360°

The road less travelled

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Federated Hermes International

www.hermes-investment.com
For professional investors only

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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

A second wave of coronavirus infections is sweeping the globe, corporate defaults are on the rise and recovery rates are well below their historical average. Meanwhile, there are risks surrounding the transition of power following the US election and the spectre of a no-deal Brexit seems increasingly likely.

At times, it feels that few share my view of markets. It is during these periods that I feel it is most important to call out herd behaviour – something that tends to increase during episodes of mass fear. To paraphrase Roman emperor and Stoic philosopher Marcus Aurelius, I firmly believe that the object of life is not to be on the side of the majority but to escape finding oneself in the ranks of the deluded.

This phenomenon is clear in today's atmosphere of unprecedented uncertainty. The relationship between growth and value is undoubtedly stretched and some valuations appear to be in – or are heading towards – bubble territory.

Meanwhile, central banks are manipulating markets with injections of liquidity in the hope that they will support demand and confidence (and eventually inflation). By accident or design, their actions are dampening volatility – and make determining the immediate direction of travel very difficult. The one thing I am certain about is that volatility will be higher over the medium and long term, while most asset classes will likely offer lower returns.

Looking to our relative-value rankings across credit classes, the changes do not appear particularly revolutionary this quarter. Most assets sold off and then recovered, and it is the relationship between the sub-asset classes and their long-term average that probably explains the current ranking – something I find frustrating, given that I do not believe in mean reversion.

On the whole, we favour assets that have performed worse than comparable securities but which do not pose a high risk of loss. Banks and certain structured-credit instruments are the best examples of this, although there is also major dispersion at this sub-asset-class level. This means that our analysts play a particularly important role in generating alpha through granular, bottom-up security selection.

While I remain on the fence when it comes to my overall risk appetite – we aim to take on a moderate degree of risk on a net basis through active and dynamic long positions, while still seeking tail hedges – there are other ways in which we are escaping the ranks of the herd. In particular, we:

- Favour European credit, despite underperformance in the region and a spate of defaults.
- See value in US and European financials.
- Emphasise the need for detailed credit analysis and high-touch execution.
- Are vigilant in our medium to long-term assumptions. Although central-bank activity appears almost unlimited in scale, it is unlikely to be in tenor.
- Look for opportunities to exploit the illiquidity premium, but not at the expense of conservative underwriting.
- Seek to move the sustainable-finance conversation forward and consider the impact of new instruments like sustainability-linked bonds.

To ascertain our forward-looking risk appetite, we closely watch credit-market technicals. There is no doubt that the technical environment is an excellent one for credit – and that this is unlikely to change over the short-to-medium term. There is little-to-no yield to be found in developed-market sovereign debt, equity income is challenged and credit spreads remain wider than their historical averages, despite the influx of central-bank liquidity. We have a less positive view on fundamentals, which in some respects are weaker than they have been for a decade.

One looming risk is the dominance of passive investing. Passive funds – by their design – will suffer all the defaults recorded by the market, as well as the downgrades and index changes. Losses, underperformance or even the perception of risk could precipitate outflows from passive funds, which could dampen liquidity at a time when it is most needed. While our approach is active and dynamic, we are keeping a watchful eye on a potential change in technicals (although for now, we believe they will remain positive).

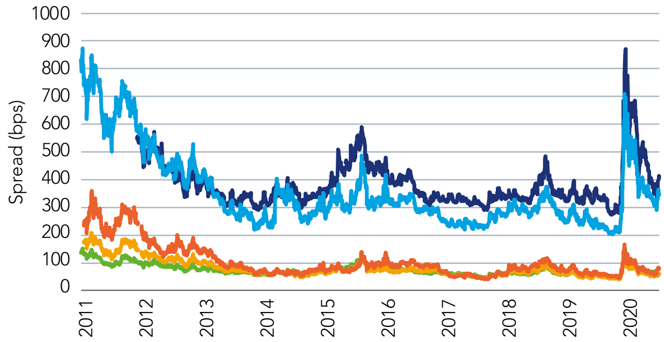
In closing, our risk appetite is moderately cautious and our focus over the next quarter will be the transition of power in the White House, Brexit negotiations and credit-market technicals. We remain positive about our ability to generate alpha in the current environment and think that credit is attractive compared to other asset classes. Going forward, we will take an active, conservative approach to credit investing that uses detailed, bottom-up analysis – something we believe will help us seek out the opportunities that are so often overlooked by the ranks of the deluded.

Relative value

Credit spreads have normalised since March but there is considerable dispersion beneath the surface, meaning that active, bottom-up security selection is the key to identifying pockets of value.

Public credit spreads have recovered since March, as central banks rushed to the rescue and economies emerged from lockdown (see figure 1). Investment-grade credit spreads – which led the recovery – are now below their five-year average, while US and European high-yield spreads are a respective 7% and 15% wider. Nonetheless, the spreads of all the main indices are above where they were in February (see figure 2).

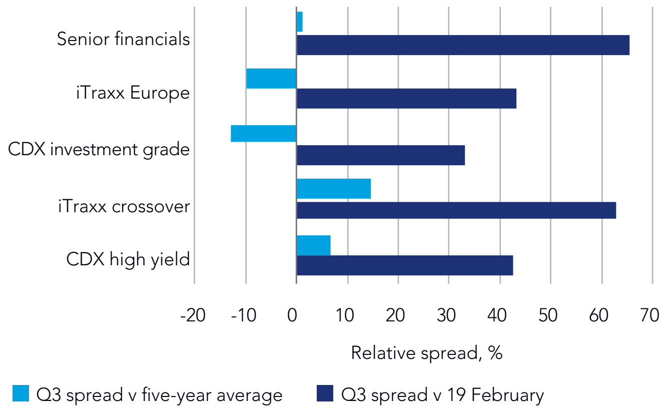
Figure 1. Spreads on credit-default swap indices



Spreads on credit-default swap indices, five year:
— CDX high yield (LHS) — iTraxx crossover (LHS) — CDX investment grade (RHS)
— iTraxx Europe (RHS) — Senior financials (RHS)

Source: Federated Hermes, Bloomberg, as at 30 September 2020.

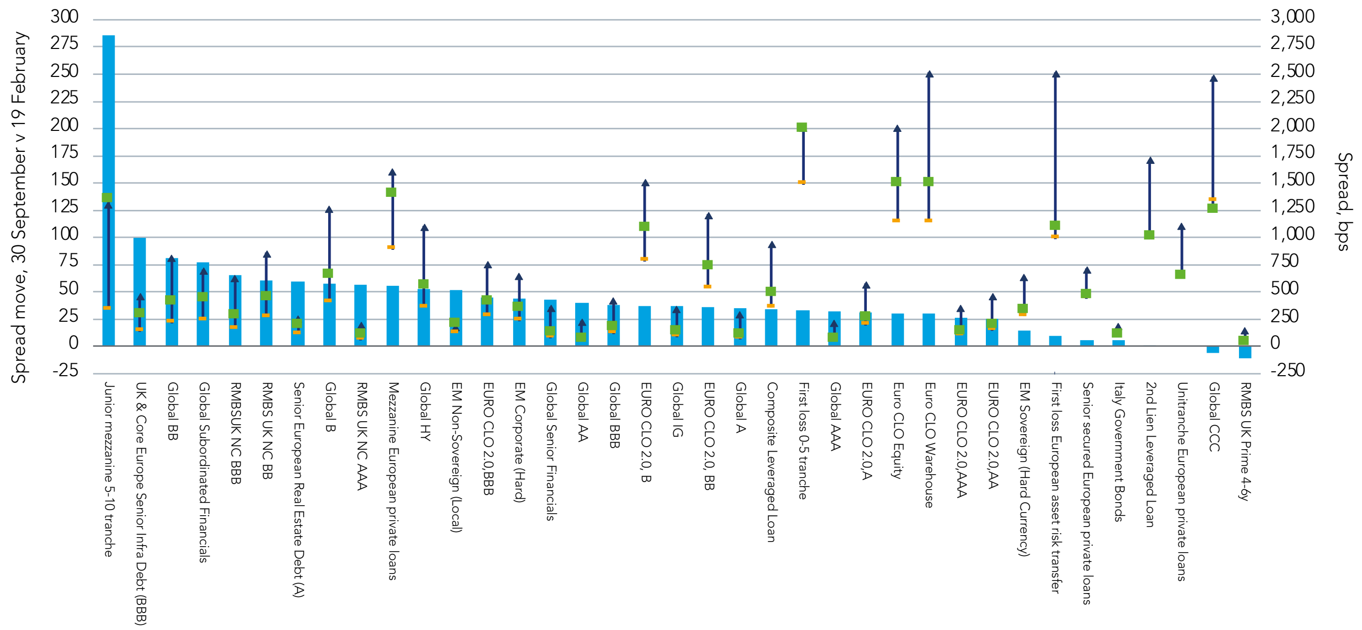
Figure 2. Credit spreads: a relative perspective



Source: Federated Hermes, Bloomberg, as at 30 September 2020.

The trend is similar across private and structured-credit markets. Spreads across the multi-asset credit spectrum have recovered but remain 25%-30% wider than in February, although there are some exceptions (see figure 3). UK prime residential mortgage-backed securities (RMBS) are tighter, as are CCC-rated corporates (although this is because higher-spread names have defaulted and exited the index).

Figure 3. Multi-asset credit: changes in spreads



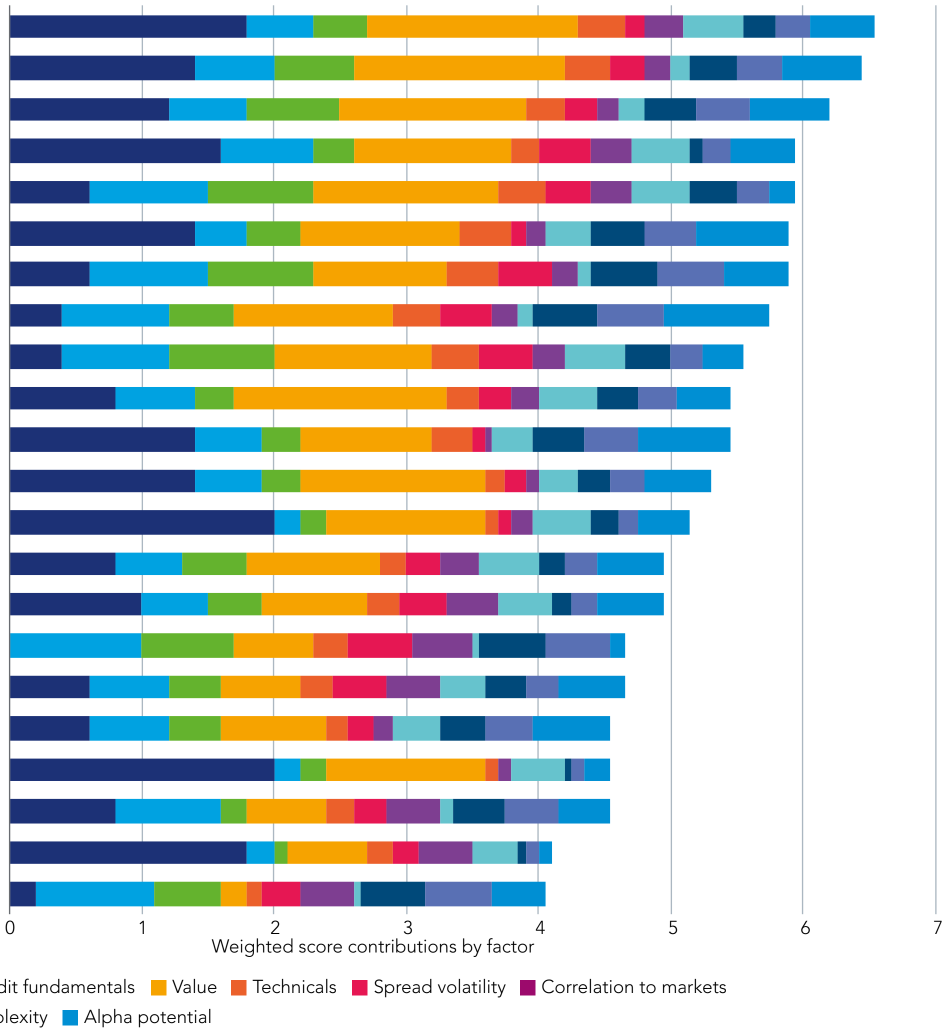
■ Relative spread move, 30 September v 19 February, % (LHS) ▲ 23 March spread, bps (RHS) ‒ 19 February spread, bps (RHS) ■ 30 September spread, bps (RHS)

Source: Federated Hermes, Bloomberg, Citi, as at 30 September 2020.

Deriving relative value from the mean reversion patterns of broad exposures is less meaningful in the current environment, as it ignores dispersion at the company or transaction level. The broader rankings also do not capture the difference in fundamentals between individual issuers or securities. For this reason, our latest Multi Asset Credit relative value framework should simply be viewed as a high-level guide to moves between the top-ranked credit classes (see figure 4). Compared to the previous two quarters, the changes in Q3 were relatively muted.

Figure 4. Multi Asset Credit relative value framework

Q3	▲	Q2	
1	▲	2	Europe CLO mezzanine
2	▼	1	EM credit
3	▲	4	Hybrids
4	▲	5	Direct SME lending
5	▲	8	Europe CLO senior
6	▲	7	Subordinated financials
7	▼	3	Senior financials
8	▼	6	Investment grade
9	▲	10	Europe ABS senior
10	▲	11	Syndicated leveraged loans
11	▼	9	High yield
12	▲	14	Mezzanine tranche
13	▲	15	Europe CLO equity
14	▼	12	Europe ABS mezzanine
15	▲	17	R.E. debt
16	▲	18	Money market
16	▲	18	Trade finance
18	▼	12	Convertibles
18	▲	20	First loss tranche
18	▼	16	EM government bonds
21	▲	22	Risk transfer
22	▼	21	Developed government bonds

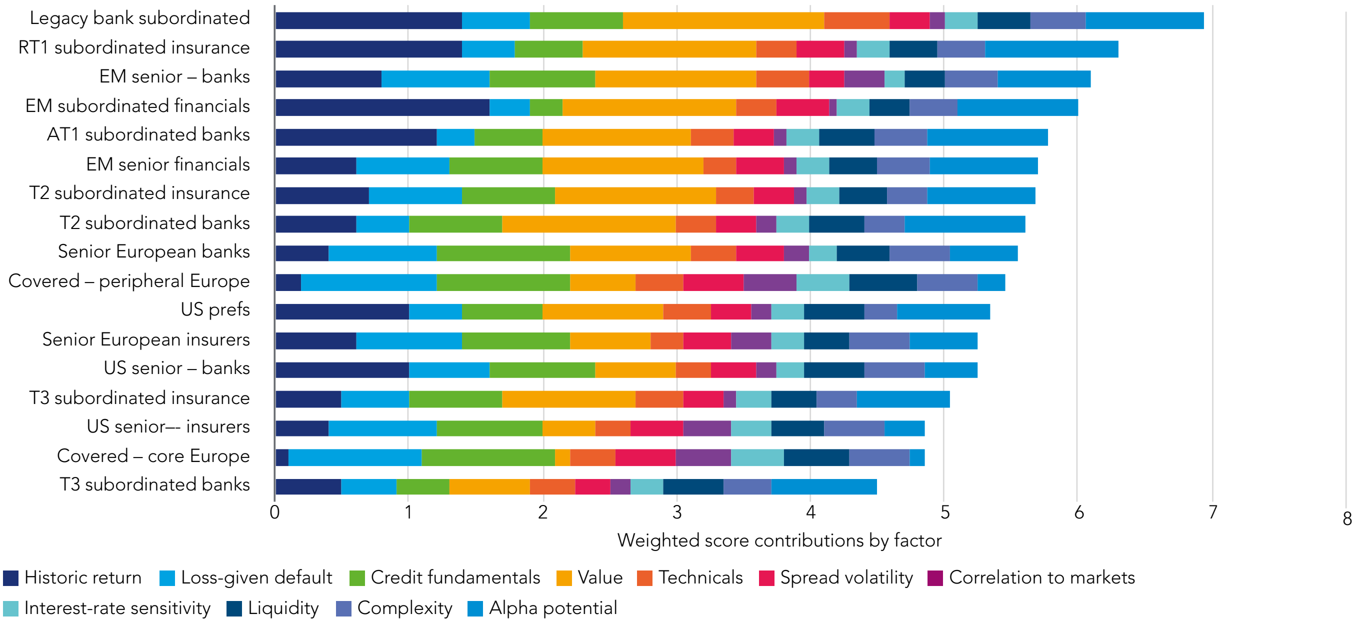


Source: Federated Hermes, as at 30 September 2020.

As figure 5 shows, our broader framework is an aggregation of underlying exposures. Given the volatility-induced dispersion seen in markets, these exposures do not necessarily reflect the overall high-level rankings. For example, a closer look at financials indicates that legacy-bank subordinated securities top the rankings, while emerging-market senior banks are higher than emerging-market subordinated financials – something that is not consistent with the broader rankings.

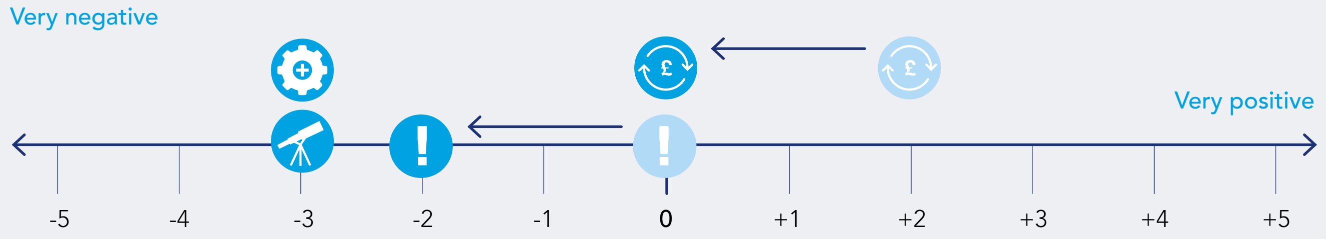
In the current environment, there is clearly a need to look beyond high-level rankings and build portfolios around idiosyncratic stories with robust fundamentals. Nonetheless, the rankings do allow us to focus our research efforts in order to identify the best bottom-up ideas and attractive investment opportunities. Given the level of uncertainty facing markets, combining these best-selection ideas with options that add convexity should help protect against another possible widening in spreads.

Figure 5. Financials



Source: Federated Hermes, as at 30 September 2020.

Q4 2020 score card



Economic outlook

- **Remain at -3**

Increasing pandemic-related restrictions offset the improvement in economic data.

Credit fundamentals

- **Remain at -3**

Fundamentals have not worsened as much as expected, but future earnings remain uncertain as coronavirus-related restrictions are on the rise again.

Valuations and technicals

- **Moved to 0 from +2**

Although technicals remain supportive, valuations are not as attractive as they were in June.

Tail risks

Moved to -2 from 0

The recovery in asset prices looks vulnerable to the material risks on the horizon.

- Rising coronavirus infection rates have increased the possibility of further lockdowns. These could reverse the economic recovery and remain a risk until a vaccine is developed.
- Although Joe Biden has won the US presidential election, President Trump has not conceded. Pending legal challenges mean the route the transition will take remains uncertain.
- Brexit means that the future trading relationship between the UK and eurozone is unclear.
- The world is reliant on continued OPEC+ production cuts to support prices, while demand remains subdued.

Contents

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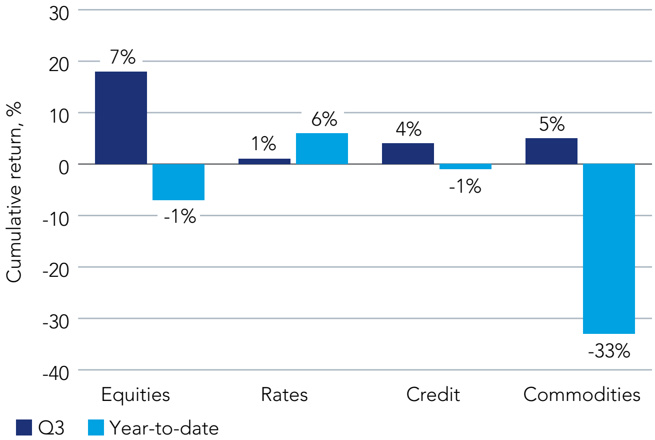
Multi asset

As markets make up the losses recorded earlier this year, we use a range of models to make sense of the moves and to ascertain which asset classes are attractive in the current environment

Only rates[1] have posted a positive return year-to-date, as equity and credit indices remain flat and commodities have declined by 33% (see figure 6). Equities performed the best over the last quarter, followed closely by commodities and credit.

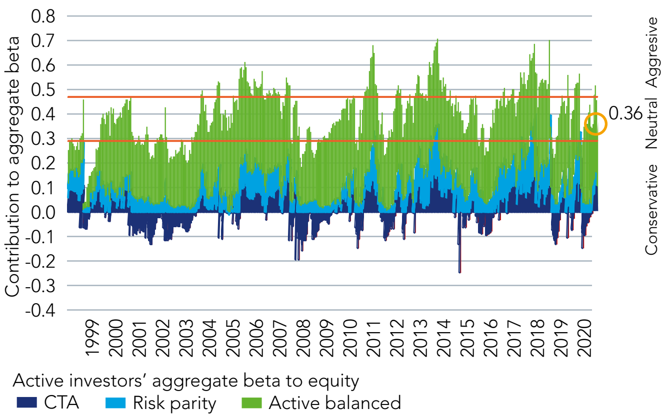
Figure 6. Asset class performance



Source: Bloomberg, Federated Hermes, as at September 2020.

Looking at the positioning of active funds, the aggregate beta to the MSCI world (measured across active investors like commodity-trading advisers, risk parity and mutual funds) is currently at 0.36, which indicates a neutral positioning. The aggregate beta moved into aggressive territory in August but soon returned to neutral after the market recorded a minor correction in September (see figure 7).

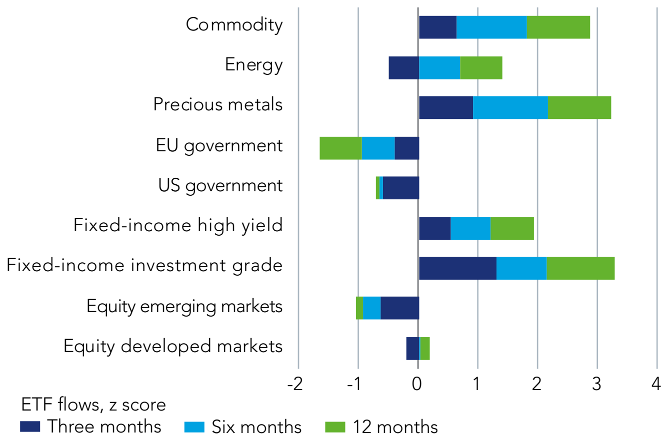
Figure 7. Active investors' aggregate beta to equity



Source: Bloomberg, Federated Hermes, as at September 2020.

There have been consistent and relatively strong flows into investment-grade and high-yield exchange-traded funds (ETFs) over the past three months. Precious metals have also recorded sustained flows, while equity emerging markets, US government bonds and energy have experienced outflows above their historical z scores (see figure 8).

Figure 8. ETF flows

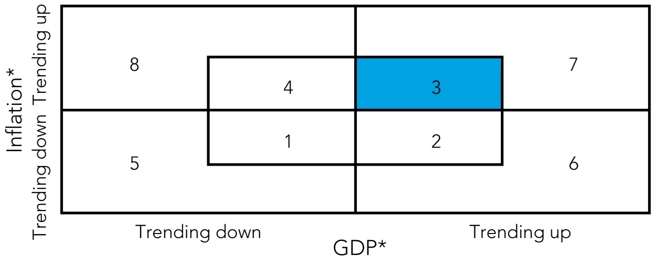


Source: Bloomberg, Federated Hermes, as at September 2020.

Over the medium-term, we use economic-scenario analysis to determine the direction in which the global economy is expected to head, before identifying the best investments for that scenario. Since the end of September, the global economy has moved to quadrant three, where both expected GDP and inflation are trending up moderately. The best assets to allocate to in this scenario are credit and equities (see figure 9).

[1] Predominantly developed-market government bonds.

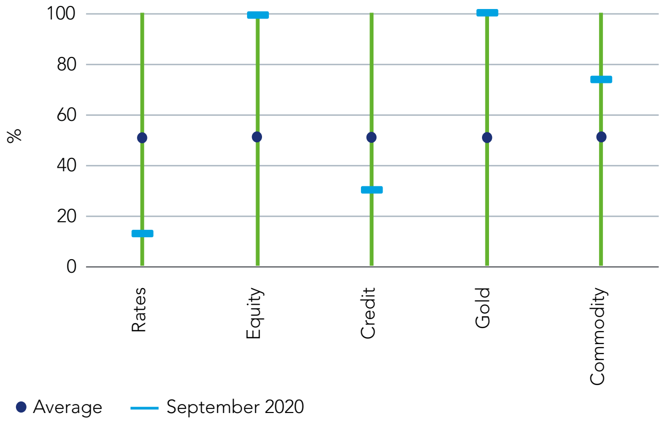
Figure 9. Economic scenario quadrant



	Q3 top 10	Q3 bottom 10
1	CDX IG	EU credit quality
2	Commodity carry	US credit quality
3	US 7-10 year TIPS	S&P consumer staples spd
4	CDX HY	MSCI DM – MSCI EM
5	iTraxx Crossover	CDX HY – iTraxx Crossover
6	CSI 300	Long USD, short EUR carry index
7	S&P/ASX 200	Coffee
8	iTraxx Europe	Long USD, short AUD carry index
9	OBX	Long USD, short NOK carry index
10	S&P/TSX	S&P utilities spd

Source: Bloomberg. Federated Hermes, as at September 2020. Based on Bloomberg pooled economists' one-year forward forecasts for both GDP growth and inflation. These forecasts are then compared to their respective six-, nine- and 12-month averages to determine the current trend. These trends are then bucketed into eight quadrants: for example, GDP trend is the current GDP minus the average. The split between the inner and outer quadrants is determined by the mid-point between the average and the maximum/minimum on each axis. The data period starts from 1956 while the expected asset returns are annualised and are estimated based on a conditional two-factor regression analysis.

Figure 10. Multi-asset model positioning



Source: Federated Hermes, as at September 2020.

We also use our own multi-asset positioning tool to identify the best investment opportunities for the final quarter of this year. This incorporates three sub-models: momentum (short-term price trends), excess money growth (excess liquidity) and value (forward-looking valuations).

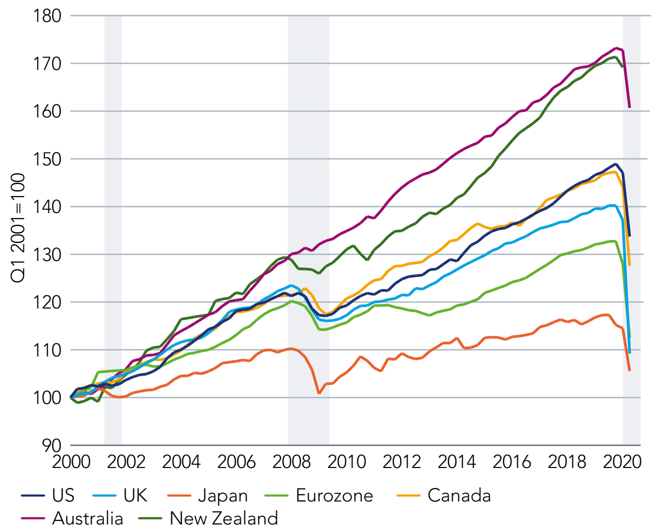
The model suggests that we should take a significant overweight position in equities and gold and a large underweight in rates (see figure 10). Our momentum and excess-money-growth models have an overweight position for credit, but the asset class remains expensive relative to equities and its value score has pushed it to a slight underweight position.

Economic outlook

As equity markets are propelled forward by yet more stimulus and ever-lower yields, policy should remain loose as concerns about debt are swept under the carpet.

The strong recovery in equity markets appears more driven by record amounts of fiscal stimulus, ultra-low bond yields and the prospect of even easier money, rather than any convincing signs that economies are returning to normal. Economic data points may have become less gloomy, but this was a low hurdle to clear after the second quarter wiped out years of economic growth (see figure 11).

Figure 11. Real GDP: a turn for the worse



Source: Refinitiv Datastream, based on national economies, as at October 2020.

The outcome depends on more than just finance. The implicit assumption of analysts that the virus is nearing its peak is dependent on a vaccine, which explains why expectations of a v-shaped recovery have morphed into something that more closely resembles a 'u' or a 'w'.

As a result, policy will stay abnormally loose. Central banks, long frustrated by the lack of inflation, are starting to question traditional reaction functions like consumer-price inflation targets and Phillips Curves, which means that mandates could change. Recent shifts – the Federal Reserve's (Fed's) move from fixed to average inflation targeting, the Bank of Japan's adoption of an explicit yield target and the Bank of England's (BoE's) potential use of quantitative tightening before eventually raising the bank rate – could all herald more paradigm shifts.

None of these actions would meaningfully tighten conditions and we estimate that the Fed and BoE will continue to run negative policy rates when taking QE into consideration (they are currently at a respective -10% and -6%). This is the loosest stance on record for either country and suggests there will be limited correction in 2021 – and that there is little need to adopt negative headline rates.

The legacy of this will be a build-up of government debt, which was amassing even before the pandemic emerged. The US, eurozone and UK's net debt as a share of GDP is approaching that of Japan's when it entered its so-called lost decade in the 1990s (see figure 12). Thankfully, this debt is denominated in local currency, which implies that the default risk is close to zero.

Figure 12. Government gross and net liabilities as a share of GDP

	Moody's rating, local currency	1997 Gross	1997 Net	2019 Gross	2019 Net	2020[1] Gross		2021[1] Gross	
						Single hit	Double hit	Single hit	Double hit
US	Aaa	62	44	109	85	129	132	133	140
Japan	A1	102	34	225	126	244	248	248	257
Eurozone	n/a	81	51	104	63	121	125[2]	120	127[2]
UK	Aa2	55	33	116	80	138	143	136	149
Greece	B1	96	70	201	141	221	233	215	229
Italy	Baa3	129	101	156	122	181	195	178	192
Iceland	A2	47[3]	17[3]	63	6	73	73	77	79
Ireland	A2	61[3]	41[3]	72	44	85	87	88	96
Latvia	A3	53[4]	n/a	44	17	51	53	52	58
OECD average		72	41	110	66	127	131	129	137

Source: OECD projections/simulations[1], Federated Hermes extrapolations[2], Moody's investor services, as at October 2020. Single and double hit refer to two virus scenarios. Data refers to 1998[3] and 2000[4].

This means that governments can prioritise growth and inflation over debt reduction – much as the UK did after the Second World War, when net debt came to 250% of GDP. This time, the UK does not have to fund the dollar-denominated obligations that forced it to borrow from the International Monetary Fund in 1976.

Yet governments cannot afford to be complacent. Debt could act as a drag on growth, while the kindness of strangers will hinge on yield and ratings considerations. In order not to crowd out the recovery, funding costs will need to be kept down – adding to the political incentives to keep the printing presses running. Even if growth is preserved, competing demands may relegate infrastructure and green initiatives down the priority list, while debt ownership raises political tensions in many emerging markets.

This suggests that QE will be even harder to abandon and could potentially further widen disparities and blur the operational distinction between monetary and fiscal authorities. The question is whether hyperinflation beckons, or if ultra-low rates and QE push us towards a Japan-type situation (a more likely scenario, we suspect). Given that either option involves malfunctioning economies, it seems increasingly likely that policymakers will trip up at some point if they continue to ignore the fast-growing debt pile.

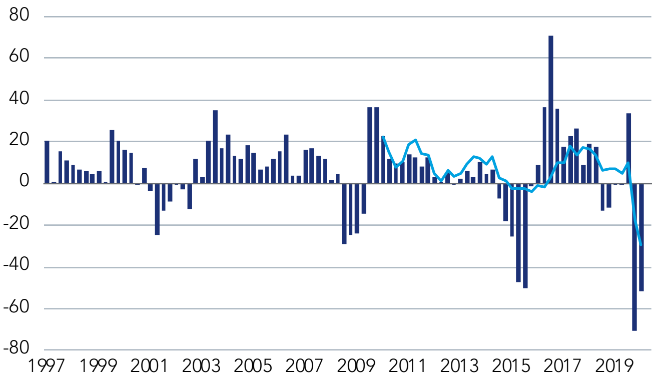
Fundamentals

A decline in ratings downgrades suggests that credit fundamentals have held up better than expected. Yet profits remain under pressure, while leverage and default rates are elevated.

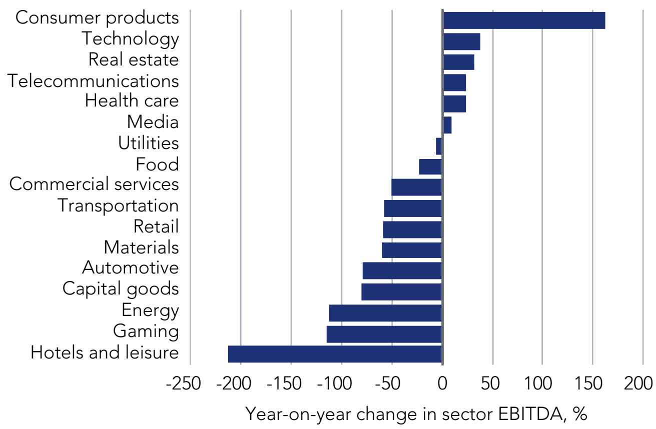
Although September was the first month since April when credit-market returns were negative, the third quarter was a positive one on the whole as economies continued to recover from post-lockdown lows. Yet there are signs that a two-speed economy is emerging in Europe: while manufacturing is growing, the services sector is struggling from a second wave of coronavirus infections.

High-yield companies recorded a particularly acute decline in earnings during the crisis and US high-yield EBITDA is down 51% year-on-year (see figure 13). This is worse than the fall for investment-grade firms and reflects the narrow revenue focus of high-yield issuers. Unsurprisingly, sectors exposed to the services industry – hotels, leisure and gaming – were the worst affected, along with energy.

Figure 13. Profits take a tumble



■ High yield EBITDAs, year-on-year percentage change
– Adjusted EBITDA growth



Source: Federated Hermes, Bank of America Merrill Lynch, as at 30 June 2020.

Leverage has also risen. The net-debt-to-EBITDA ratio in the US for the median investment-grade company was at its highest level in nearly two decades at the end of Q2, while in high yield it was slightly below the peak recorded in 2016. Overall, US high-yield leverage rose by 1.2x quarter-on-quarter to 6.7x.

While net margins and revenue growth have contracted sharply this year, US firms performed better than their European counterparts. The plunge in profitability and revenue was behind the deterioration in net-debt-to-EBITDA and coverage ratios in both the US and Europe. The difference lies in the fact that European net margins have been flat for a decade, while US firms went into the crisis with profits at the higher end of the range recorded over the last 20 years.

Turning to balance sheets, the cash-to-EBITDA ratio has almost doubled in the US this year and increased by 41 percentage points to 110% in Europe. This compares favourably to the aftermath of the global financial crisis, when the ratio jumped from 45%-60% in Europe.

This rise suggests that non-financial firms took advantage of wide-open debt-capital markets to meaningfully strengthen their liquidity positions. Amid the surge of central-bank stimulus, the average interest expense for high-yield issuers has actually declined.

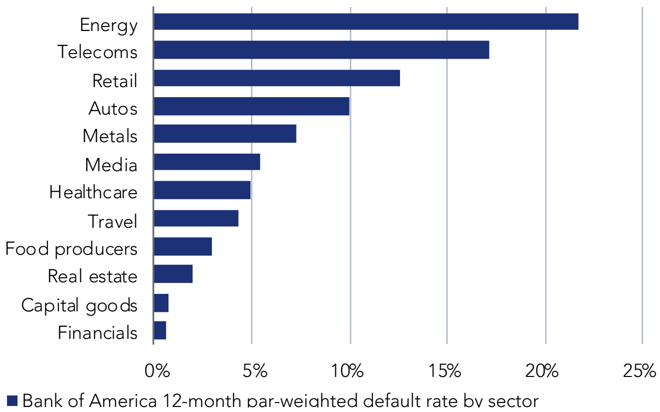
It is clear that credit fundamentals have been less affected than some anticipated, which is shown by the decline in ratings-agency downgrades. This followed a raft of fallen angels – or issuers downgraded to high-yield status – emerging in the first half of the year. It also appears that ratings agencies are more willing to emphasise balance-sheet liquidity positions relative to other cycles. While the year-to-date total of European fallen angels stands at the highest level since 2012, the value for August was the lowest since the start of the crisis.

Looking ahead, the amount of mid- and low-BBB-rated bonds on active review for downgrade in the USD market has declined to more normal levels. However, the amount of similarly rated debt with a more benign – but still cautionary – negative outlook remains very high and in excess of $940bn.

The number of defaults year-to-date remains elevated and comes to a total of $123.4bn (including distressed exchanges) which is the second highest on record. US default activity increased in September from a modest August, although it did not approach the heightened levels recorded in March and July.

The US high-yield default rate stands at 6.36%, although this declines to 4.33% if the energy sector is excluded. The sector was affected by the oil-price crash earlier this year and accounts for 29% of the 92 default actions this year.

Figure 14. In trouble: default rates by sector



Source: Federated Hermes, Bank of America Merrill Lynch, as at 30 September 2020.

Recovery rates for high-yield bonds and institutional loans also remain near record lows. High-yield bond recoveries average 15.3% over the last twelve months, 25.1 percentage points below the 25-year annual average, while energy recoveries are only 10.2%.

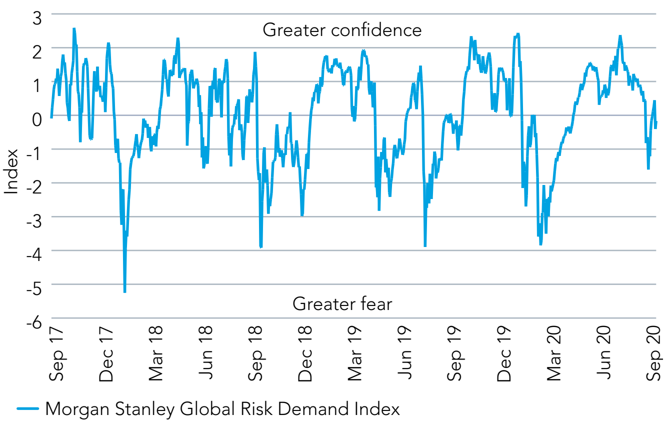
Looking to Europe, September was the heaviest month for defaults this year as three more issuers and €2.2bn-worth of bonds were added to the tally. These restructurings increase the trailing 12-month default rate from 1.1% at the end of April to 2.9% in September.

Valuations and technicals

While the tail events on the horizon mean that sentiment has soured, investors in search of yield continue to look to credit.

Sentiment has slightly deteriorated since our last report in early Q3, given higher event risk and the deterioration of certain macroeconomic data in the past few months. The market has taken stock and revised its expectations about the speed of the recovery accordingly. Looking forward, the final quarter of this unprecedented year presents several event risks: the transition of power in the White House, further Brexit negotiations and efforts to suppress the coronavirus pandemic throughout the northern-hemisphere flu season.

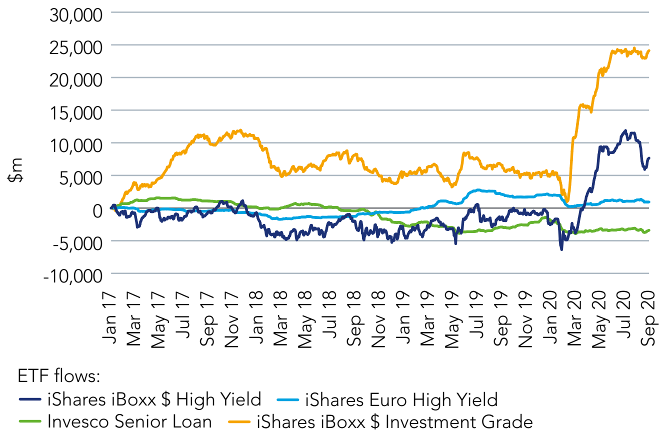
Figure 15. Sentiment slumped in August and September



Source: Federated Hermes, Morgan Stanley, as at September 2020

Inflows into investment-grade markets remained more resilient as asset allocators continue to target the spreads available in corporate credit. High-yield markets suffered outflows in the past two months given the weaker macroeconomic momentum and implications for highly leveraged companies. Meanwhile, central banks' continued suppression of interest rates is dampening demand for leveraged loans.

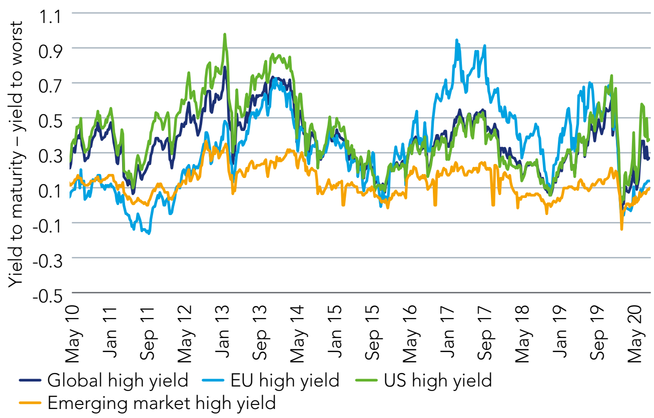
Figure 16. All eyes on investment-grade credit



Source: Federated Hermes, Bloomberg, as at September 2020

This trend in flows has undoubtedly created value in parts of the high-yield market as spreads in the sector trade at multi-year wides relative to the investment-grade market. This is partly driven by increased central-bank support for the investment-grade space and the necessity for selective, bottom-up investment within high yield given the macroeconomic headwinds. This makes its a challenging, yet potentially strongly rewarding time for high-yield credit pickers.

Figure 17. Spread differentials across the high-yield universe



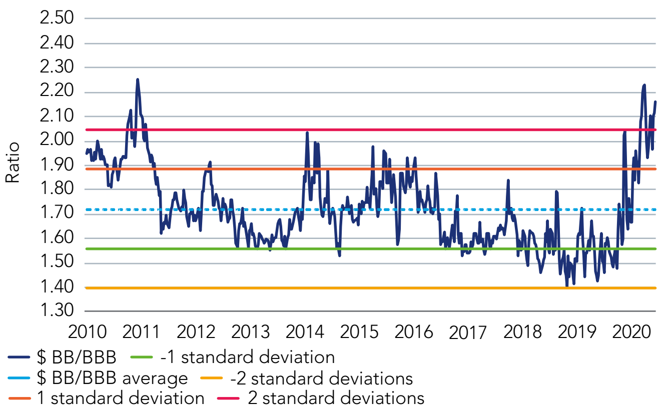
Source: Federated Hermes, ICE Bond Indices, as at September 2020.

Public credit

High-yield credit has underperformed investment grade, leaving BB-rated securities looking cheap.

Looking at credit ratings, the underperformance of BB-rated securities against both BBBs and Bs has been the most interesting development over the past few months. There is a logical explanation: the descent of fallen angels this year has made the BB market more cyclical and strong demand among spread-seeking investors for BBB paper, underpinned by solid central bank support for funding markets, is driving this anomalous situation.

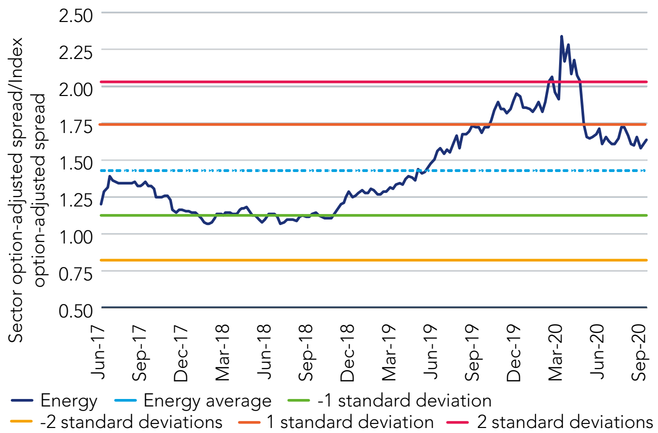
Figure 18. The spread differential between BB and BBB credit is well above trend



Source: Federated Hermes, ICE bond Indices, as at 30 September 2020.

Valuations in the energy sector have contracted significantly from the wide spreads experienced during the March sell-off. The sector currently trades closer to its average versus the index, but it is important to note that defaults and the exit of fallen angels have helped increase the average quality of issuers within it. This change in valuations, combined with the fundamental environment for the energy sector, makes it less attractive to us now.

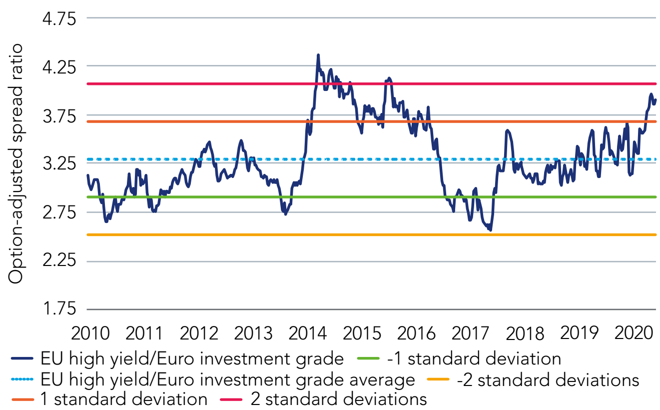
Figure 19. Powering down: valuations in the energy sector



Source: Federated Hermes, ICE bond Indices, as at 30 September 2020

Investors' focus on generating returns by moving down the quality and liquidity spectrum, while avoiding higher default risk, has caused the high-yield market to underperform investment grade in Europe. On an option-adjusted spread basis, the relationship is nearing the level reached during the European sovereign-debt crisis. This suggests that investors are cautious about the fundamental outlook for lower-rated companies.

Figure 20. Risk aversion is on the rise in Europe



Source: Federated Hermes, ICE bond Indices, as at 30 September 2020

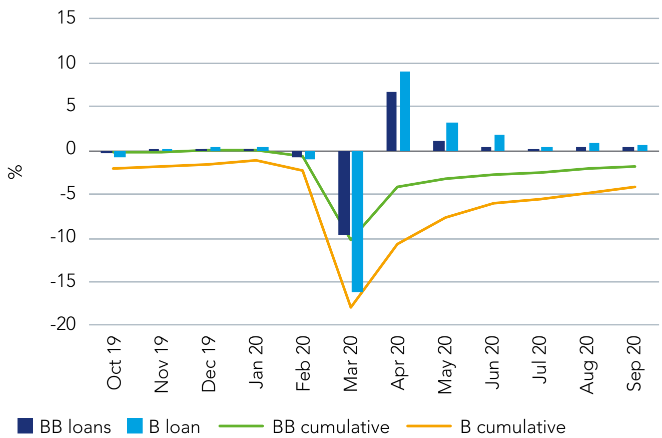
Leveraged loans

B-rated paper concentration has made the leveraged-loan index more volatile.

Loans reported volatility of 5.23% in the 12 months to September, compared to 4.61% for the high-yield market and 5.41% for equities. The European leveraged-loan market has lagged high yield both year to date and over the third quarter, returning 1.67% in Q3 compared to 2.61% for junk bonds.

This can be explained in part by the fact that B-rated paper makes up a higher share of the S&P European Leveraged Loan Index (ELLI) than the high-yield index, constituting 74.48% of the former and 20.73% of the latter. The BB-rated section of the ELLI has significantly outperformed the B-rated segment and has fallen by 1.81% since the start to the year, compared to a 4.2% decline for the lower-rated loans (see figure 21).

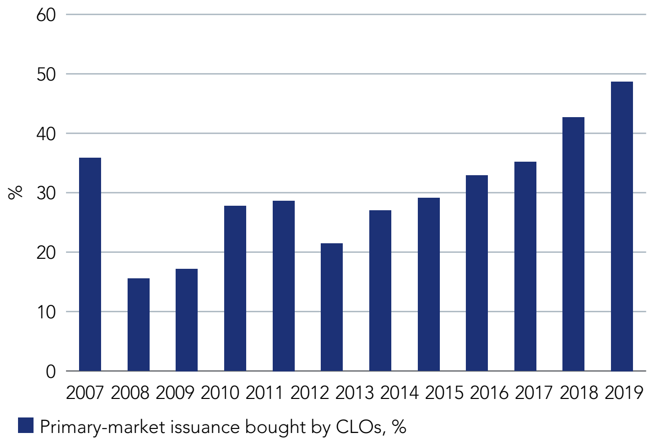
Figure 21. Leveraged-loan performance by credit rating



Source: LCD, as at October 2020.

The share of primary market issuance bought by collateralised-loan obligations (CLOs) has grown from 21.4% in 2013 to 48.7% at the end of last year (see figure 22). During buoyant periods, CLO vehicles tend to be conservative and adopt a buy-and-hold strategy by limiting trading and supporting stability in the market.

Figure 22. CLO presence in the primary market ticks up



Source: LCD Research, as at October 2020.

By contrast, the recent crisis forced CLO managers to exit, buy or switch their holdings in order to respect the limits imposed by CLO documentation. As a result, trading increased and supported the decline in the S&P ELLI.

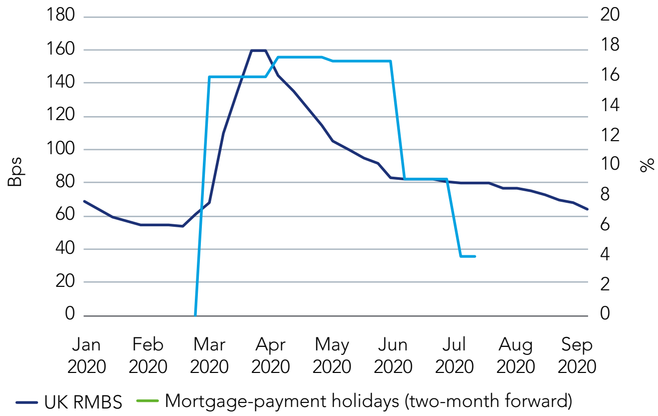
Structured credit

Since the pandemic erupted, structured-credit investors have focused on one fundamental driver: the ability of issuers to repay and service their debt.

Conditions over the past six months have been difficult, yet credit fundamentals have not weakened as much as some predicted. Mortgage-payment holidays (MPHs) are one example of this. While requirements across countries varied, UK mortgage lenders were instructed to give anyone who requested one a holiday. At their peak, UK MPHs accounted for one in every six mortgages.

While this suggests that 17% of borrowers were in financial difficulty, this was not the case. The number of MPHs has declined since its peak and evidence suggests that many took holidays out of prudence. Anticipating the decline in MPHs, spreads for UK residential-mortgage-back securities (RMBS) have tightened as structures coped with the missed payments from borrowers (see figure 23).

Figure 23. RMBS spreads tighten

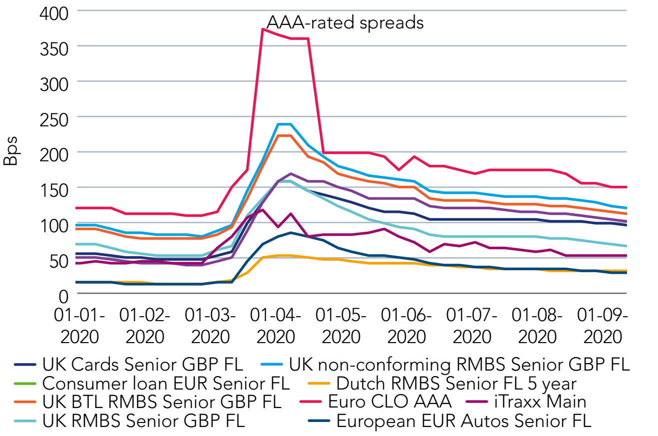


Source: JPM, Silverstone Master Issuesr, as at October 2020.

The threat that leveraged-loan downgrades and defaults would weigh on the performance of CLOs has also receded for the time being. Loan defaults in the US and Europe peaked at a respective 10.81% and 10.54% during the global financial crisis but now stand at a more modest 3.23% and 2.09%.

None of this stopped spreads rising in March, but the speed, coordination and extent of central-bank and government responses prevented an even worse economic fallout. This means that structured-credit spreads have tightened significantly from their widest points (see figure 24). While the pandemic poses an ongoing threat to spreads, a widening similar to that seen in March could be headed off by central-bank action, or the mere expectation of it.

Figure 24. Spreads: on a downwards trajectory



Source: JP Morgan, as at October 2020.

The fundamental performance of underlying asset-backed securities (ABS) or CLOs loans will likely suffer during a second wave of infections. This will weigh on credit fundamentals and put pressure on ABS and CLO stacks, which in turn will be reflected in pricing.

Supply and demand will also influence spreads. In Europe, central-bank support means that large amounts of core ABS supply from banks – and building societies in the UK – have been diverted away from the public securitisation market. Although a number of deals have come to the market since the summer lull from non-bank issuers, issuance volumes will likely be lower this year.

And while there is a decent pipeline of CLO new issues, these deals are from warehouses that were open before the pandemic erupted and so are being cleared out. We understand from the arranging banks that fewer warehouses have opened over the six months than on average, meaning that the potential for high levels of CLO issuance could be constrained.

Less supply in the face of continuing demand will also mean that spreads tighten – although this could be easily offset by any change in the fundamental outlook.

Private credit

The next few months will be vital in determining which small-and-medium enterprises (SMEs) can weather any further lockdowns and a drawdown in state support.

European private-credit market activity typically slows over the summer, a phenomenon that was heightened this year by coronavirus-related disruption. A resurgence in infections now risks disrupting the relatively robust pickup recorded in September, with the majority of new transactions centred around add-on facilities and refinancings. Nonetheless, pricing remained stable over the past quarter and is currently 25bps higher than pre-coronavirus levels for both senior secured and unitranche lending.

Unitranche funds are seeking to deploy capital but need to achieve yield targets and so are unable to compete on price. As a result, we have seen more aggressive loan structures offered – a continuation of the trend seen before the summer, when unitranche lenders became increasingly willing to dilute protection rights in return for yield and deployment. As unitranche lenders look to make themselves attractive to potential borrowers, we anticipate this trend to continue – particularly for non-cyclical companies.

Senior-secured lenders who lend at lower yields continue to be the main beneficiaries in the current market as they win market share from unitranche lenders. This is largely due to structural concerns with unitranche products, as well as the fact that most borrowers are non-cyclical corporates that are more interested in borrowing at lower yields than seeking flexible loan structures.

Defaults continue to rise and have started to affect the wider economy and not just consumer-spending businesses. Any further lockdown restrictions in Europe will accelerate this trend at a time when some governments are reducing safety nets for small-and-medium enterprises (SMEs). The next quarter will be crucial in determining whether SMEs will be able to weather the storm.

Overall, we favour senior-secured loans due to their conservative structures and significant equity buffers. While some view unitranche loans as senior-secured risk, they are less attractive given that they go deeper into the capital structure and have looser protection rights. Over the next few quarters, we believe that a focus on non-cyclical companies will be key to mitigating downside risks.

Asset-based lending

As the UK experiences a second wave of coronavirus infections, people are once more working from home and pubs and restaurants face new restrictions

While risks abound – the transition of power in the White House and Brexit, to name a few – there are also more positive developments to focus on. Despite varying levels of rent collection, borrowers are largely paying the interest on their loans in full. This has squeezed landlords and is causing some discomfort for the most highly geared property owners.

Governments continue to pump vast sums of money into the system, which will have a number of consequences. Interest rates will stay near zero for many years to come, while QE will be with us for the foreseeable future.

As a result, returns on real-estate lending look attractive. As an automatic reaction to the uncertainty, margins have modestly widened since the start of the pandemic – something that continued over the summer, with a number of financings that completed with higher margins than would have been the case before March. Part of this is because concerns about falling property values are being priced in. And while transaction volumes have picked up, not all lenders are chasing the same few deals.

Even excluding distressed-situation financing, lenders that can focus on new lending should find good value compared to the second quarter of this year. Senior lending on real estate aims to generate a decent positive return at any point of the cycle, but there is no doubt that the aftermath of a crisis tends to offer exceptional value – although we have not yet reached this point.

Both banks and non-bank lenders have accommodated borrowers who breached financial covenants. Only non-payments defaults have been taken seriously, but lenders will need to revalue the collateral that secures their loans and make provisions against any loan for which there is effectively no equity left.

Lenders almost universally vowed not to 'extend and pretend' in the aftermath of the financial crisis, arguing that breaches must be remedied, or enforcement would follow. But this crisis has been different, meaning the response has been accommodative.

Yet there comes a point when the cause of stress matters very little. If the recovery becomes uncertain, lenders will become more demanding. The longer these exceptional circumstances last, the higher the chance that lenders will be forced to act on their existing loan books.

Sustainable finance

Green bonds are necessary, but they are not sufficient to solve the climate crisis. Instead, the focus needs to shift to behaviours at the company level.

The call for the private and public sectors to collaborate in the fight to slow global warming is becoming louder and more sophisticated. It has also triggered a renewed focus on how companies can continue to create economic value whilst decarbonising their operations and products.

While project-based financing from green bonds has been an important tool in shifting the world from its current +4.5°C warming trajectory to a +1.5°C pathway, consensus is building that much more needs to be done at the firm level.

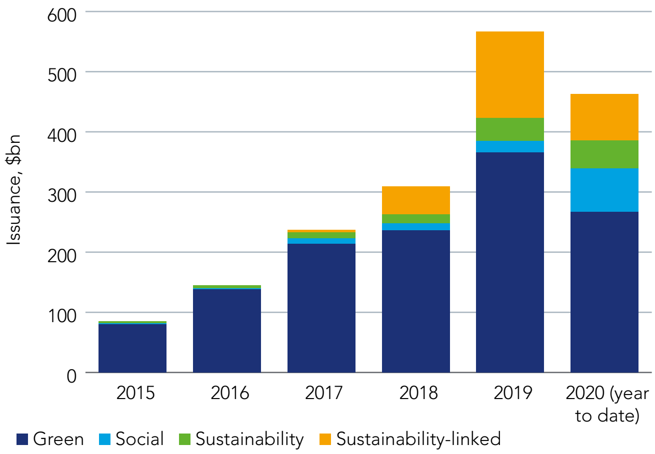
On 22 September, the ECB announced that it would accept sustainability linked bonds (SLBs) as collateral for its Eurosystem credit operations from 1 January 2021. SLBs will also be eligible for the Corporate Sector Purchase Programme's (CSPP's) open-market operations if they are compliant with existing eligibility criteria.

By making what we see as an exceptional exception to its CSPP rules, we believe that the ECB has demonstrated its unqualified support for the sustainable finance industry and that it – like us – believes that companies must decarbonise their activities across the entire firm if they are to address the climate crisis and create a greener, more equitable future.

The Bank of International Settlements also recently published an article[2] that considers the impact of fighting the climate crisis through green-bond-funded corporate projects, concluding that "green bond projects have not necessarily translated into comparatively low or falling carbon emissions at the firm level."

We unequivocally agree that climate assessments at the security level are not a good way to assess the decarbonisation pathways of individual firms. And while green-bond-financed projects are necessary to solve the climate crisis, they are not enough. The growth of the green-bond market (see figure 25) is clearly a positive development, yet decarbonisation will not happen unless companies find ways to create economic value and simultaneously align their activities with the goals of the Paris Agreement.

Figure 25. Sustainability-themed credit issuance



Source: Bloomberg New Energy Finance, as at October 2020.

[2] 'Green bonds and carbon emissions: exploring the case for a rating system at the firm level', published by the Bank of International Settlements on 14 September 2020.

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