360°

Credit investing in the coronavirus era: a new Goldilocks scenario?

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Fixed Income Quarterly Report
Q3 2020

Federated Hermes International

www.hermes-investment.com
For professional investors only

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Commentary

The coronavirus pandemic has placed credit markets in a precarious position. Concerns about market fundamentals – the decline in GDP and rise in unemployment, defaults and number of leveraged balance sheets – have so far been countered by injections of liquidity and financial support from central banks and governments. The tug-of-war between the two has created opportunities – and yet for credit markets to perform, we hope that neither element prevails for now.

It's not V – but is it U?

The damage that the coronavirus has wrought on the economy, livelihoods and corporate welfare is vast and has not run its final course, although the unprecedented reaction from central banks and governments has offset some of the pain. On p.12, we compare the stimulus measures to the Marshall Plan, a package which spurred 30 years of global growth, and observe that this year's response already comes to multiples of the 1948 package.

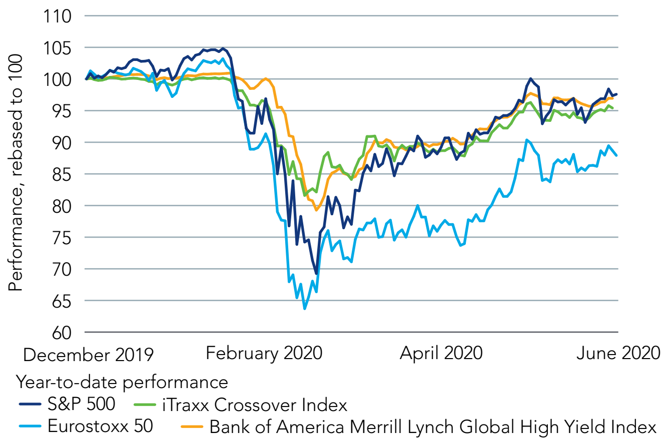
The final outcome of the pandemic – and the road we take to get there – is yet to be defined. Clearly, the situation could worsen if the virus emerges in subsequent waves or if spending patterns don't return to normal quickly.

But each time there is a wobble, central banks pump out liquidity and governments announce spending plans – and markets find their feet again. Conversely, the environment could improve if the virus's virulence wanes, but then helicopter money would fade away, interest rates could rise to contain the rebound and markets might fall again.

Financial commentators have become nervous about pointing out facts that support a bearish narrative. But we must state an irrevocable truth: a 'v' is a symmetrical figure that has the same gradient and length on the way down as the way up. By this geometrical standard, we are past the point where a v-shaped recovery is possible.

My view is premised on the fact that market fundamentals are now worse – in some instances far, far worse – than in February. The market recovery (see figure 1) was no natural bounce off the bottom, but a massive upwards push supported by the largest, fastest and most coordinated central-bank intervention in the history of modern finance.

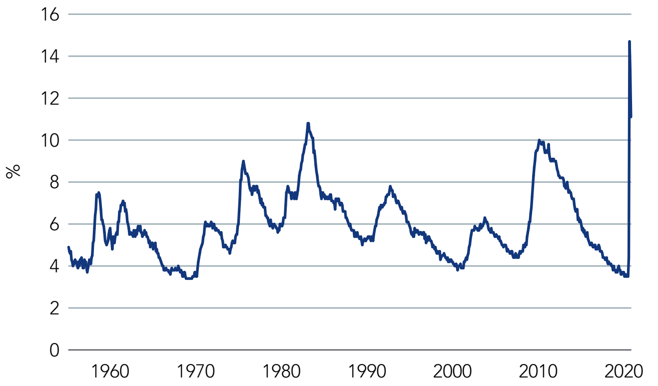
Figure 1. Year-to-date performance of credit and equity indices



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

I am not saying that this intervention was unnecessary, wrong or even that there will be a longer-term price to pay. Nor, indeed, have I argued that the recovery will be slow, incomplete, or that irrational exuberance rules the day. Furthermore, I have not weighed in on the accuracy of the most bearish warnings of a second wave of virus infections, rising geopolitical tensions, unprecedented growth in unemployment (see figure 2) and hugely inflated levels of global debt.

Figure 2. A sharp rise in US unemployment



US unemployment rate, aged 15 and over, seasonally adjusted

Source: Federated Hermes, Refinitiv Datastream, Bureau of Labour Statistics, as at June 2020.

With this in mind, let's reflect on one of the most remarkable half-year periods in financial markets.

- Rising financial distress has seen a large number of companies and individuals unable to support their debt burdens. Lenders recorded significant losses as the ensuing bankruptcies, defaults and restructurings unfolded. During the second quarter, defaults hit the highest level since the same period in 2009, while the corporate default rate tripled between the first and second quarters.
- Despite the savage economic jolt, many entities and individuals have survived intact, but a significant proportion of this cohort remains at risk of falling into the distressed zone unless a solid recovery arrives soon. In particular, the hospitality, travel and retail sectors are teetering.
- Other, more fortunate companies and individuals are in better shape, buoyed by direct or indirect support measures. Many in this group may have acted to shore up their creditworthiness by cutting dividends, reducing costs or laying off employees. Regardless, ongoing uncertainty, a protracted recovery or a permanent shift in patterns could see many of these companies slide off the edge. A large number of sectors fall into this category, with many corporates already downgraded.
- Elsewhere, a much smaller group of entities has sailed through the crisis almost stress-free, with any risks fully covered by government and central-bank largesse.
- And finally, an even smaller club of companies and individuals are now in a better position than six months ago. Starting from a position of strength, companies in industries such as logistics and technology were well-positioned to capitalise on the changes in behaviour that have been accelerated by lockdowns.

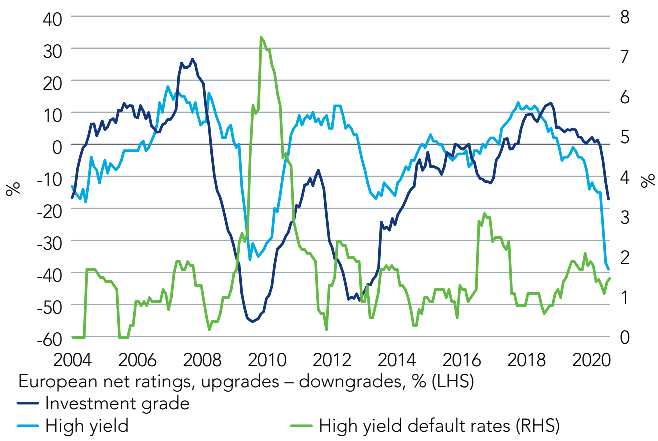
Fundamentally resilient

For now, our focus is on the short-term impacts and the probable, rather than possible repercussions of the pandemic. In particular, we are looking at what will probably be a mild trickle-down effect to single-name casualties, and the volatile-but-containable credit-market adjustments.

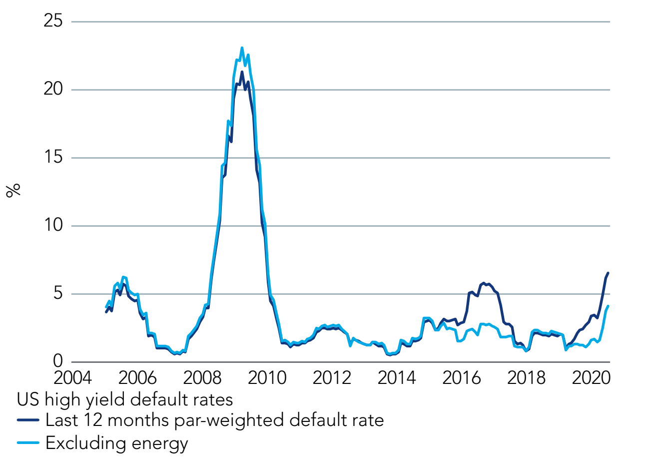
Looking at almost any measure of the strength of credit fundamentals, the world is now in a worse position than before the crisis. Yet, importantly, metrics indicate that markets are not in a uniformly poorer state – nor that the situation is so bad that fixed-income investors can't find pockets of good value.

Indeed, the crisis has highlighted both the relative resilience and value of fixed income as an asset class – although it should be acknowledged that there has been an increase in leverage, reduced debt affordability, downgrades, defaults and below-average historical recovery rates (see figure 3).

Figure 3. Defaults and downgrades



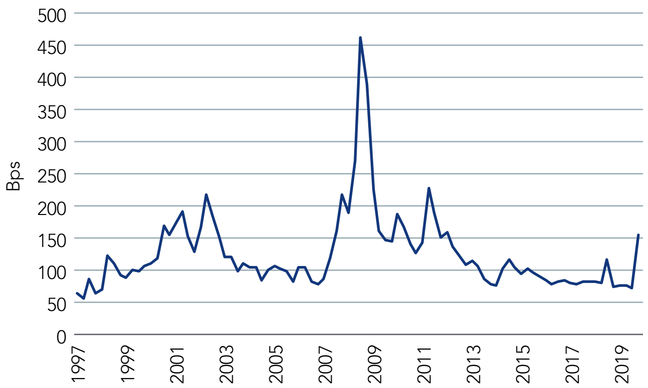
Source: Federated Hermes, JP Morgan, as at June 2020.



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

Perhaps the most important question is whether credit fundamentals have worsened enough to justify another major widening in credit spreads (figure 4).

Figure 4. US high yield: spreads relative to leverage



High-yield credit spreads, per unit of leverage

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

On the one hand, credit spreads are 50%-75% higher than in the pre-crisis period. Fixed income is one of the few defensive asset classes to offer the prospect of positive returns and many companies seem like good value after making it this far through the crisis without suffering major distress. Furthermore, relative-value opportunities are emerging, while lending strategies have the potential to offer meaningful upside.

But coupled with these positives, there are also material tail risks. These centre around the impact of a second wave and what recoveries will look like after a long period of 'amend to extend' agreements. In addition, it is unclear whether central banks will continue to support markets even when the evidence suggests that their actions are not reviving economies, and if geopolitical sabre rattling will make assumptions about future growth untenable.

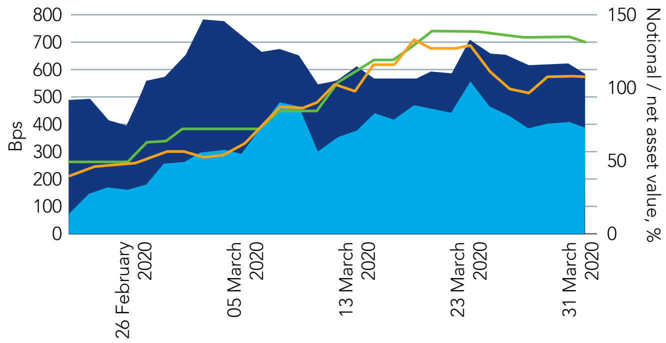
A balancing act

With both perspectives in mind, we find ourselves in the middle ground. Overall, we have a positive view on credit markets – but with caveats. For years, we heard about the Goldilocks economy in which credit thrived when growth was neither too hot nor too cold – much like the infamous porridge. We now think of Goldilocks and credit in terms of epidemiology, where the situation is not too safe, nor too risky.

What does this mean in practice? We expect ongoing volatility, corporate casualties, for sectors to fight for survival and for an appealing trade-off of risks and returns. Both public and private credit markets currently offer rich opportunities (read about these in our relative-value section on p.5). Nonetheless, the level of uncertainty means we also like to support our convictions with hedges.

Fortunately, volatility has fallen considerably, as has the hedge on some credits that others perceive to have minimal risk. Figure 5 shows the value of the options overlay on our Unconstrained Credit Strategy during the sell-off as an example, when the dynamic, active management of the options book throughout the end of February and March allowed the team to crystallise profits while maintaining convexity and a level of protection.

Figure 5. The value of an options overlay



Active management of the option payers on Itraxx Crossover on the Unconstrained Credit Strategy

Notional (RHS) Delta-adjusted notional (RHS)
Options book average strike (LHS) iTraxx Crossover level (LHS)

Past performance is not a reliable indicator of future results.

Source: Federated Hermes, as at June 2020.

In an environment of unprecedented uncertainty, there is more of a need than ever to take an active approach to fixed income. Investors should be selective, attentive, analytical, paranoid and introspective – all traits that we expect in our analysts and portfolio managers.

The granular, bottom-up work of our analysts has never been more important, and the team has worked tirelessly throughout the first half of the year – and will continue to be fully occupied analysing the results and forecasts of companies who have been operating in the dark throughout global lockdowns.

As a company whose history is steeped in stewardship and engagement, environmental, social and governance (ESG) analysis has been a powerful aid to understanding the unique challenges that our investments face and the paths the team may take in tackling them.

Looking back over the last six months, we are grateful that our risk-minded underwriting within the private-credit space and flexible approach to liquid credit has helped us to deliver the type of performance our clients expect. Moreover, regular communication with these clients has helped us understand the pattern of flows between asset classes and note the particular uptick into those with an ESG or sustainable emphasis.

In closing, we would like to thank all of our clients for their support during this period. While the ultimate outcome of the pandemic remains uncertain, we see a wealth of opportunities to seek out alpha – and look forward to sharing with you our insights and strategy in the months ahead.

The value of investments and income from them may go down as well as up, and you may not get back the original amount invested.

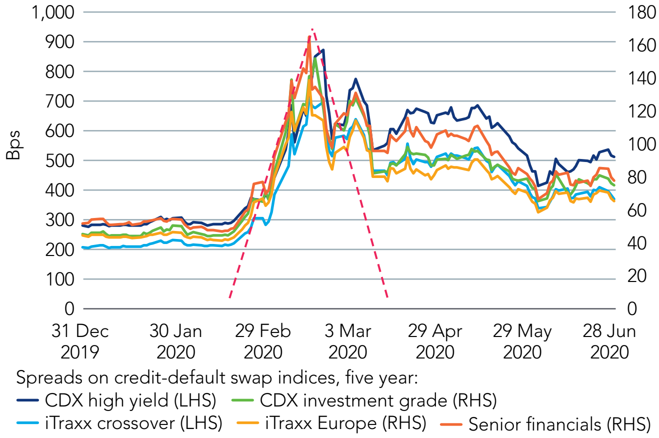
Relative value between asset classes

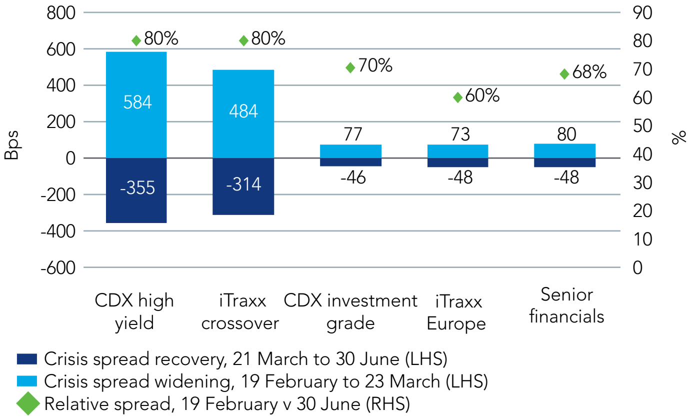
After a rapid sell-off off in credit markets in February and March, the recovery in spreads has not followed the v-shaped contour associated with a sharp bounce back.

The spreads on credit-default swap (CDS) indices show that the market recovery curve over the past few months has been more akin to a 'Nike swoosh' than a 'v' shape, with spreads still 60%-80% wider than pre-crisis levels at the end of Q2 (see figure 6). We can also see that the move in investment-grade spreads was higher than for high yield, while Europe outperformed the US.

But a look beyond the most liquid CDS indices shows that there is greater dispersion in spread moves, which range from 20% wider to many multiples more for exposures that are deeper in the capital structure (see figure 7).

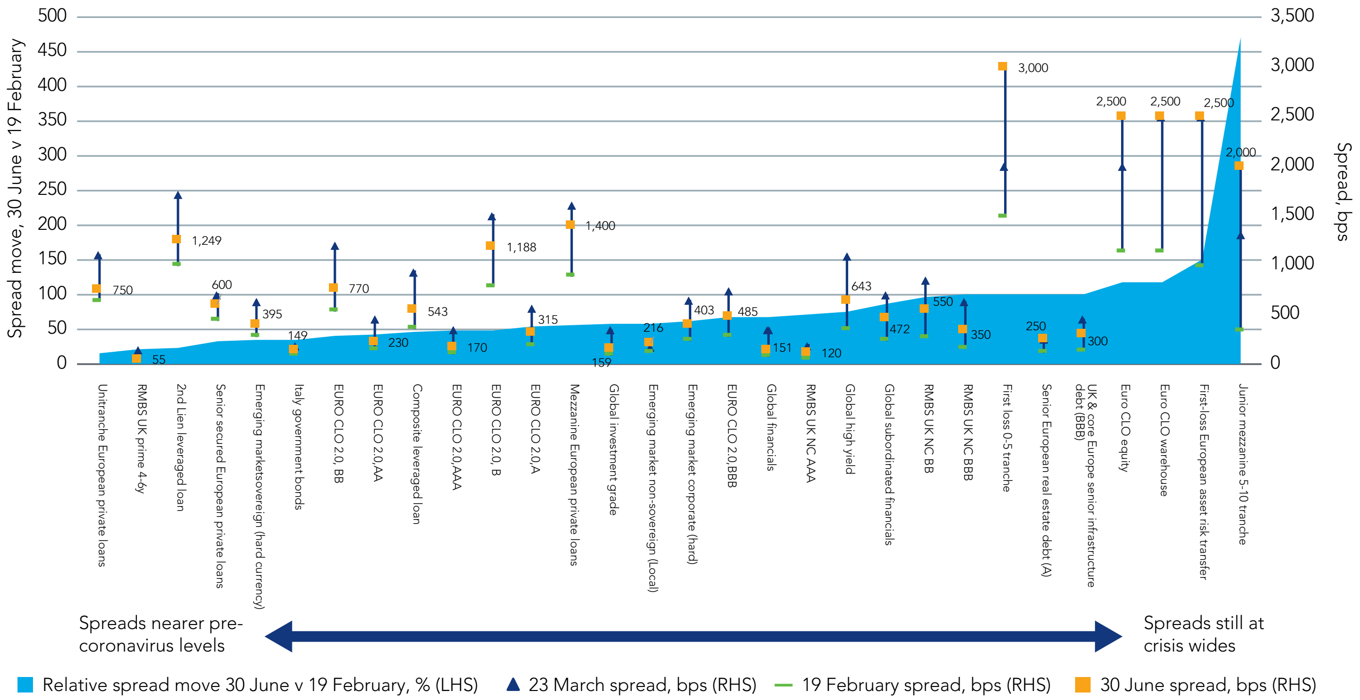
Figure 6. Year-to-date spread move in CDS indices





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

Figure 7. Change in credit spreads

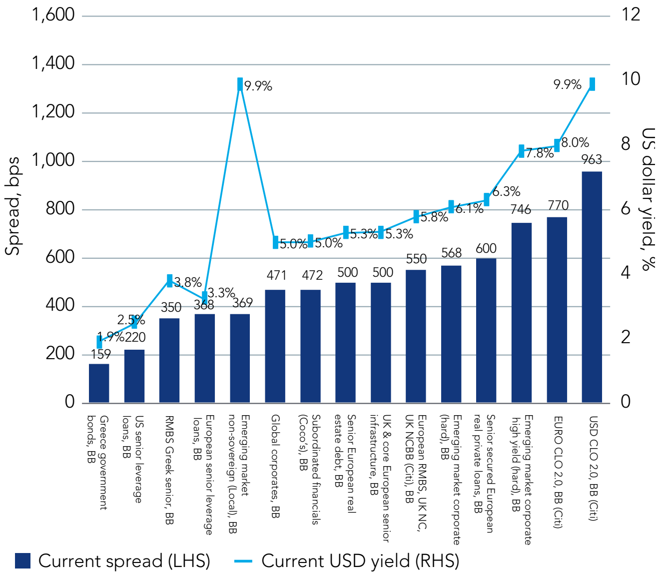


Source: Federated Hermes, Bloomberg, Citi, as at 30 June 2020.

Compared to Q1, the second quarter offered better price discovery as liquidity normalised in public credit markets and more transactions took place in private credit markets. Given that valuations are a better reflection of underlying fundamentals, we can derive a more accurate comparison of relative value (see figure 8).

But an analysis of relative value across investments with similar levels of credit risk provides only a partial perspective. For a more complete picture, our Multi Asset Credit relative value framework assesses a broader range of factors to better account for the structural differences between these exposures (see figure 9). This quarter, we look at the moves relative to both March and the start of the year.

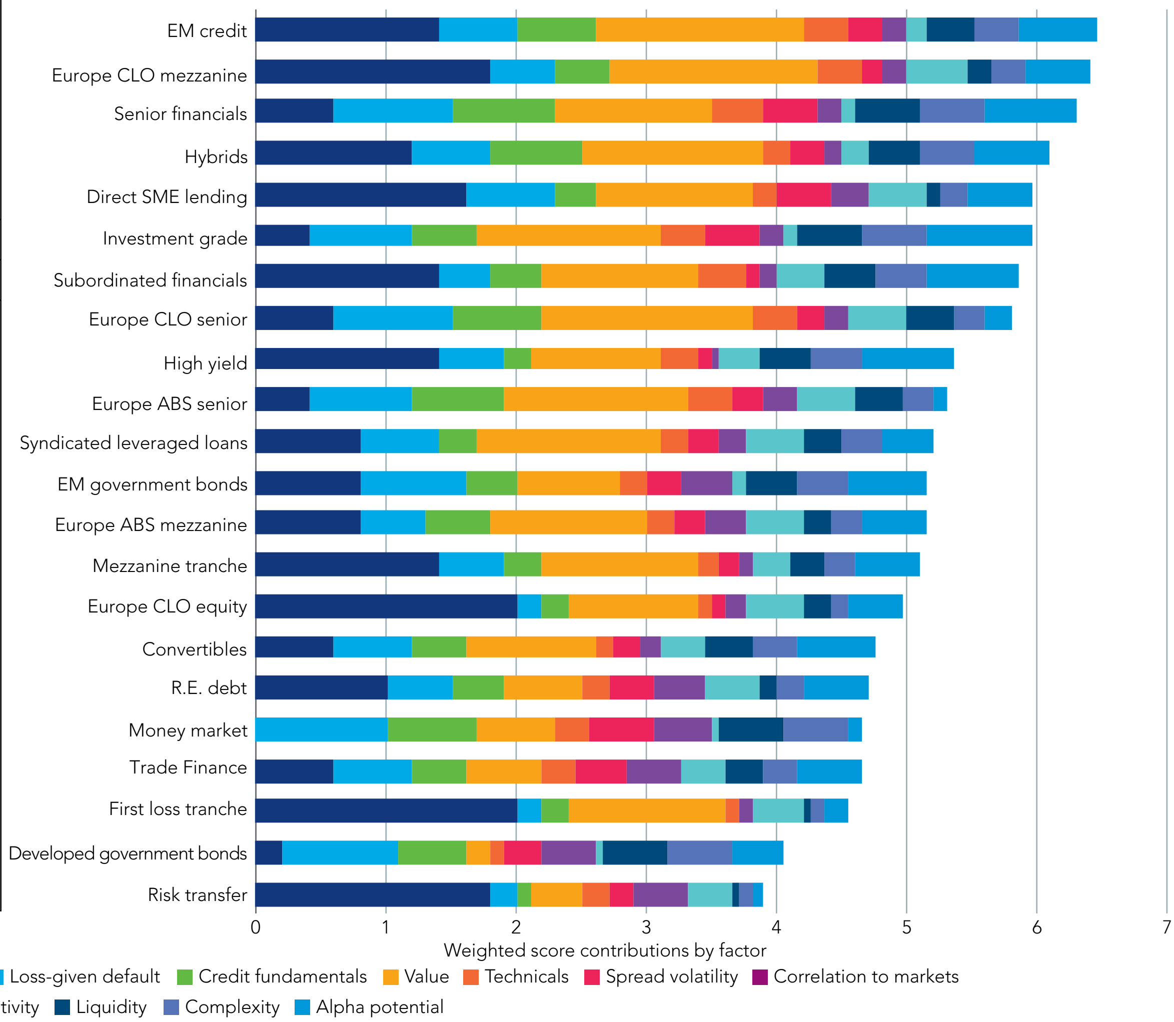
Figure 8. Relative value among BB-rated exposures



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

Figure 9. Our Multi Asset Credit relative value framework, 30 June 2020

Q2	▲	Q1	▲	Q4
1	▲	10	▼	2
2	–	2	▼	1
3	▼	1	▲	3
4	▲	9	▼	5
5	▲	8	▼	4
6	▼	3	▲	6
7	▼	4	▲	7
8	▼	7	▲	10
9	▼	6	▲	17
10	▼	5	▲	13
11	▲	14	▼	12
12	▲	18	▲	N/A
12	▼	11	▲	15
14	▲	16	▼	15
15	▼	14	▲	18
16	▲	18	▲	21
17	▲	20	▼	9
18	▼	17	▼	14
18	▲	21	▼	7
20	▼	13	▲	20
21	▼	12	▲	18
22	–	22	▼	11

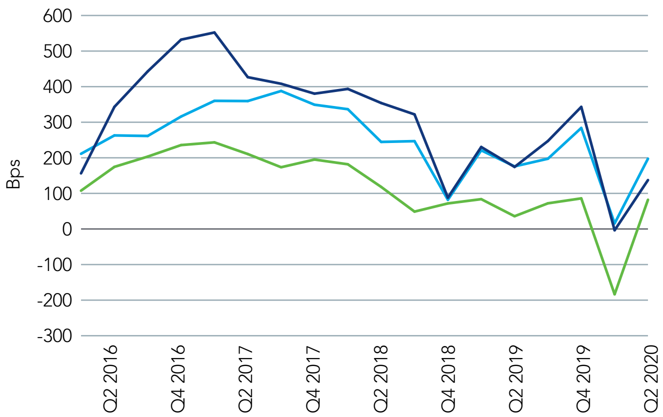


Source: Federated Hermes, as at 30 June 2020.

In March, credit valuations were at record lows and uncertainty had peaked. As a result, our framework favoured more defensive, higher-quality and liquid exposures. But in the latest period, the analysis reveals a different picture. For example, emerging-market credit now sits at the top of the ranking, having risen from 10th place last quarter.

Several factors contribute to these changes, including a rally in higher-quality exposures, an improved economic outlook that supports valuations of select lower-quality credits and the re-emergence of an illiquidity premium in areas of private credit – particularly in direct lending (see figure 10).

Figure 10. The illiquidity premium of European senior middle-market direct lending



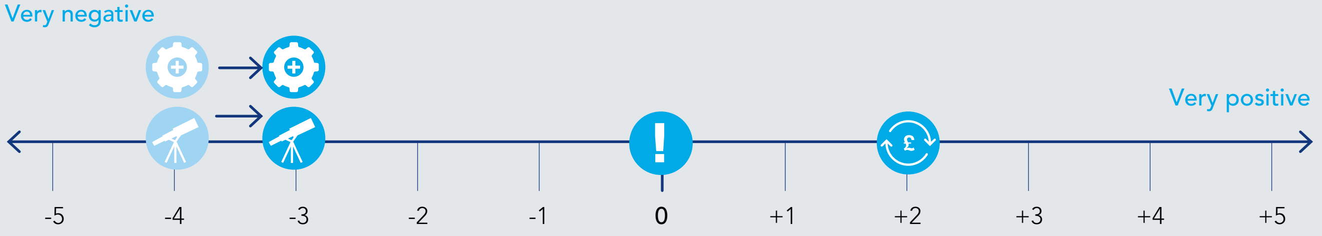
Source: Federated Hermes, Bloomberg, S&P LCD, World Bank, Bank of America Merrill Lynch Research, as at 30 June 2020.

We now list some of the key themes emerging from the latest quarterly ranking:

- The spreads on liquid cash bonds have widened. **Investment grade** has recovered the most, aided in part by downgraded names moving into the high-yield universe.
- **Emerging-market credit, financials** and **global high yield**, which are more exposed to the weak economic outlook, have lagged. **Emerging-market credit's** position is primarily due to its positive value score and it offers a strong spread premium and pick-up in yield.
- **Corporate hybrids** which pass our robust selection criteria offer attractive relative value. We are happy to collect the premium for lending for longer to companies we like.
- **Direct lending** has risen up the ranking as transaction activity has picked up and senior and unitranche middle-market margins remain resilient, with the added benefit of stricter covenants and fewer 'cov-lite' deals. We see the most value in senior secured loans, where an illiquidity premium has resurfaced.
- **Euro CLO mezzanine** tranches continue to offer an attractive spread premium, while the recovery in loan prices demonstrates the market's resilience. **Euro CLO AAA**-rated exposures offer interesting spreads and 0% coupon floors.
- Both the spreads of **commercial mortgage-backed securities** and **residential mortgage-backed securities** moved wider, reflecting continued uncertainty and the prospect of payment holidays ending.
- Bespoke **mezzanine tranches** have moved wider and are now priced at an attractive level for a higher target-return portfolio. Mezzanine tranches benefit from subordination cushions, which provide some protection against credit losses. This is to the detriment of **first-loss tranches**, which we are less enthusiastic about.

Despite the attractive spreads on offer, we feel it is too soon to buy into the deepest parts of the capital structure where the risk of material losses is higher. Our preference is to use a diversified portfolio to implement these relative-value ideas, combining substantial liquidity with options to help protect against the downside, in order to create a strategy that we think should be flexible enough to respond to the fast-changing economic environment.

Q2 2020 score card



Economic outlook

- **Moved to -3 from -4**

Credit fundamentals

- **Moved to -3 from -4**

Valuations and technicals

- **Stayed at +2**

Tail risks

Remains at 0

- The market has recovered from its March lows but remains out of sync with the global economy, which is in poor health.
- Without a vaccine, a second wave of infections seems likely. This could trigger more lockdowns, which would derail the economy recovery and depress risk assets.
- High unemployment rates could impact consumption and prevent a return to pre-lockdown levels of output.
- The oil price could crash again if the Organisation for Petroleum Exporting Countries fails to agree a supply cut.
- In the run up to the election, President Trump could initiate more protectionist policies which would likely dampen any recovery in asset prices.

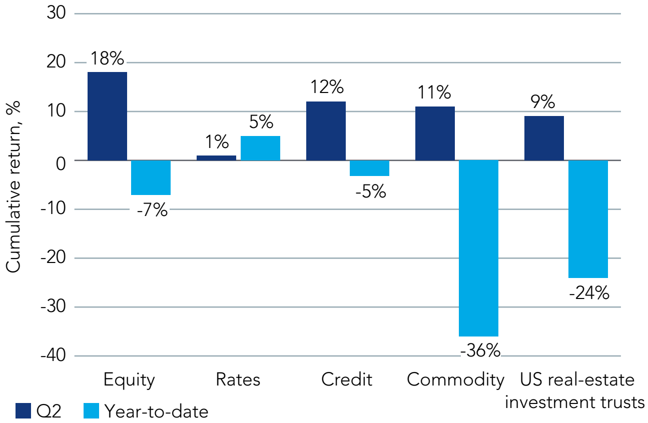
Contents

Multi asset

As we pass the halfway point of a turbulent year, markets have recovered a significant amount of their early coronavirus-related losses.

With the exception of rates[1], all asset classes remain in the red year-to-date. Energy volatility meant that commodities performed the worst, while equity and credit markets rebounded in Q2. Traditionally a hedge, rates provided the best year-to-date return, but remained flat over the second quarter (see figure 11).

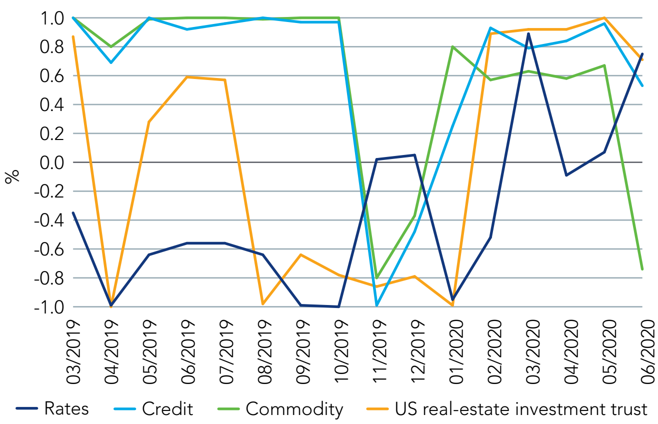
Figure 11. Asset class performance



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

We also analysed the three-month rolling correlation of different asset classes to equities. Notably, the correlations of commodities, credit and US real-estate investment trusts have begun to diverge from equities only in the last month (see figure 12).

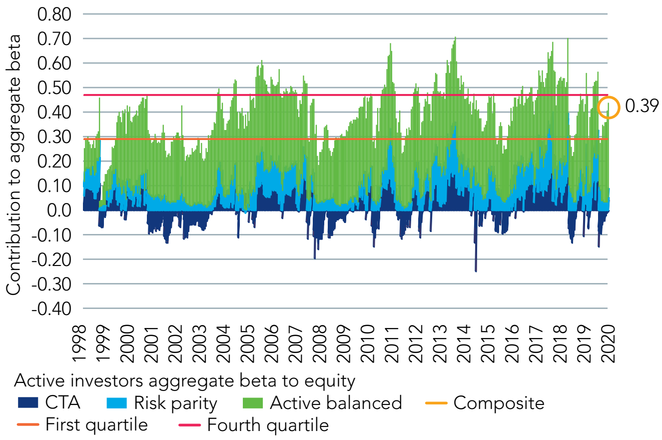
Figure 12. Three-month rolling correlation with equity



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

The aggregate beta of active funds to the MSCI World index – measured across investors like commodity trading advisers (CTAs), risk parity and mutual funds – is currently at 0.39, indicating a neutral positioning. CTAs are neutral on equity and credit, while risk-parity funds are long on both asset classes. However, their positioning has decreased over the last three- and six-month periods (see figure 13).

Figure 13. Active investors' aggregate beta to equity



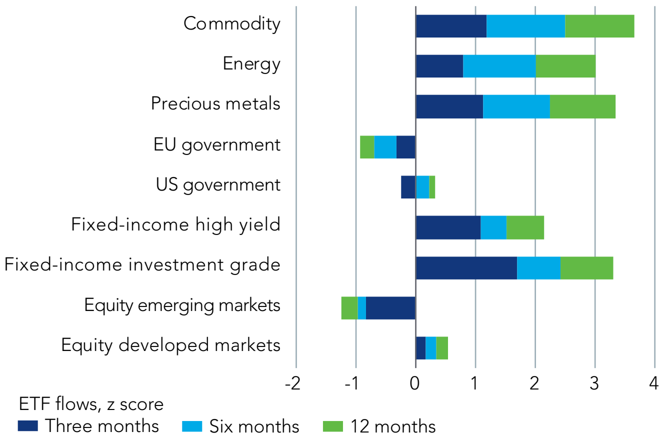
Source: Bloomberg. Federated Hermes, as at June 2020.

Our exchange-traded fund (ETF) data shows the combined Z scores of ETF flows for each asset over the last three, six and 12 months. Clearly, the demand for precious metals has stayed consistent, suggesting some apprehension in the market.

Equity ETF flows also indicate a risk-off mood, with developed markets recording minor inflows and emerging markets sustained outflows for each period. Credit markets are more bullish and have enjoyed significant inflows over the past three months, primarily within investment grade (see figure 14).

[1] Predominantly developed-market government bonds.

Figure 14. ETF flows

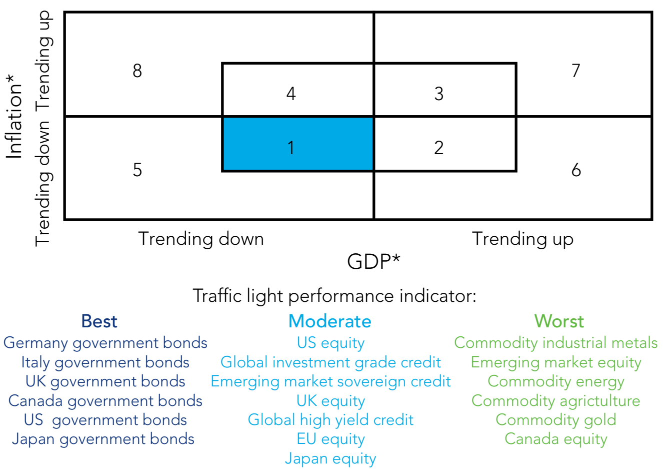


Source: Bloomberg. Federated Hermes, as at June 2020.

While markets are generally trading in a tight range, we continue to seek medium- and long-term- opportunities across asset classes.

Over the medium-term, we use our 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 beginning of June, the global economy has moved to quadrant one, where both expected GDP and inflation are trending down moderately. We believe that the best assets to invest in for this scenario would be rates, followed by credit and equity, and lastly commodities (see figure 15).

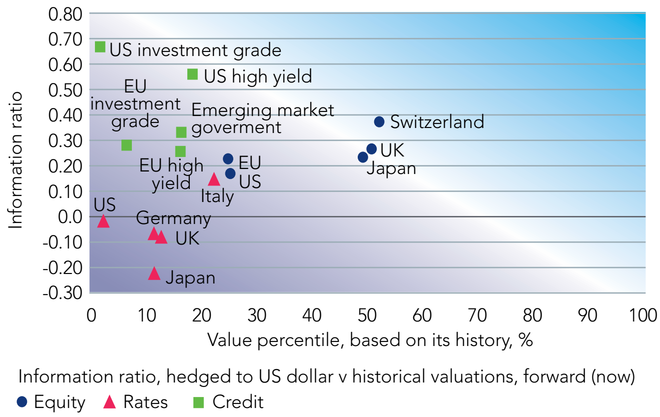
Figure 15. Economic scenario quadrant



Source: Bloomberg. Federated Hermes, as at June 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.

For a longer-term outlook, we consider forward-looking valuations across asset classes. Following the post-March market rally, most assets have become more expensive based on their historical valuations. With their historically low yields, rates remain the most expensive and least attractive. Credit – particularly US investment grade and high yield – seems the most appealing in terms of its expected information ratio (see figure 16).

Figure 16. Information ratio v historical valuations



Source: Federated Hermes, as at June 2020.

In the shorter term, markets have likely reached a crossroads. The rally from the bottom has been ignited by extraordinary monetary and fiscal policies and fuelled by the optimism surrounding the reopening of economies. Now that the marginal impact of the liquidity pulse is waning and investors' expectations have adjusted to a series of better-than-expected economic data, the good news is largely priced in.

Looking forward, the direction of markets will be a function of the tug of war between two factors. One, the deflationary forces stemming from the real economic damage caused by the coronavirus, and two, the reflationary element resulting from the expectation of more expansionary policy and the human resilience and ingenuity that could find a way through the crisis.

Central banks have made it clear that they will not let credit markets collapse, meaning the floor is likely higher than the one we experienced in March. In addition, credit markets may be less sensitive than equities to the strength of the recovery. Conversely, credit should offer less upside than equities should the recovery prove to be stronger than anticipated.

As a result, we expect credit markets to offer a better risk-reward balance than equities should the recovery be either lower or on par with expectations, and to underperform if the recovery is stronger than expected.

Economic outlook

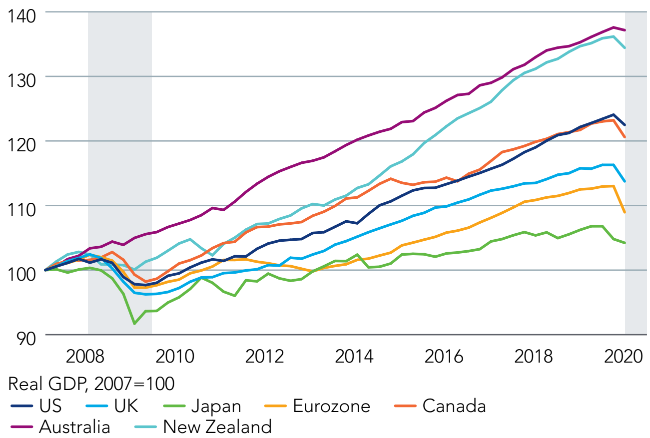
A sense that the coronavirus has passed its peak means that GDP projections are gradually moderating from worst-case scenarios. Yet markets are reliant on the pacifying influence of stimulus, and it will be increasingly hard to bring the era of cheap money to an end.

The global economy is in a strange shape. A v-shaped recovery is looking increasingly unlikely, and a 'w', 'u' or 'l' all remain distinct possibilities. Encouragingly, some advanced-economy metrics – such as Purchasing Managers' Index surveys and US payroll data – are slowly improving. Yet the contraction in GDP may be prolonged if the virus persists in densely populated nations like Brazil, India and Russia, while a more protectionist US – and stronger dollar – could further harm the world economy.

Even if the US Congress is divided in 2021, it may not be able to prevent further trade restrictions – especially if President Trump is re-elected. His ability to use Section 301 of the 1974 Trade Act without approval from Congress or the World Trade Organisation would curtail other countries' growth rates. Moreover, competitive retaliations – such as a depreciation in the renminbi – could incite a deflationary flow back to the US.

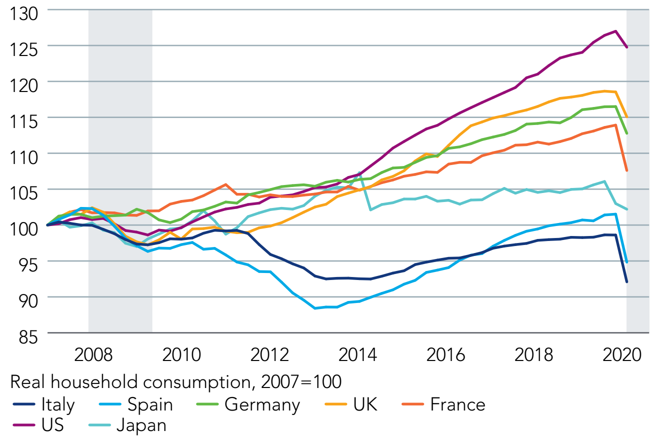
Such an outcome would hinder any global economic recovery. As figure 17 shows, it took five to six years for the UK and US to return to pre-crisis levels of real GDP after the last balance-sheet recession in 2008-9. Meanwhile, consumers in Japan, Italy and Spain have yet to recover (see figure 18).

Figure 17. Real GDP



Source: Refinitiv Datastream, based on national data, as at June 2020.

Figure 18. Real household consumption



Source: Refinitiv Datastream, based on national data, as at June 2020.

This time, the rise in unemployment – US payrolls have fallen by a net 15m since February and the unemployment rate has trebled – echoes the trend seen in the 1930s. The US employment participation rate is also at a 45-year low, showing that the issue is not just job losses, but replacing those leaving the labour force.

Even if 60% of these coronavirus-related job losses prove temporary, the 8% unemployment rate that would result from a full, immediate rehire would be more than double the February figure. Rapid labour downturns, such as that experienced over 2007-9, do not guarantee sharp recoveries. Moreover, benefit cuts and difficulties locating those who need state support could dampen overall spending – as could the problem of spend-thrift returning workers.

The monetary response has been rapid and widespread. Our analysis suggests that quantitative easing (QE) adjusted policy rates are a respective -10% and -6% in the US and UK. This is the loosest stance in nearly three decades-worth of data, with little correction expected in 2021. These low implied monetary-policy settings question the urgency for the Federal Reserve (Fed) and the Bank of England to follow Japan and Europe down the path of negative interest rates.

Meanwhile, central banks continue to take unprecedented steps. The Fed has initiated the use of special-purpose vehicles to buy corporate names, including qualifying fallen angels (issuers downgraded to high-yield status). Meanwhile, the European Central Bank has extended and ramped up asset purchases until the middle of 2021, while the Bank of England has announced an additional £100bn-worth of QE.

Fiscal expansions vary in speed and scale, but the global legacy will be debt. The US, eurozone and UK's government-debt ratios are twice that of Japan's when it entered a so-called 'lost decade'. The UK's debt-to-GDP ratio has risen from 80% to 100% over the past year, the highest level since 1963. If debt continues to accumulate at this pace and nominal growth fails to increase, the ratio could reach 250% by 2030, a post-war high.

In these circumstances, QE would be even more difficult to abandon – especially as central banks are striving for the status quo. The ongoing precedent for loose policy and governments' dependence on it suggest we may be little more than half-way through the era of cheap money.

In 1951, the US Treasury-Federal Reserve Accord brought the era of QE to an end. That deal will not be repeated this time around: indeed, money-printing restraints could be loosened further. Either way, in a high-debt world, the challenge will be to keep a clear operational distinction between monetary and fiscal authorities as bond issuance escalates and governments' addiction to QE builds. Perhaps, we may eventually have to look beyond the English alphabet to describe the shape of things to come.

The Marshall Plan: the historical precedence for stimulus

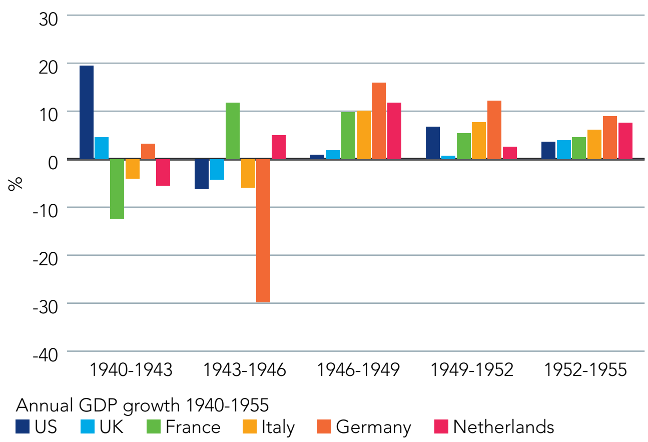
History is full of crises of global economic significance. While some observers have compared the pandemic to the Black Death in the 14th century, others have looked to a more recent historical example to understand the potential economic consequences.

Ursula von der Leyen, the European Commission President, recently referenced the Second World War in a bid to put the economic damage from the pandemic into context, arguing that the global economy "will need massive investment in the form of a Marshall Plan for Europe."[2]

The Marshall Plan emerged out the Economic Recovery Act that was signed into law in 1948 by US President Harry Truman. Named after the US Secretary of State at the time, George Marshall, the US-sponsored plan was designed to fight communism, provide economic assistance to restore Europe's infrastructure and support the American economy by ensuring Marshall Plan funds were spent on US goods.

During the Second World War, most European economies – including the UK – recorded a fall in economic output[3] (see figure 19). To mitigate this, the Marshall Plan transferred over $12.9bn ($128bn in today's money) to European countries. The largest recipient was the UK, which accounted for almost 25% of the total. The Marshall Plan provided substantial support for the largest European economies. Between 1948-1955, the combined GDP of the five main European countries grew by 6.3% a year.

Figure 19. Annual GDP growth in Europe



Source: University of Groningen, as at June 2020.

Unlike in the aftermath of the Second World War, the enemy is invisible. Yet as in the 1940s, the threat is destroying the global economy. Fitch, a ratings agency, expects the global economy to decline by 1.9% in 2020, with the US, eurozone and UK economies set to shrink by a respective 3.3%, 4.2% and 3.9%. As bad as these numbers seem, the contractions recorded during the war were far worse – for example, US GDP fell by 20.6% in 1946.

[2] 'Do we need a new Marshall Plan to rebuild Europe after Covid-19?', published by the World Economic Forum on 9 April 2020.

[3] All GDP data in this chapter are based on 1990 international Geary-Khamis dollars. Source: Angus Maddison at the Groningen Growth and Development Centre, University of Groningen, as at June 2020.

In the face of the threat from the pandemic, most European economies have put in place fiscal measures. These fall under three categories:

- **Immediate fiscal impulse (cash equivalent).** Government spending or the cancelation of certain taxes. These measures have an immediate impact on the budget balance without any direct compensation.
- **Deferrals** of certain payments, including taxes and social-security contributions, which in principle should be paid back later. These measures will improve solvency and the cash flows of individuals. They will have an impact on 2020 budget balances but should be restored later.
- **Other liquidity provisions and guarantees.** These measures include export guarantees, liquidity assistance and credit lines, which will require company action. This range of support mechanisms shouldn't impact 2020 budget balances but will create contingent liabilities that may in time convert into expenses.

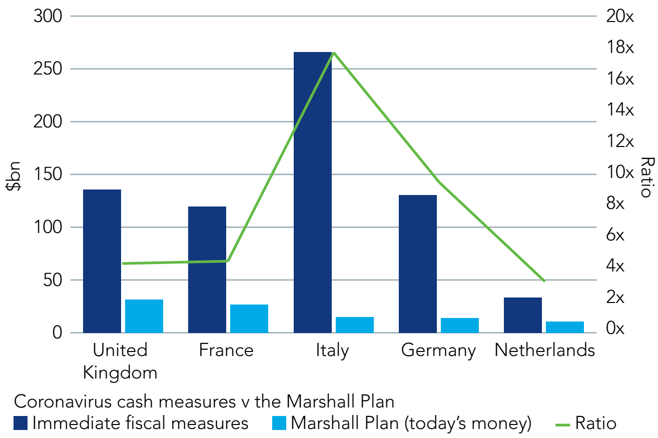
Figure 20. Discretionary fiscal measures adopted in response to the coronavirus pandemic, as % of 2019 GDP

	Immediate	Deferral	Other	Total	Last update
UK	4.8%	1.9%	14.9%	21.6%	30/04/2020
France	4.4%	8.7%	14.2%	27.3%	18/06/2020
Germany	13.3%	7.3%	27.2%	47.8%	03/06/2020
Italy	3.4%	13.2%	32.1%	48.7%	22/06/2020
Netherlands	3.7%	7.9%	3.4%	15.0%	27/05/2020

Source: Bruegel, as at June 2020.

In order to compare the stimulus measures to the Marshall Plan, we analysed the immediate fiscal impulse across the five main countries that were helped by the post-Second World War economic rescue effort. As figure 21 shows, the coronavirus fiscal response significantly outweighs the Marshall Plan program. In Italy, the immediate fiscal measures are worth almost 18 times the amount the country received through the Marshall Plan.

Figure 21. Coronavirus cash measures compared to the Marshall Plan



Source: Federated Hermes, as at June 2020.

Undoubtedly, the current economic crisis pales in comparison to the darkest years of the Second World War. Yet governments across the world have responded at a scale that far eclipses the historic Marshall Plan that subsequently led to 30 years of 'glorious growth'.[4]

History is also in the making in other ways. The European Union has endorsed a full package of €1.85trn to support the eurozone (of which €500bn is in grants) – the closest collaboration between most European countries for many years.

[4] "Les Trente Glorieuses': From the Marshall Plan to the Oil Crisis', published by The Oxford Handbook of Postwar European History in May 2012.

Fundamentals

The market sell-off in March sharply reversed in the second quarter as central banks and governments applied triage to banks, industries and capital markets.

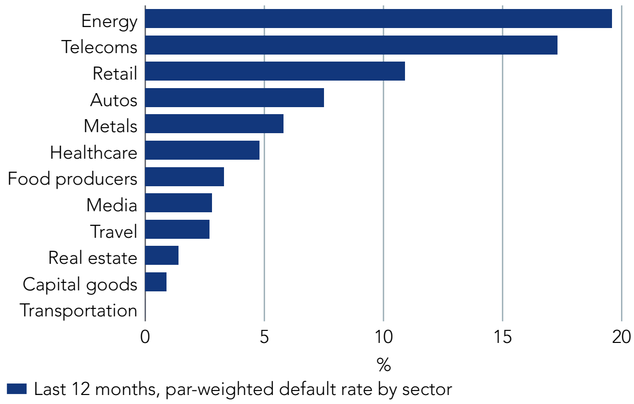
Although the dust has yet to settle, the second quarter was marked by record amounts of debt issuance by companies (particularly in the US) and a surge of flows into credit funds.

At the same time, credit spreads rallied, curves steepened, and macroeconomic data improved sharply. The global response to the coronavirus crisis served to mitigate the immediate and acute financial risks – the most injurious of fundamental risks – as cash balances were padded, front-end debt was rolled forward (or exchanged) and refinancing rates declined.

But while central banks and governments facilitated a much-needed breather for industry and capital markets, the long-term effects of this triage are unlikely to be known for months, if not years.

It didn't take long for casualties to emerge in the period between the market crash and subsequent bounce. Defaults ticked up (see figure 2) and there were high-profile bankruptcies, including Hertz, JC Penney and multiple names in the energy sector. There was also a raft of fallen angels, including Pemex and General Motors, while banks' balance sheets came under pressure.

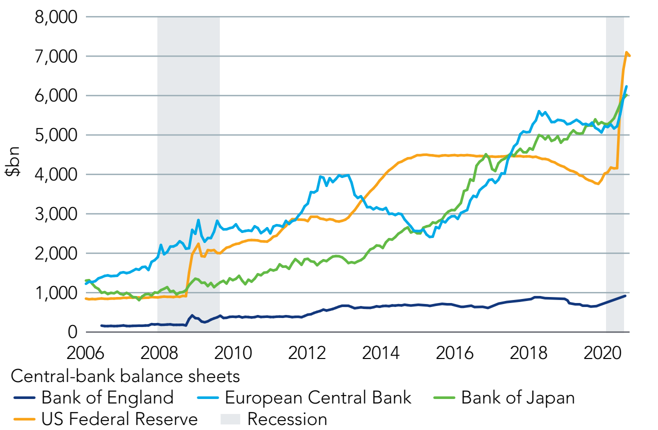
Figure 22. US high-yield default rates



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

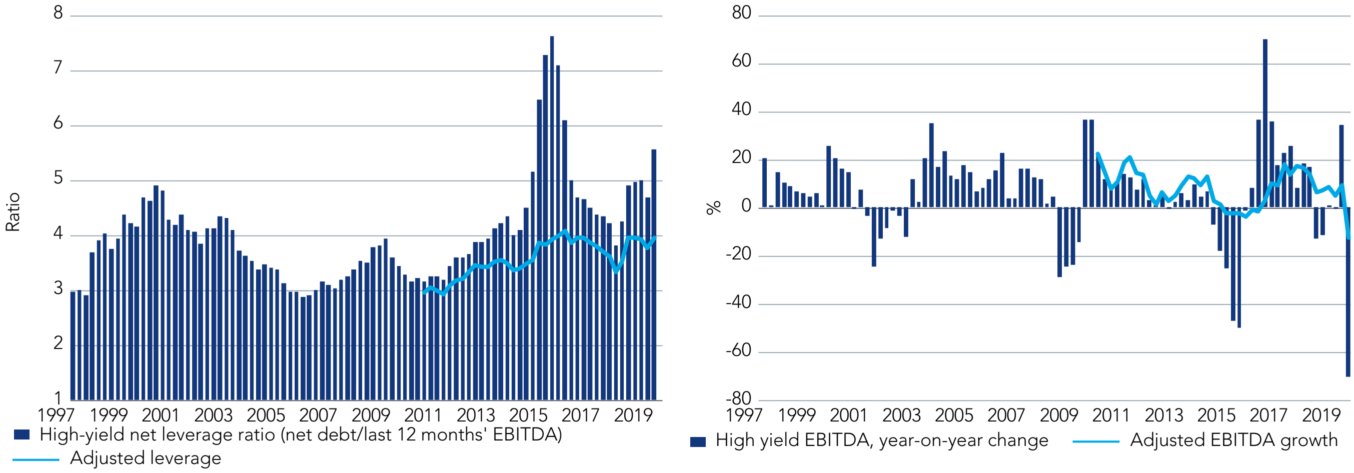
Governments and corporates have also significantly expanded their balance sheets from already-high levels (see figures 23 and 24). This, combined with a forthcoming decline in operating cashflows, means that financial leverage is rising. Moreover, operating risks – particularly in the leisure, travel, retail and auto sectors – remain very high, particularly for small and medium-sized businesses. In turn, this is likely to put pressure on banks and some structured products.

Figure 23. Major central banks expand their balance sheets



Source: Federated Hermes, Refinitiv Datastream, based on central bank data, as at June 2020.

Figure 24. Companies add leverage as earnings decline



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

One of the negative side effects of increasing central-bank balance sheets is debt-service costs. Just as GDP is under pressure, debt-service costs are rising globally. This can be a headwind for global growth, as cash is redirected from investments to pay interest.

Meanwhile, slow economic growth and rising debt can be a major headwind for companies that need growth in order to service their own expanding balance sheets. This compounds pressure on their own debt-service needs, which implies less cash for capital expenditures and research – key inputs for innovation and growth.

Credit fundamentals will remain challenged as it becomes even more difficult for highly levered firms (particularly in coronavirus-affected sectors) to grow into their balance sheets. The strong and well-provisioned will survive, while the weaker will suffer – as we have seen from rising default rates. As a result, we remain largely focused on capital appreciation, security selection and carry opportunities in the areas of higher-quality credit where we see pockets of value.

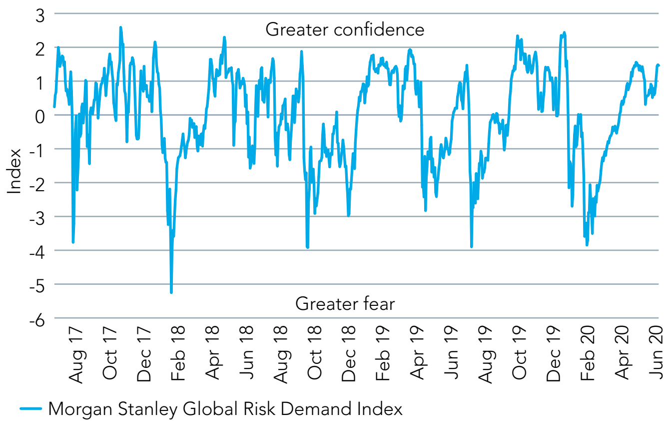
Valuations and technicals

Sentiment has been boosted by central-bank liquidity, which prompted an uptick in flows into credit funds over the second quarter. Meanwhile, credit markets still offer attractive levels of convexity.

Sentiment

After the hit to sentiment in the first quarter, the market mood has turned decidedly brighter (see figure 25). Strong positive sentiment has been buoyed by unparalleled support from central banks across the globe, a better-balanced oil market and progress in containing the pandemic. Lower volatility has since increased demand for risk assets in a market where government bonds only offer limited income for investors.

Figure 25. Market sentiment

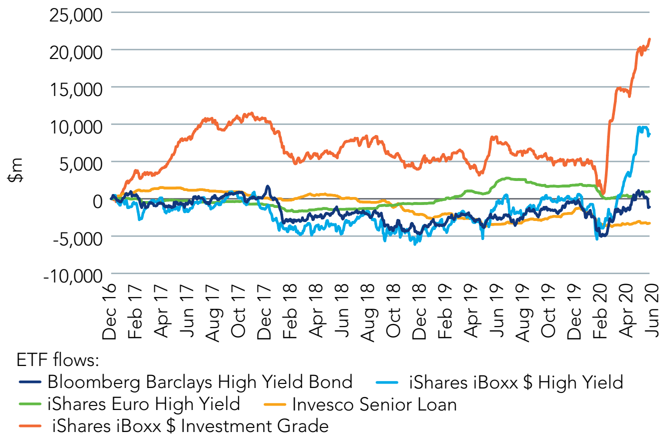


Source: Morgan Stanley, as at June 2020.

Asset flows

Upbeat global credit flows also underscore the rapid turnaround in sentiment from its March lows – a trend fuelled in part by a sharp rise in savings in many jurisdictions. These savings have flowed to the quality end of the fixed-income market, targeting assets higher in the capital structure with mandatory coupons and attractive upside potential. Overall, the technical picture supports credit markets, driven by doubts about the strength of the global economic recovery and the fact that equity-market returns are still dependent on dividends and buybacks (see figure 26).

Figure 26. Fund flows

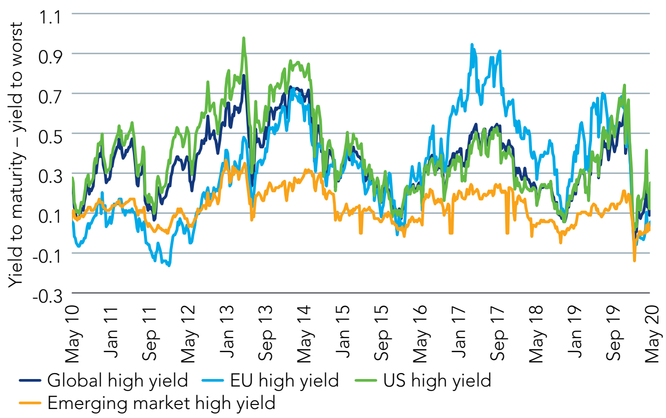


Source: Bloomberg, as at June 2020.

Valuations

Strong demand for risk assets and spread products saw valuations pared back in the second quarter. The market still offers plenty of convexity, but investors must focus on avoiding defaults, picking the right macroeconomic themes and identifying single-name credits that are better-positioned for the post-coronavirus world. In the current market, credit is likely to appeal to asset allocators that are looking for income and the potential to capture the upside during a recovery (see figure 27).

Figure 27. Valuations in high yield



Source: ICE Bond Indices, as at June 2020.

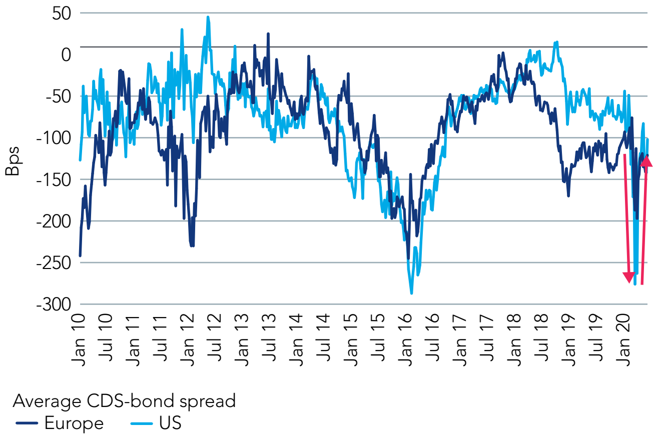
Public credit

The relationship between cash bonds and CDS has returned to its usual levels, while homebuilders look appealing in the lower-for-longer environment.

The correlation between the cash-bond and synthetic markets has returned to pre-crisis levels, indicating that market normalisation is under way. As investors looked for liquidity during the peak of the volatility, cash bonds significantly underperformed CDS and the relationship between the two diverged to historical extremes.

However, as credit returned to favour in the new risk-on environment, the traditional link between the CDS and cash-bond markets reverted to its normal range (see figure 28). Nonetheless, bonds still offer better value in most capital structures given that cash prices remain below call levels.

Figure 28. CDS v cash bonds



Source: ICE Bond Indices, as at June 2020.

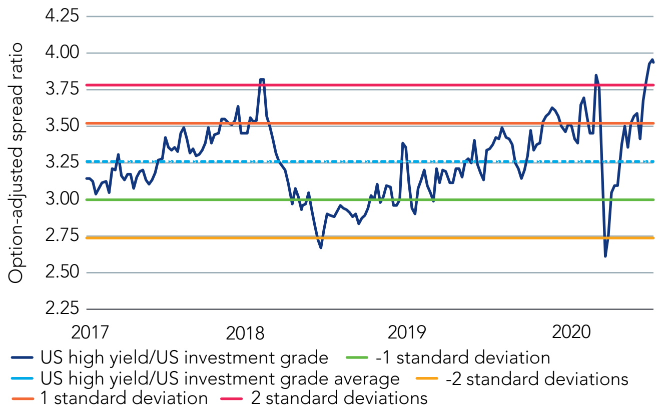
The current environment presents a raft of opportunities for stock pickers, especially those able to position their portfolios to capture post-coronavirus cash flows. But markets also appear attractive from a top-down perspective. For example, the homebuilder sector offers good value to investors, given that housing demand is likely to hold up in a low-rate environment (see figure 29).

Figure 29. Homebuilders look attractive

Source: ICE Bond Indices, as at June 2020.

The first quarter of this year was also characterised by a marked liquidity crunch, as financial institutions rushed to secure cash in the first phase of the sell-off. As a result, the most liquid parts of credit markets sold off heavily and prompted investment-grade credit to underperform in March. Since then, the market has refocused on fundamentals and investment grade is now outperforming high yield (see figure 30).

Figure 30. Investment grade outperforms high yield



Source: ICE Bond Indices, as at June 2020.

Leveraged loans

Leveraged loans bounced back in the second quarter, while lenders took the opportunity to embed new protections into their loans.

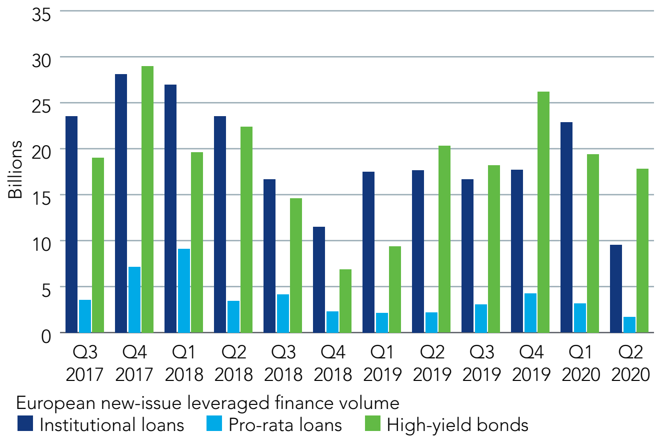
The S&P European Leveraged Loans Index (ELLI) rebounded strongly in June and closed up 12.3%, after falling almost 15% in the previous three-month period. Loans outperformed European high yield over Q2, although the ELLI still lags the asset class year-to-date.

Among the leveraged-loan sub-groups, B-rated assets returned 14.4%, almost double that of BB-rated loans. However, BB-rated loans have proved more robust year-to-date, falling by just 2.9%, compared to 4.6% for B-rated loans.

The second quarter also saw a material fall in new issuance. In Europe, the total volume of leveraged finance primary dropped to €29bn, the slowest quarter since the final three months of 2018.

Within this, leveraged-loan issuance plummeted from €22.9bn in Q1 to a mere €9.5bn in the second quarter, while high-yield volumes were down slightly from €19.4bn to €17.8bn during the same timeframe (see figure 31). This difference is partly because high yield has a deeper investor base, while CLO managers were mainly focused on actively managing CCC-rated securities.

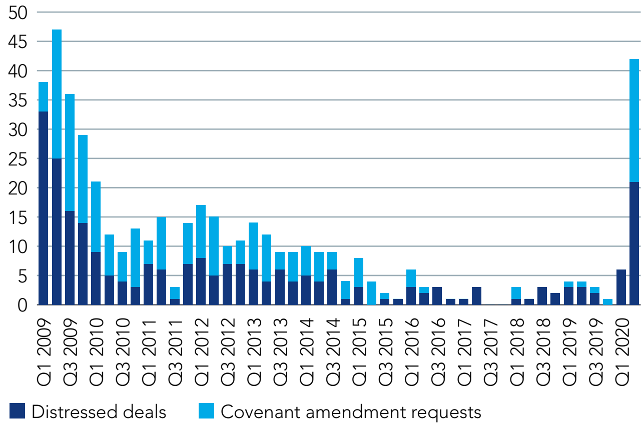
Figure 31. European new-issue leveraged finance volume



Source: S&P – LCD News, as at June 2020.

Furthermore, many lenders took the opportunity afforded by the coronavirus-related disruption to review offer documents, adding new protections that reversed the previous rise in cov-lite issuances. In the three months to 15 June, issuers made 21 covenant-amendment requests – the highest number since the second quarter of 2009 (see figure 32).

Figure 32. Number of covenant amendments and distressed deals



Source: S&P – LCD News, as at June 2020.

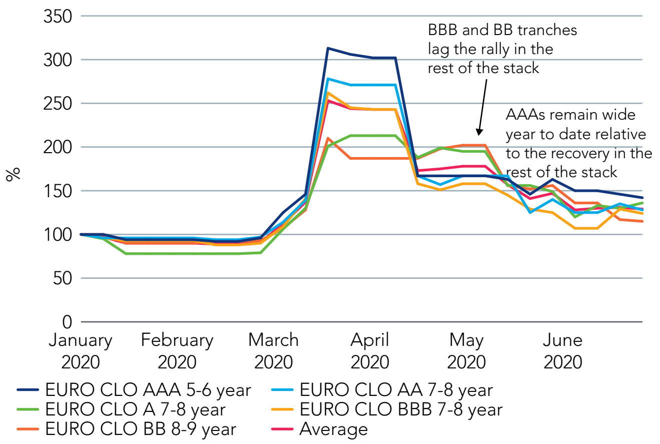
Structured securities

The market may have stabilised, but the full impact of the economic crisis has yet to feed through to the structured-credit universe.

At the end of June, the structured-credit market appeared stable after experiencing severe wobbles at the peak of the coronavirus-related panic. This prompted new issues of both asset-backed securities (ABSs) and CLOs, which were all met with enthusiastic investor demand. Yet credit fundamentals have deteriorated and the full economic fallout from the pandemic is yet to affect the structured-credit market.

CLOs remained liquid and trading volumes held up throughout the quarter. Because investor interest moves across the stack at different times, changes in spread compression between tranches can create investment opportunities (see figure 33).

Figure 33. European CLOs: relative value across the capital structure



Source: Federated Hermes, JP Morgan, as at June 2020.

After the initial snap-back in spreads early in April, BBB and BB-rated credits began to lag the market bounce (those rated B traded very rarely at this point). Relative to the rallying iTraxx Crossover index, BBB and BB-rated CLO tranches appeared attractive and we were active in this area early on in the quarter.

However, surging investor interest in BBB and BB-rated tranches later on in the quarter compressed spreads in line with average moves across the capital stack. Elsewhere, AAA-rated securities remained off-trend and were trading at spreads that were almost 50% wider than pre-crisis levels.

To date, very few structured-credit vehicles have hit performance barriers that are likely to ring alarm bells. However, most European CLOs now have high levels of CCC-rated exposures and other deteriorating collateral metrics. Consequently, rating agencies have issued downgrades or put some tranches on watch or negative outlook, although senior tranches remain unsullied for now.

Rising valuations and the active management of CLO portfolios has strengthened the loans market. However, even with the overall sentiment boost, manager selection remains critical.

ABS credit structures continue to function well, although payment-holiday relief – which many debtors have taken advantage of – has created some stress in the market. Investors will be watching to see how many consumers remain on payment holidays at the end of the first three-month relief period.

The level of payment relief varies widely and holidays numbers are linked to the efficiency of the application and approval system in each country. In the UK, the payment-holiday application process is very simple and lenders automatically approve requests. Consequently, about 1.9m borrowers have taken mortgage-payment holiday (MPH) in the UK (this accounts for about one in six of all home loans).

MPH levels of 20%-30% are common in UK ABS pools, although the proportion can rise to 40% or more. In countries where borrowers are required to show more proof that their financial stress is high enough to warrant mortgage relief, MPH numbers are much lower.

We expect MPH levels to fall going forward. Some took a tactical payment holiday as an insurance measure early on in the crisis but have maintained normal income levels and will resume their usual mortgage-payment schedules. As these better-off borrowers revive mortgage payments, cash flows in the ABS market will improve.

However, it is unclear how many payment holidaymakers will roll further into arrears after the current relief period ends. Ultimately, MPH figures will hinge on the underlying employment situation, but we expect arrears to stay higher for some time yet.

Private credit

The number of European mergers and acquisitions (M&As) is gradually increasing, but industry- and country-specific risks abound while tight loan covenants have become a necessity.

After an initial freeze in new transactions, the private-credit market is slowly reopening, although M&A volumes remain well below 2019 levels. Most new transactions have targeted add-on acquisitions by companies in defensive industries, which have weathered the coronavirus crisis better than their cyclical counterparts.

Germany accounts for between 60%-70% of all private-credit transactions in Europe, with Scandinavia, France and the Benelux region making up the difference. Deals have been scant in the UK, Italy and Spain, which have suffered the most from the pandemic and political uncertainty.

Compared to February 2020, new senior secured and unitranche transactions are now priced about 75bps higher and are framed around more conservative leverage structures. On the whole, lender-protection rights for loans issued since the pandemic erupted have increased.

However, there has been some backsliding, For example, rising competition among unitranche lenders has prompted some issuers to ease protections. This is largely when target-return requirements mean they can't compete on price alone, and is clearly an unwelcome return to the loose loan conditions offered by some providers before the crisis.

Defaults are also on the rise, notably in sectors dependent on consumer spending such as retail, travel, leisure and hospitality. We believe that this trend will continue throughout this year as more businesses suffer from continued economic uncertainty, the winding down of government support schemes and tightening covenants in loan documentation.

In our opinion, success in the private-credit market will hinge on allocating to non-cyclical businesses and the implementation of conservative covenant structures that can provide an early warning of potential problems.

We expect true senior-secured loans, which benefit from substantial equity protection, to offer the most value. Conversely, going down the capital structure in search of higher yields at this time of extreme economic uncertainty puts investors at risk of material loss.

Asset-based lending

Most UK property owners have kept up with interest payments during lockdown. However, real-estate debt investors face a changed market as the country slowly reopens.

At the end of the first quarter, the UK government allowed tenants to defer rent payments in order to ease immediate cash-flow issues. This was perhaps also subconsciously because tenants were unable to use their properties – and what is rent, if not simply compensation for the use of property.

In parallel, interest in the eyes of a borrower is compensation for the use of capital. During lockdown, borrowers were still in receipt of the capital invested in their properties – and, as a result, interest on loans was still due and payable. To their credit, most borrowers did make interest payments and some went out of their way to do so. Interest-collection numbers compare favourably to rent-collection statistics over the last three months.

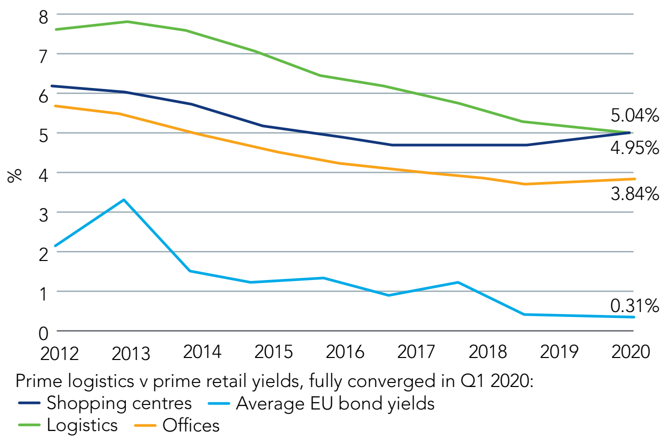
Senior lenders continued to deliver stable income throughout the lockdown. The same is not necessarily true for subordinated lenders. Since the global financial crisis, senior leverage has generally stayed reasonably modest and covenants tightly structured.

As a result, many senior loans experienced a breach of covenant when the pandemic hit. This puts senior lenders in control of these non-recourse structures and generally cuts off cash to subordinated lenders. The double-edged sword of leverage affects anybody that is not in a senior position.

As the storm clouds start to disappear, we are left with a retail landscape that is almost unrecognisable. Some retailers have disappeared altogether, while social-distancing requirements mean that queuing is a common sight.

Conversion rates in shops are at record highs, indicating that browsers have stayed at home. Nonetheless, it is difficult to make money at such reduced capacity and rental expectations will have to come down. Online sales have increased, which is reflected by investor appetite for the sector. We expect logistics yields to tighten, as retail yields widen further (see figure 34).

Figure 34. Prime logistics and retail yields



Source: Savills Research, as at June 2020.

Offices are slowly reopening, but it is unclear how they will be able to operate at full capacity while social-distancing requirements remain in place. The last 100 years of office history has been characterised by increasing density – a trend that is set to reverse, at least temporarily.

As lockdown eases, there is a considerable amount of capital looking for a home. As a result, margins for modestly geared loans on the best properties have not moved out very far – perhaps as little as 25bps. For anything that is more vulnerable to the heightened uncertainty (assets with shorter lease lengths, for example) margins have moved out in the region of 100bps.

Compared to the aftermath of the financial crisis, these are modest margin increases. Yet in the context of central-bank liquidity and the lower-for-longer environment, they are not unattractive relative returns.

ESG

The short-term consequences of the pandemic are becoming clearer for fixed-income investors. However, the underlying challenges of this human health crisis are complex and investors cannot ignore the link between climate action and global diseases.

The coronavirus pandemic is a reminder of the crucial links between human wellbeing and our shared natural environment, while the crisis has undoubtedly brought the relationship between climate change and human health into even sharper focus.

In particular, the global nature of the current pandemic has flagged the long-term risks we all face in a world where a changing climate raises the likelihood of further disease outbreaks. A growing body of research has shown that rising temperatures and subsequent changes to climate systems have a wide range of negative human health impacts, including the increased spread of infectious diseases.

As with other physical climate risks, chronic or acute changes in the environment can act as a threat multiplier for infectious diseases. The climate-related risk is projected to increase the number of people exposed to infectious diseases by 453-900m by 2080,[5] more than half of which will be in Europe.

The most relevant chronic, climate-change indicators for disease propagation relate to temperature, humidity and precipitation. Each of these climate attributes has a positive, non-linear relationship with the spread of infectious diseases.

The Intergovernmental Panel on Climate Change forecasts that these changes will affect the transmission intensity and seasonality of certain infectious diseases, although it is difficult to draw simple causal relationships between these climate variables and the spread of disease.

Some disease vectors, particularly mosquitoes, are well adapted to warmer climates and are sensitive to small shifts in temperature. An increase in temperatures, therefore, will expand the range over which they can survive and transmit diseases such as malaria and dengue fever.[6]

Droughts and floods, which are likely to increase in severity and frequency as the climate breaks down, will also influence disease patterns. High levels of evaporation and human demand for the liquid resource during droughts increase the likelihood of the remaining water turning stagnant, forming an ideal breeding grounds for mosquitoes and other vectors.

Secondary impacts from extreme weather events, such as changes in farmed land and increasing poverty, will further exacerbate vulnerabilities to infectious diseases.

There is considerable uncertainty about when the coronavirus pandemic will begin to subside. When it does, it is critical that the inevitable economic stimulus has climate mitigation, adaptation and conservation at its heart. A potential $26trn-worth of economic benefits could be realised by 2030, while mitigating the climate-related impact on health and society in the long term.[7] Overdue infrastructure spending is likely to feature, and this may allow for an acceleration in the decarbonisation of transport and energy systems.

Governments must reserve a portion of stimulus packages for investing in research and development in sectors deemed the most difficult to decarbonise. Agriculture is often overlooked, but the sector accounts for about 24% of global greenhouse-gas emissions[8] and adding more alternative protein to the food mix could reduce the need to continue clearing virgin land for agriculture – a key driver of biodiversity loss and the emergence of infectious diseases.

As our global economy begins to emerge from the coronavirus fog, it is even more critical for policymakers, investors and organisations to fully grasp the crucial relationship between the climate crisis and future health risks.

Beyond supporting the ecosystem services that we rely on for all life and economic activity, investments in decarbonisation, resiliency and adaptation offer solutions to the many social challenges ahead, including in human health.

As a result, the wide-ranging benefits of climate action are as important to understand as the systemic risks – a principle that underpins the engagement activities of our stewardship team, EOS at Federated Hermes. In turn, our Credit team draws on these stewardship insights in order to build a holistic view of the systemic nature of the risks – and opportunities – that all issuers must confront.

[5] Morgan Stanley, as at June 2020.

[6] 'The 2019 report of The Lancet Countdown on health and climate change: ensuring that the health of a child born today is not defined by a changing climate', published by The Lancet on 13 November 2019.

[7] 'Unlocking the inclusive growth story of the 21st Century: accelerating climate action in urgent times', published by The New Climate Economy in 2019.

[8] 'Global greenhouse gas emissions data', published by the United States Environmental Protection Agency.

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