** moved from sixth to seventh place as spreads have tightened.
- **Europe CLO senior** is ranked 10th, higher than **ABS senior** at 13th, which has suffered by being outside the ECB purchase programme. ABS spreads also widened after large Japanese institutions moved away from the asset class.
- The volume of **risk transfer** deals has increased and offers yields of 11%-12%, which makes them very attractive for investors who can handle illiquidity and have a higher risk appetite.
- **Convertibles** now sit at the bottom of the ranking. Given lofty equity valuations, we place low value on embedded equity options.



Economic outlook

Monetary easing and a partial resolution of trade tensions mean the short-term outlook has improved. But it is not clear whether this will be sustained, given that geopolitical risks remain elevated.

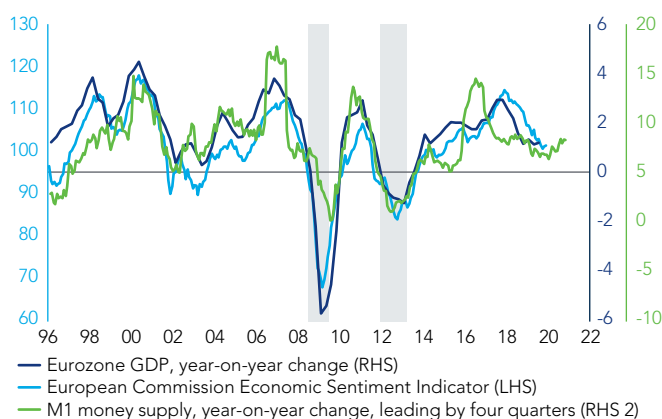
The global economic outlook has brightened recently. It seems that the slowdown has bottomed out and we expect a modest uptick in growth over the first half of this year as looser monetary policy starts to take effect and trade-policy uncertainty eases. The rosier outlook is mainly driven by:

- The dovish bias of central banks.** While the Fed and ECB are currently holding rates, tighter policy requires prolonged inflation overshooting – which seems unlikely for now.
- China's willingness to provide stimulus.** The People's Bank of China cut the reserve requirement ratio by 50bps in January, which released about 800bn yuan of liquidity.
- US-China relations.** The two sides signed a phase-one trade deal in Washington in January.

Recent economic data – despite being mixed – point to a tentative recovery, as the global composite Purchasing Managers' Index (PMI) rose to 51.7 in December, the highest since April 2019. The manufacturing sector remains in the doldrums: while it has recovered from the low it hit in Q3 2019, the recent global PMI reading of 50.1 is consistent with stagnation, while factory output continues to contract.

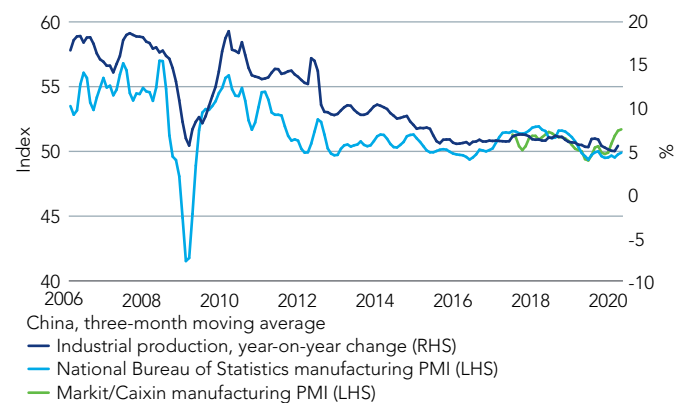
Yet business sentiment seems to be rising, while services-sector surveys also look cheery. Strong labour markets – unemployment is running at record lows in the US, UK and Japan – mean that consumer confidence is solid, while economies which experienced a sharp slowdown in 2019 (like China and the eurozone) are now showing green shoots (see figures 6 and 7).

Figure 6. Recovery in Europe



Source: Refinitiv, Eurostat, ECB, European Commission, as at January 2020.

Figure 7. Chinese manufacturing activity stabilises



Source: Refinitiv, National Bureau of Statistics, Markit/Caixin, as at January 2020.

But there are several remaining sources of geopolitical instability, and it remains to be seen whether this pick-up in growth will be sustained. The Middle East poses the greatest risk in the short term. While an outright war between the US and Iran seems unlikely – Iran is weak, and the US is reluctant to get involved in another conflict – oil prices have risen by almost 25% in recent months, which will boost inflation and reduce consumers' purchasing power.

And in the long term, the trade truce between the US and China looks fragile. While the phase-one trade deal is undoubtedly positive, tensions could easily resurface. Meanwhile, US and German elections could act as another source of volatility.

All eyes will be on fiscal policy going forward. There is widespread agreement that fiscal stimulus should take a more active role, given the decreasing efficacy of monetary policy. But even despite this, it still seems that fiscal stimulus will be somewhat limited this year.

Credit fundamentals

Central banks have eased monetary policies which has support declining default rates and may improve the outlook for corporate earnings. Nonetheless, we remain cautious of chasing excessive risk.

Following the wobble at the end of 2018, credit delivered very strong returns last year. This was principally thanks to the fact that the quantitative-easing (QE) punchbowl was replenished: all market participants – banks, investors and issuers – had been standing round in anticipation, and eagerly dipped their cups when it arrived.

Looking at issuers, for example, we can see that just over \$2.5tn of corporate debt was issued in 2019 – a record high. Aghast at the \$17tn-worth of negative-yielding assets, investors also poured money into credit funds in a hunt for value.

It is no coincidence that low interest rates were aligned with low default rates, which – though rising marginally – remained well below trend at 1.5% for emerging-market credit, 1.8% for European high yield and 2.94% for US high yield. It is worth noting that the US high-yield figure falls to 1.28% when controlling for a spike in commodities-related defaults.

Looking beyond the positive effect of QE, credit fundamentals have quietly deteriorated in certain parts of the world. Revenue, EBITDA and earnings growth all decelerated, while the pace of debt expansion has increased in the US (indeed, all US credit metrics have worsened).

On the positive side, debt issuance was principally driven by issuers rated A and above – who were funding mergers and acquisitions and paying cash to shareholders – while BBB-rated issuers focused on delevering. While we have been relatively sanguine about the rise of BBB-rated debt, this was a major concern of investors – and the press – a year ago.

What does 2020 portend? Lower for even longer, for a start. As noted in the economic outlook (see p.8), the forecast for monetary policy is dovish and the resumption of QE is the main impetus behind the modestly positive short-term outlook.

Although this should have no obvious or immediate effect on fundamentals, the US-China trade negotiations do at least suggest some positive momentum and the reduced uncertainty is a positive for companies.

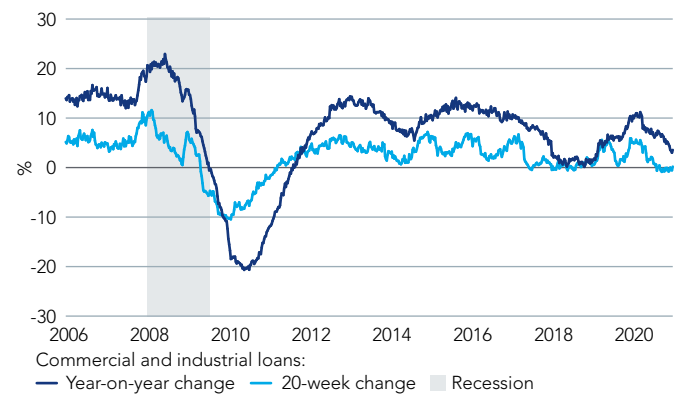
That said, we do not expect stellar Q4 numbers. But given the improved macroeconomic outlook, the more important message to glean will be whether QE means the outlook for earnings has improved. Because of this, we will be focusing more on earnings forecasts than Q4 figures.

Therefore, there is a real contrast between the (positive) effect that QE has had on the macroeconomic outlook and the rising levels of leverage in certain parts of the world. On balance, we are somewhat more optimistic than we were in the autumn, given that the global economy is picking up and refinancing activity remains robust.

But it is unlikely that global growth will rebound to the extent that we will start chasing equity-like risk in credit markets – particularly given the rally in CCC-rated instruments towards the end of last year.

Finally, we remain concerned that the extension of credit to commercial and industrial companies in the US remains curiously – and frustratingly – soft (see figure 8). Historically, this has been a leading indicator of stress and, given the return of QE, we would have thought that the deceleration of this lending would have reversed.

Figure 8. US commercial and industrial lending



Source: Refinitiv, Federal Reserve, as at December 2019.



European managers have generated the groundswell of CLOs with an ESG tilt.

Last year saw the emergence of so-called ESG CLOs, with European managers – including Bardin Hill, Capital Four, Fair Oaks, King Street, NIBC and Permira – leading the wave.

In Europe, the typical approach has been to apply exclusions to eligible collateral. These tend to focus on industries and sectors like fossil-fuel extraction and electricity production, firearms, controversial weapons, hazardous chemicals, tobacco, gambling and payday lending.

We are long-time advocates of integrating ESG into the investment process. In fact, we see it as an investment imperative because we believe – and have proved – that ESG factors impact the performance of companies and their equity and debt (see figure 9).

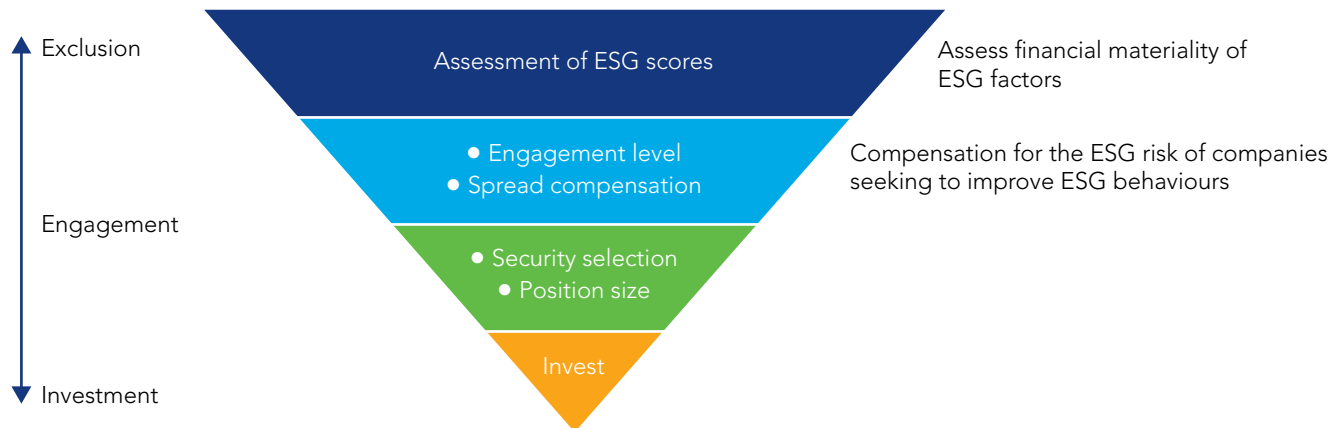
Industry and sector exclusions tend to happen at the start of the ESG-integration process. In that respect, the CLO market is at the preliminary stage of integrating ESG.

Figure 9. The relationship between ESG factors and credit risk



Source: Federated Hermes, as at January 2020

Figure 10. The full spectrum of ESG-integrated investment



Source: Federated Hermes, as at January 2020

Excluding entire sectors or industries is one way to approach ESG investing. However, not all companies within non-excluded sectors and industries perform the same and so need to be assessed separately and scored on their ESG factors.

In Europe, only one ESG CLO – managed by NIBC – has moved the screening process beyond exclusions. NIBC applied a score to individual loans and also committed to constant monitoring of the instruments. This is a move in the right direction as managers become more thorough and committed to screening the underlying loans for ESG factors.

This lack of differentiation has also been expressed in the pricing: we are yet to see ESG CLOs benefit from tighter spreads. However, it is worth pointing out that regardless of whether the CLO features ESG integration or not, the differentiation (or tiering) between managers has been largely muted recently anyway.

Speaking to managers, we have also found that even for deals not specifically marketed as having embedded ESG analysis, investors are increasingly asking about the topic. As a result, ESG considerations are finding their way to the core of investment processes (although responses range from manager to manager).

CLO investors must choose the managers and deals that fulfil their own mandate criteria, regardless of whether this includes a focus on ESG. But when CLO investors make it clear that ESG is an important consideration in their investment decisions, this will place an onus on CLO managers to focus on ESG-compliant loans. This should in turn trigger interest from sponsors – and ultimately the companies – in ESG factors. This chain of events is yet to happen, but the trajectory of other asset classes suggest that once this groundswell gathers force, it continues to make waves.



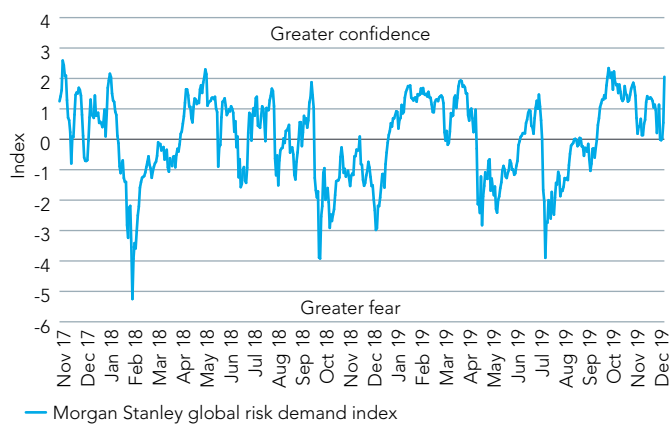
Valuations and technicals

Revived economic growth has supported sentiment and there is still room for credit markets to rise further. But convexity remains an issue and it is not always easy to capture the upside.

Sentiment

Sentiment remained strong during the fourth quarter, as macroeconomic data improved and there was initial progress in trade talks between the US and China. Investors are increasingly optimistic that growth will improve in 2020, as monetary stimulus starts to have a positive impact on underlying fundamentals (see figure 11).

Figure 11. Sentiment improves

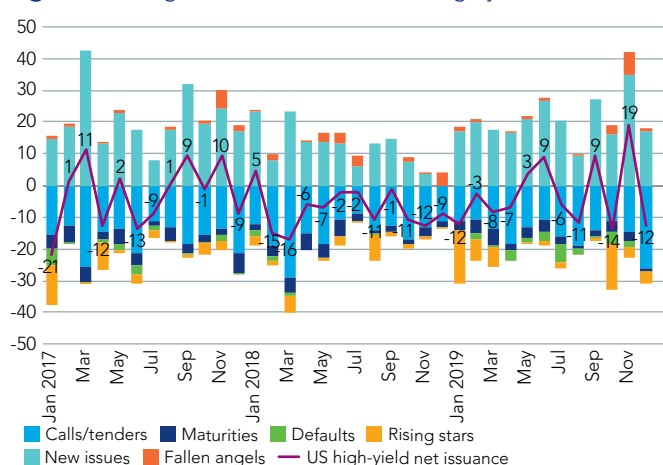


Source: Morgan Stanley, as at January 2020.

Asset flows

There was strong demand for products that offered spread in the last three months of the year, with inflows across both developed and emerging-market high yield and investment grade. While leveraged loans continued to suffer in the US – they lost about 25% of assets under management over the year – we predict a good year of inflows in 2020. New issuance was well digested overall, with negative net issuance in US high yield (see figure 12).

Figure 12. Negative net issuance in US high yield

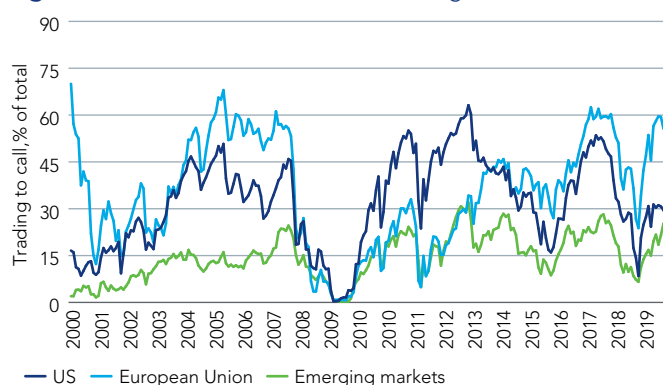


Source: Bank of America Merrill Lynch, as at December 2019.

Valuations

Given the technical backdrop, there is still room for credit markets to rally further. But convexity – or the ability to capture the upside – is not the same across different segments of the market. For example, there is stark difference between the bonds trading above call in European and US high yield (see figure 13). In our view, the ability to perform well in 2020 will be driven by an active approach that combines both top-down and bottom-up analysis.

Figure 13. Share of bonds that are trading to call



Source: Bank of America Merrill Lynch, as at January 2020.



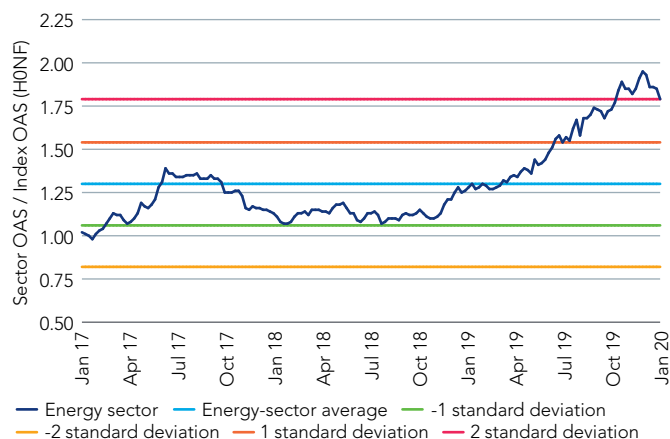
Public credit

The beleaguered energy sector offers opportunities for active investors, but the Russian corporate market now offers little chance to grow investors' capital.

The energy sector

For the second time in less than five years, the energy sector is trading two standard deviations cheaper than the index on a spread-ratio basis (see figure 14). Investors have focused on the pickup in defaults over the past year, as companies with less sustainable capital structures were forced to restructure.

Figure 14. Opportunities in the energy sector



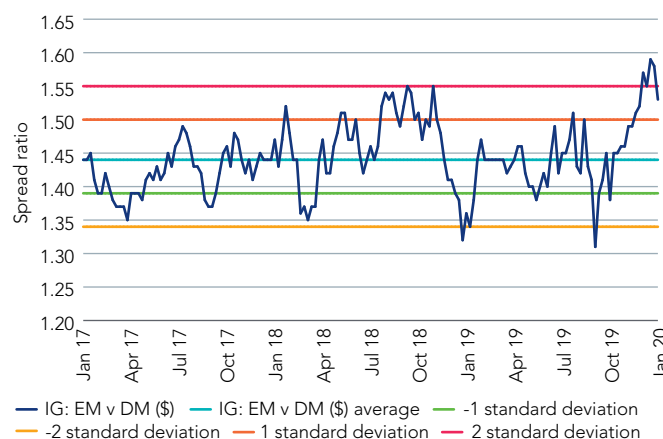
Source: Federated Hermes, as at January 2020.

But a bottom-up look at the sector showed us that there are opportunities for investors that take an active approach. We have added to our energy exposure by investing in names that have become dislocated from their fundamentals.

Emerging-market investment-grade credit

PMI readings have stabilised and growth in emerging markets is expected to pick up in 2020, driven by monetary stimulus and a partial resolution of the US-China trade dispute. Higher quality emerging-market investment grade looks more attractive than that of developed markets and trillions of dollars in negative-yielding assets could lead to an increase in demand for corporate credit (see figure 15).

Figure 15. Emerging and developed-market investment

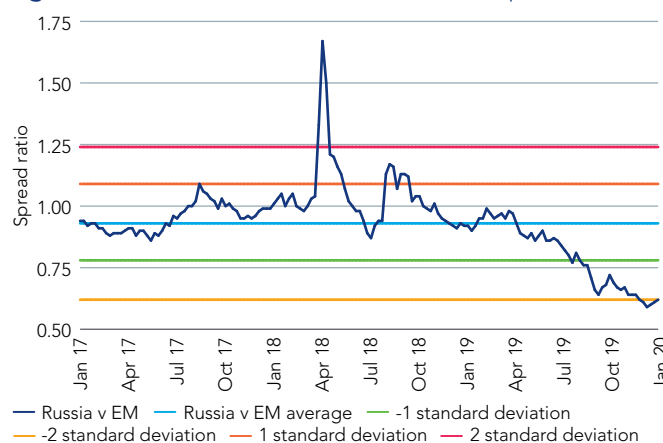


Source: Federated Hermes, as at January 2020.

Russian corporate credit

We have reduced our exposure to Russian corporates because of their stretched valuations and positive consensus surrounding the country's economic prospects this year. The Russian corporate-credit market has tightened and is trading two standard deviations below emerging markets, offering little potential for capital appreciation (see figure 16).

Figure 16. Stretched valuations for Russian corporates



Source: Federated Hermes, as at January 2020.



Leveraged loans

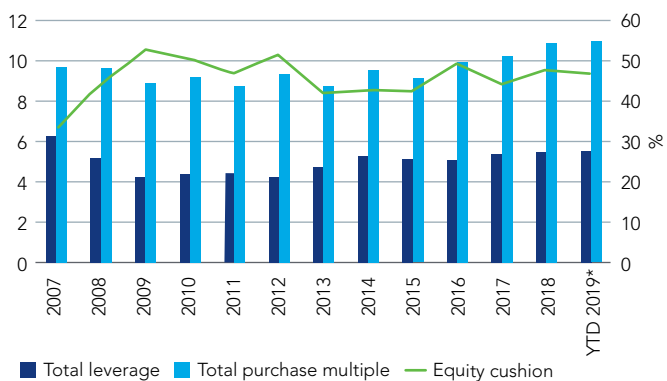
Leveraged loans performed well over 2019. Although leverage multiples are deep, equity cushions are high enough to offer some protection.

The S&P European Leveraged Loan Index delivered 4.5% in 2019. Despite concerns about rising leverage, this is a good performance for a market known for its typically low volatility. Given that equity cushions are high and there is good refinancing momentum, we think there are some opportunities in the short term.

At the end of 2019 the average European leverage ratio remained high at 5.18x, although this was lower than the 5.55x seen at the start of the year. In particular, the leverage multiples for buyout are to settle at 5.58x in 2019, which is the highest since 2007, when buyout leverage was 6.28x.

However, this needs to be viewed in context, as current equity multiples are higher than in 2007: 10.99x in November 2019, compared to 9.7x at the end of 2007. Because of this, the equity cushion significantly increased from 33.6% in 2007 to 47.1% in the 11 months ending November 2019 (see figure 17).

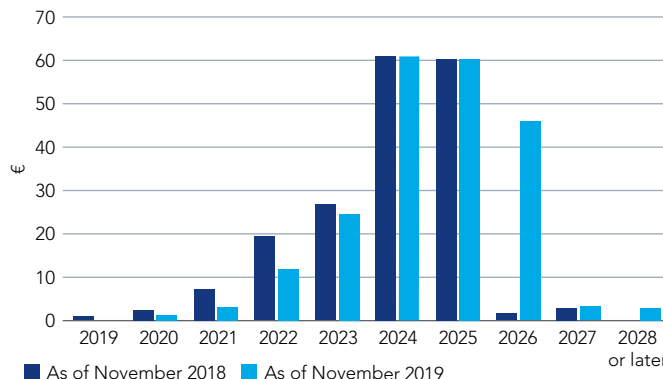
Figure 17. The evolution of equity and debt



Source: LCD News, as at November 2019.

What about refinancing risk? At the end of 2018, €28.74bn – or 15.87% – of the European leveraged-loan market was due to mature before the end of 2022, and €116.36bn before the end of 2024. It appears that corporates have found it easier to refinance their loans this year. As of November, €16.30 (or 7.62%) of European loans will mature before the end of 2022, and €101.52bn before the end 2024 (see figure 18).

Figure 18. The European leverage-loan maturity wall



Source: LCD News, as at November 2019.

The market for CLOs was very active in 2019. CLOs remain the primary investors in leveraged loans and there is a need for them to ramp up their warehouses which provide liquidity and create good momentum for new syndication and good names trading below par.

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

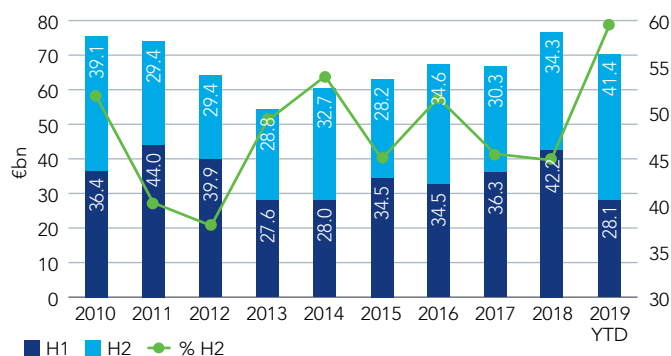


Structured securities

The ABS market is booming, while the number of European CLO managers has reached a record level. Is consolidation likely?

The European ABS market finished the year with robust issuance volume and spreads. With practically no new issues in the first quarter, it seemed the market spent the rest of the year catching up and the final six months recorded the highest H2 supply in absolute terms and as a share of total supply (see figure 19).

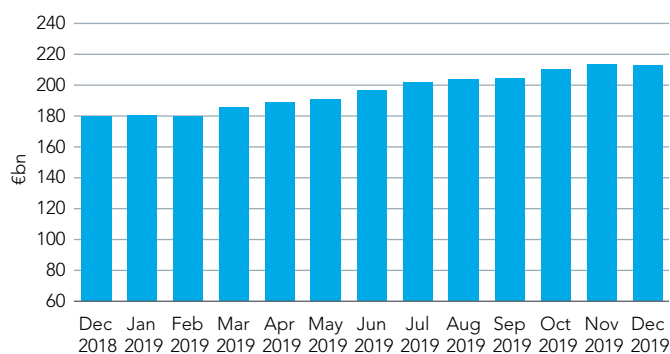
Figure 19. European ABS issuance



Source: JP Morgan, as at January 2020.

Issuance of European CLOs also hit record levels, beating the last post-crisis record, which was seen in 2018. There are also currently more managers in the European CLO market than at any time before – which indicates considerable growth since the market reopened in 2013. While this presents investors with more choice of manager style, investment philosophy and process, it does mean there are more managers chasing a still-limited number of opportunities.

Figure 20. European Leveraged Loan Index, par amount



Source: LCD, as at January 2020.

Looking forward to the rest of this year, there should certainly be less regulatory uncertainty than in 2019. Given this and all other things being equal, it is reasonable to assume there will be a robust new-issue pipeline in European structured credit.

Most investment-bank research teams forecast ABS issuance volumes to be roughly in line or slightly higher than in 2019. The range of issuers is key and new names come to securitise every year. With the more common platforms finding alternative sources of funding, the landscape continues to evolve.

Meanwhile, this year could see a contraction in CLO new-issue volumes. More importantly, with a greater number of managers – and more with smaller platforms – the market may become ripe for consolidation.



Private credit

Some lenders are accepting demands from sponsors for increasingly aggressive leverage. Given loan defaults are rising in Europe, this could create a perilous precedent.

Refinancings and recapitalisations have increased in recent months, as some private-equity sponsors choose to hold portfolio companies for longer and use debt markets to partially realise value instead of undertaking a full-sale exit. This is because these sponsors are struggling to reach the multiples they need to meet their target returns, given the high multiples they paid on entry.

This has led to more dividend recapitalisation loans, along with demand from sponsors for lenders to provide more aggressive leverage. At a time when segments of the European economy are stagnating and loan defaults are on the rise, this creates a dangerous situation for lenders.

And while banks have been far more disciplined with lending, unitranche lenders that need to deploy capital, and which target higher returns, are increasingly accepting these aggressive demands. This has resulted in more aggressive EBITDA add-backs in unitranche loans, which are used as a way to increase leverage levels in loans.

The most aggressive loan structures have been in the upper mid-market in Germany and France, and more recently the UK. Value therefore remains in the lower mid-market, which has proved far less competitive.

The popularity of the upper mid-market is due to the fact that funds have to provide large loans in order to deploy capital, meaning they need to lend to more sizeable companies. These firms also tend to have access to capital markets, and therefore use this competitive leverage to drive down lender protections.

The German lower mid-market shows considerable value. It is often overlooked by the larger funds due to its strong links with the banking sector, which makes loan origination difficult. However, yields are stable and lender-protection rights remain good. While the Scandinavian market has been quieter in recent months, it remains an interesting market with strong yields and conservative loan structures.

Asset-based lending

The UK has a new Conservative government with a historic majority and the long-awaited Brexit withdrawal agreement has been passed. As a result, UK real estate comes into focus this year.

The real-estate lending market suffered from Brexit-related uncertainty in 2019, as lenders crowded into the vanilla parts of the market and compressed margins. Although a cliff-edge exit has been avoided for now, much-needed clarity about the UK's future trading relationship with the European Union has yet to materialise.

This continued uncertainty hampers the medium-term underwriting of real-estate loans. The European market doesn't suffer from Brexit to the same extent, but low rates have raised asset prices to unprecedented levels. Lenders are speaking more and more of 'end-of-cycle' market characteristics, indicating a reluctance to take on risk.

Low transaction volumes last year were predominantly attributable to Brexit. The considerable amount of dry powder in private-equity real-estate funds suggests that this capital will now seek deployment in 2020. For lenders, that means there may be an uptick in transactions – both acquisitions and

refinancings – in the near term. However, in the absence of any government stimulus and concrete trade proposals, we see potential for market value to decline in some of the underlying real-estate markets.

During the UK general election campaign there was talk of a Conservative government cutting business rates, which would provide the UK's shopping-centre market a much-needed shot in the arm. In our view, these reforms are pretty low on the government's priority list. The European shopping-centre market has not suffered as much as that of the UK, but identical pressures apply. This sector must be approached with extreme caution.

Across Europe, loan pricing remains competitive for prime real estate, especially logistics and offices property. However, there is limited liquidity for debt against the retail sector. On an absolute-return basis, the UK continues to provide better value for senior loans.

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