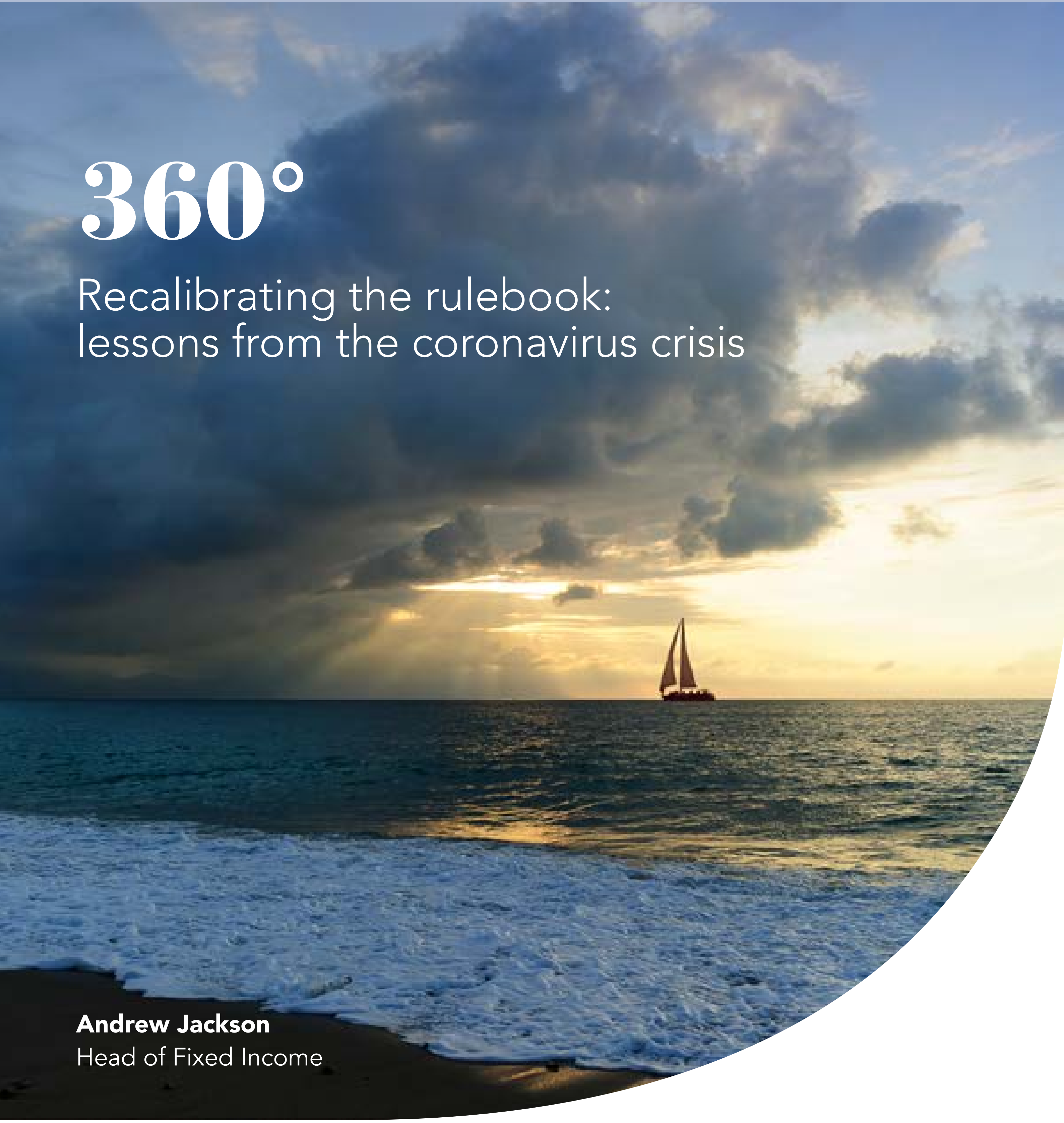

360°

Recalibrating the rulebook: lessons from the coronavirus crisis

Andrew Jackson
Head of Fixed Income

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Federated Hermes
International

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

Considerable uncertainty remains about the trajectory and impact of the coronavirus pandemic. Yet in these troubled times, there is also potential for high-conviction, active credit investors to find idiosyncratic stories.

In the Q4 2019 edition of *360°*, we took note of – and warned against – the level of complacency in markets. Yet we had little sense of the human tragedy that was to come, or the impact that it has had on lives, economies and markets. Any investment commentary feels trite in these times, and there are aspects of this crisis that have humbled and encouraged me to reflect on my place in society.

I have been amazed by the investment industry's ability to assume that it understands virology, epidemiology and statistics better than the people who have studied the fields for decades. During our daily investment meetings, we avoid analysing the pandemic from a medical perspective and focus instead on assessing the potential impact on markets (read more about this in our coronavirus update on page 5).

Before the pandemic erupted, the market seemed to be ignoring almost all tail risk and was pricing in a near-perfect world – with the caveat that if perfection was not immediately available, we could call on central banks to deliver it on a silver platter.

This prompted me to draw a parallel in the Q4 2019 issue of *360°* between investor optimism and the character of Rabbit in A.A. Milne's Winnie-the-Pooh books. I am certain that Rabbit did not read the report, but if he had he might have (rightly) argued that no one could have anticipated the pandemic. Nonetheless, I would point out that any sensible risk taker – strategist, politician or fixed-income portfolio manager – is mindful that no one can predict the future.

Even before the sell-off, central banks had pumped markets full of liquidity and lowered interest rates to a level where little-to-no risk was priced in. For this reason, I see almost no possibility that markets will rapidly return to the levels they were at in early February.

This is not to say that markets cannot revert to 'normal'. Instead, the state of markets before the crisis was clearly far from normal. If markets do return to these highs, it will indicate that central-bank intervention has simply distorted them further.

Navigating the new normal

There is colossal uncertainty about the effect of the virus on economies, companies and individuals, while the impact is highly correlated across geographies, industries and asset classes. The potential outcomes are too severe to only affect equities, and credit could also suffer losses. Moreover, we have not seen the decline in volumes or liquidations that we would expect. Until the number of coronavirus cases starts to flatten and companies report results, this uncertainty will persist.

We have witnessed an immense, rapid and coordinated intervention in markets. The rulebooks for government and central-bank support have been rewritten, if not completely torn up. While this is the continuation of a decade of loose policy, it is still unprecedented in scale. Markets have been supported, calmed and caught out by these moves, and alarm bells are ringing about when the reckoning may come. Yet for now, we must be mindful not to fight the Federal Reserve (Fed) and its friends.

Despite this, we remain cautiously optimistic about markets – and very optimistic about the potential to generate supernormal alpha in credit markets over the next 12 months. Flexibility, clarity of thinking, a diligent underwriting process and avoiding complacency will all be essential. As dour credit investors, we thrive in markets like this. Nonetheless, we remain mindful that the lows may not be behind us just yet – and that the volatility is almost certainly not.

In this edition, we will examine the impact of the virus on fixed-income markets and review the actions taken by governments, central banks, ratings agencies, banks and corporates. We also discuss the uncertainty we face in analysing future outcomes and try to formalise a set of probabilities around a mean expectation. It is important to emphasise that we still see significantly more uncertainty than most commentators seem to imply in their forward-looking views.

Sectors in focus: financials and energy

To help formulate our broader view of market fundamentals, we have looked at two of the sectors most affected by the crisis: financials and energy. These two industries are bell weathers for the future state of credit markets (read more about this in our fundamentals chapter on page 12).

We see an opportunity to invest in financials, which represent about 30% of aggregate exposure across investment-grade indices. Markets do not seem to have factored in the strong capital position or balance-sheet strength of many banks, as well as the support they have received. We favour national champion banks, as they tend to be the transmission mechanism for stimulus.

Nonetheless, we do recognise that the asset quality of banks has deteriorated over the last quarter. Among other measures, the fact that companies have been forced to draw on their revolving credit facilities (RCFs) means that the balance sheets of banks have expanded at a time when they might have preferred to tighten their lending disciplines.

A positive view of the credit instruments of banks does not imply attractive equity valuations. While European banks have been banned from paying dividends, the chair of the European Central Bank's (ECB's) supervisory board has said that there are "no plans" to order banks to suspend interest payments on debt instruments like additional tier one (AT1) or tier two instruments.[1]

Meanwhile, the energy sector was under pressure even before the Organisation of Petroleum Exporting Countries (OPEC) and Russia failed to come to a supply-cut agreement. This was cataclysmic for oil prices, and most keenly felt by North American producers and their support infrastructure. An agreement was reached in April to cut exports by 9.7m barrels per day, although this is unlikely to be enough to stabilise prices.

There is currently a substantial imbalance between supply and demand, which should remain for several quarters. North American producers with weak liquidity and balance sheets can now only hope for direct government support. Bankruptcies within the sector have already started and we expect them to increase, irrespective of how markets recover.

This will have material implications for credit markets. Energy accounts for 10% of the US high-yield market, a share that will increase as fallen angels – or credits downgraded from investment-grade status – are added to the index.

Seeking opportunities in the eye of the storm

We find ourselves faced with more nuanced and idiosyncratic stories across sectors, geographies and sub-asset classes – an incredibly fertile ground for our Credit and Private Debt teams. We take an active, high-conviction approach to investing, which history suggests has the potential to perform well in volatile periods.

There is little doubt in my mind that we will see more volatility – both above and beneath the surface – in the months ahead. We have seen considerable distress within markets, ratings downgrades and an uptick in defaults. There will be a credit cycle – even if it is a small one – and markets will undergo a cleansing.

This is one reason that there is unlikely to be a symmetrical recovery such as the one we witnessed after the sell-off in Q4 2018. Companies with less leveraged balance sheets are not as likely to be affected in the longer term, but in some sectors even the most defensive issuers could default in the absence of external support.

This is not a 'buy the dip' situation, and credit analysis will be at a premium. Our credit analysts have been working diligently alongside our engagement professionals to recalibrate the inputs in their models, and in some cases completely rewrite them. Even as I write, my excitement is rising at the prospect that underwriting discipline will be fully valued once again.

Central banks and governments are battling against this turmoil in markets. No one should be under any illusion about the extent of their monetary-policy actions (see figure 1). This was accompanied by an equally monumental fiscal response, which includes wage subsidies, tax relief, grants, loans, bailout packages and universal income. Following these announcements, there have been times when the 'shock and awe' flowing through markets has taken my breath away.

[1] 'ECB financial supervisor urges banks to cut back on bonuses', published by the FT on 31 March 2020.

Figure 1. Summary of actions by major central banks

Central bank	Pre-crisis interest rate	Current interest rate	Summary of policy actions
Federal Reserve (funds target range)	1.50-1.75	0.0-0.25	• Unlimited, open-ended quantitative easing through purchases of US Treasuries and mortgage-backed securities • Expanded loan and funding facilities. • Up to $750bn-worth of special-purpose vehicles to buy corporate names, including qualifying fallen angels.
European Central Bank (deposit rate)	-0.5	-0.5	• Asset purchases increased from €20bn to at least €100bn a month for sovereigns and corporates. • A more flexible approach to the capital key buying limits.
Bank of England (bank rate)	0.75	0.1	• An extra £200bn-worth of quantitative easing, mainly in the form of gilts but also corporates. • Commercial-paper assistance. • Bank funding facility.
Bank of Japan (overnight rate)	-0.1	-0.1	• Targeting a 0% 10-year yield by flexibly varying the amount of quantitative easing. • 80trn yen-worth of asset purchases a year, mainly in the form of government bonds but also real-estate investment trusts.

Source: Federated Hermes, as at April 2020.

There are questions about the moral hazard of central-bank decisions, as well as whether they could result in longer-term issues. While these points have some merit, I believe that fast action was required in this instance. Moreover, central banks are not given precision instruments to work with. As a result, they have used a sledgehammer to crack a nut.

While some may conclude that central-bank intervention has been insufficient or even counterproductive, it has succeeded at stabilising markets. Hopefully, this means that the transmission mechanisms lying beneath the surface will be able to facilitate the support that individuals and companies need.

It seems likely that quantitative easing (QE) and zero interest-rate policy will be here for a long time. One day, we will examine whether our central-bank emperors are wearing any clothes. However, this question – and social questions about how we treated different members of society as we entered the crisis – is for another day.

Looking to our relative-value framework on page 6, readers will note that structured-credit instruments have risen up the ranking, despite the fact that liquidity in this area was far from perfect during the sell-off. Our analysis suggests that the asset class will benefit from some of the government initiatives and that protection remains more robust than price moves suggest.

In other areas, we can see that the less-liquid asset classes have fallen down the ranking as we find less evidence that their illiquidity premia have been maintained. Nonetheless, an ideal portfolio would still include a selection of illiquid assets: as liquidations start to flow, we see supernormal opportunities to seek value in this space.

We will close by thanking all of you for your support during this difficult period. Our Fixed Income team has reacted nimbly and effectively throughout the crisis, and we continue to be humbled by the trust you have placed in us. Please do reach out to us with any questions you may have – and stay safe out there.

Coronavirus update

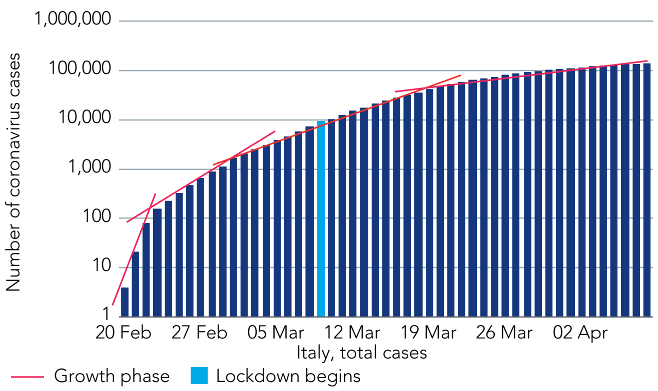
The quality of data on coronavirus cases and deaths remains poor, while drawing correlations between different countries can be a challenge.

The coronavirus was barely on our collective radars in February, yet by that point the first wave of reported cases in China had already reached a peak and the country would soon see fruits of its aggressive lockdown policy. The World Health Organisation formally named the disease Covid-19 on 11 February, just before the epicentre of the pandemic moved west.

We are not virologists, so we should not – and will not – attempt to analyse this from a medical perspective. The quality of data is weak, and it is not clear how much we can glean from the number of cases and deaths – whether this is due to limited testing and verification of deaths outside hospitals, or a lack of transparency.

As a result, we have focused on trends within similar datasets, rather than across them. Italy is an early and aggressive example of contagion, where a logarithmic scale shows there seemed to be four clear growth phases as of 9 April (see figure 2). At the time of writing, we expect to imminently enter another phase of deceleration.

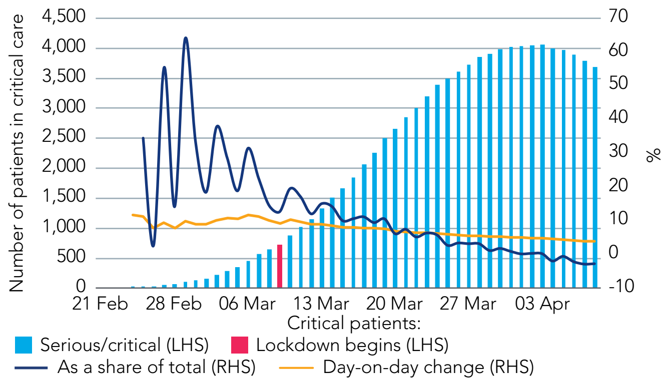
Figure 2. Coronavirus cases in Italy



Source: Ministero della Salute, as at 9 April 2020.

This trend has allowed the medical system and authorities to cope better with the influx of patients. Figure 3 shows how the number of patients in critical care peaked at 4,000 at the start of April and has fallen steadily since. We know that this has led to lower death rates for those in critical care, perhaps because there is less stress on the system.

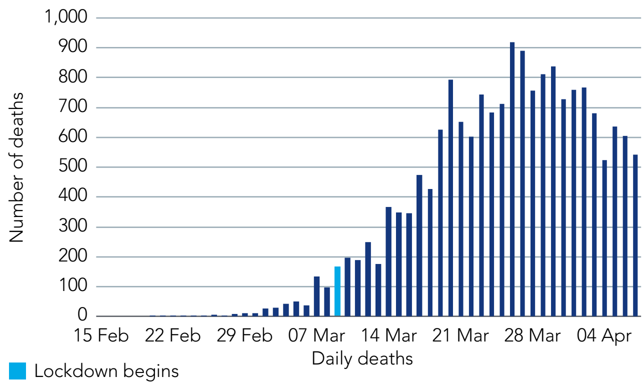
Figure 3. Italian coronavirus patients in critical care



Source: Ministero della Salute, as at 9 April 2020.

Figure 4 shows that the peak in daily deaths was reached at the end of March, and we hope to see the downward trend continue. It is notable how long it took to achieve real progress after the lockdown was announced.

Figure 4. Daily coronavirus deaths in Italy



Source: Ministero della Salute, as at 9 April 2020.

While we can see trends developing, we caution against extrapolating previous experiences onto other geographies. Despite draconian measures in Spain and Italy, we have not seen China's prompt reduction of new cases in other countries.

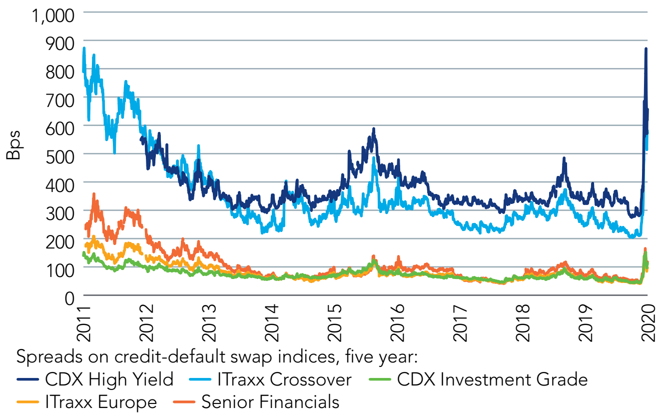
We can also see dramatically different mortality rates which do not necessarily correlate with the quality of medical care. As with most coronavirus statistics, it is unclear whether the difference emanates from the number of deaths, cases or the transparency of reporting. It seems likely that we will be subject to containment measures for longer than the public or investment community seem to believe.

Relative value between asset classes

The rapid market moves mean that credit instruments have dramatically repriced, throwing up a raft of opportunities to seek yield – providing that idiosyncratic risk is fully assessed.

In the last edition of *360°*, we faced the challenge of seeking yield across credit markets that were at record tight levels. As the world absorbed the likely economic impact of a prolonged lockdown, credit spreads soared to the highest level since 2011 (see figure 5). The iTraxx Crossover rose from about 200bps to 700bps, while the global high-yield index breached 1,000bps.

Figure 5: Spreads on credit-default swap indices



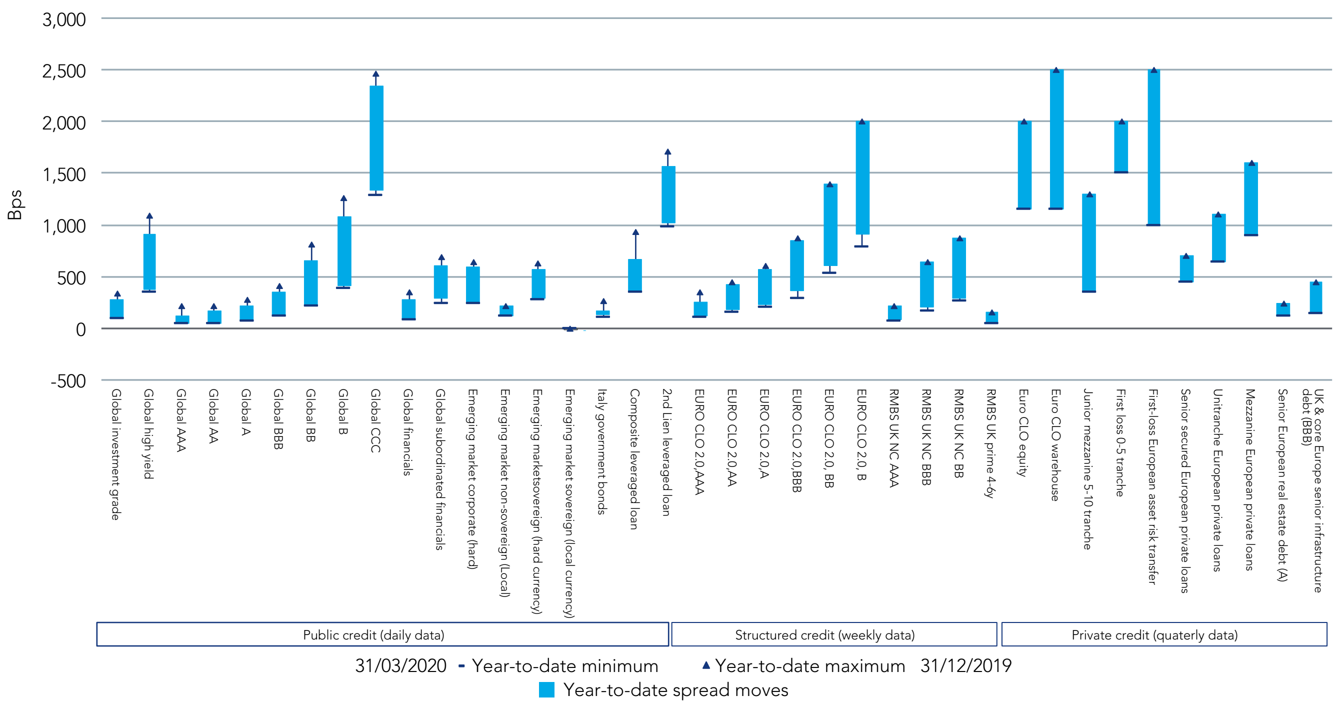
Source: Federated Hermes, Bloomberg, as at 31 March 2020.

With the exception of the most liquid areas of public credit, many parts of the market were not trading. This means that credit benchmarks have been priced using the estimated marks of brokers. Unsurprisingly, price discovery has been even more challenged in private markets.

As a result, index data do not necessarily reflect the price at which securities would actually trade. This is illustrated by the fact that many exchange-traded funds (ETFs) have traded at heavy discounts to their net asset values (although this has now largely reversed). As assets start to trade rather than be valued in a vacuum, we expect clarity around pricing to improve.

It is clear that the more liquid – and by extension, higher-quality – credit has been relatively more affected by the market rout as investors have sold what they can, rather than what they wish to (see figure 6). This started to change towards the end of March, as public-credit spreads began to recover. As usual, private credit moved less than public credit. Structured credit was initially slow to react, before moving rapidly and overshooting the broader market.

Figure 6: Movement in credit spreads since the start of the year

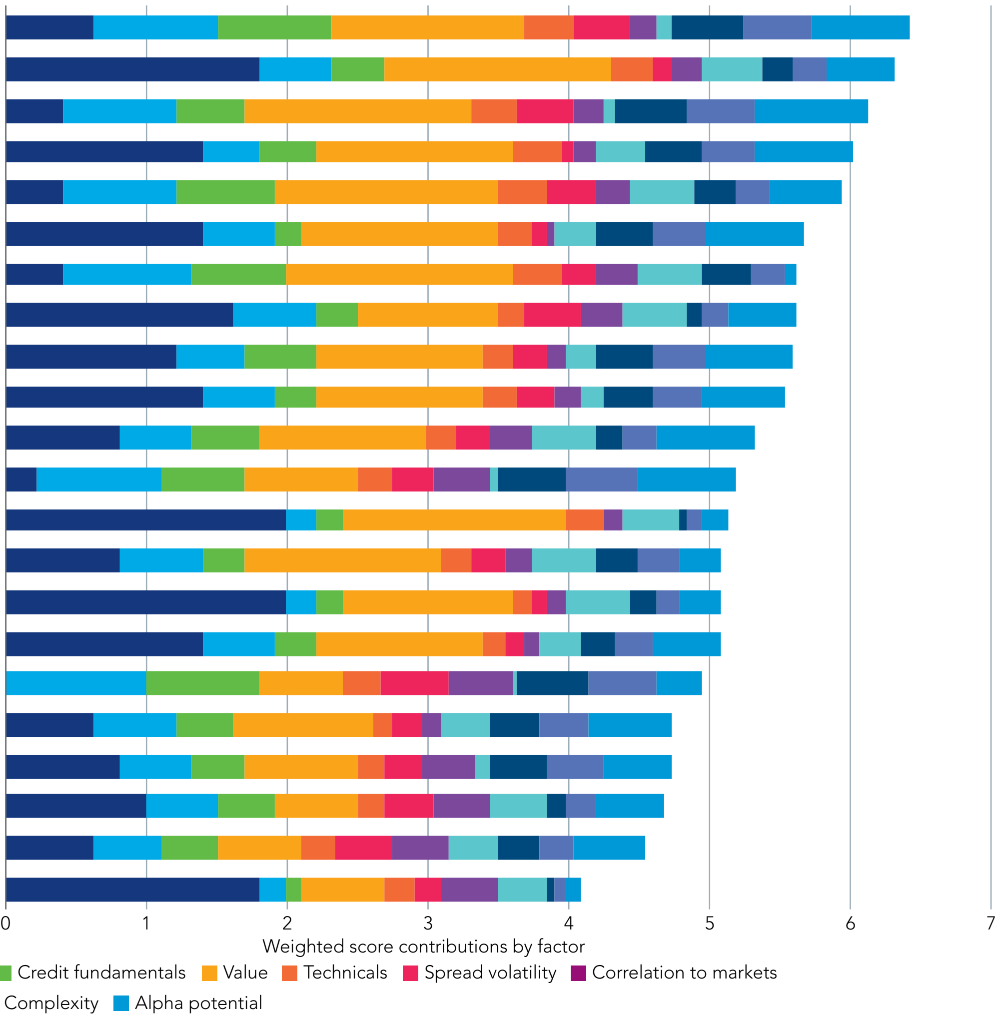


Source: Federated Hermes, Bloomberg, Citi, as at 31 March 2020.

Every quarter, we compile a relative-value framework of fixed-income assets across the public and private credit spectrum, ranking them by 11 different factors. Price visibility is poor for some credits, while it is hard to anticipate the impact that central-bank and government stimulus will have on the market. Moreover, liquidity is constrained and has caused excessive trading costs in some cases. Nonetheless, our framework represents our view of the market and will guide asset-allocation decisions across our Multi Asset Credit solutions.

Figure 7: Our Multi Asset Credit relative value framework, 31 March 2020

Q1	▲	Q4	
1	▲	3	Senior financials
2	–	1	Europe CLO mezzanine
3	▲	6	Investment grade
4	▲	7	Subordinated financials
5	▲	13	Europe ABS senior
6	▲	17	High yield
7	▲	10	Europe CLO senior
8	▼	4	Direct SME lending
9	▼	5	Hybrids
10	▼	2	EM credit
11	▲	15	Europe ABS mezzanine
12	▲	18	Developed Government bonds
13	▲	20	First loss tranche
14	▲	18	Europe CLO equity
14	▲	12	Syndicated leveraged loans
16	▲	15	Mezzanine tranche
17	▼	14	Money market
18	▼	N/A	EM government bonds
18	▲	21	Convertibles
20	▼	9	R.E. debt
21	▼	7	Trade Finance
22	▼	1	Risk transfer



Source: Federated Hermes, as at 31 March 2020.

Following the large moves in public-credit markets, the top of the ranking is now dominated by the more liquid exposures.

- **Senior financials and investment grade** now offer attractive risk-adjusted returns. Investors have been forced to sell these high-quality, liquid assets, while they also benefit from the fact that they are eligible for central-bank asset-purchase programmes. We see particular value in national champion banks, which are in a stronger capital position than in 2008. Given they are the key transmission mechanism for central-bank stimulus, they are unlikely to be allowed to fail. For this reason, we are also happy to invest lower down in the capital structure of **subordinated securities**.
- **High yield** has moved the most and now offers attractive yields and improved convexity. We see less value in **emerging-market credit**, as we believe that these economies are not well equipped to fight the longer-term economic impact of the virus.
- **Collateralised-loan obligation (CLO) mezzanine tranches** remain near the top of the ranking, although we prefer the higher-rated tranches which have less default and loss risk.
- **Senior asset-backed securities (ABS)** and **CLO tranches** have moved wider and also look attractive. ABS are now priced on an extension basis, leaving calls a potential upside.

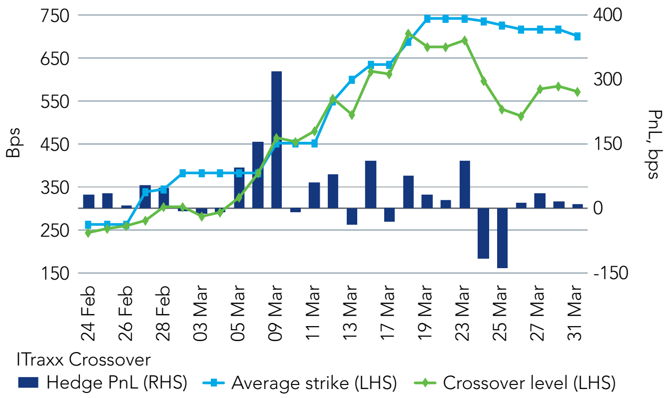
- **Private-credit exposures** have moved down the ranking. Despite facing the same fundamental pressures as public credits, they have not moved to the same extent which means that their illiquidity premia are diminished.
- **Trade finance** recorded the biggest downward move, in part due to uncertainty about the value of the assets that collateralise the debt. The additional premium generated by this asset class is less valuable when yields are high.

In the current environment, asset allocation is only part of the solution. As always, active credit selection is critical to portfolio construction. It is necessary to assess the idiosyncrasies of each trade by modelling and stress-testing the fundamentals of various economic scenarios, as well as considering the impact of technical or regulatory factors.

Tools that help protect against the downside are also vital during periods of volatility. Credit derivatives, such as credit index options or credit-default swaps (CDS), can be used to manage risk and help generate alpha. Having the right quantum of aggregate risk during these magnified market moves is as important as the individual risks themselves.

For example, the dynamic options overlay on our Unconstrained Credit Strategy helped to compensate for the recent market rout by continuously crystallising option profit and loss and rolling into further out-of-the-money options as spreads moved wider. Figure 8 shows our options payer (put) position on the iTraxx Crossover and demonstrates how a rapid widening of options positions has the potential to add considerable value.

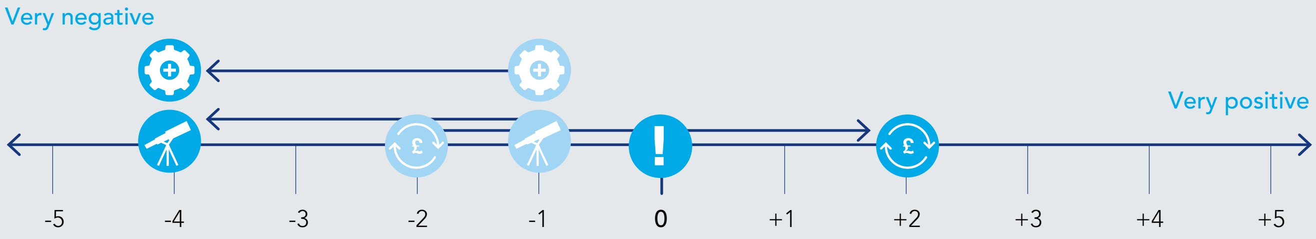
Figure 8: Unconstrained Credit Strategy: options overlay



Past performance is not a reliable indicator of future returns.

Source: Federated Hermes, Bloomberg as at 31 March 2020. Performance shown is the hedge overlay PnL of the Hermes Unconstrained Credit Strategy in USD, gross of fees. Crossover level represents the level of the IHS Markit iTraxx Crossover CDS index.

Q1 2020 score card



Economic outlook

- **Moved to -4 from -1**

Credit fundamentals

- **Moved to -4 from -1**

Valuations and technicals

- **Moved to +2 from -2**

Tail risks

Remains at 0

- Despite initial signs of recovery in China, Italy and Spain, the trajectory of the virus – and its economic impact – in the rest of the world is still unclear.
- Should no effective testing or vaccine emerge, it is possible that the lockdowns in place will be extended to contain the initial and future peaks
- Even though OPEC and Russia have agreed to cut supply, pressure on demand means that low oil prices will continue to weigh on the world economy.
- Nonetheless, with credit markets already at wide levels, there is less risk of further moves.

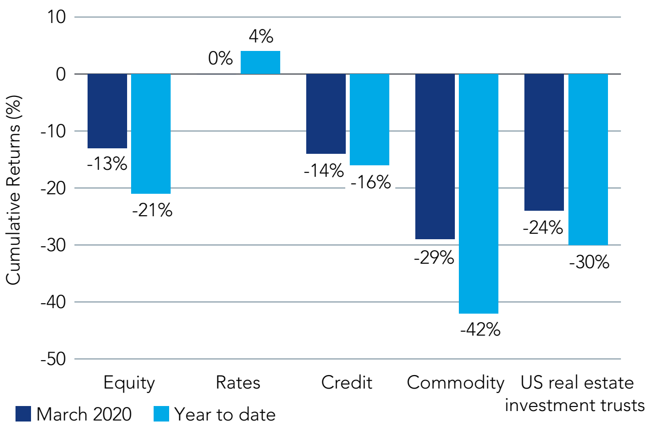
Contents

Multi asset

As the coronavirus pandemic continues to cause turmoil in markets, it can be beneficial for investors to look beyond the short-term chaos.

The market sell-off in March resulted in negative performance across asset classes (see figure 9). Even rates[2] – which usually provide some protection during risk-off periods – remained flat in March, meaning the market was left to fall without a cushion.

Figure 9. Asset-class performance



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

We can quantify how much 'fear' there is in the market by looking at our 17 sentiment indicators. Since the start of the year, the number that indicate a high level of risk has jumped from six to 14. This extreme level of risk is similar to that recorded during the financial crisis. As a result, our measure of sentiment has become very negative.

When looking at the positioning of active funds, their aggregate beta to MSCI World – measured across active investors like commodity trading advisor (CTA), risk parity and mutual funds – has risen from 0.23 at the end of February to 0.35 at the start of April, which indicates the market has moved from oversold to neutral (largely driven by mutual funds).

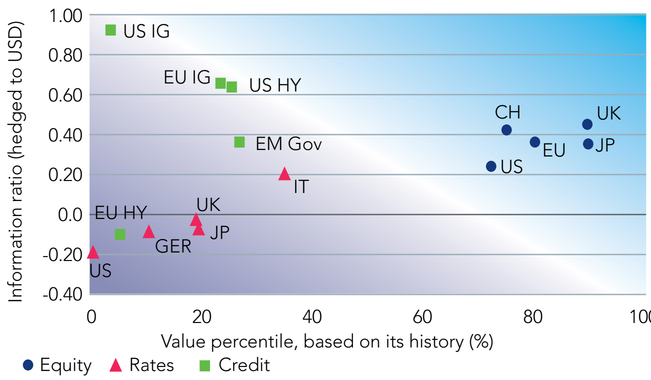
CTA funds have a net short equity beta, while risk-parity funds have also decreased their allocation to risky assets. In addition, the net future position of gold is close to an all-time high and shows a clear flight to safe-haven assets.

ETFs also show some gradual risk-on flows: there have been strong flows into energy, equity emerging markets and growth, and large outflows from fixed-income investment grade and inflation-protected strategies.

For investors with a medium-term outlook, determining the economic scenario we are in (based on forecast GDP and inflation numbers) can help identify the best investments. Since the beginning of April, the global economy has moved into the third quadrant where both expected GDP and inflation are trending up moderately. The most attractive assets are equities, followed by credit and then rates.

For those with a longer-term outlook, we look at forward-looking valuations. Following the recent market sell-off, equity and credit (with the exception of European high yield) have become cheaper than their historical valuations. Credit also offers a high expected information ratio (see figure 10). Risker assets like equities and credit now look attractive, while rates are expensive relative to history and offer flat-to-negative expected yields.

Figure 10. Information ratio and historical valuations



Source: Federated Hermes, as at April 2020.

[2] Predominantly developed-market government bonds.

Economic outlook

Central banks and governments are responding to the coronavirus crisis with a raft of measures, providing a spirited challenge to the argument that their monetary toolboxes are depleted and fiscal coffers closed.

The coronavirus is affecting both supply and demand and will have a significant impact on output, with the International Monetary Fund is now forecasting that global GDP will shrink by 3% this year. It is unclear whether we will see the hoped-for short, sharp 'V-shaped' recovery in GDP (see figure 11) or whether it will be a 'U', a 'W', or even an 'L', indicating the process could take much longer to play out.

Figure 11. GDP estimates and forecasts, year-on-year change

	2019	2020	2021
US	2.3	-4.0	3.9
Eurozone	1.2	-5.7	5.4

Source: Consensus Economics, as at April 2020.

While the response of some G7 policymakers has been prompt, there is clearly less monetary ammunition to react with. Major economies are in a liquidity trap and should lag markets, demonstrated by the eye-watering US initial jobless claims which climbed by 22m in the month leading up to the middle of April.

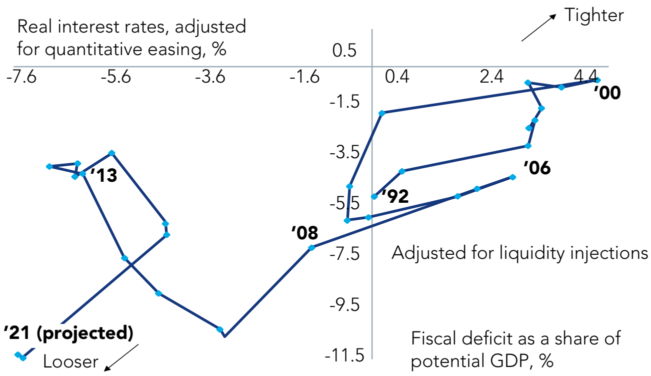
At this pace, we could see a US unemployment rate of 13% by June. These numbers will be unpalatable to the current US President, who is doubtless putting pressure on the Fed to fire its final monetary bullets. The Fed will be more focused on the fact that unemployment has already risen above its estimated long-term non-accelerating inflation rate of unemployment of 4.2%, a level above which wages decelerate.

The outcome for the world economy rests on more than finance. But for major economies, inflation will be driven by whether demand or supply adjusts first. This inflation will surely be the type driven by shortages rather than demand. Even if oil prices can rebound following the supply agreements, easy money will still be extended as economies stagflate.

Central banks emphasise that they are still prepared to act. Their willingness to do so can be seen by the Fed's pledge in early April to buy fallen angels, as well as its commitment to use part of its $750bn Secondary Market Corporate Credit Facility to buy US high-yield ETFs and CLOs – an unprecedented move.

Policies are undoubtedly extremely loose. Our in-house policy-looseness analysis suggests there were de-facto negative rates in the US even before the coronavirus epidemic erupted, and that the overall policy stance is now looser than in 2008 (see figure 12).

Figure 12. The US policy mix has loosened considerably



Source: Federated Hermes, as at April 2020.

After the coronavirus crisis eases, it seems likely that we will see low inflation, sluggish demand and escalating debt – which should make it even harder to tighten policies. Considering the threats posed by the virus and protectionism, we may be little more than halfway through this era of cheap money.

Fundamentals

Credit-market fundamentals have worsened, but central banks could provide some companies with a soft landing and many firms have drawn on their credit lines in a bid stay afloat.

The velocity of the moves in credit fundamentals and spreads, as well as the unbridled reach for cash from banks, corporates, and asset managers, is a testament to how profoundly blindsided the economy was by the relentless spread of the coronavirus.

In the US, jobless claims have spiked, auto and retail sales have collapsed and earnings will likely plunge. Meanwhile, central banks and governments have rolled out a suite of monetary and fiscal mitigants to cushion the fall. These policy responses will certainly benefit many higher-quality companies, while others will disappear altogether or be forced to restructure their debt.

The violent surge in operating risks will translate into rising financial risks for many industries. While net debt should remain largely flat, operating cash flow will decline. Financial risks will rise as debt-service obligations become more burdensome, particularly in the most affected sectors, and some companies will struggle to grow into their capital structures.

Goldman Sachs recently reduced its earnings-growth expectations for S&P 500 companies from 7% to zero.[3] Although first and second-quarter earnings will decline by a record amount for many industries, a focus on the outlook, visibility and cash management will be a better way to assess the future trajectory of credit risk.

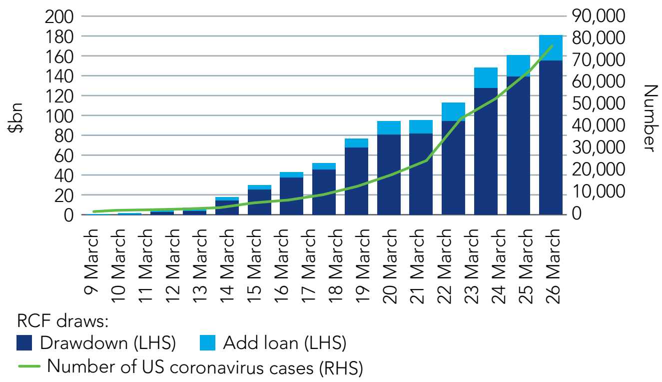
In an instinctive move to survive, companies have enhanced their cash liquidity and defended their balance sheets by cutting dividends, cancelling share-repurchase programs, reducing operating and capital expenditures and drawing on their RCFs.

Companies draw on their credit lines

The coronavirus pandemic means many companies have shuttered their businesses and ceased activities. In order to pay their fixed costs amid declining revenues, many corporates have turned to their RCFs to enhance liquidity.

An RCF is an additional credit facility generally provided by banks, which normally helps companies finance short-term cash needs and working-capital requirements. This can be drawn on and reimbursed at will. The multitude of drawdowns is occurring so rapidly (see figure 13) that is it affecting ratings action.

Figure 13. Draws on RCFs in March 2020



Source: Federated Hermes, as at April 2020.

RCFs are used globally and we have identified $5.5trn-worth of credit lines in 48 different currencies. Between 9 and 27 March, 210 US companies announced draws, and within three weeks the share of RCF draws went from 11% to 64.3%. The rate was above 70% for technology, consumer staples, consumer discretionary and financials. Coincidentally, 56 of the 198 companies that report public periodic figures related to their RCF management were downgraded.

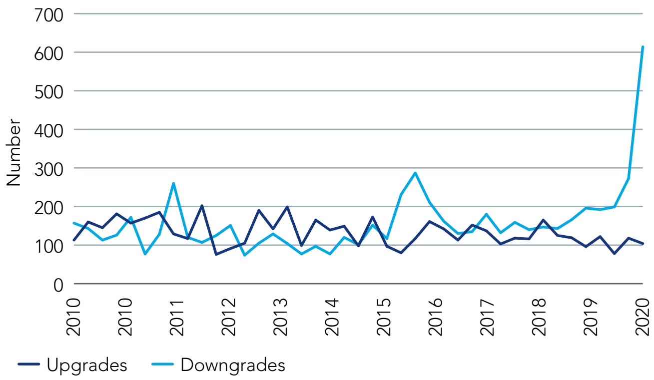
CLO investors are keeping a close eye on their exposure to credits rated B-, as there is now a high probability of downgrades. Within the S&P European Leverage Loan Index (ELLI), the exposure of credits rated B- rose from 11.5% at the end of December to 14% at the end of March.

If the current crisis persists, we could see another wave of downgrades as RCFs are generally used to fix short-term issues. This should mean that junior CLO tranches are placed on negative watch and subsequently downgraded.

[3] 'Global markets daily: flat earnings growth to further pressure credit fundamentals (Lynam)', published by Goldman Sachs on 3 March 2020.

There has been a dramatic spike in downgrades (see figure 14) and the ratio of upgrades to downgrades now stands at a ten-year low. Within high yield, downgrades are taking place at ten times the rate of upgrades.

Figure 14. Downgrades have spiked



Source: Bloomberg, as at March 2020.

The surge in downgrades has created a record amount of fallen angels. According to Goldman Sachs, the value of outstanding new fallen-angel bonds rose to $149bn in Q1 and could increase by an additional $555bn over the next six months.[4]

As thinly capitalised firms are locked out of refinancing markets, it is inevitable that there will be an uptick in defaults. Moody's default rate was 3.1% in February, but could rise to 6.8% in the event of a short downturn and as high as 20.8% if there is a severe recession.[5] Defaults should be concentrated within the sectors most affected by the virus: gaming, hotels, autos, retail, energy and advertising-dependent media. The more resilient sectors are technology, telecommunications, consumer and non-cyclicals.

We also believe that the response of fiscal policy – and certain aspects of monetary policy – will support higher-quality companies and those with scale. Central banks across the globe have ensured that liquidity is cheap and available, and banks have become the transmission mechanism to support companies in need.

Fundamentals have clearly diverged across different sectors. We now take a closer look at the energy and banking industries.

Energy: a sector in turmoil

The energy sector has been hit by the oil-price war and the fall in demand triggered by the coronavirus pandemic. Oil prices have declined by about 60% year to date, which has implications for energy firms' earnings, cash flow and survival. After a month of uncertainty, OPEC and Russia – nudged by the US – have agreed to cut exports. While this will provide some relief, it is unlikely to be enough.

If demand stays weak, markets could become oversupplied and storage capacity could be reached by Q3. It will take time for coordinated cuts to kick in, demand to increase and storage to normalise, which means additional near-term pressure on oil prices (although in a normalised environment, prices should be around $40-$50 a barrel). While the US President has discussed aid for the industry, the plans lack specific details.

Energy companies have responded proactively. Exploration and production companies have reduced capital expenditure by 30%, while firms are limiting operating expenses and securing additional near-term liquidity through bank loans. Dividends have been reduced or suspended, while midstream companies have cancelled growth capital projects and are reducing distributions.

We saw the first credit-market victim at the start of April as Whiting Petroleum, a small US operator, filed for Chapter 11. Debt-capital markets are currently shut for high-yield issuers, meaning many lower-quality highly levered energy credits will be unable to refinance their upcoming maturities and could follow suit.

At the time of writing, five energy companies are moving from investment-grade to high-yield status, accounting for about $25bn in market value and 30% of all fallen angels. The high-yield index has become more concentrated on higher-quality names with larger capital structures, while lower-quality, distressed names have become less relevant.

We prefer midstream companies that lack direct exposure to commodity-price volatility, are protected through long-term or minimum-volume commitment contracts and are able to postpone growth projects and reduce distributions. We also like producing firms of scale with low break-even costs, strong balance sheets and good liquidity. Natural-gas producers should also benefit as declining oil production reduces associated gas production, resulting in more normalised market dynamics.

[4] 'Credit note: downgrades arrive with a bang: more to come', published by Goldman Sachs on 30 March 2020.
[5] 'Credit Outlook', published by Moody's on 3 March 2020.

Global banks in a time of crisis

Delinquencies and defaults are set to rise, while leverage has crept higher and covenants have been loosened. Many borrowers have drawn their RCFs, meaning that banks now have larger exposures. There has also been a correlation of stress across sectors and borrowers, which affects the ability of banks to manage losses. Forbearance will be required, and policymakers have responded quickly with packages that aim to address short-term liquidity issues.

With interest rates at record lows, governments have turned to fiscal measures and are using banks as the transmission mechanism for stimulus. Despite the political and moral hazard involved, banks will underwrite losses in the system. In turn, these losses should be mitigated by government guarantees. While European banks are still paying coupons on debt instruments, their decision to suspend dividends will help protect capital if support is needed.

Although profitability and net-interest margins have not returned to pre-financial crisis levels, liquidity coverage ratios for the largest US banks are four-times higher than they were before 2008. Coverage ratios are well over 130% in Europe, meaning that funding gaps have fallen. Since the coronavirus crisis erupted, new government schemes have injected liquidity into the market, while there are measures in place to support commercial paper and repurchase-agreement markets.

During the last financial crisis, liquidity issues and a mismatch between assets and liabilities were the final straw. Regulators and banks have reduced this risk over the last decade, and there are currently few signs of stress.

Even accounting for more stringent calculation criteria, tier one (T1) and tier two ratios are materially higher than before the financial crisis. The average T1 ratio of European banks going into 2008 was 8%, while their fully-loaded common-equity tier-one ratio – considered the gold standard of T1 ratios – is now almost 14%.

In addition, US money-centre banks have suspended their significant share buyback programs, while capital buffers have been dropped in Europe. In the UK, measures have created an additional 200bps-worth of loss-absorbing capital.

Looking to asset quality, there will be an increase in the loan-loss provisions (LLPs) of banks. During the financial crisis, LLPs as a share of loan books peaked at 3.5% in the US and 1.7% in Europe. In a 'normal' recession, there could be 100-130bps-worth of LLPs.

Nonetheless, the wave of losses in the loan books of small-and-medium enterprises (SMEs) will be on an accrual basis, rather than a mark-to-market basis as they were in 2008. The ECB is tolerating slower non-performing exposure targets and delayed recognition of NPLs.

We expect a material increase in provisions and for loan losses to crystalise, but support from governments, regulators and supervisory bodies means this should only affect profits and is unlikely to require an injection of capital. Nonetheless, there will be significant dispersion in outcomes and a few banks will suffer in the longer term. This makes it even more important to understand the quality and lending standards of individual banks.

Banks have lost about a third of their market capitalisation since the sell-off and their debt instruments have experienced some of the greatest losses of any sector. While there is uncertainty about loan performance and support for banks and borrowers, we believe the sector offers considerable value – particularly the larger 'national champion' banks, which will be used as the transmission mechanism for stimulus in the months ahead.

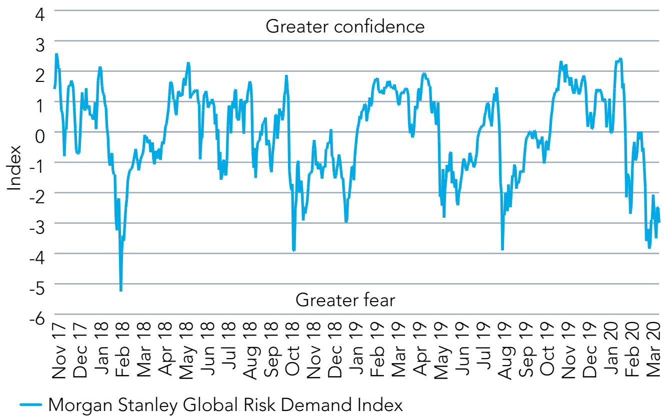
Sentiment and technicals

Flows and valuations have normalised since the extreme market moves in March and sentiment is on the mend.

Sentiment

There has been a significant pick-up in uncertainty this quarter as sentiment fell into 'fear' territory in February, although it has improved as flows have normalised and valuations readjusted (see figure 15). However, there still remains a high degree of uncertainty given the levels of implied volatility across all asset classes.

Figure 15. Morgan Stanley Global Risk Demand Index

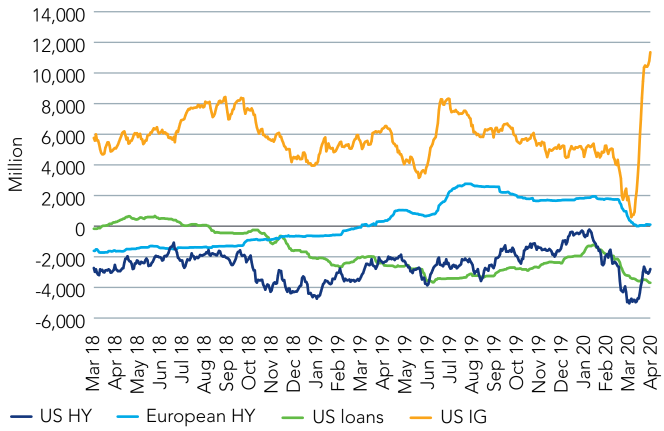


Source: Morgan Stanley, as at April 2020.

Asset flows

As the market sell-off took hold, investors started to sell their most liquid credit holdings (including ETFs) and reallocate to money-market and government-bond funds in a bid to reduce risk. This has led to significant outflows for both the bond and loan market (see figure 16). ETFs started to trade at a very high discount to net asset value, although this has since reversed.

Figure 16. Outflows across credit ETFs

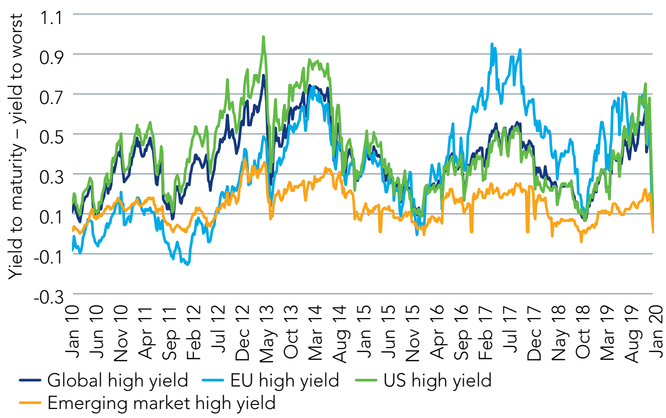


Source: Bloomberg, as at April 2020.

Valuations

As the fundamental outlook deteriorated, convexity within the high-yield market started to improve rapidly. With high-yield spreads breaching 1,000bps for the first time since 2008, the risk-reward profile of the asset class has improved for investors with a medium-term outlook (see figure 17).

Figure 17. High yield looks attractive



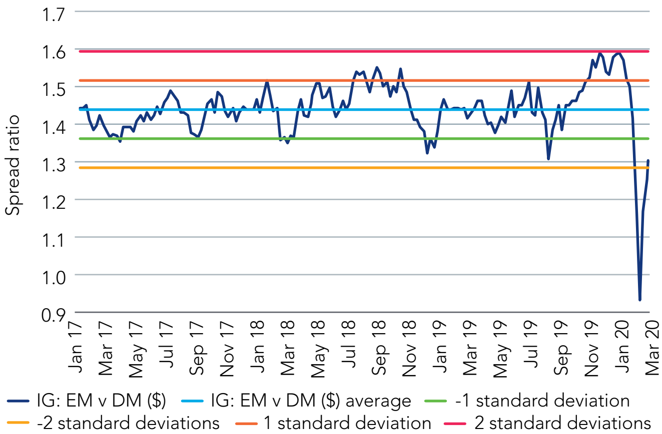
Source: ICE Bond Indices, as at March 2020.

Public credit

Emerging markets initially outperformed their developed counterparts, while the Fed has supported short-term investment grade securities.

Emerging markets outperformed developed markets in the first stage of the sell-off, as the initial outflows took place in developed markets (see figure 18). At this point, emerging economies were still benefiting from the inflows recorded at the start of the year that had been prompted by a search for yield. This slowly corrected as the impact of the coronavirus became clear, as well as the realisation that many governments were poorly equipped to support their economies.

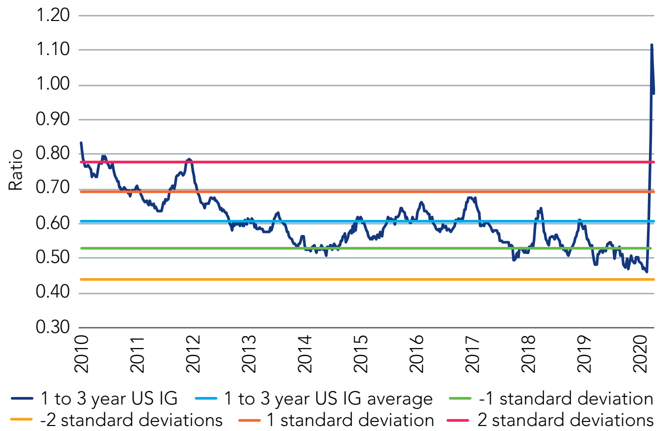
Figure 18. Emerging and developed-market credit



Source: ICE Bond Indices, as at April 2020.

The front end of the investment-grade curve is under pressure as institutions have focused on raising liquidity. The one- to three-year investment-grade curve has inverted to the rest of the curve for the first time since the financial crisis (see figure 19). This has eased since the Fed launched a bond and ETF repurchase programme focused on the short-term investment-grade curve. The reopening of the investment-grade primary market also eased worries that companies would not be able to refinance immediate maturities.

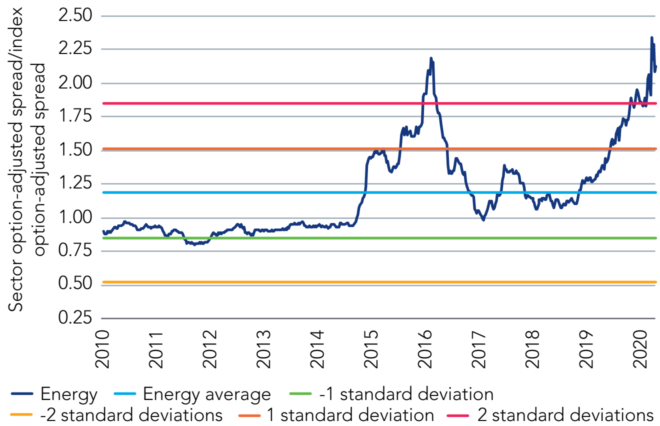
Figure 19. US investment grade one- to three-year curve



Source: ICE Bond Indices, as at April 2020.

The energy sector was already in a weak position at the start of the year and was placed under severe pressure by the oil-price war, which has affected both high yield and investment grade. To navigate this sector, investors need to identify companies that have a mix of asset quality and the balance-sheet flexibility to withstand a period of volatility.

Figure 20. Energy-sector spreads have soared



Source: ICE Bond Indices, as at April 2020.

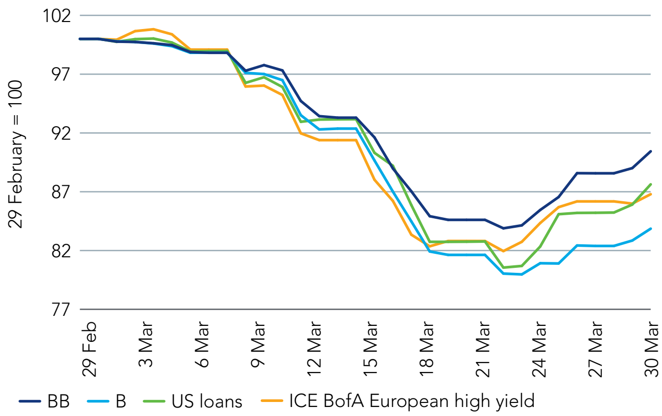
Leveraged loans

The leveraged-loan market was not spared from the coronavirus pandemic, despite the fact that the asset class typically exhibits lower volatility.

The S&P ELLI fell by 14.78% in March – the largest monthly decline on record since its inception in 2002 – and by 14.91% over the first quarter. Prices hit a bottom of 78.92 on 24 March, the lowest since September 2009, before closing the quarter at 82.8.

Investors were looking for quality paper in March. B-rated leveraged loans, which represent about 75% of the ELLI, declined by 16.14%, underperforming those rated BB which fell by 9.56%. European leveraged loans underperformed US loans, which fell by 2.37% in March. Finally, European high yield outperformed European loans and fell by 13.21% over March and 14.63% year-to-date (see figure 21).

Figure 21. US loans outperform



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

One of the main concerns is that underlying loans will be downgraded from B- to CCC. For CLOs, a higher exposure to CCCs will increase the weighted-average rating factor. Collateral-quality tests could be breached, haircuts applied in the calculation of coverage tests and repayments accelerated.

Downgrades to CCC have been limited so far and their share in the ELLI rose from 3.1% at the end of 2019 to 3.6% at the end of Q1 2020. But pressure remains high, and the proportion of those rated B- rose from 11.5% to 14% over the same period.

Structured credit

Structured credit initially lagged the broader market sell off, but soon caught up as investors started to sell their higher-quality holdings to raise cash.

While other asset classes sold off significantly at the start of March, structured credit mostly held out. ABS spreads changed very little, largely due to low trading volumes, while CLOs moved more in line with high yield – although there was also relatively little trading until markets became more stressed.

As the crisis developed and liquidity became more challenged, sentiment and momentum changed. Because AAA-rated ABS spreads had not widened very much, they still offered the opportunity to raise the maximum amount of cash with little pain, meaning that investors looked to sell their AAA-rated holdings – presumably in a bid to meet redemptions.

With many sellers coming to a market that had few active buyers, spreads widened and selling activity ground to a halt. Despite the barrage of lists from sellers, not everything traded off them. This suggested that the amount that buyers were willing to pay did not meet the targets of sellers, and that sellers were not that motivated – in other words, forced – to sell.

Structured-credit spreads have since stabilised: AAA-rated UK prime residential mortgage-backed securities (RMBS) reached a peak of SONIA +200bps but have since settled to the mid-100s, while AAA-rated European CLOs widened to EURIBOR +400bps before levelling out to the low 300s. By the end of the month, there were only buyers in AAA-rated ABS, particularly in UK prime RMBS, and very little was offered in AAA-rated CLOs.

Nonetheless, liquidity has come back to the market and, unlike in other asset classes, it is still possible to trade sizeable volumes. There are pockets of activity in ratings brackets below AAA, although there is a sense that investors are holding onto their positions in areas where credit fundamentals and structures remain solid.

In this environment, there is a clear need to stress test our underlying portfolios. The scale, severity and duration of the crisis is unknown, and we are assessing whether structures can withstand the deterioration in performance, lack of cash flow and increase in defaults.

Private debt

With mergers and acquisitions (M&A) on hold, the SME lending market has all but shut down for primary issues.

The focus of most corporate-management teams during the crisis has been on internal matters, rather than on the acquisition of third parties. The few M&A transactions being negotiated were launched before the crisis.

Once the pandemic is over, M&A activity volumes should pick up relatively quickly compared to in 2008. This is a crisis created by a pandemic, rather than weakness in financial institutions. A quick pick-up in M&A activity should benefit direct lenders who provide financing for acquisitions.

Most lenders have made it clear that they are willing to financially support portfolio companies. As such, SMEs have been provided with liquidity facilities. Pricing has increased by 150-200bps, with senior-secured and unitranche yields at 7.5%-9% and 10%. The unitranche premium reflects its subordination to the super senior's RCF facilities, which have been drawn. Senior-secured lending, which sits at the top of a company's capital structure, provides the best protection when defaults are increasing.

The impact of the lockdown on company earnings means that defaults and covenant resets should increase later this year. While first-quarter earnings showed that many SMEs benefited from stockpiling, SMEs in some sectors – including travel and leisure, retail and dining – have been badly affected since the start of the crisis. This reinforces our aim to avoid lending to sectors that are heavily reliant on consumer spending, given that they tend to be more cyclical.

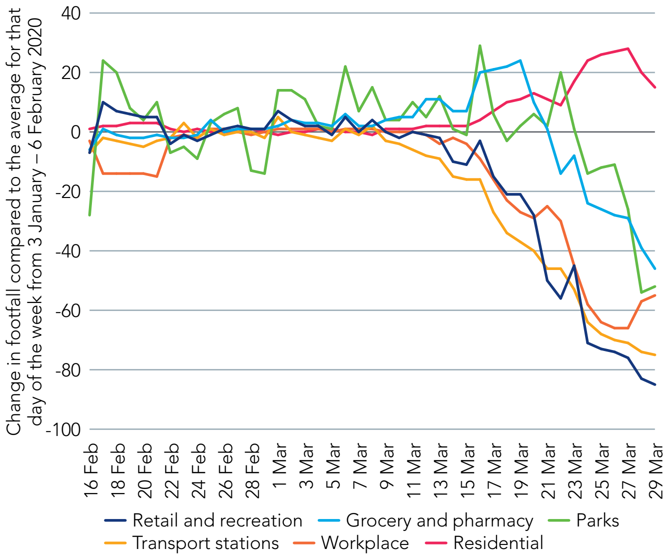
Unlike in 2008, SMEs have entered the current crisis committed to managing liquidity and have drawn their RCFs. If the market sell-off is prolonged, liquidity will remain the key risk for many SMEs – which explains why many European governments have placed pressure on banks to provide liquidity, as well as put in place mechanisms to support SMEs.

Asset-based lending

The impact of the coronavirus pandemic on the high street feeds through to real-estate loans and also affects transaction volumes, values and liquidity.

In the UK, the coronavirus outbreak took a heavy toll from the end of March (see figure 22). The demand shock has been unprecedented for shops, restaurants, cinemas and hotels.

Figure 22. Mobility trends in the UK



Source: Google, Github, as at April 2020.

The value of real estate lies in its utility to occupiers, their willingness and ability to pay rent. The crisis has bolstered this principle. The announcement that the non-payment of rent is not cause for eviction has affected rental arrears: although rent is still due and payable, it has had an impact on landlords' short-term cash flows.

In some sectors, rent collection has fallen by as much as 70%. Many tenants not using their properties are unable to generate income, meaning their willingness and ability to pay rent has been affected. Hotel operators that cannot run their businesses have been impacted more than any other sector.

Reduced rent payments mean that borrowers are less able to pay interest. For now, senior real-estate loans continue to deliver stable cash flows through what is already a very severe crisis, but we expect next quarter to be more difficult.

The lockdown means that properties cannot be inspected and transaction volumes have fallen to all-time lows. Writing new loans is difficult enough in an environment of such low trading volumes, but it is harder still when there is no ability to physically inspect property, a lack of clarity on when properties can be occupied again and an increased risk that changes to the law will occur.

On a more positive note, the government is helping businesses with initiatives like a 12-month business-rates holiday for tenants in certain sectors. Given that business rates form a large proportion of occupational costs, this improves the short-term cash position of many tenants.

However, the lack of trading means that it is not possible to adjust the positioning of real-estate debt portfolios in the short term. Even though our underwriting had not envisaged a shock of this nature, the quality of our collateral and its continued ability to generate rental income will determine its performance through the crisis.

Changes to lending in response to the crisis

Governments have proposed a raft of initiatives to protect businesses and employees from the impact of the coronavirus pandemic, which will have material implications for credit markets.

The banking sector, wider lending community and governments are working to help companies and citizens weather the volatile economic climate. Measures used will support credit markets as they should provide a cushion against the inevitable spike in defaults.

Unlike in 2008, the current crisis has not emanated from weakness in the banking sector. As a result, authorities have moved to protect banks from the impact of the downturn and have maximised their ability to inject liquidity into the real economy.

Most regulators have followed the recommendation of the ECB's supervisory arm to ban banks from paying a dividend in 2019, which should generate an additional €30bn of capital for European banks. The UK has followed suit with a similar request.

This benefited credit markets, as it protects the capital position of banks. Payment of AT1 coupons have not been affected by the decision, although this could change if the situation deteriorates significantly.

Banks have led the way in providing liquidity to the real economy, primarily through RCF draws. This stands in contrast to 2008, when borrowers were reluctant to draw their RCFS and in some cases struggled to do so.

Borrowers within our SME private-debt portfolio have between six and 12 months of liquidity on their balance sheets. Draws on RCFs are increasing daily and banks are shouldering the initial injections of cash into the economy. These draws reinforce the liquidity position of borrowers, which supports credit markets.

Banks and alternative lenders are also under heavy pressure to behave responsibly towards borrowers. Interest holidays have been applied in a number of European markets, where interest payments have been added to the capital value repaid at maturity and term-loan A amortisation payments have been cancelled. Generally, lenders are supporting portfolio companies that were performing before the crisis.

Governments have established national funds to support companies. Overall, countries with significant social-support infrastructure – such as Belgium and the Nordic nations – have funds in place which support the liquidity of businesses, rather than their employees.

Other countries are also supporting corporates through loan-guarantee schemes and liquidity facilities. These schemes are beneficial for credit markets as they reduce the default risk of companies in the short term.

Changes to insolvency rules

Insolvency regimes have been under scrutiny during the pandemic, particularly in the UK, France and Germany. The UK government announced that Parliament would review key aspects of its insolvency law. This focused on two themes:

Wrongful trading: There will be a temporary suspension of 'wrongful trading' provisions for company directors.

Moratorium on insolvency: A short moratorium will be given to companies in difficulty to let them explore rescue options. With little detail, most commentators argue that this is a replication of Chapter 11 in the US. This is when companies continue to operate with protection against creditors in order to find a restructuring solution. This could be an unwelcome challenge to UK creditors, given that it will constrain their ability to recover their loans in the short term.

The impact on structured credit

Most European securitisation is backed by loans to consumers, such as residential mortgages, car loans and credit cards. The drop in economic activity has caused personal incomes to decline, which diminishes the ability of consumers to reduce their debts.

Various measures have been brought in to help consumers meet their debt obligations, including payment holidays for mortgages, credit cards and other consumer-debt products (although the obligation remains with the individual to service the debt). It will be up to lenders to decide whether to extend the payment holidays, although existing arrangements to protect borrowers remain in place.

While governments and central banks have announced supportive measures, we still believe that arrears will rise. Where these mortgages and loans have been securitised, there will be disruptions to the usual cash flows coming into the special-purpose vehicles holding them. This will affect the loans backing CLOs, as well as the degree to which individuals are able to repay the debts that underly RMBS and ABS securitisations.

Structures are designed to withstand borrowers not paying interest and principal for a period of time. The length of time, as well as how much can be covered by reserves in the structure, varies.

There are also support mechanisms for companies, although we expect some deterioration in the credit quality of the collateral backing CLOs as revenues have been severely hit. We expect ratings agencies to take large-scale action on loans and for defaults to increase, which will impact the CLOs that hold them.

ESG

Sustainable fixed income has been resilient amid the market shock, while the crisis offers an opportunity to engage with companies on environmental, social and governance (ESG) issues.

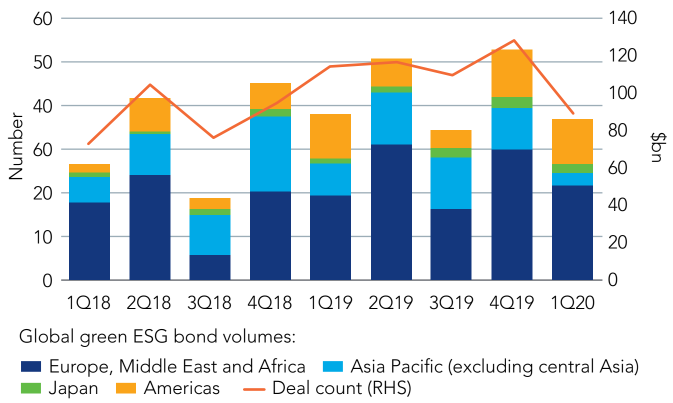
The recent rise in capital-market activities described as ESG or sustainable has been nothing short of mercurial. Before the sell-off, we were often asked whether the growing prominence of 'green' finance was evidence that we were in the late stages of a record-long, central-bank-supported bull market – with the implication that ESG investing is a luxury that can be enjoyed as long as we can afford it.

Looking at a small sample of capital-market activity in the early weeks of the drawdown, we can unequivocally say that the trend is irrevocable.

- Volkswagen launched a Green Finance Framework that includes clear guidelines for sustainable debt instruments and the creation of a Green Finance Committee.[6]
- UPM signed a €750m RCF with a margin tied to climate targets.[7]
- Philips issued €1bn-worth of bonds whose proceeds are tied to its ESG framework.[8]
- Engie issued a triple-tranche green bond for €2.5bn.[9]
- ICMA released guidance on bonds issued to address social problems created by the coronavirus.[10]

Moreover, the issuance of so-called ESG bonds in Q1 only declined modestly on a year-on-year basis, despite the profound market disruption (see figure 23).

Figure 23. Global green ESG bond volumes by region



Source: IFR, as at April 2020.

Engaging throughout market conditions

The market shock offers a unique opportunity to understand how companies stay true to their values. As this crisis wears on, we continue to engage with companies on ESG, risk and strategy issues. We are impressed with the open dialogue that most companies have sought to maintain.

During recent engagements, we have sought to understand how companies are responding to near-term risks that carry damaging financial, social and reputational consequences if mishandled. This helps our credit analysts develop a more precise understanding of the near-term responses of different companies to key risks, as well as provide a snapshot of the ethos, skill and decision-making capabilities of senior managers.

Importantly, our approach provides a very real test of underlying corporate cultures of responsibility. These factors influence the difficult decisions that preserve financial health, while also extending fairness to stakeholders – including worried employees and customers, vulnerable suppliers and the wider communities that these companies conduct business in.

For example, in recent conversations with telecommunication firms Altice USA and Millicom, we were pleased to learn that both had activated continuity and crisis functions as early as January 2020. Altice USA also indicated it would consider lifting bandwidth and data caps, and one day after we met announced that it would provide free broadband to New York households with students who lacked access.

Finally, a meeting with Sealed Air, a packaging firm, showed us that the personal health of its workforce was its first concern after it shifted to crisis-management mode in January – months ahead of instructions by US regulators.

[6] 'Volkswagen presents Green Finance Framework', published by Volkswagen in March 2020.

[7] 'UPM signs a EUR 750 million revolving credit facility with a margin tied to long-term biodiversity and climate targets', published by UPM on 17 March 2020.

[8] 'Philips successfully prices offering of Notes for EUR 1 billion', published by Philips on 25 March 2020.

[9] 'ENGIE issues a triple tranche bond for a total amount of 2.5 bn EUR', published by Engie on 24 March 2020.

[10] 'Green and Social Bond Principles with ICMA underline relevance of Social Bonds in addressing COVID-19 crisis and provide additional guidance', published by ICMA on 31 March 2020.

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