Fixed Income Quarterly Report

Q2 2021

Federated Hermes International

www.hermes-investment.com
For professional investors only

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

I have always been drawn to the River Thames. Having lived in London for most of my life, the river has been my constant companion on walks and runs around the city. I've canoed and rowed on the river and, while sitting in parks or at a pub, I often watch the water pass by. Thinking about this quarter's *360°*, I recalled the one time I swam in the Thames. The experience was breath-taking, both physically and mentally.

The first quarter of 2021 has seen credit spreads move broadly sideways (although on a tightening trajectory) and, in fact, the top-level figures for most of the moves have been benign, verging on boring. That, like looking at the surface of the River Thames, hides the tumult below the surface for fixed income investors. In this publication, we focus almost exclusively on what's happening in credit land. There is never a shortage of topics to discuss and this quarter is no different, however, our focus for Q1 2021 has to be on rates and the inflation (or the prospect of inflation) that is driving them.

Investment grade corporate credit spreads have barely moved over the quarter either in Europe or in the US. Yet, the asset class has had one of its most negative, and most volatile, quarters ever. The US Investment Grade Corporate Credit index lost 4.5% in the first quarter of 2021, making it the worst quarterly performance since the global financial crisis. High yield markets fared no better with a loss of 0.08% for global high yield. The surface of these markets has been pretty quiet but, below the surface, the currents have been violent. Although many of us were focussed on the possibility of this, it has caught market participants off guard, particularly those for whom rates have been a permanent source of income: consistent, solid, one way and always positive.

A few words of caution before we proceed. Credit spread markets have been relatively benign but, as you can see from our comments later in the document. that is purely relative. There is MUCH to do in credit, and indeed the prospect of dispersion in the speed of escape from the grip of the pandemic may magnify the potential for alpha. Rates markets have not been consistent in their moves across the globe, this reflects the fact that, while in the US, it looks like inflation and growth may be in sight, Europe (both mainland and the UK) look far behind. Some asset classes within credit have benefitted, in a credit sense, from the movement in rates, the most obvious being banks for whom the steepening in rates curves is a signal that they may finally see a rise in net interest margins. Finally, focussing on rates and the relationship between rates and credit, it may feel like we have turned the page from the focus on the pandemic. We have not. We continue to watch the progress of the virus and vaccine programmes closely. The news from India is, therefore, both deeply upsetting and disturbing, and our view on valuations reflects the fact that we believe markets have almost completely dismissed the prospect of new lockdowns, let alone a new wave.

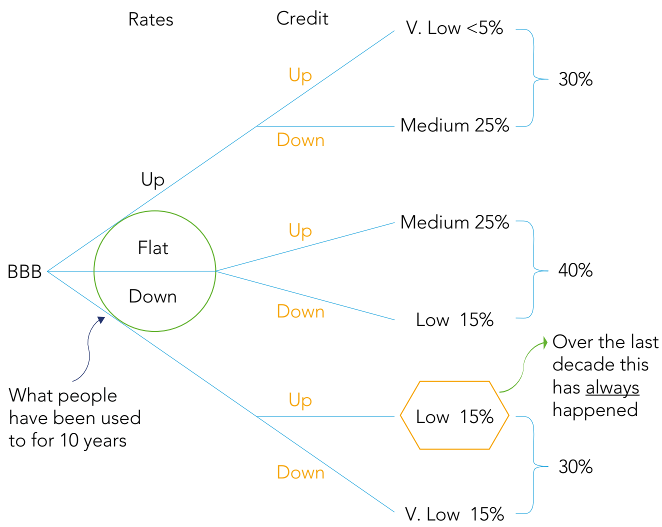
As we survey the fixed income markets for the rest of 2021, our views on risk appetite and relative value are hugely influenced by the path of inflation, rates, and sensitivity to movements and volatility in rates.

Thinking about potential paths for the future, I found it useful to draw a simple tree diagram showing the path of rates and credit spreads. First, we will do so for Investment Grade Corporate Credit.

Why has the move been so violent?

1. Rates had nowhere to go. The spring had been compressed, and compressed over the last decade.
2. The prospect of inflation in the US arrived more rapidly than most market participants expected (although one should caution that the inflation that the market is pricing in has yet to arrive).
3. The duration of both Investment Grade and High Yield debt has been hugely extended over the last five years, meaning the exposure to a movement in rates, as well as the exposure to a steepening in very long-end rates is magnified.
4. Central banks – far from containing the chatter around the prospects for inflation – repeated their stated desire to see inflation materialise before they would react.

Figure 1: Investment Grade Credit Tree



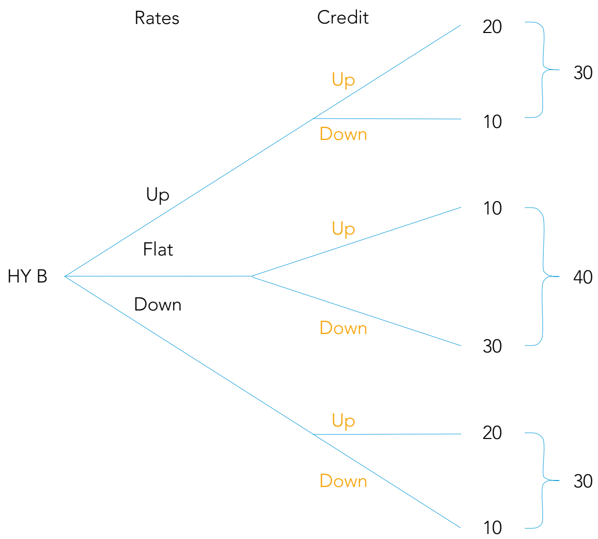
In analysing the probabilities associated with each of these nodes, and the associated market-to-market movements, we have ignored (for simplicity) the time to get there and the theta accrued in the meantime.

1. Rates up and credit spreads wider: We consider this to be a very low probability event. It is likely that an increase in interest rates would be associated (at first at least) with an improvement in macro conditions and likely improvement in fundamentals for the underlying corporates. One note of caution around this broad thesis: in Europe, any signal that the European Central Bank is worried about inflation may signal a reduction in their willingness to buy corporate bonds at the same time as signalling future rate rises. We consider this to be extremely unlikely in the short term.
2. Rates up and credit spreads tighter: A continued improvement in economic conditions would potentially support a further increase in rates, and a steepening in curves. We believe this is likely to be associated with further improvements in fundamental conditions for large investment grade corporates.
3. Rates flat and credit spreads wider: This scenario is hard to describe as it contains a number of different potential paths, all are broadly associated with an acceptance that the moves in rates that we saw in Q1 are 'enough' for now, but that credit spreads may not be taking into account the longer-term borrowing costs of corporates in this new rate regime.
4. Rates flat and credit spreads tighter: Given current levels of spreads within this asset class, coupled with the volume of issuance we have seen recently (albeit that net issuance remains easily digestible), this seems like an unlikely path.
5. Rates down and credit spreads wider: This would be associated with a worsening in macro conditions, and is more likely in the US than in other parts of the world.

   Broadly, this path is explained by a market accepting that the US Federal Reserve will not be moving for a long time yet, and that valuations are not supported by fundamentals or technical.
6. Rates down and credit spreads tighter: Our final path is the path that markets took between the depths of last year's crisis and the end of June 2020. This one looks extremely unlikely but, for those dip buyers out there, it becomes much more likely after another major market sell off. This is also the discrete path that market participants have seen on most occasions in the last decade.

Next we will perform the same analysis for High Yield Corporate Credit.

Figure 2: High Yield Credit Tree



1. I hope that the first thing that you notice in comparing the Investment Grade and the High Yield trees, is the marked difference in probability. High Yield corporates are more levered than they have ever been, the issuance of High Yield Bonds (particularly 'B' and 'CCC') has been huge and, if rates rise materially, the probability of default amongst this cohort is large. For us, this is by far the most important observation to be drawn from this analysis.
2. We think the likelihood of improving macro conditions leading to a tightening in already tight spreads is low but cannot be dismissed.
3. Similarly to this path within the Investment Grade tree – but given the hunt for yield and the current 'buy any dip' culture – we see this as less likely than 4.
4. If rates remain stable for an extended period, it is possible that the inexorable hunt for yield will eventually give rise to the last juice being squeezed out of High Yield.
5. One might expect the 'up-up' scenario having a high likelihood to signal that the 'down-up' scenario should be low. In fact, we think that the High Yield market broadly sits

in a Goldilocks situation with regards to rates. A reduction in rates is likely to be associated with a worsening macro backdrop and this is more likely to lead to a widening in credit spreads than a tightening.

6. The counter to the above argument, of course, is that technicals remain strong within credit and fixed income markets and a tightening in rates may drive a further "hunt for yield" sending credit spreads further into unknown territory. We see this as unlikely, given where we currently find valuations.

A few carve-outs from this analysis: First, we believe financials and banks, in particular, do not follow the same paths. As you can see from our Relative Value ranking and commentary, we continue to feel well-compensated for the risk associated with investing in most parts of the capital structures of the banks that we favour. Second, the above analysis is VERY broad brush, by necessity, and is purely an illustration of the way we are thinking about current markets. The exception I have noted here also has an exception: that even among banks, there are huge differences between those we like and those we do not.

Our view on the beta of the markets we invest in has been our focus but, as each day passes in 2021, our view that there is an abundance of alpha grows. Third, we warn that almost all parts of the fixed income universe are convexity poor. This is very worrisome for the lowest quality ends of the credit spectrum where a low cash price is often a first line of defence for investors. Last, we have not refenced structured credit here. We think this asset class has several interesting characteristics (not least that it is almost exclusively a floating rate product) that mean it has risen significantly in our rankings.

In the next *360°*, assuming markets allow, we will dive more deeply into our views on structured credit: value, fundamentals, why people still find it so easy to hate (and why we are delighted that they do!) and how one can analyse the asset class through an ESG lens.

I hope you have managed to navigate the first quarter of 2021 successfully and that, like us, you are looking forward to the rest of the year. This wouldn't be a fixed income quarterly and I wouldn't be a grumpy old fixed income investor, if we didn't close by saying, "Can you imagine what could happen to markets if there were some inflation, if central banks did begin to reverse quantitative easing, and if they moved their base rates to something close to historic norms?"

Credit options are cheap!

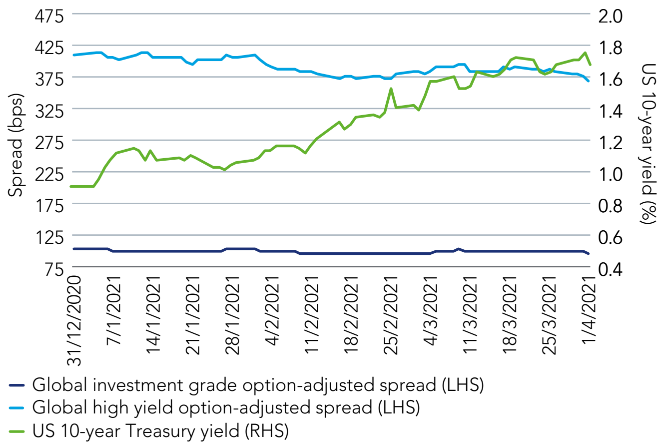
Relative value

As the market began to price in rising US inflation, rates curves steepened and the US 10-year treasury yield moved higher, but there was little impact on spreads.

Credit spreads in liquid credit default swap (CDS) indices moved little during the first quarter as trading remained range bound and close to pre-pandemic historic tights. The iTraxx Xover index moved from 242 basis points (bps) to 252bps over the quarter, and the iTraxx Main index from 48 to 52bps.

Rates curves steepened during the period as the market began to price-in rising inflation amid expectations that the US economy could overheat on account of the fiscal package and progress made on the roll-out of the vaccine. Against this backdrop, the US 10-year treasury yield moved from 0.91% to 1.74% during the quarter, although there was little impact on spreads (see Figure 3). This volatility in rates impacted total returns of higher-duration, higher-quality exposures that are more sensitive to rates. With effective duration at record highs, the Global Investment Grade Corporate index suffered losses of -4.3% for the quarter (see Figure 4), while the Global High Yield index, with a much lower duration, was less impacted, returning +0.08%.

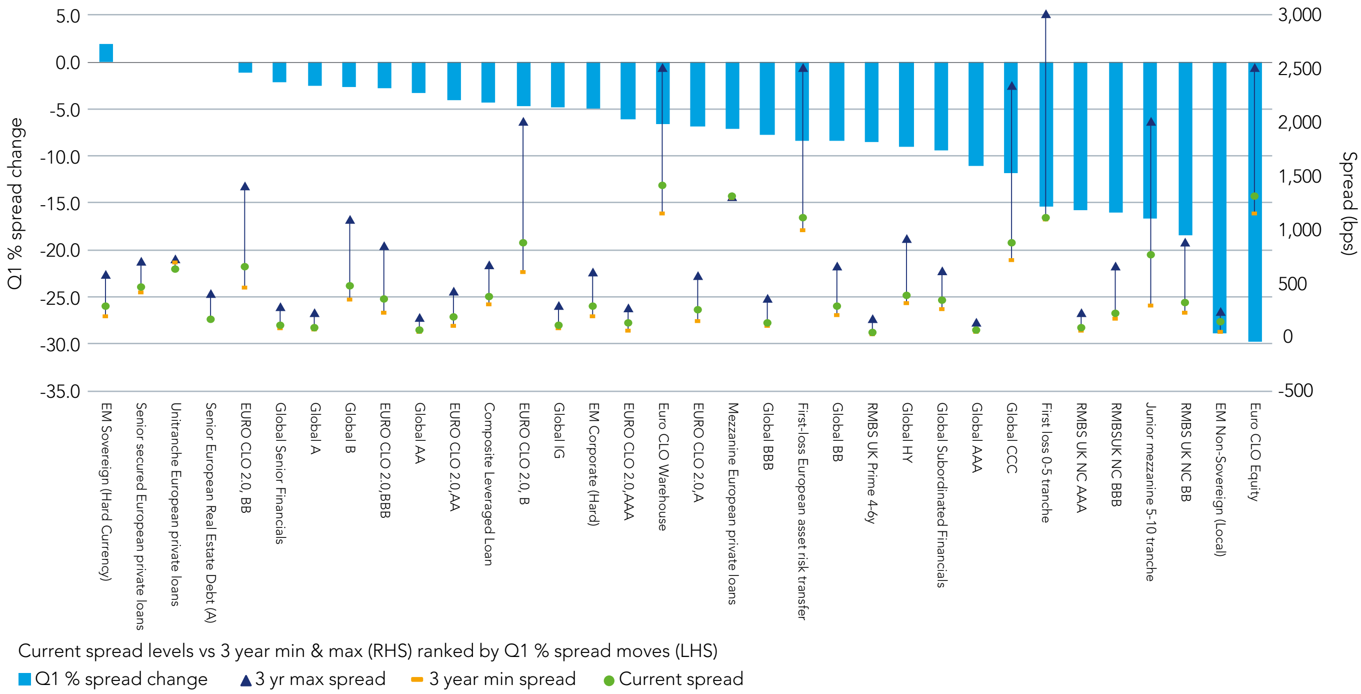
Figure 3: Spreads on Global Investment Grade and Global High Yield corporate bond indices and the US 10-year treasury yield



Source: ICE Indices, Bloomberg as at 31 March 2021.

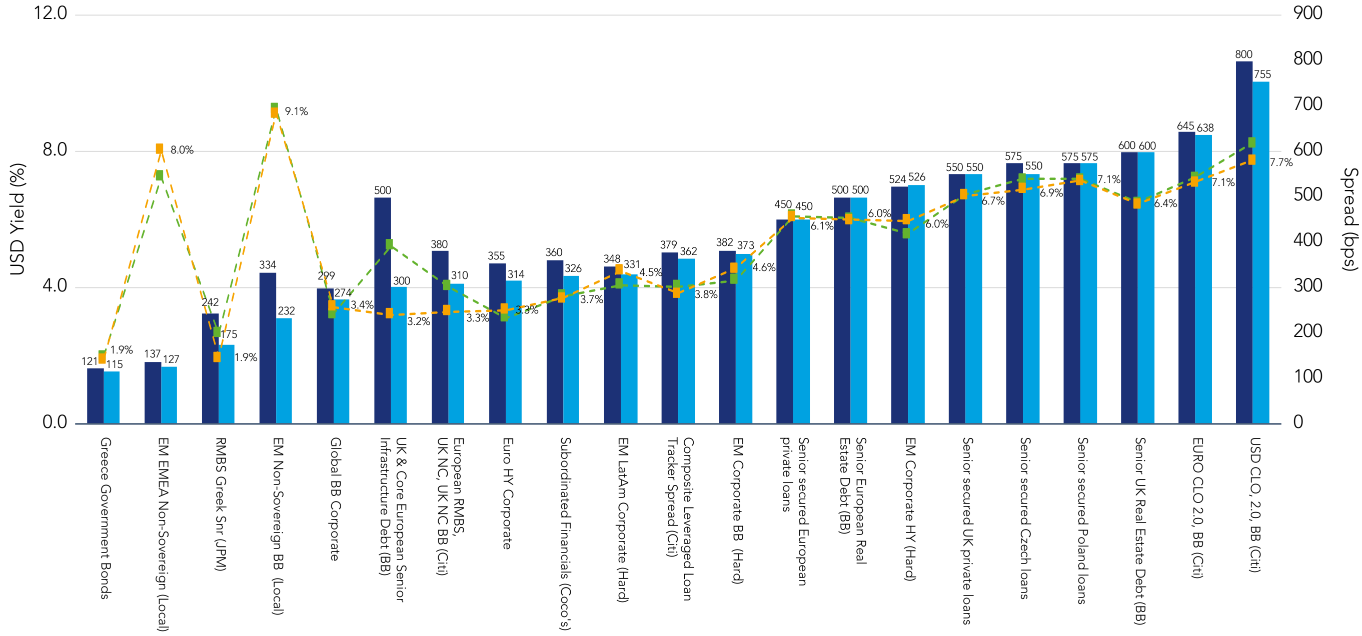
Looking more broadly across the credit spectrum, there were some exposures with larger spread moves. The largest moves during the quarter were for collateralised loan obligations (CLO) equity tranches which were down 30% to 1300 (from 1850bps for Euro equity CLOs).

Figure 4: Change in credit spreads



Source: Federated Hermes, Bloomberg, Citi as of 31 March 2021.

Figure 5: Relative value within selected BB-rated exposures



Spread and USD Yield comparision for BB and equivalent rated exposures at the beginning and end of Q1 2021

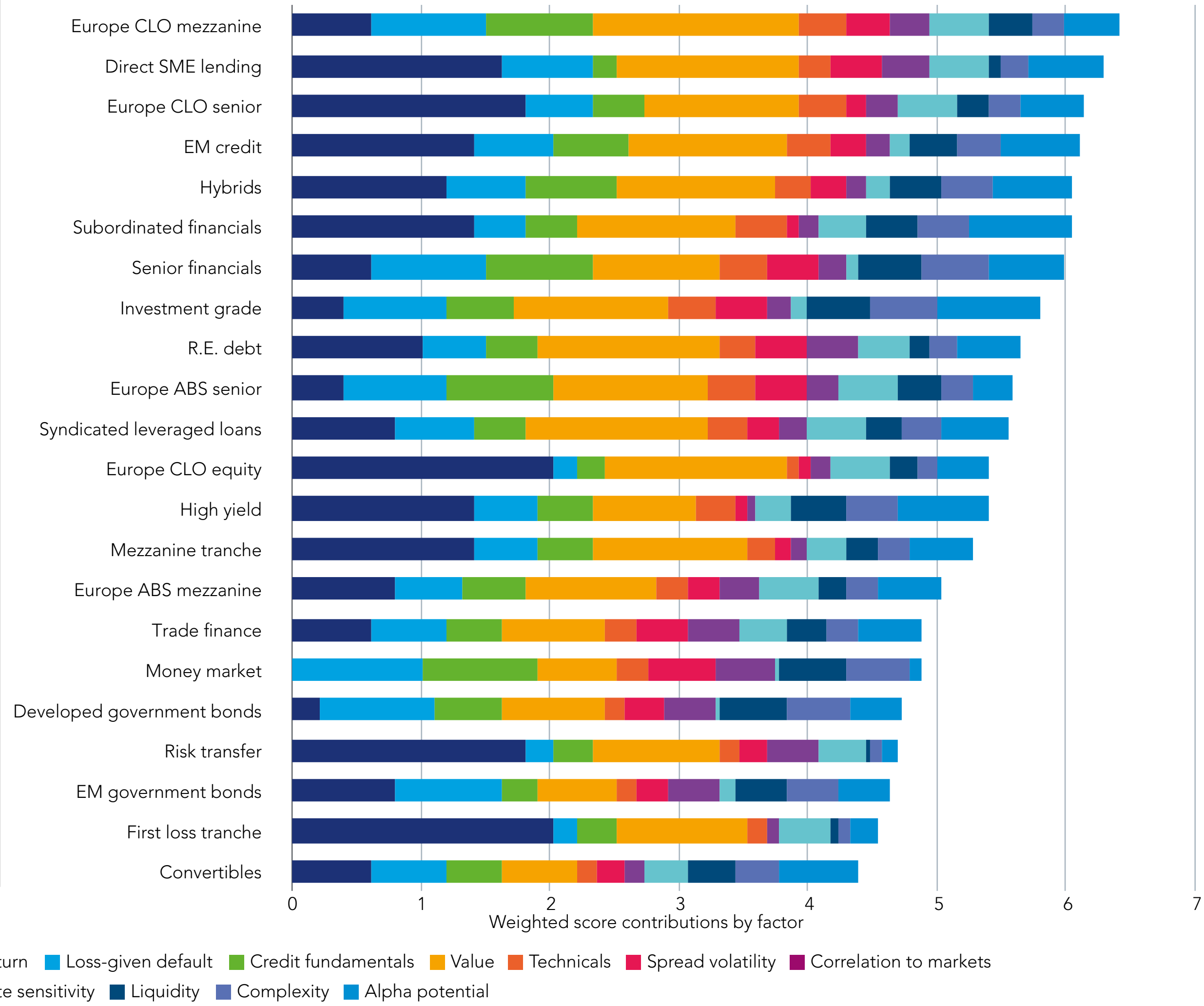
Q4 20 Spread (RHS) Q1 21 Spread (RHS) Q4 20 Yield (LHS) Q1 21 Yield (LHS)

Source: Federated Hermes, Bloomberg, Citi as of 31 March 2021.

Figure 5 shows the relative value in spread, and USD yield terms, for equivalent rated exposures at the end of Q1 2021 versus the end of Q4 2020. CLO mezzanine tranches look attractive on a spread basis as do direct lending and real estate debt. In public credit, hard currency emerging markets (EM) corporates look attractive. EM local currency corporates look less attractive on a pure spread basis, but attractive in USD yield terms.

Figure 6. Multi Asset Credit relative value framework

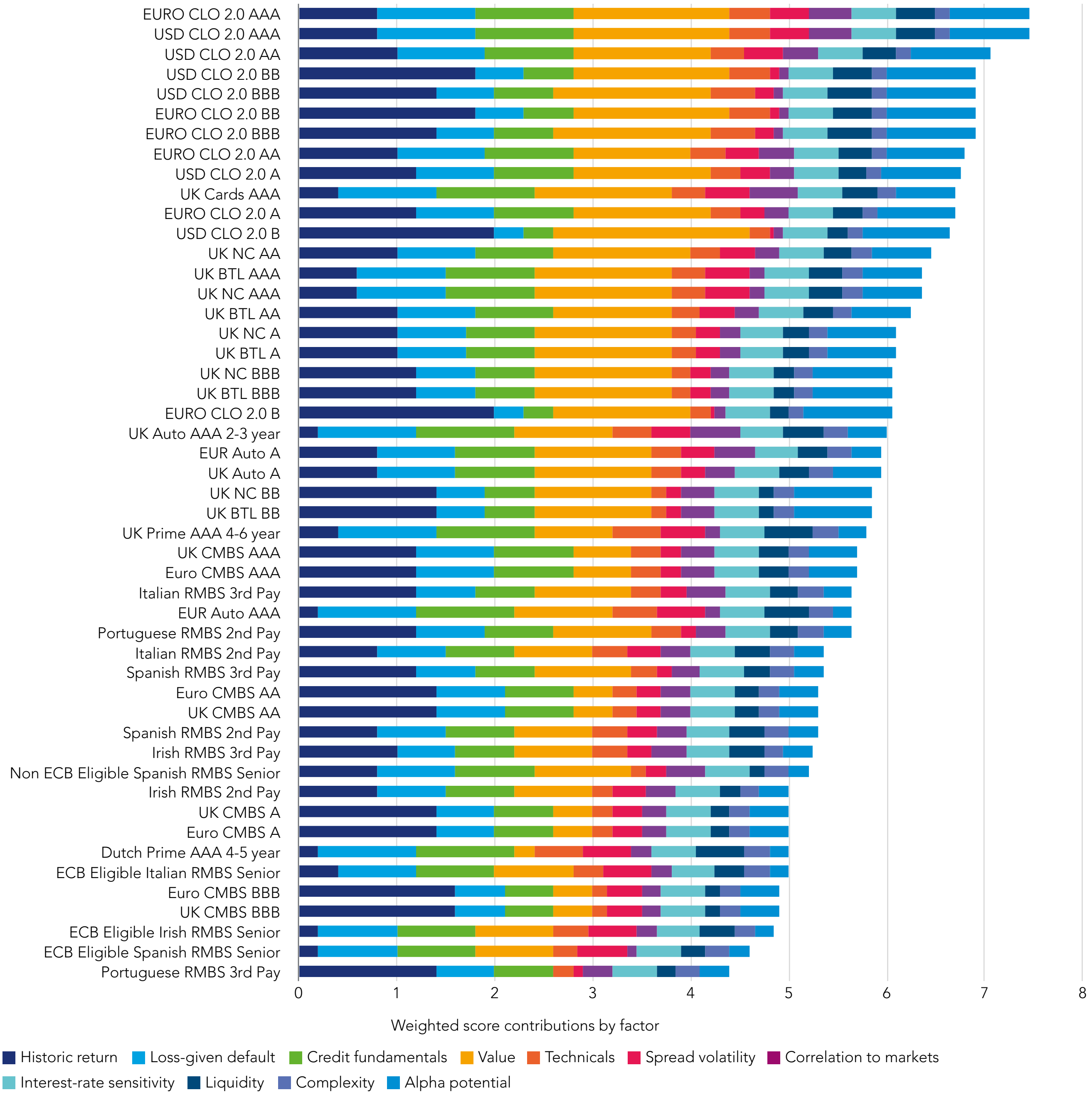
Q1	▲	Q4
1	▲	4
2	—	2
3	▲	5
4	▼	1
5	▼	2
6	—	6
7	—	7
8	—	8
9	▲	13
10	▼	9
11	—	11
12	▼	10
13	▼	11
14	—	14
15	—	15
16	▲	17
17	▼	16
18	▲	22
19	▲	21
20	▼	17
21	▼	20
22	▼	19



Source: Federated Hermes, as of 31st March 2021

Figure 7 illustrates the team's views on relative value within the structured credit universe. In Q1, Euro CLO AAA tranches topped the ranking for the first time on account of their excellent value on a risk-adjusted basis as the most senior tranche has lagged the moves of other parts of the CLO stack and provide an extremely low probability of losses based on historical data. They also benefit from being floating with a zero floor. From a rates perspective, their capped downside will allow them to benefit should curves continue to steepen.

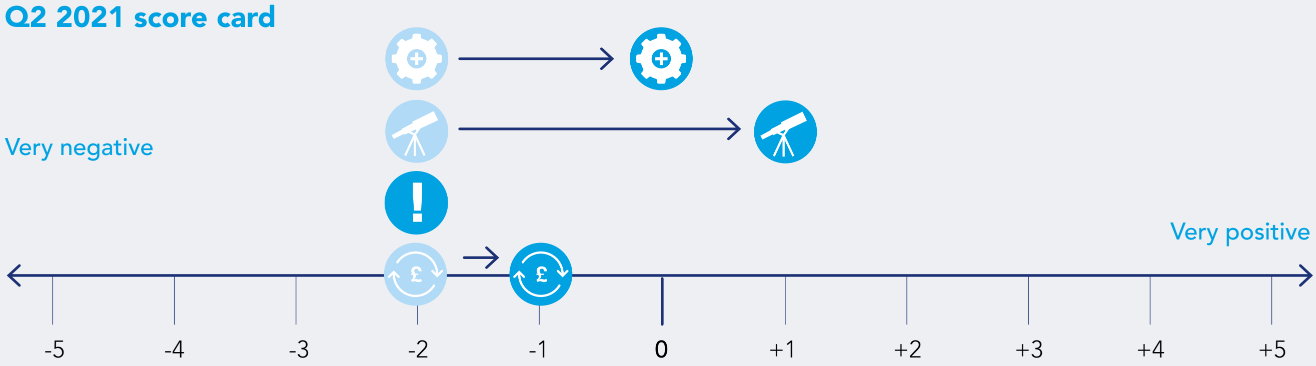
Figure 7. Our Structured Credit relative value framework



Source Federated Hermes, as of 31 March 2021.

The widening of US treasury yields over the quarter increased the value score of developed government bonds. This lifted them from bottom of the ranking to 18th and above EM government bonds, which moved down from 17th to 20th. This now leaves convertible bonds at the bottom on account of their rich valuations. First loss tranches remain in the bottom three exposures because, despite attractive yields and an improved economic outlook, they remain heavily exposed to potential losses from defaults in the tail.

Q2 2021 score card



Economic outlook

- **Move to +1 from -2**

Economic data has turned positive and further tailwinds are expected from the US stimulus bill and positive momentum in the vaccine roll out.

Credit fundamentals

- **Move to 0 from -2**

Leverage levels remain high but default rates have stabilised and rating migrations are levelling off.

Valuations and technicals

- **Move to -2 from -1**

Credit valuations are looking rich with spreads near historic tight levels in many areas and flows into credit have moderated as a result.

Tail risks

Stay at -2

With rich valuations, the following are the key tail risks:

- Rising inflation causes market disorder.
- Rates or taper tantrum, if muddled central bank messaging causes a disorderly sell-off in rates.
- Slower recovery from Covid-19 than the market anticipates for reasons such as new waves causing further lockdowns, slow vaccine roll out and reduced vaccine efficacy to new variants.

Contents

Authors

Andrew Jackson
Head of Fixed Income

Mark Bruen
Head of Fixed Income Solutions

Stephane Michel
Senior Portfolio Manager

Silvia Dall'Angelo
Senior Economist

Anna Karim
Investment Director – Fixed Income

Clarinda Tsang
Senior Analyst, Multi Asset

Emeric Chenebaux
Structured Finance Analyst and Junior Portfolio Manager

Andrew Lennox
Senior Portfolio Manager – Structured Credit

Vincent Nobel
Head of Asset Based Lending

Mitch Reznick
Head of Research and Sustainable Fixed Income

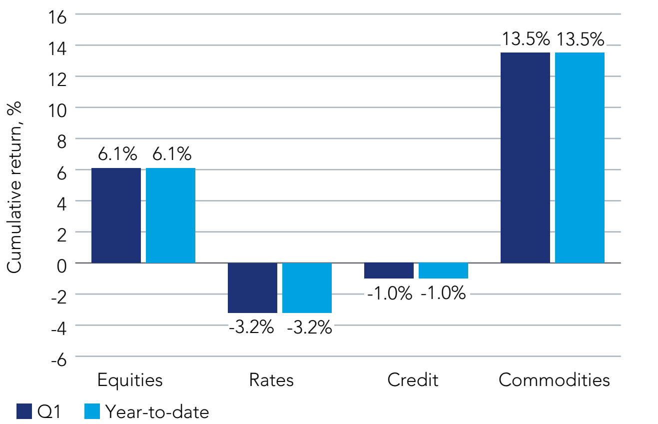
Patrick Marshall
Executive Director – Head of Private Debt and CLOs

Multi asset

Global GDP expectations and inflation are trending moderately higher, and we see credit, commodity carry and TIPS as the best asset classes to invest in for this scenario.

Commodities were the market leaders, outshining equities, and delivering double-digit returns in Q1. This said, equities did maintain their positive run from 2020, generating 6.5% for the quarter while rates continued to lag (see Figure 8).

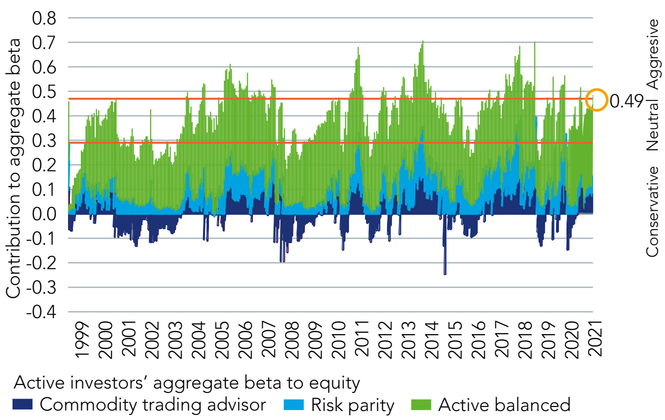
Figure 8. Asset class performance



Source: Bloomberg, Federated Hermes, as at March 2021.

In terms of active fund positioning, the aggregate beta to MSCI World (measured across active investors like Commodity Trading Advisors, risk parity and mutual funds) is currently at 0.49; this indicates aggressive positioning. The aggregate beta crossed over to this aggressive positioning in August 2020, but it started to shift back to neutral after the slight market correction in mid-September (see Figure 9).

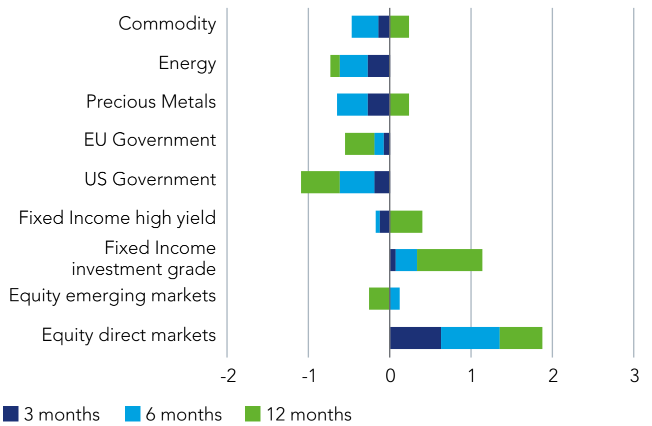
Figure 9. Active investors' aggregate beta to equity



Source: Bloomberg, Federated Hermes, as at March 2021.

Our ETF Flow Z score shows the combined Z scores of ETF flows for each asset for the last three, six, and 12 months (see Figure 10). Over these timeframes, fixed income investment grade and developed market equities attracted consistent inflows. On the flipside, both US and EU government bonds showed sustained outflows in each of those time windows. In the shorter term, commodity and related sectors have seen money move out of the space.

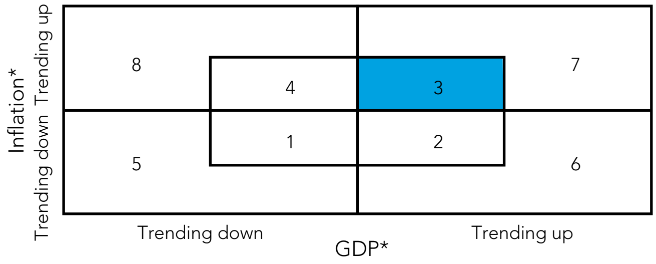
Figure 10. ETF flows



Source: Bloomberg, Federated Hermes, as at March 2021.

In terms of our outlook, we use our economic scenario analysis to first determine where the global economy is expected to be, then we identify the best investments for that scenario. At the end of February 2021, the global economy had moved to quadrant 3 (Figure 11), wherein both expected GDP and inflation were trending moderately higher. The best assets to invest in for this scenario are credit, commodity carry and TIPS. On average, we remain in quadrant 3 for four months and then pivot to quadrant 4 where we see positive inflation but diminishing economic growth.

Figure 11. Economic scenario quadrant



S/N	Q3 top 10	Q3 bottom 10
1	Credit default swap index	EU credit quality
2	Commodity carry	US credit quality
3	Credit default swap high yield	S&P Consumer staples SPDR
4	US 7-10 year inflation-protected securities	USD/EUR Cross rate
5	iTraxx Crossover index	MSCI DM – MSCI EM
6	iTraxx Europe	Credit default swap high yield – iTraxx Crossover
7	China Securities Index 300	Coffee
8	Oslo OBX index	USD/AUD Cross rate
9	S&P/ASX 200	USD/NOK Cross rate
10	S&P/TSX	S&P Utilities SPDR

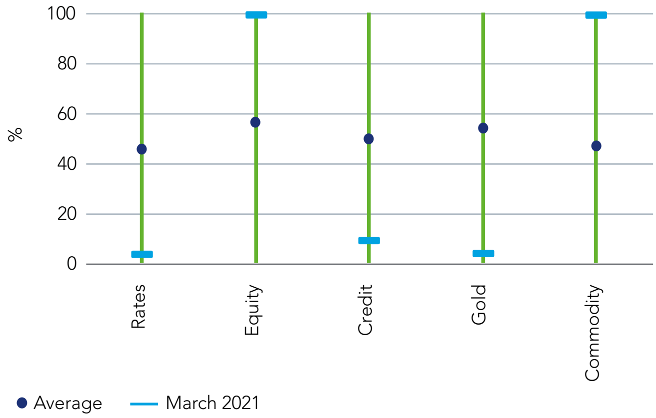
Source: Bloomberg, Federated Hermes, as at March 2021. Based on Bloomberg pooled economists' one-year forward forecasts for both GDP growth and inflation. These forecasts are then compared to their respective six, nine, 12-months averages to determine the current trend. These trends are then bucketed into eight quadrants. for example, GDP trend is the current GDP forecast – avg.[(avg. Six-month GDP forecast), (avg. Nine-month GDP forecast), (avg. 12m GDP forecast)]. The split between the inner and outer quadrants is determined by the mid-point between the average and the maximum/minimum on each axis. Data period starts from 1956, the expected asset returns are annualised and are estimated based on a conditional two-factor regression analysis.

We use our Multi Asset Positioning Model to identify the most attractive assets and investment opportunities in the market. Our Multi Asset Positioning model incorporates three different sub-models:

- Momentum (which captures short-term price trends),
- Excess money growth (which measures how much excess liquidity is present)
- Value (a longer-term model that looks at forward-looking valuations).

According to our model, we have a significant overweight in equity and commodity, and a significant underweight in rates (see Figure 12). Credit continues to be expensive relative to equity, resulting in our Value model contributing to an overall underweight in the asset class.

Figure 12. Multi Asset Model Positioning



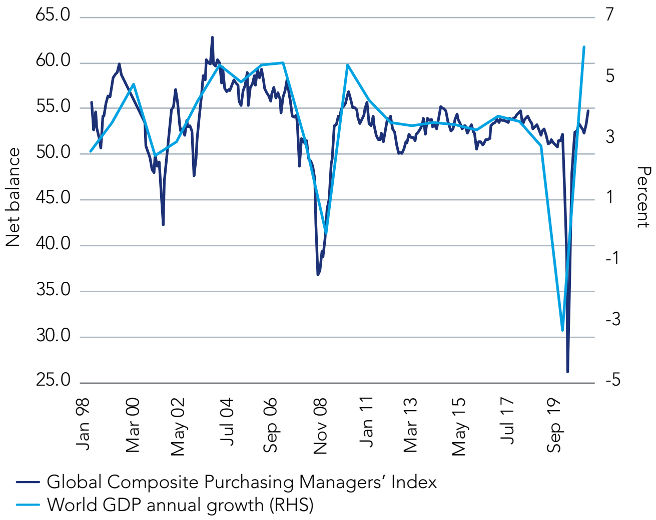
Source: Federated Hermes, as at March 2021.

Economic outlook

The global economic recovery continued to gather pace in the first months of 2021 supported by recent upside surprises.

The increasingly positive outlook for the global economy follows progress in the various vaccination programmes across the world and a new round of fiscal stimulus, including a $1.9tn package in the US. Accordingly, the IMF has recently upgraded its forecast for 2021 global growth by half percentage point to 6% (Figure 13), reflecting a significant upward revision to its US growth projection (to 6.4%, from 5.1%).

Figure 13. Purchasing Managers' Index vs global growth (including latest IMF forecast for 2021)



Source: Refinitiv Datastream, IMF, JPM/Markit, as of April 2021.

The recovery has, however, become more uneven across countries and regions. China and the US have led the way out of the crisis and are experiencing what looks like a V-shaped recovery. Emerging markets have bounced back strongly, but they now risk missing out on an inclusive and sustainable recovery due to various factors such as the slower roll out of vaccinations. Within advanced economies, the divergence between the US and the euro zone has widened on account of differences in the pace of vaccination and implementation of fiscal stimulus. The US economy is set to accelerate sharply throughout the year, returning to pre-crisis growth in the coming months. In contrast, the euro zone has probably experienced a double-dip recession and is set for a more gradual emergence from the crisis. Forecasts suggest the region's economy will return to its pre-crisis level next year and to its pre-crisis growth trajectory in a few years.

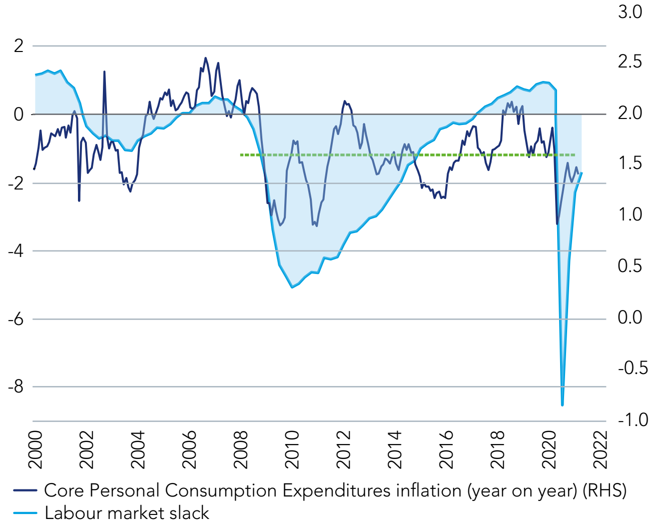
The policy mix is likely to remain accommodative for the next couple of years. The fiscal response to the pandemic has been strong relative to other crises with stimulus amounting to approximately $16tn globally over the last year (concentrated in developed countries and largely front loaded).

Such stimulus has been closely coordinated with monetary policy as central banks' accommodative policies have enabled fiscal largesse by slashing debt servicing costs. Major central banks have pushed back against the recent bond sell-off and reiterated their determination to avoid an unwarranted tightening of financial conditions on account of the improved economic outlook.

Policy rates will likely remain close to their effective lower bound for several years, and purchasing programmes will likely proceed at a sustained pace through the end of this year at least. This is justified by the significant slack in the labour market and subdued underlying inflationary pressures. Going forward, debt sustainability will rely on the return of inflation and/or additional financial repression with central banks looking for new tools and mandate adjustments to ensure monetary conditions remain easy.

Labour markets have improved recently and, as a result, underlying inflationary pressures are likely to remain contained in the next couple of years. Base effects in energy, higher commodity prices and pandemic-related supply constraints will likely put temporary upward pressure on prices. However, demand-pull pressures are likely to remain contained, reflecting slack in the labour market (Figure 14) and low wage growth. In the medium to long run, the picture is more complex as structural factors that have muted inflation for many years – globalisation, wealth inequality, technological progress and low productivity among them – are set to evolve in different directions.

Figure 14. US core PCE inflation vs slack in the labour market



Source: Refinitiv Datastream, US BEA, US BLS, CBO, as of April 2021.

Fundamentals

Despite strong growth rates expected in 2021, there remain many challenges ahead for credit markets.

During what has proved a volatile first quarter for fixed income returns, the US Investment Grade Corporate index lost 4.42%, the second largest quarterly loss on record after 3Q 2008.

Driving much of this negative return was the 10-year treasury yield, which rose by 82.7bps during the quarter.

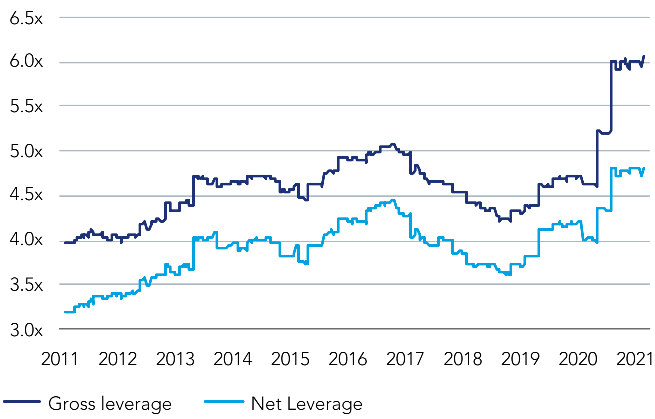
Leverage

In US Investment Grade, Q4 gross leverage continued to decline from its peak earlier in the year, falling by 0.1x to 2.66x. Gross leverage remains approximately 0.3x higher year on year (see Figure 15). The drop in leverage was relatively widespread with 60% of Investment Grade companies seeing an improvement over the previous quarter. That said, on a year-on-year basis, 64% of Investment Grade companies still have higher leverage.

As companies continued to build on record balance sheet liquidity, cash/debt ratios hit five-year highs of 28% with nearly three-quarters of issuers seeing cash/debt improvements on a year-on-year basis.

US high yield saw an uptick in leverage from the third to the fourth quarter of 2020, when gross leverage increased to 6.4x from 5.9x. Earnings (trailing 12-month EBITDA) growth in Q4 worsened to -27% year-on-year while debt growth subsided from 5.4% to 4.1% over the same period.

Figure 15. Leverage

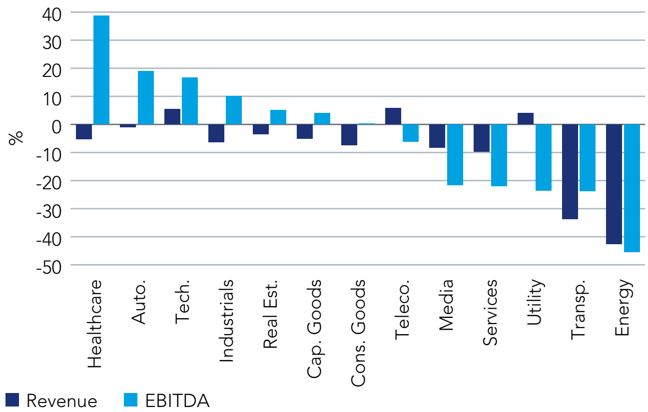


Source: Bank of America Merrill Lynch, based on pre-screened raw data that includes direct input from credit analysts.

In Europe, EBITDA extended its rebound and likely ended 2020 only 1.5% lower than a year ago. Sales were 5.2% down year-on-year. Investment grade firms fared slightly better than their high yield peers in 2020, enough for the space to post a lower annual EBITDA drop (-1.5% vs -6% for high yield). Yet, the quarter-on-quarter earnings growth in High Yield outpaced that of Investment Grade in 2H20.

Figure 16. Change in earnings as of Q4 2020, by sector

Six sectors posted positive EBITDA growth year on year



Source: Bank of America Global Research, ICE Data Indices LLC Bloomberg. Large sample of listed non-financial corporations constituents of ER00 Index European firms only. Median estimates

Downgrades and upgrades

Net downgrades (downgrades less upgrades) for credits in the BofA US Investment Grade Index increased to $223bn in March 2021 from -$16.6bn in February. Net last-twelve-months downgrades decreased to 11.89% of index notional in March from 11.91% of index notional in February.

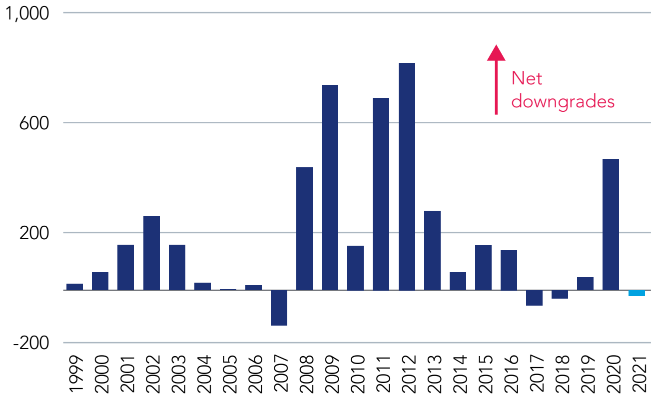
Conversely, in US High Yield with the uninterrupted net upgrades since the beginning of the year, year-to-date net upgrade volume has been brought up to close to $100bn.

In Europe, we are seeing a similar trend in which rating agencies have engaged in another wave of downgrades in European Investment Grade. While some downgrades may have reflected a deteriorating credit outlook, others have reflected industry-specific structural challenges for the European oil & gas sector. Euro Investment Grade saw net downgrades to the tune of €29bn in February, bringing the year-to-date volume of net downgrades to €19bn.

Conversely, the positive momentum in European High Yield shows little sign of abating. Net upgrades eased to below €2bn, down from €10.8bn in January 2021, putting 2021 on track for the fastest start to an upgrade cycle on record. Rating agencies may have rushed to downgrade High Yield-rated firms last year so the year-to-date upgrades could be driven by an effort to restore the fair credit rating of some issuers.

Figure 17. Euro credit annual net migration volumes (euro bn, IG + HY)

More downgrades than upgrades in 2021 so far



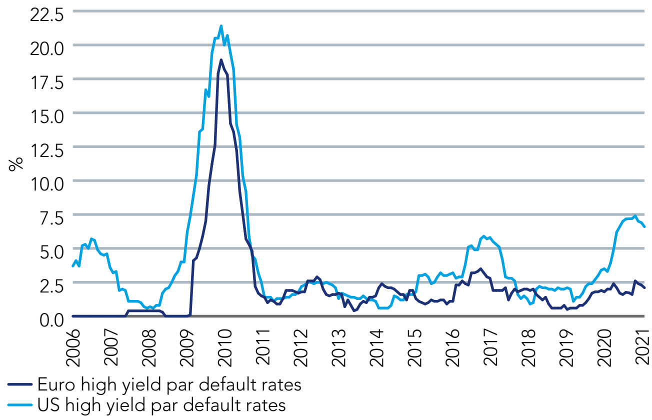
Source: Bank of America Global Research, ICE Data Indices LLC Bloomberg. Positive migration volume v positive net downgrade volumes. Data for 2021 show only January net migration in IG + HY volumes

Defaults

In March, the par-weighted US High Yield default rate decreased 129bps to 4.80%, due to a sizeable $16bn of bonds falling out of the last-twelve-months default rate calculation. The default rate is now down 137bps year to date, but remains 149bps higher than at the same time last year. The US high-yield default rate (including distressed exchanges) ended the month at 5.37% (down 129bps month on month, down 139bps year to date, and up 187bps year on year).

European High Yield recorded no new defaults in March. The 12-month trailing default rate fell by 25bps to 3.5%, while the annual loss rate dropped by 11bps to 1.4%. In the year since the outbreak of the pandemic, 17 issuers defaulted on European currency high yield bonds, with a combined notional value of $11.1bn.

Figure 18: Defaults in Euro High Yield



Source: Bank of America Global Research, ICE Data Indices LLC, US HY Credit Strategy. 12-month last twelve month par-weighted default rates

Challenges

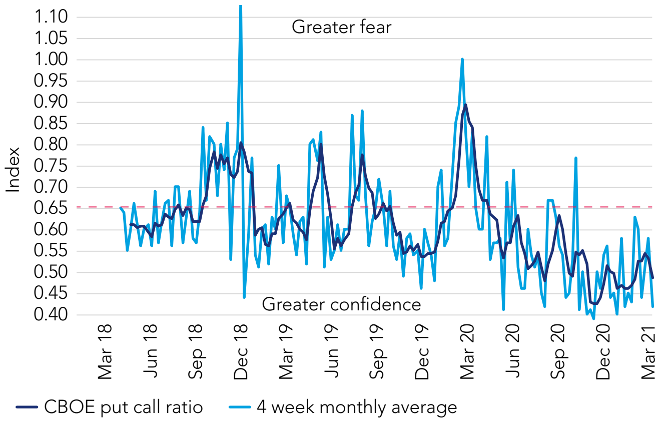
There remain many challenges ahead for credit markets in spite of the strong growth rates expected in 2021. Such challenges include inflation expectations, increased rate volatility and the overall starting level of spreads.

Valuations and technicals

While the market's positive sentiment carried over from the end of 2020 into the first quarter of 2021, asset flows were weak for both Investment Grade and High Yield.

Strong growth momentum created by the raft of government stimulus and support, as well as progress on the roll-out of the Covid-19 vaccine, is stoking optimism in the market about the trajectory of the global economy from here.

Figure 19. Sentiment

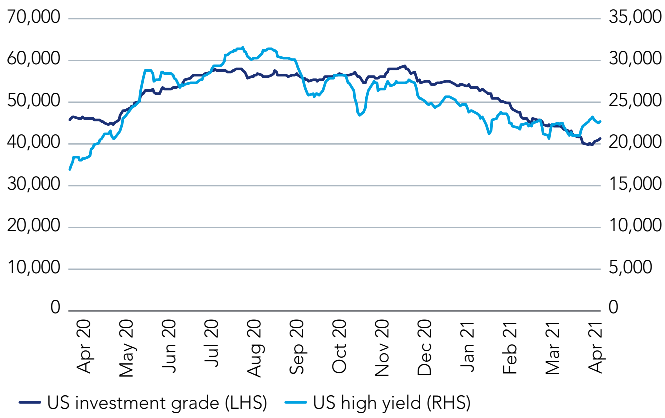


Source: Bloomberg as at March 31st.

Asset flows

The first quarter was weak for assets flows in both Investment Grade and High Yield markets. On the back of a very strong performance for the credit market, investors increasingly looked to take money out of passive vehicles (i.e. ETFs) and move into active funds (i.e. funds that are able to take advantage of the environment and generate the extra alpha required this year).

Figure 20. Investment Grade ETFs vs High Yield ETFs



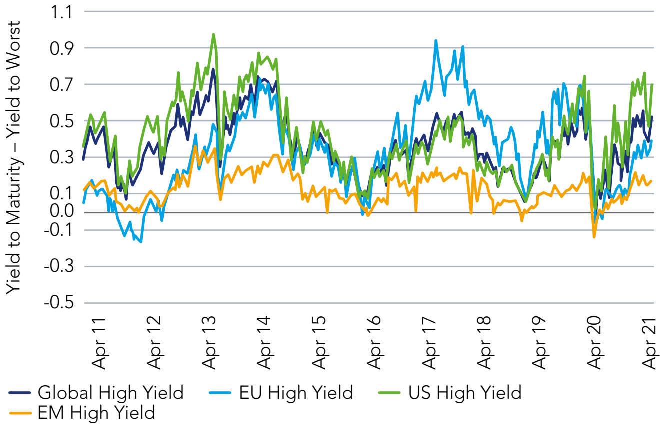
Source: Bloomberg as at March 31st.

Public credit

Public credit enjoyed a benign first quarter amid tightening spreads in the Investment Grade market.

After a short period of weakness at the start of the year, valuations are slowly grinding back towards tights. Convexity is an issue for the market again, particularly in the US. Europe, meanwhile, is looking better from this angle and, as a result, offers better capital appreciation potential in the current environment.

Figure 21. Rich valuations and lack of convexity

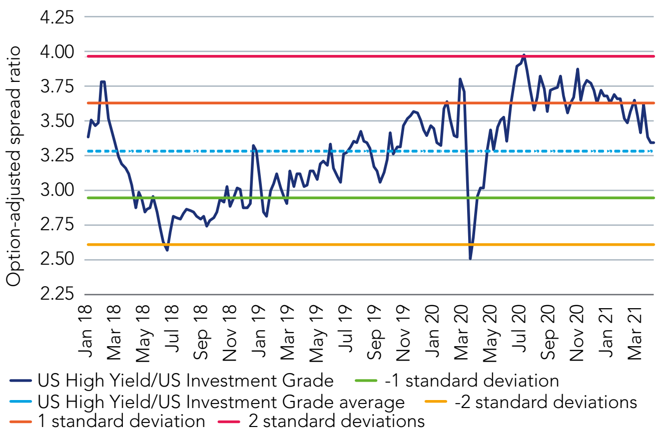


Source: ICE Bond indices, as 31 March 2021.

Compression between High Yield and Investment Grade

As spreads in the Investment Grade market hit pre-Covid-19 tights, the rest of the performance had to come from the lower quality. As a result, the positive sentiment fed through to the High Yield market, leading to compression between Investment Grade and High Yield in both Europe and the US. From here it will be harder for the compression to continue at the same pace.

Figure 22. Option-adjusted spread ratio – US IG / US HY



Source: ICE Bond indices, as 31 March 2021.

CCCs close to 10-year tights

CCC-rated credits have been the best-performing part of the market so far this year. They delivered more than 5% in Q1 versus less than 1.5% for the global High Yield market and less than 50bps for the BB part of the market. This rally started after Joe Biden won the US presidential election, and the chances of a significant stimulus package increased. CCCs now trade close to 10-year tights compared to B-rated credits.

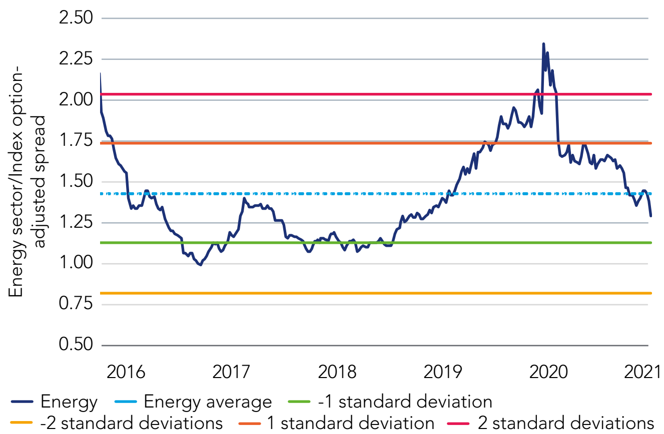
Figure 23: US High Yield ratings ratio

Source: ICE Bond indices, as 31 March 2021.

Limited cyclicality premium on offer

The energy sector has been performing very well, with oil prices remaining above $60 per barrel. Many issuers are now back to generating positive cash flow after a challenging 2020. In a similar fashion to CCCs, the energy sector has been attracting a significant amount of capital from investors and is now trading below its five-year average versus the wider High Yield market, suggesting limited cyclicality premium.

Figure 24. Energy sector option-adjusted spread



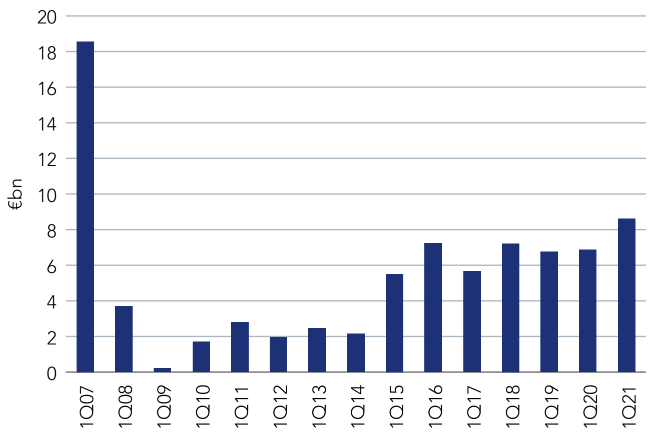
Source: ICE Bond indices, as 31 March 2021.

Leveraged loans

The European leveraged loan market got off to a flying start to the year with the primary market experiencing new leveraged buyout loans at a level unseen since 2008.

Private equity funds ended 2020 with a significant amount of cash reserves as European governments provided strong liquidity support to corporates and many leveraged buy-outs (LBO) transactions were suspended due to the pandemic.

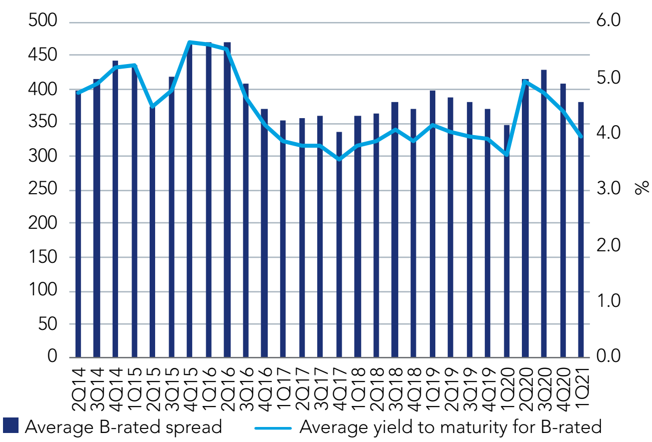
Figure 25. Institutional buyout volume (€bn)



Source: S&P Global Market Intelligence, as at 31 March 2021.

Meanwhile, the strong demand for leveraged loans (driven by strong CLO issuances) helped liquidity and brought pricing back to pre-crisis levels. The yield on B-rated loans was below 4.0% at the end of Q1-2021.

Figure 26: Average B-rated loans yield



Source: S&P, as at 31 March 2021.

Positive momentum was also observed in the secondary market as the S&P ELLI (European Leveraged Loan Index) ended Q1 2021 at 98.41 and is now in line with the levels experienced at the end of 2019 (98.28). Over the quarter, the leveraged loan index returned +0.86% and outperformed the High Yield index (ICE BofA High Yield Index) which increased by +0.69% (price return). In terms of total return (excluding currency), the S&P ELLI returned +1.79% and was largely driven by B-rated loans (+1.91%) which continued to outperform BB-rated loans (+1.04%).

Moreover, the pressure on weaker credits continued to ease thanks to all the governments' assistance on liquidity. This is evidenced by continued declining distress ratios (loans trading below 80) in the S&P ELLI, and a declining default rate.

Finally, the market and the rating agencies maintain increasingly divergent views on the asset class, with the latter holding a distinctly conservative outlook. In particular, the share of the 'CCC+ and below' in the S&P ELLI increased from 8.53% at the end of 2020 to 8.72% at the end of Q1 2021.

Structured credit

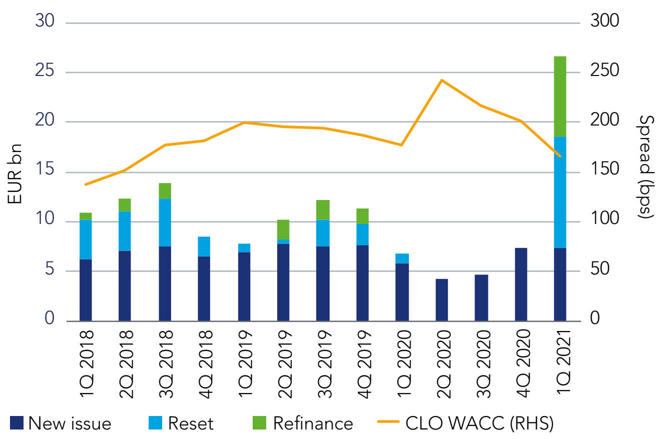
In the first real test of the market since the global financial crisis, the robustness of structured credit provided a boast for investor confidence.

The structured credit market (in terms of both ABS and CLOs) posted a positive first quarter with spreads tightening across tranches in most parts of the market. During the turbulence of 2020, one thing has become very clear: structured credit has delivered. Structures have done what they were designed to do and investors were appropriately protected from credit deterioration.

The move in rates, along with higher inflation expectations, have also benefited ABS and CLOs, which are predominantly floating-rate instruments. Some investors have been pivoting away from fixed-rate bonds in favour of the floating-rate segment which has seen inflows into leveraged loans.

With the system still awash with liquidity, issuers are not having to look to the ABS market for funding despite the levels of demand from investors and tightening spreads. It has, therefore, been a relatively muted start to the year for ABS issuance, and we expect this to continue for the foreseeable future. But the opposite was true for CLOs. Given the compression of spreads, there is a large number of outstanding deals that can be refinanced or reset. That pipeline has been very strong this year and shows little sign of abating any time soon. News of large Japanese AAA investors returning to European CLOs after a two-year hiatus has added depth to the investor base with AAA pricings tightening over recent months.

Figure 27. Refinancing and reset pipeline

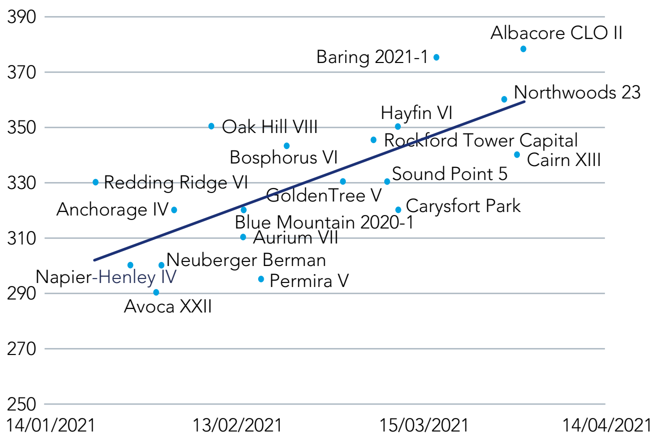


Source: LCD, an offering of S&P Global Market Intelligence.

AAAs are the largest contributing factor to the overall cost of the liability stack, and therefore determine whether a deal is refinanced or reset (a process by which the CLO manager improves the cost of funding and, therefore, the arbitrage within the deal). As we can see from Figure 27, the overall cost of the liability stack has compressed since mid-2020, and currently stands at a level tighter than the weighted average cost of capital of deals printed in the past two to three years. This means that refinancing or resetting them now makes sense for the CLO manager. The market has, therefore, seen an explosion in the refinancing and reset pipeline.

It doesn't necessarily follow, however, that all tranches are printing tighter in order for the reset to still work. Given the amount of supply, we have seen some tranches widen over recent months.

Figure 28. Primary – BBB spread



Source: Federated Hermes.

As credit fundamentals continue to stabilise or improve, these technical drivers can give rise to some interesting investment opportunities. From a credit point of view, the experience of 2020, and how CLO managers dealt with those challenges, are giving us a useful insight into how their deals perform in times of high stress. These differing performance metrics across managers and deals have brought a greater amount of differentiation to the market and investors can price accordingly. Although the environment remains benign for the time being, we would expect to see this differentiation to continue in 2021.

Private credit

The direct lending markets saw increased defaults in the first quarter as the sector continued to be affected by the Covid-19 pandemic.

Participants in the direct lending market are balancing optimism about the easing of Covid-19 restrictions and the vaccination roll-out with fears that a third wave is driving uncertainty about the timing of any market recovery. This tension is reflected in the varied levels of deal flow across geographies. In the UK, where restrictions have begun to be eased, deal flow is picking up significantly, while in many EU countries the pipeline is less predictable.

The key investment themes of the last 12 months continue to surround healthcare, pharma, and TMT. Investors also have their eyes towards businesses with strong contracted revenue streams being able to come to the market. These types of borrowers are typically attracting lender interest. With the full impact of Covid-19 still yet to be realised, owners and companies are predominantly looking to recaps and add-ons – rather than full exits – giving incumbent lenders, such as banks, a strong position in the market. Yields remain stable across the region but are likely to increase slightly as defaults rise. The second half of the year should see a peak in defaults as borrowers struggle with the impact of any further lockdowns in many jurisdictions and/or reduced government support.

Federated Hermes continues to see value in the creditor-friendly northern European jurisdictions, especially Scandinavia and, increasingly, the UK. At a time of rising defaults, we see a conservative lending strategy is a most prudent approach to the direct lending market.

Asset-based lending

Valuations across the global market continue to emphasise the popularity of logistics and prime offices.

There are few investors more keenly awaiting the lifting of Covid-19 restrictions than participants in the global real estate market. In the UK, in particular, the market is eagerly looking towards the end of the eviction moratorium. Valuations across the global market continue to emphasise the popularity of logistics and prime offices. The market is saying that the reliance on online shopping has now been so thoroughly baked into our habits that there will be no going back to old ways. However, as far as office life is concerned, people are largely expected to return to their places of work because, it seems, the office is not just a place where your computer is located (now obsolete for that purpose), it provides a much-needed space of a community of like-minded people to work towards a common goal.

There are obviously many assumptions built into this positioning and, to the extent that good returns can be found in those sectors, we do not dispute the comfort they provide. However, with transaction volumes still down from previous levels, we cannot speak of normal market conditions, let alone of an efficient market. For investors, this provides opportunities.

We believe that the retail warehouse sector, which gives us the practical yet charmless out-of-town stores, has been unfairly painted with the same brush as high street and shopping centre retail. The fundamentals of the warehouse sector, however, look much more appealing. Rents are affordable, and in most cases have been paid throughout the pandemic. Their popularity is driven both by free parking and the low shopper density which these large shops provide. This makes for much easier Covid-19 safety arrangements, relative to small stores in shopping centres. Many of the schemes have low exposure to the more volatile fashion sector, and focus on home furnishings and DIY, which has had a 'good pandemic' compared to the rest of the retail sector. Leverage requests for many of these trades have been modest, therefore, delivering strong credit fundamentals at attractive yields.

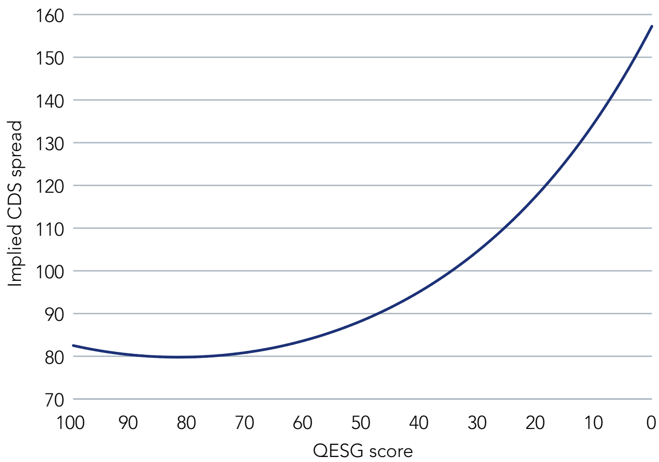
Sustainable finance

Credit markets are likely to reward companies that make the transition from ESG laggards to leaders with tighter CDS spreads, according to our latest study.

The strong correlation between ESG factors and CDS persisted during the high market volatility of 2020, suggesting that the market's ability to differentiate between (and price in) low ESG quality and high ESG quality is creating real opportunities for investors.

Using our bespoke pricing model, we analysed the link between ESG factors and credit spreads and found clear evidence that companies with better ESG practices tend to have lower CDS spreads, even after controlling for credit risk. In the study, now in its third year, we expanded the sample period to include the period from the start of 2012 to the end of a volatile 2020.

Figure 29. Implied CDS spreads and corresponding QESG scores, 2012-2020



Source: Federated Hermes, as at 31 December 2020. Note: The QESG scores, generated by our Global Equities team at the international business of Federated Hermes, rank each stock worldwide in accordance with its ESG risk.

Our results suggest that credit markets are likely to reward companies that make the transition from ESG laggards to leaders with tighter CDS spreads. This observation is particularly poignant given that asset owners and fund managers are increasingly looking to 'screen in' companies seen as ESG and sustainability leaders to reinforce the ESG credentials of their portfolios. In this environment, companies with credible transition stories represent an excellent investment opportunity as they join the elite sustainable leaders of their industries.

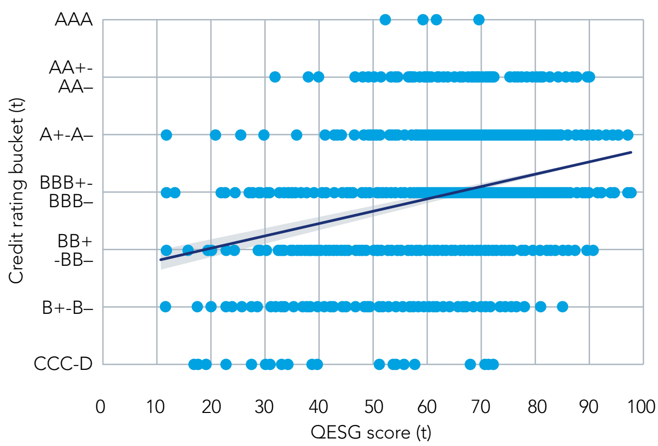
Companies with better ESG practices tend to have a lower cost of capital, lower operational costs and are less vulnerable to negative cash events than their less-sustainable peers. There is also evidence that successful company engagement by institutional investors on ESG considerations can have positive implications for a company's performance. Conversely, companies with poor ESG characteristics tend to have a higher cost of capital because they are exposed to more risks and costs stemming from non-financial externalities – such as fines for not complying with environmental or health and safety regulations – that undermine corporate financial performance.

Having completed this third review, we are encouraged that our pricing model for ESG factors not only remains robust but its explanatory power, as measured by the R-squared, has increased. What's more, the model has performed effectively through one of the most volatile periods ever in credit markets.

Unpicking the ratings conundrum

Having reconfirmed the persistent correlation between companies' ESG credentials and their CDS spreads, we focused on looking for any correlation between ESG concerns and credit ratings: a significant relationship between credit ratings and ESG performance would mean that we would have to control for credit ratings in our empirical analysis.

Figure 30. QESG scores by credit rating, 2012-2020



Source: Federated Hermes, as at 31 December 2020.

In Figure 30, the upwards-sloping blue line depicts the predicted relationship between credit ratings and QESG scores. The grey area around the straight blue line is the 95%

confidence interval, depicting the area in which the actual observations fall within a 95% likelihood. The scatter plot of blue dots depicts the actual observations in our sample.

The results offer an interesting insight: there is a significant positive correlation, with higher QESG scores tending to coincide with better credit ratings, on average.

Understanding the opportunity

The investment implications of the market's ability to differentiate between low ESG quality and high ESG quality creates real opportunities. While it is important to control for operating and financial risks, we believe buying into credible transition stories can deliver alpha – whilst also benefiting society – as the market recognises an improving ESG story.

BD007801 0010800 04/21

Federated Hermes

International

Federated Hermes

Federated Hermes is a global leader in active, responsible investing.

Guided by our conviction that responsible investing is the best way to create long-term wealth, we provide specialised capabilities across equity, fixed income and private markets, multi-asset and liquidity management strategies, and world-leading stewardship.

Our goals are to help people invest and retire better, to help clients achieve better risk-adjusted returns, and to contribute to positive outcomes that benefit the wider world.

All activities previously carried out by Hermes now form the international business of Federated Hermes. Our brand has evolved, but we still offer the same distinct investment propositions and pioneering responsible investment and stewardship services for which we are renowned – in addition to important new strategies from the entire group.

Our investment and stewardship capabilities:

- **Active equities:** global and regional
- **Fixed income:** across regions, sectors and the yield curve
- **Liquidity:** solutions driven by four decades of experience
- **Private markets:** real estate, infrastructure, private equity and debt
- **Stewardship:** corporate engagement, proxy voting, policy advocacy

For more information, visit **www.hermes-investment.com** or connect with us on social media: