360°

A test of endurance

Andrew Jackson
Head of Fixed Income

Fixed Income Quarterly Report
Q3 2021

Federated Hermes International

www.hermes-investment.com
For professional investors only

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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

There's more going on in fixed-income markets than first meets the eye. Investors may be in an optimistic mood, but markets are deriving momentum not from good news but from the policy response to successive crises. Meanwhile, one asset class in particular may have been unfairly maligned.

Le Tour de France is my favourite sporting event of the year for many reasons. The landscapes and scenery are spectacular. Then there are the tactics, the subtleties of the scoring systems, the roles of the individuals within each team, the various *maillots* and the ever-changing technology behind the bikes. There are also huge individual personalities within cycling, both female and male. The 2021 version has seen some huge new personalities emerge and one all-time great cement his place in history.

But if there is only one thing about this sporting event that I love, it would have to be the suffering.

Maybe that's why I'm a fixed-income investor, and maybe that's why I am once again reminding you that not all is rosy in the garden.

Stocks are at all-time highs, credit spreads are near all-time lows, the supply of financing is plentiful, funding is cheap, and, at the time of writing, mergers and acquisitions (M&A) are exploding. But all is not good, I'm afraid. Interest rates are not at zero because things are great, quantitative easing does not continue apace because everything is good, the pandemic is not over and, I am sorry to say, growth is not uniformly strong.

To return to my cycling introduction, it feels like we are flying up the Col du Tourmalet at 25 kilometres an hour, with the wind in our hair, sun on our backs and unlimited strength in our legs. But look down! You're riding an electric bike, and the assistance the motor is providing is the only thing preventing you rolling all the way back down the climb. Let's hope our battery doesn't run out anytime soon.

Wheels within wheels

Our Relative Value Framework is throwing up a few things this quarter that I think are really worthy of mention. The first is that one can clearly see illiquidity and complexity premia coming to the fore. The second is that despite the record issuance of collateralised loan obligations (CLOs) that is likely in 2021, we still see meaningful value there and, indeed, within the underlying syndicated leveraged loans. The third is that interest rates, absolute levels, volatility and sensitivity to interest rates continue to have a major influence (we covered this in detail last quarter's *360*). The last is what we don't see when we look at this top level analysis but we do see once we dive one layer further down. That is that while our view on the beta of some of these sub-asset classes may not be high, there is a level of alpha from security, issuer/borrower and instrument type that is well beyond what we would normally expect to see.

Figure 1. The top 10 ranked exposures in our Relative Value Framework is dominated by exposures that exhibit illiquidity and/or complexity premia

	2021 scores		
Exposure	**Q2**	**▲**	**Q1**
Direct SME Lending	1	▲	2
Europe CLO Mezzanine	2	▲	3
Europe CLO Senior	3	▼	1
EM Credit	4	–	4
Hybrids	5	–	5
Syndicated Leveraged Loans	6	▲	11
Subordinated Financials	7	▼	6
Real Estate Debt	7	▲	9
Senior Financials	9	▼	7
Europe ABS Mezzanine	10	▲	15

Source: Federated Hermes, as at 30 June 2021.

Unsung heroes

Most non-cycling fans will have heard of Chris Froome or Geraint Thomas, both of whom won the general classification of Le Tour. Some will even remember far enough back to winners like Stephen Roche, but very, very few will have heard of some of the greatest and most renowned cyclists in history who were their contemporaries but won *le maillot vert*, the green points jersey, instead. For cycling fans, Sean Kelly, Peter Sagan and Mark Cavendish are perhaps even more feted than their general-classification colleagues.

Most investors look at fixed-income markets the way the world looks at Le Tour, noticing only the absolute level of spreads offered by credit markets (for most people, high-yield bonds). When looked at through the rear-view mirror, the second quarter of 2021 will be described as a period of consolidation, a transition while we wait to see how the next phase of the global economy plays out. Even during the last quarter, it did, on occasion, feel like not a great deal was happening, but that is not what we are seeing. Looking through the headlines of this rather benign period, we have seen compression in credit spreads in a fairly uniform fashion, classic yield-hunting behaviour squeezing juice out of the less-loved areas of markets and a classical loosening in lending standards. But much like watching Le Tour only through one lens, this approach has missed a myriad of subtleties. We have little doubt that the credit-default-swap-versus-bond move has been missed by most, and the emerging-versus-developed-market risk that we have been highlighting has similarly flown below the radar as excessive leverage and EBITDA add-backs have hogged the headlines.

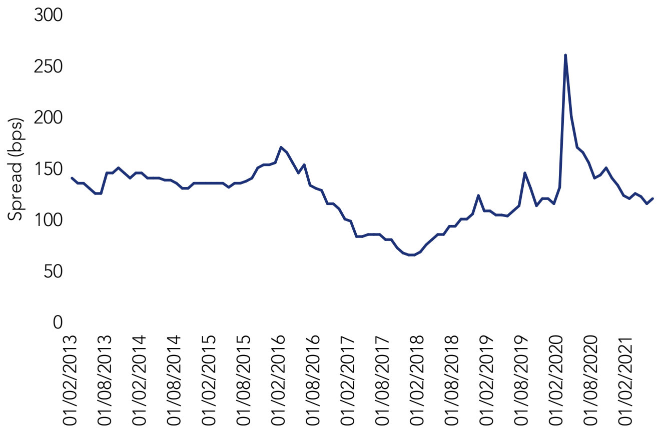
Reputation and reality

The last analogy I will draw is with a sport that has found it almost impossible to shrug off a tarnished reputation. Asked to name one famous cyclist, many people will name not Eddy Merckx, Bernard Hinault or Tadej Pogacar, but the Texan cheat. Cycling continues to live in the shadow of that individual and of the drug-taking and doping that, through him, tarnished the whole history of the sport.

There is one part of the credit markets that has also had a sullied reputation for some time: structured credit. Like cycling, structured credit went through an incredibly tempestuous period during which it developed a reputation for excess and cheating. The result was a reputation sullied for the long term. Over a decade after the financial crisis in which some parts of that asset class made their way onto evening news programmes, there are still many investors who feel the asset class is full of the equivalent of drug cheats.

I am of the opinion that this reputation is broadly unwarranted, and that structured credit is now a very attractive asset class to invest in on a risk-adjusted basis. In the next issue of the 360, we will dive into the history of the asset class and examine some of the myths that surround it.

Figure 2. Spreads on Euro CLO 2.0 AAAs



Source: Federated Hermes, Citi as at 30 June 2021.

But I will close by saying that an AAA tranche of a CLO pays 100 basis points (bps) over a risk-free rate with a floor at zero if that risk-free rate turns negative. That tranche has sufficient structural support that at least 10 times the highest-ever losses would have to occur in order for any loss to be suffered. Furthermore, if any of these tranches were to experience material mark-to-market losses, then I would expect pension funds and other large long-term investors to begin investing heavily. As low risk as this strategy is, it may well be the equivalent of Wout van Aert, winner of a time-trial, mountain stage and sprint, in that these trades have it all, but barely anyone knows they exist.

Have a wonderful summer, all, and look out for Mr Van Aert in Tokyo!

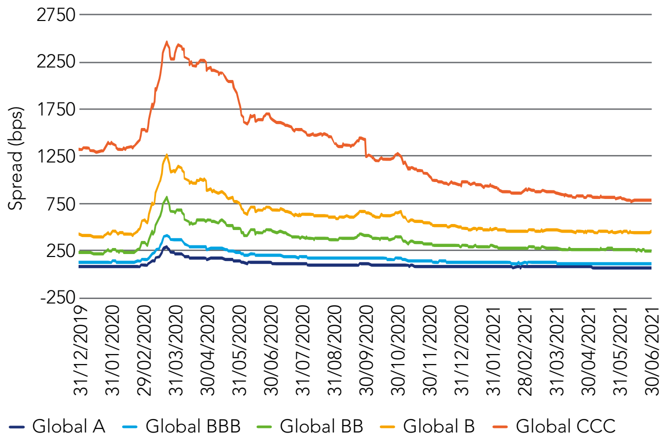
Relative value

Credit spreads drifted lower over the second quarter, with many now below their pre-pandemic levels. As a consequence, valuations are looking full in many parts of the market, making bottom-up selection increasingly important.

For the majority of the quarter, public-credit spreads remained fairly flat, initially moving marginally wider until the US Federal Reserve (Fed) meeting in mid-June, when spreads moved gradually lower to finish the quarter tighter. This now leaves spreads on all the major credit-default-swap (CDS) indices not far off their historical lows. In fact, CDX High Yield finished the quarter at 273bps, which now brings it below its pre-pandemic low while by comparison the iTraxx Crossover at 231bps remains 14% off its tightest pre-pandemic levels.[1]

In terms of total returns for corporate bonds, global investment grade returned 2.70% in the second quarter and is down 1.72% for the year to date. Meanwhile, global high yield delivered 2.56% in the second quarter and has outperformed with a year-to-date gain of 2.48%.[2] In contrast to CDS indices, spreads for global corporate cash-bond indices are now below their pre-pandemic levels; the global high-yield and corporate combined index spreads are 6% lower. If we drill down into the individual rating buckets, spreads on bonds rated BB and B are 11% and 8% wider, respectively, than their pre-pandemic levels. All other ratings are at tighter levels. Global CCC-rated bonds have moved the most, as they have continued to rally with the resurgent risk-on sentiment in the markets. Their spreads are now 41% lower than in February 2020 and remain near their post-financial-crisis lows. However, unlike in the other rating buckets, CCC-rated spreads were not at historical lows as they entered the pandemic because parts of the universe were already at distressed levels. This leaves CCC valuations looking very stretched and public credit in general looking very rich. Now more than ever, bottom-up selection is critical to generating outperformance.

Figure 3: Spreads of corporate credit-rating bucket indices since 2020

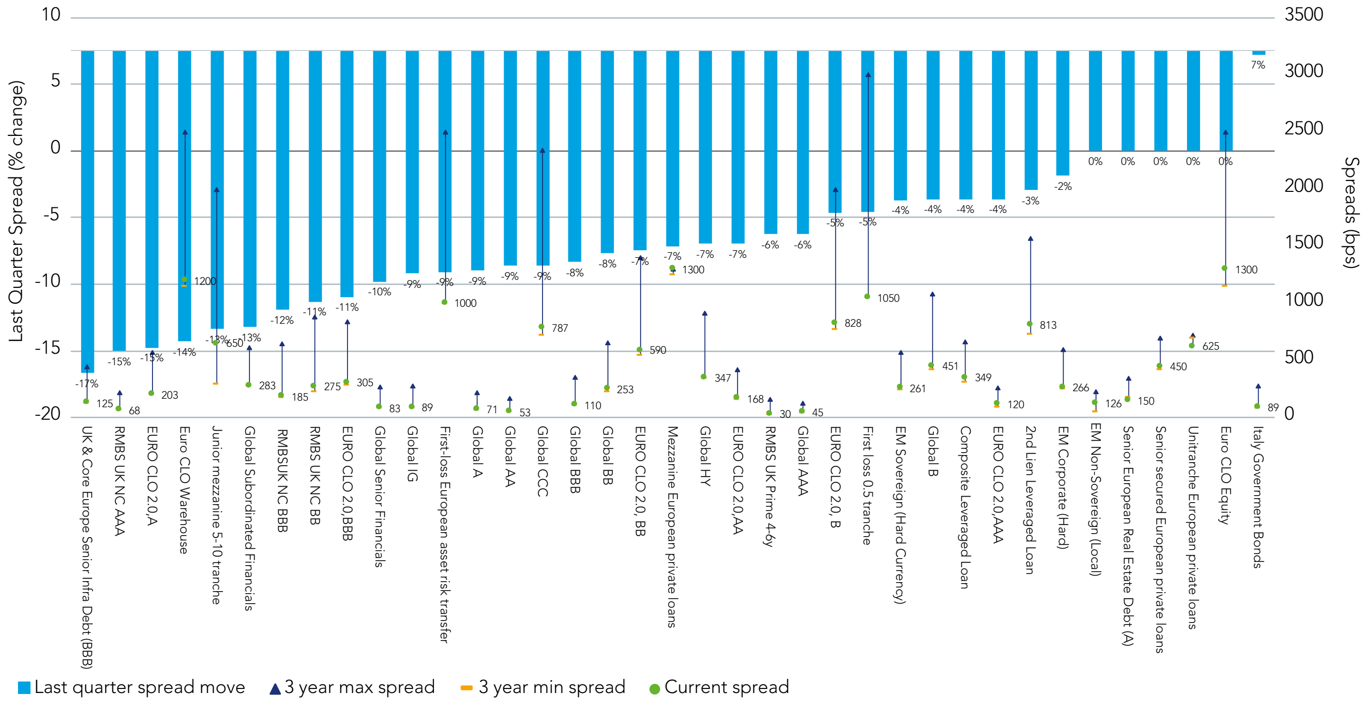


Source: ICE Indices, Bloomberg, as at 30 June 2021.

We will now look more broadly across the credit spectrum at spread moves. In figure 4, we show for selected exposures their current spread levels in the context of their three-year minimum and maximum levels, all ranked by their second-quarter percentage spread move. In general, it is structured credit that has tightened the most and more than public corporates. Meanwhile, spreads on emerging-market (EM) credit and private credit exposures have moved less.

[1] Source: Bloomberg, as at 30 June 2021.
[2] Source: Bloomberg, as at 30 June 2021.

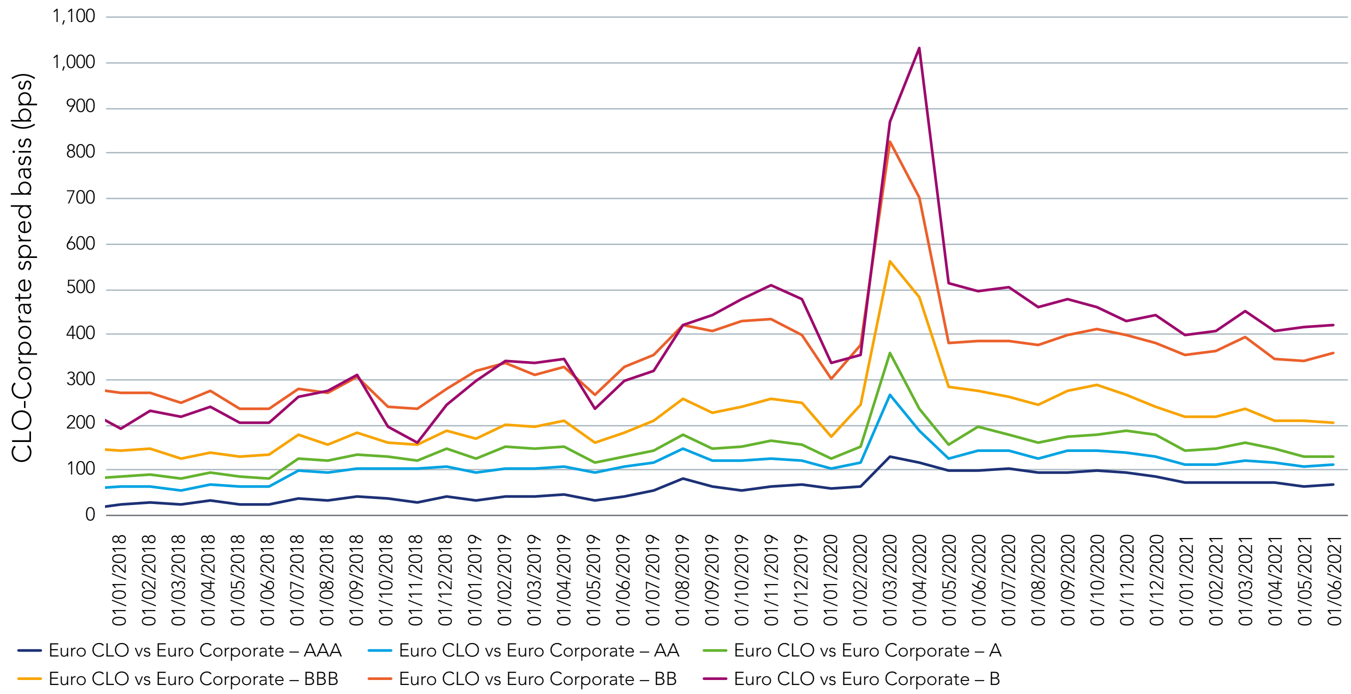
Figure 4: Current spread levels vs three-year minimum and maximum (RHS) ranked by second-quarter percentage spread moves (LHS) for selected multi-asset credit exposures



Source: Federated Hermes, Bloomberg, Citi as of 30 June 2021.

Structured credit continues to benefit from strong flows as new investors allocate to the asset class. These investors are looking to capture both the complexity premium and floating coupons after these structures stood up during the pandemic. But despite these new entrants to the market, an attractive premium still exists relative to equivalent-rated corporate bonds, which should support further demand for the asset class. See figure 5, which compares the basis between euro-denominated CLOs and equivalent-rated corporates.

Figure 5: Spread basis between euro CLOs and equivalent-rated euro corporate bonds over the last three years

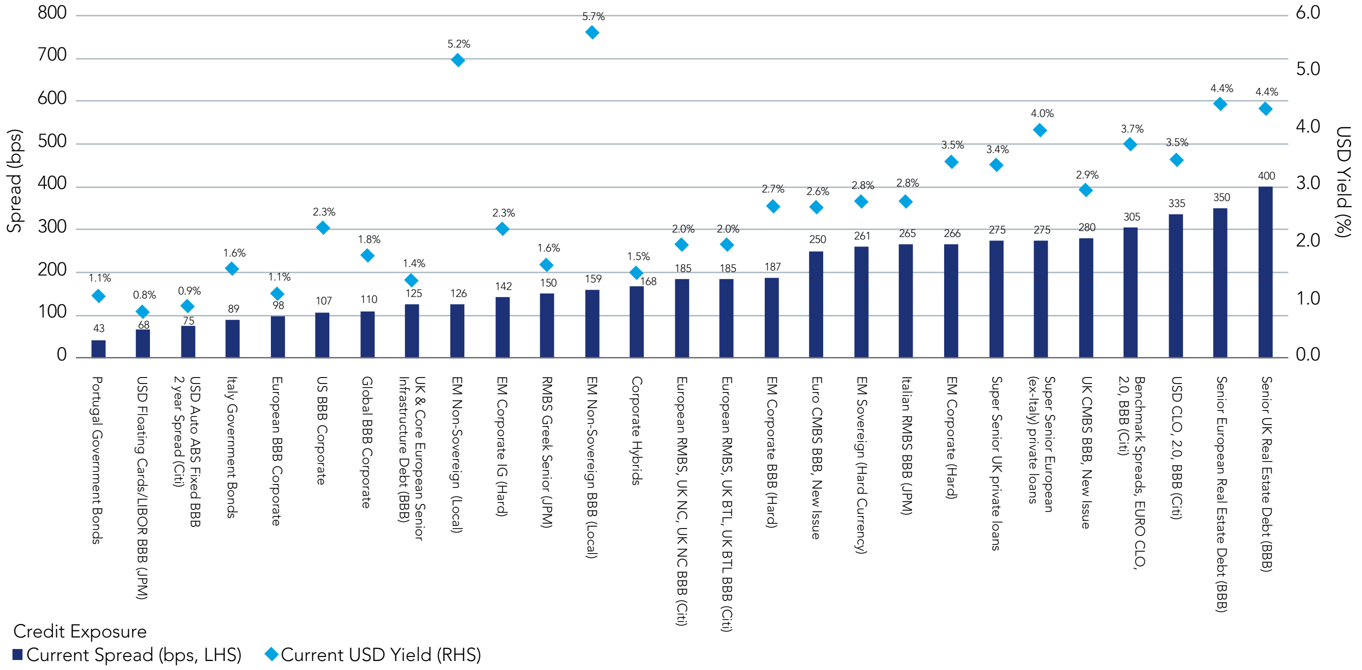


Source Federated Hermes, Citi, Bloomberg, as at 30 June 2021.

With many credit exposures looking rich in isolation compared with their own history, it is now especially helpful to broaden our view to focus on finding attractive relative value within the full credit universe. This is particularly relevant for mandates that have the flexibility to allocate more broadly across the spectrum, including multi-asset credit (MAC) strategies. Comparing valuations of various MAC exposures with the same equivalent rating provides one lens to identify pockets of attractive value. For more detail, please see figures 6 and 7 for spread and USD yield comparisons for BBB and BB-rated exposures.

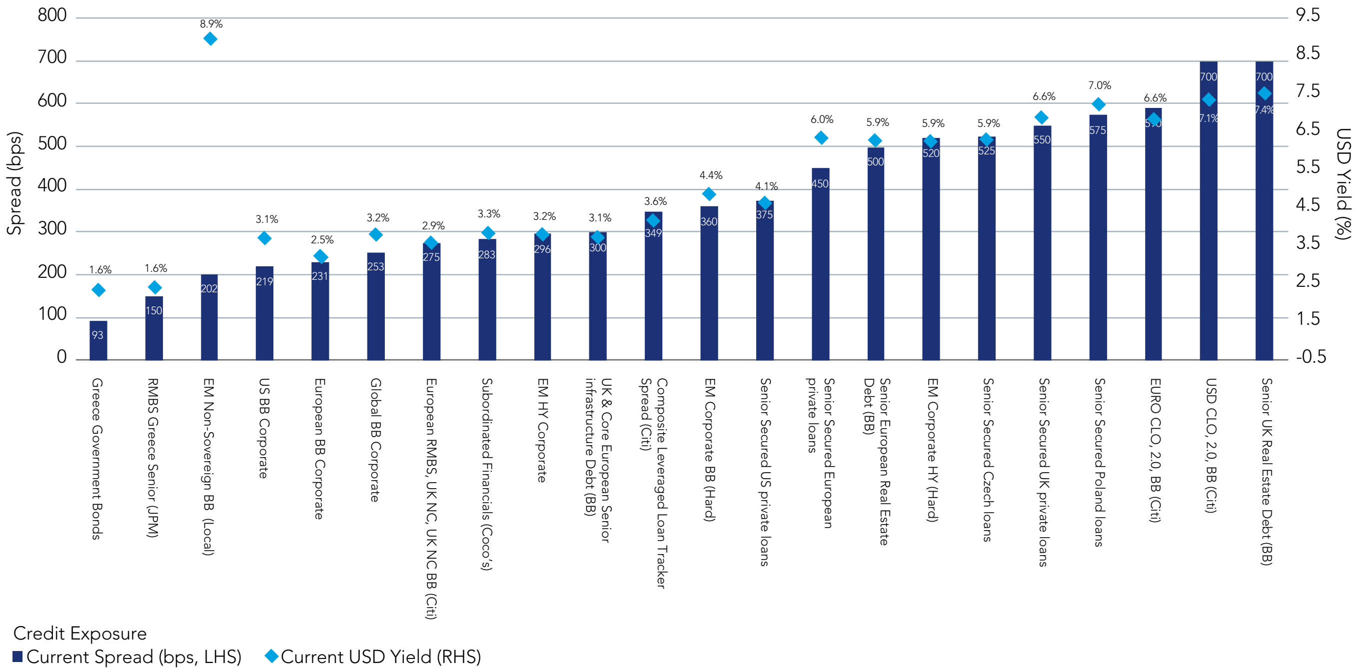
We see that in public credit, EM corporates have an attractive spread pick-up compared with developed-market (DM) corporates. As demonstrated above, CLOs offer an attractive premium over equivalent-rated public and private corporates. However, real estate debt continues to look attractive, with pricing still wider than its pre-pandemic levels. Exposures that offer less value in spread terms are sovereign debt, corporate credit and some areas of the asset-backed securities (ABS) market.

Figure 6. Spread and USD yield comparisons for BBB and equivalent-rated MAC exposures



Source: Federated Hermes, Bloomberg, JPM and Citi, as at 30 June 2021.

Figure 7. Spread and USD yield comparisons for BB and equivalent-rated MAC exposures

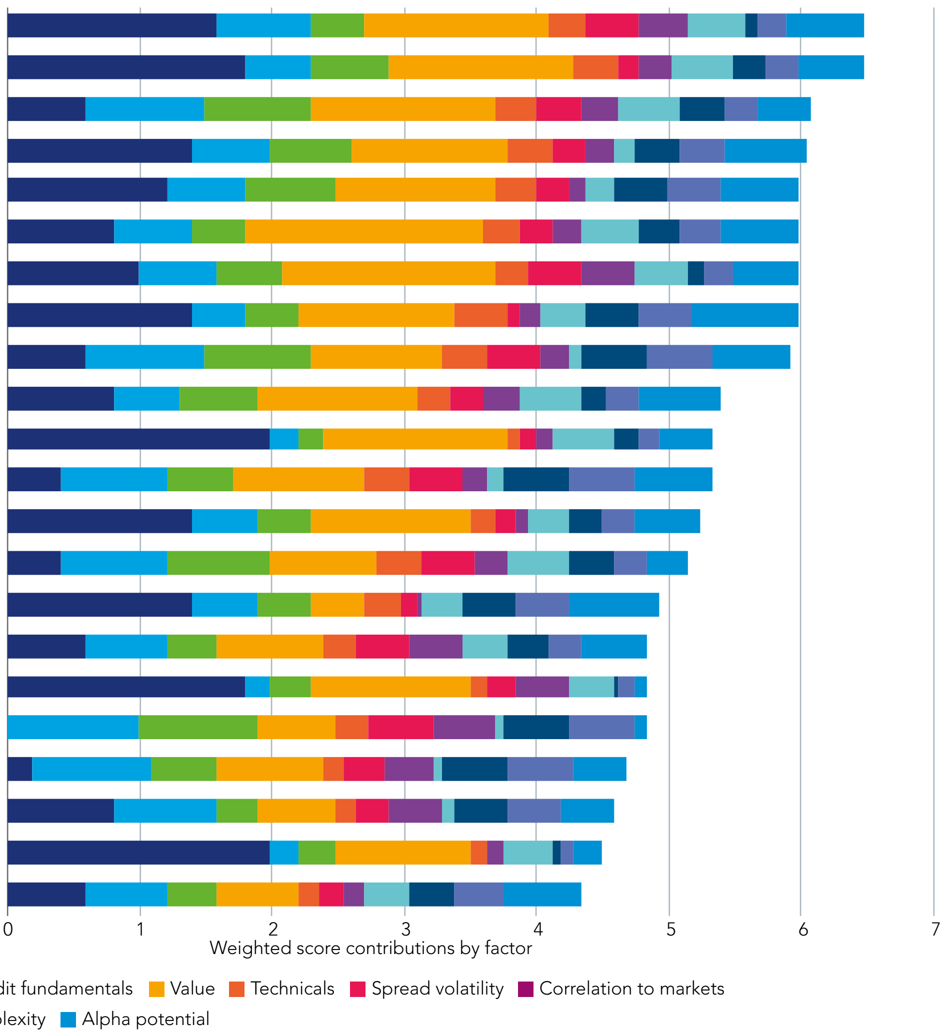


Source: Federated Hermes, Bloomberg, JPM and Citi, as at 30 June 2021.

When we assess relative value, however, we consider a broader range of factors beyond current valuations within our MAC Relative Value Framework. This quarter marks the three-year anniversary of when we first published our relative-value rankings back in June 2018. To mark the occasion, I have added some additional data on the ranking history and trends over the past three years at the end of this section. Figure 8 shows the current rankings as of the end of the second quarter of 2021. There has been quite a bit of movement for a quarter, with muted spread moves across most exposures.

Figure 8. Our latest MAC Relative Value Framework

Q2	▲	Q1	
1	▲	2	Direct SME lending
2	▲	3	Europe CLO mezzanine
3	▼	1	Europe CLO senior
4	—	4	EM credit
5	—	5	Hybrids
6	▲	11	Syndicated leveraged loans
7	▼	6	R.E. debt
7	▲	9	Subordinated financials
9	▼	7	Senior financials
10	▲	15	Europe ABS mezzanine
11	▲	12	Europe CLO equity
12	▼	8	Investment grade
13	▲	14	Mezzanine tranche
14	▼	10	Europe ABS senior
15	▼	13	High yield
16	—	16	Trade finance
17	—	17	Risk transfer
17	▲	19	Money market
19	▼	18	Developed government bonds
20	—	20	EM government bonds
21	—	21	First loss tranche
22	—	22	Convertibles



Source: Federated Hermes, as at 30 June 2021.

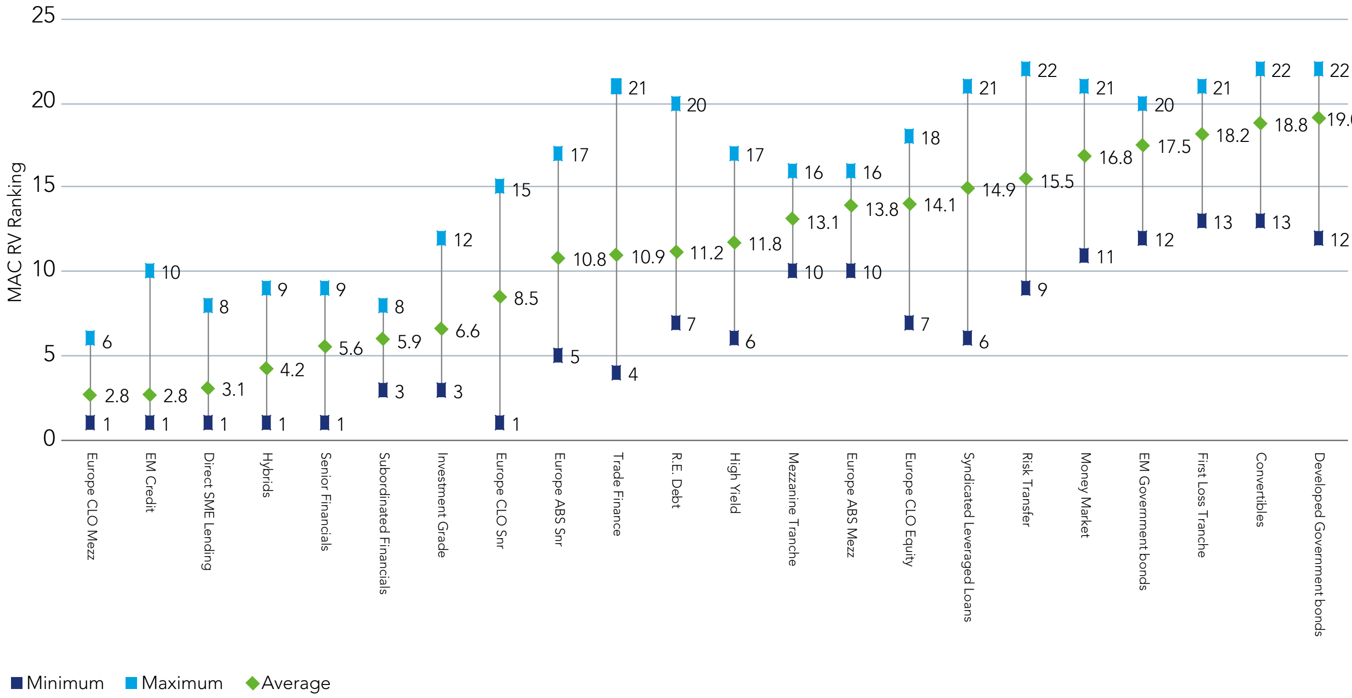
Direct lending takes the top ranking for the third time in the framework's history. This quarter, there were upgrades to its fundamental score to reflect two things: first, the improved earnings outlook as economies reopen; and second, recognition of the large amounts of funding available to such companies from lenders to small and medium-sized enterprises in the event that they need liquidity. The technical score was also upgraded because, despite the large numbers of lenders looking to deploy, the very high volumes of M&A activity provide lots of choice in the lending opportunities available. Furthermore, we see opportunities to create enhanced internal rates of return because of the high levels of liquidity in this space, which offer the potential to accept refinancing at par on some deals and benefit from the early crystallisation of up-front fees. We continue to prefer senior secured lending at conservative leverage levels. Also, within private credit, real estate debt continues its move up the rankings, from ninth to seventh, which reflects the attractive spread levels (shown in figures 6 and 7) and improved fundamentals as economies reopen. We see better value in loans rated BBB, where there is less competition from core lenders when compared with prime, and in loans rated A, where there has been a flight to quality.

Euro-denominated CLO AAAs move down from first to third. Despite spreads lagging other parts of the stack and still looking attractive compared with other high-quality exposures, we downgraded the value and technical scores to reflect the large volume of supply from resets and new issues. This could push spreads wider over the next quarter because there are fewer immediate buyers in the market at these levels. But we think such moves will be limited because, as spreads breach 100 bps, there will be support from institutional investors.

Mezzanine tranches of CLOs move above the senior tranche to second place because they continue to offer an attractive spread pick-up compared with other asset classes and should continue to see demand at these levels. Within IG mezzanine, Euro CLO BBBs finish top as they offer attractive risk-adjusted returns, an attractive premium compared with other investment-grade exposures and benefit from attractive supply and demand technicals. Mezzanine ABS exposures move up from 15th to 10th, which reflects an attractive spread pick-up and floating coupons compared with other exposures, which is not the case for ABS senior tranches (down from 10th to 14th), despite looking very rich relative to their own history.

Within public credit, EM credit remains in fourth place as EMs continue to lag DMs and look better value. But I will focus on leveraged loans, which jumped from 11th to sixth, taking them into the top 10 rankings for the first time in the three-year history. We continue to see more value here than in high-yield bonds, which fell from 13th place to 15th. While the value score for high yield was downgraded by 2, the equivalent score for leveraged loans was upgraded by 2 to reflect the better convexity that loans offer within the secondary market, with lower price levels and the potential to benefit from a pull to par as large M&A activity leads to a wave of refinancings. The floating nature of leveraged loans also makes them attractive should the Fed surprise the market with earlier rate rises.

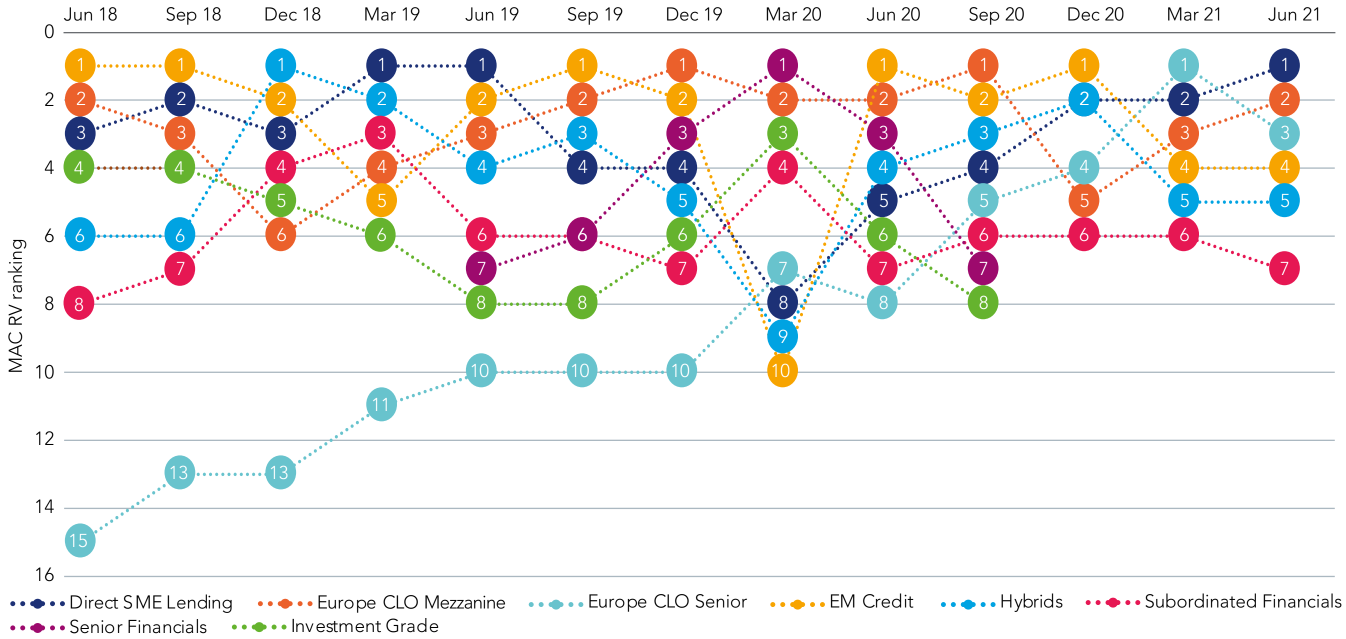
Figure 9. Minimum, maximum and average MAC RV rankings over the three-year history



Source: Federated Hermes, as at 30 June 2021.

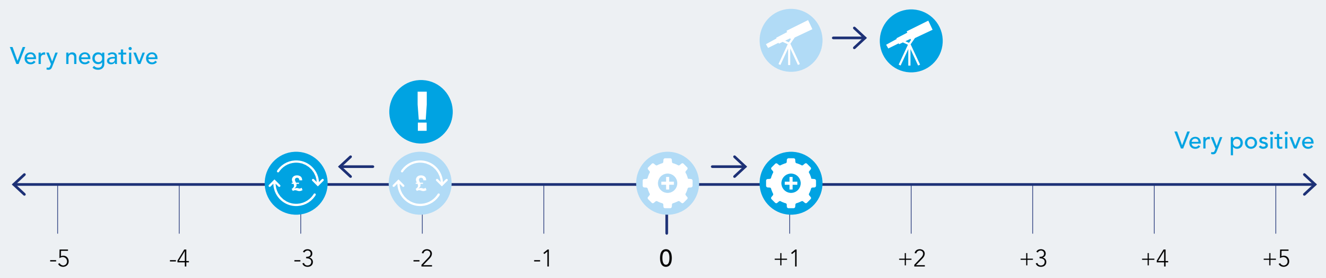
Finally, I wanted to share some insights from looking back over the three-year MAC Relative Value Framework history. Figure 9 sorts each MAC exposure by its average ranking in the context of its range. This suggests Euro CLO mezzanine, EM credit and direct lending have been most attractive with the lowest average rank while DM government bonds, convertibles and first-loss tranches have been ranked the lowest on average. Meanwhile, trade finance, CLO senior and leveraged loans have experienced the widest ranges. Figure 10 shows that our framework is dynamic, demonstrating that there has been movement in the top-three-ranked exposures over its history. It also shows that EM credit topped the rankings for five quarters, which is more than any other exposure.

Figure 10. Movement in the top-three-ranked exposures over the three-year history



Source: Federated Hermes, as of 30 June 2021.

Q3 2021 score card



Economic outlook

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

Economic data remains positive, and central banks have signalled a willingness to react to prevent the economy overheating should inflation not prove transitory.

Credit fundamentals

- **Move to +1 from 0**

Leverage levels remain high but are improving, earnings are looking positive, default rates are falling, and we are seeing positive rating migrations.

Valuations and technicals

- **Move to -3 from -2**

Credit valuations are looking rich with spreads at historically tight levels.

Tail risks

Stay at -2

With rich valuations, the risks remain to the downside. The following key tail risks could trigger a correction:

- Large inflation shock that takes the market by surprise and forces central banks to raise rates sooner than signalled.
- Slowing Covid-19 recovery with the spread of vaccine-resistant virus variants.
- Weakened corporate liquidity from a premature move to shareholder-friendly practices.
- China–Taiwan tensions escalate.
- Chinese real estate lending issues creating contagion in global credit markets.

Contents

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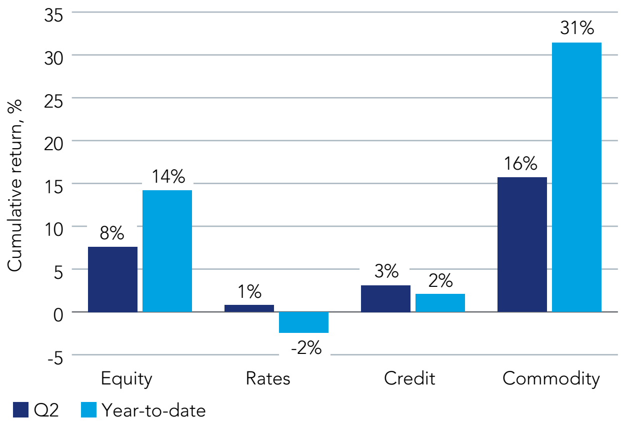
Multi asset

Most asset classes were up over the second quarter, with commodities leading the pack. We continue to favour equities and commodities in our models.

Commodities continued to deliver strong returns in the second quarter, outperforming the other asset classes by wide margins and finishing up 31% for the year to date. Equities added a further 8% to their first-quarter performance, for a first-half return of 14%. Credit and rates remained anaemic (see figure 11).

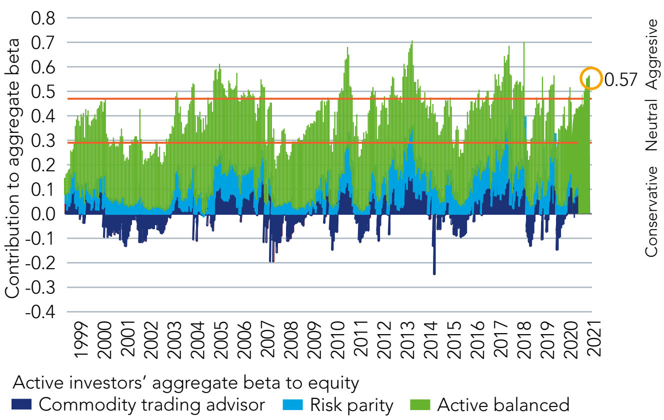
Figure 11. Asset-class performance



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

With regard to the positioning of active funds, the aggregate beta to the MSCI World (measured across active investors such as commodity trading advisors, risk-parity funds and mutual funds) is currently at 0.57. This indicates aggressive positioning (see figure 12).

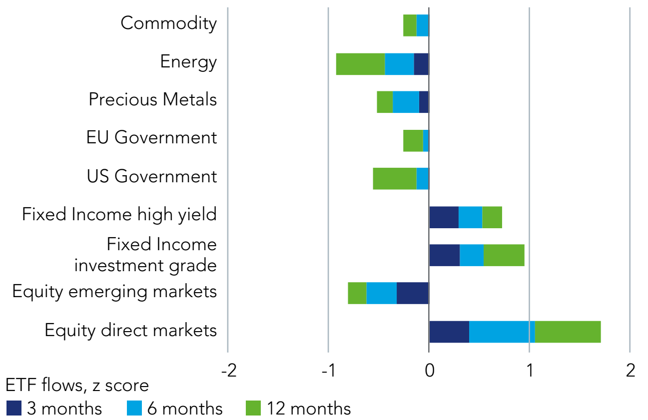
Figure 12. Active investors' aggregate beta to equity



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

Our ETF Flow Z Score shows us the combined Z Scores of flows into exchange-traded funds (ETFs) for each asset for the last three, six and 12 months. Investment-grade and high-yield bonds have exhibited consistent inflows over those timeframes, as have developed equity markets. Money has moved out of commodities and related sectors, however.

Figure 13. ETF flows

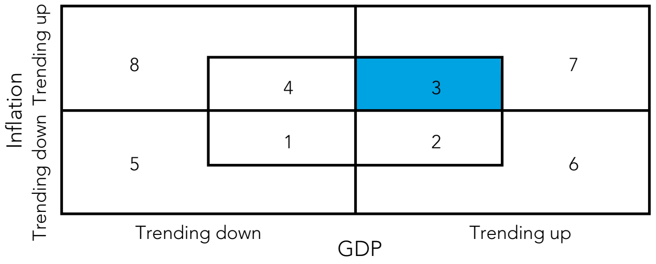


Source: Bloomberg, Federated Hermes, as at June 2021.

For a forward-looking perspective, we use our economic scenario analysis to first determine where the global economy is expected to be at and then to identify the best investments for that scenario. By the end of February, the global economy had moved into quadrant 3 (Q3), with both expected gross domestic product (GDP) and inflation trending up moderately. This remains the relevant quadrant as we enter the third quarter.

In this scenario, the best assets to invest in are credit, commodity carry and Treasury inflation-protected securities (TIPS), as shown in figure 14.

Figure 14. Economic scenario quadrant

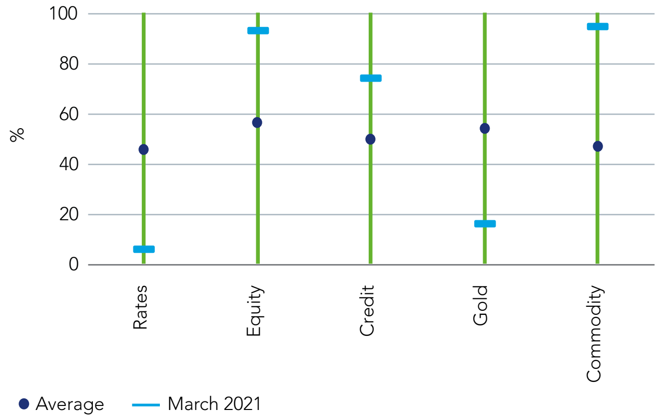


S/N	Q3 top 10	Q3 bottom 10
1	Credit default swap index	EU credit quality
2	Commodity carry	US credit quality
3	Credit default swap high yield	S&P Consumer staples SPDR
4	US 7-10 year inflation-protected securities	USD/EUR Cross rate
5	iTraxx Crossover index	MSCI DM – MSCI EM
6	iTraxx Europe	Credit default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

Source: Bloomberg, Federated Hermes, as at June 2021. Based on Bloomberg pooled economists' 1-year forward forecasts for both GDP growth and inflation. These forecasts are then compared to their respective 6, 9 and 12 months averages to determine the current trend. These trends are then bucketed into 8 quadrants. E.g. GDP trend = Current GDP forecast – avg.[(avg. 6m GDP forecast), (avg. 9m GDP forecast), (avg. 12m GDP forecast)]. The split between the inner and outer quadrants is determined by the mid-point between the average and the maximum/minimum on each axis. Data period starts from 1956, the expected asset returns are annualised and are estimated based on a conditional 2-factor regression analysis.

To seek out the best investment opportunities, we use our multi-asset positioning model to identify which assets are most attractive. This model incorporates three different sub-models: momentum (which captures short-term price trends); excess money growth (which measures how much excess liquidity is present); and value (a longer-term model that looks at forward-looking valuations). Based on our model, we would have a significant overweight in equities and commodities, and a significant underweight in rates (see figure 15). Our overweight in credit has risen.

Figure 15. Multi-asset model positioning



Source: Federated Hermes, as at March 2021.

Economic outlook

The global recovery from the Covid-19 crisis is well underway but still appears fragile. Fiscal policy should remain accommodative, but the Fed is signalling a gradual reduction of its asset purchases.

The short-term economic picture has remained upbeat, underpinned by strong fundamentals. Vaccine rollouts have continued to make progress – notably across advanced economies – and the policy setting has remained accommodative. Despite some surveys pointing to somewhat slower momentum recently, most data are still consistent with global output matching the estimate by the International Monetary Fund (IMF) of 6% growth in 2021. That would be the fastest growth rate since 1980 (the start of the IMF series for global GDP), following the sharpest-ever contraction in 2020.

That said, the recovery still looks fragile to the extent that it is still uneven across and within regions, countries and sectors. Divergences have been particularly pronounced between emerging and developed economies, reflecting different abilities to tap the necessary resources to contain the pandemic and support the recovery. That poses short-term risks as more problematic virus variants could emerge in places where the pandemic has not been properly tackled.

The US economy is now leading the recovery (see figure 16): it has outperformed the rest of the world recently, and it is set to go back to its pre-crisis trend by the end of the year. China, which experienced what looked like a V-shaped recovery in the second half of 2020, has slowed down recently (see figure 17), probably reflecting a prudent and balanced approach to policy stimulus. The Eurozone, which was the laggard among advanced economies, has started to catch up and is likely to accelerate in the second half of the year, with its growth prospects supported by the early disbursements from the €750bn Recovery Fund.

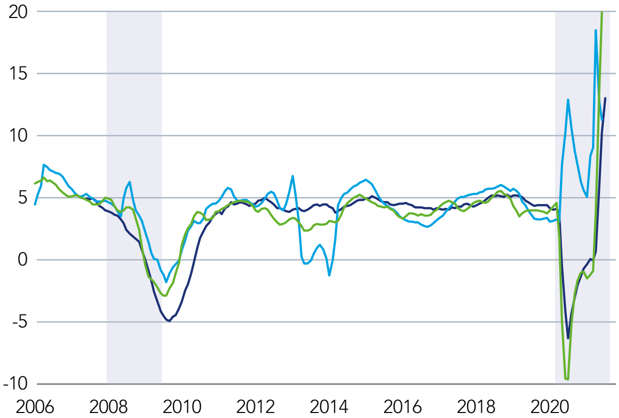
As the year progresses, the recovery should broaden further, resulting in sustained growth at a global level for the balance of the year. Also, distortions should lessen, making it somewhat easier to identify underlying trends in activity, labour markets and inflation. Once unemployment-insurance programmes and furlough schemes are phased out in the coming months, a more complete picture should emerge of the slack in the labour market.

It will probably take some time for labour markets to heal, implying that underlying inflationary pressures are likely to remain contained, despite a short-term surge in inflation, largely driven by temporary factors. Base effects in energy, higher commodity prices and Covid-19-related supply constraints have already pushed inflation higher across the board. Bottleneck effects will keep inflation elevated in the coming months, but should fade once supply/demand dynamics normalise.

Accordingly, central banks are likely to look through the overshooting of inflation for now and maintain accommodative monetary conditions. In particular, the Fed is likely to favour the employment aspect of its mandate while its recently adopted average inflation targeting strategy means that it will tolerate above-target inflation for some time. That said, as the economy strengthens, the Fed will have to think about tapering, i.e. reducing the pace of its asset purchasing. The approach to tapering is likely to be gradual and very well telegraphed to markets. The Fed will continue its discussion in coming meetings, with a view to providing a plan for tapering in the fourth quarter of this year and implementing it in early 2022.

Meanwhile, fiscal policy in developed economies will remain accommodative this year and, to a lesser extent, next, taking advantage of easy monetary conditions. The fiscal response to the pandemic has been much stronger compared with previous crises: over the last year, fiscal stimulus has amounted to about $16trn globally – mainly concentrated in developed countries and largely front-loaded. As the fiscal impulse starts to diminish across most developed economies between the end of this year and middle of next, growth rates are likely to normalise yet stay above potential. Fiscal stimulus has helped prevent a sharper output contraction in 2020. However, it is not clear that the composition of fiscal stimulus is sufficient to tackle some structural challenges that predate the pandemic. It remains to be seen whether existing policies will succeed in lifting medium-term prospects by boosting productivity growth and allowing for a greener and more inclusive expansion.

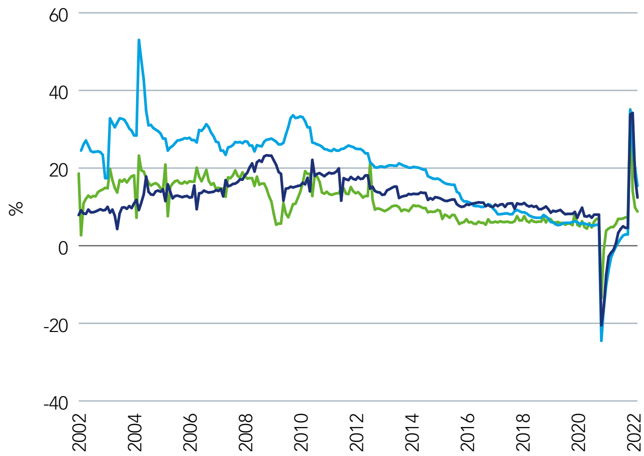
Figure 16. US consumption booming



NFP nominal income proxy (private employment times average weekly earnings), year-on-year, three-month moving average
Disposable personal income, year-on-year, three-month moving average
Personal consumption expenditure, year-on-year, three-month moving average
Recession

Source: Refinitiv Datastream, as at July 2021.

Figure 17. China slowing and hardly rebalancing



China, retail sales, year-on-year
China, fixed asset investment (ex rural), year-on-year
China, industrial production, year-on-year

Source: Refinitiv Datastream, as at July 2021.

Fundamentals

Credit fundamentals continue to improve, but rising leveraged buyouts (LBOs) activity combined with valuations close to historical tights offer limited upside. The rebound in second-quarter earnings is expected to be even stronger than in the first quarter, but supply shortages and rising inflation need to be watched.

In the first quarter of 2021, 63% of US high-yield companies beat expectations for EBITDA, and 53% of companies provided positive guidance. In the US and Europe, consensus estimates have been a lot more conservative than actual reported numbers, so we have seen consistent earnings beats for over a year now. Sector-wise, basic materials, financials and energy have been delivering the bulk of the recovery in earnings. The rebound in earnings is expected to have been even stronger in the second quarter, which makes sense since Covid-19 only really started to halt the global economy in the second quarter of last year. According to Bank of America, US investment-grade issuers were estimated to grow earnings by 25%, year on year, in the first quarter of 2021, accelerating to a year-on-year increase of 45% in the second quarter, before moderating to 17% in the third.

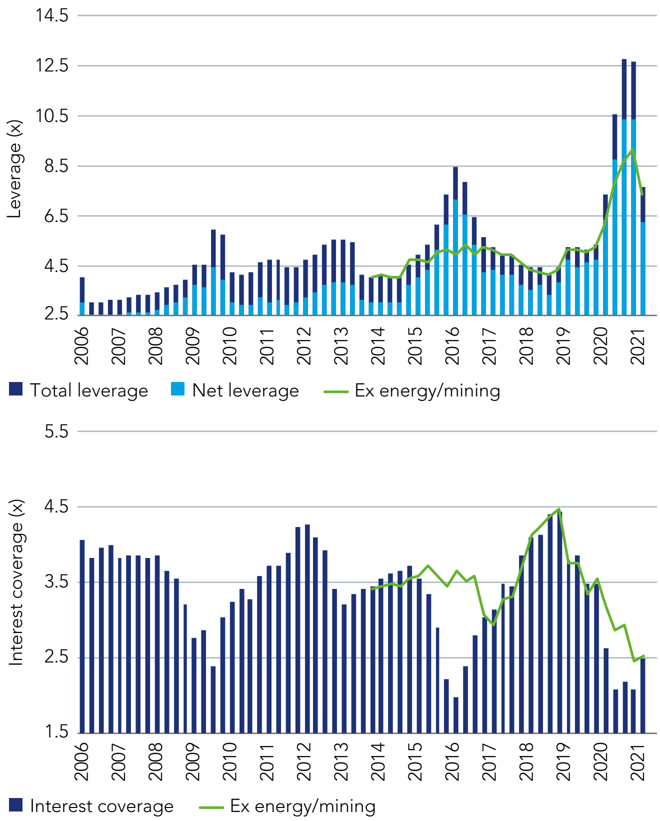
Microchip shortages have been a headwind for auto manufacturers, but pricing remains very strong, partly offsetting the revenue loss from volumes. So, the credit profiles of automakers have not been significantly affected. In the US, the Consumer Price Index (CPI) was up 5% year-on-year in May (core CPI ex food and energy +3.8%), its fastest pace since the 5.4% of August 2008. This increase was driven by last year's low levels of inflation because of Covid-19, with the highest price increases coming from car sales and rentals, apparel and the increasing cost of flying. Inflation can have a positive impact on corporate profitability; research by Barclays has found a positive relationship between rising CPI and margins as higher costs are offset by price increases. Also, energy and metals are some of the best-positioned sectors as inflation picks up.

Credit metrics are starting to improve, with rating-agency upgrades versus downgrades trending 4 to 1

After the elevated credit metrics of 2020, we are starting to see improvements in leverage and interest-coverage metrics in both investment-grade and high-yield issuers. In the US, high-yield net leverage declined from 10.4x in the fourth quarter of 2020 to 6.2x in the first quarter of 2021. Meanwhile, interest coverage improved from 2.1x to 2.5x. Investment-grade net leverage improved from 2.6x in the fourth quarter to 2.3x in the first while interest coverage improved from 8.6x to 9.7x .

As a result of improving fundamentals and credit metrics, rating agencies' actions have reversed compared with last year. According to Goldman Sachs' calculations, downgrades to high yield outnumbered upgrades by 3 to 1 in 2020. So far this year, however, upgrades have outnumbered downgrades by a 4:1 ratio. The cycle of upgrades is likely to continue into 2022.

Figure 18. Leverage and interest coverage



Source: BofAML, as at 31 March 2021.

Shareholder-friendly activities resuming, but not at the expense of bondholders (yet)

In contrast to last year, when companies suspended dividends and buybacks to preserve liquidity, our analyst team is currently noticing a slight pickup in shareholder-friendly activity. We are seeing this in the form of dividend resumptions and share-buyback announcements at financials, miners and steel companies, as well as at some packaging companies. In our view, however, these activities are coming from a position of cash-flow and balance-sheet strength and are not to the detriment of credit at this point.

M&A picking up, with a higher share of all-equity transactions

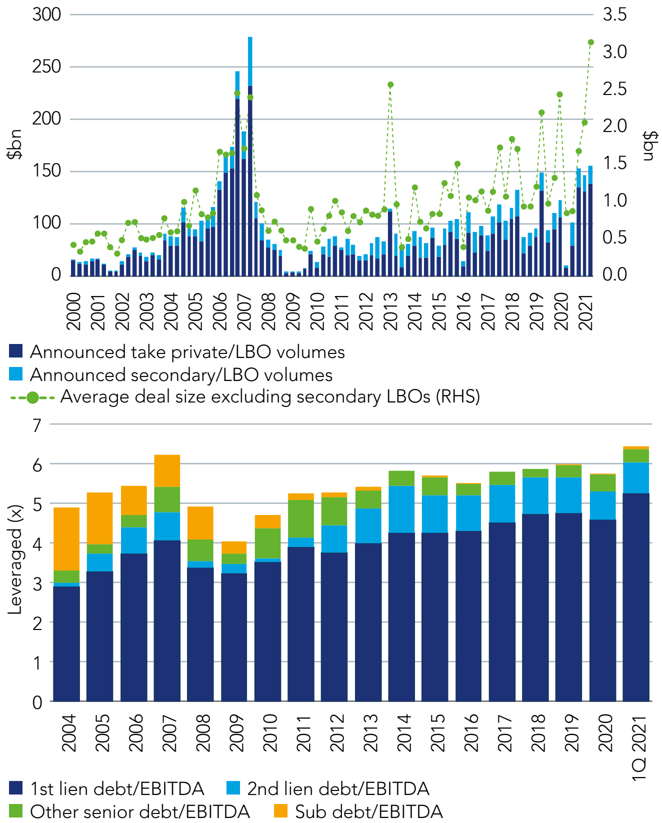
This year we are seeing a significant pick-up in M&A activity in capital markets, with more than $2trn worth of deals announced by North American and European acquirers so far this year. This compares with all-time highs of $3.4trn in 2007 and $2.9trn in 2015, with most deals in technology, media and telecommunications and in energy and utilities. From a credit standpoint, we have seen quite a few energy deals in the US, counting eight notable ones since August of last year. Deals are being driven by the need to gain scale to reduce costs in this commoditised space and thus be better positioned for a more volatile operating environment as the energy transition accelerates.

While it can be situation-specific and we have seen some re-leveraging, the funding of deals has been manageable for bondholders. According to Dealogic, 51% of year-to-date strategic deals have been funded entirely with cash (debt). This compares with 52% over the 2016–2020 period and an average of 58% following the global financial crisis. Also, 32% of M&A activity this year has been entirely funded with equity, which compares with 26% in the 2016–2020 period.

LBOs are back, with an uptick in deal sizes and a modest increase in leverage

As sponsors have plenty of capital and interest rates remain historically low, we have seen an uptick in LBO activity lately. While US and European LBOs remain below the peak of before the global financial crisis, UK activity has ramped up quite substantially. Buyout groups have announced bids for 366 UK companies so far this year, the most since the 1980s, according to Refinitiv. The most prominent example is the buyout of supermarket operator Morrisons. The average size of deals has picked up too, and gross leverage increased for US LBOs in the first quarter.

Figure 19. LBO deal size and leverage both up



Source: Dealogic, Goldman Sachs Global Investment Research and S&P Capital IQ LCD.

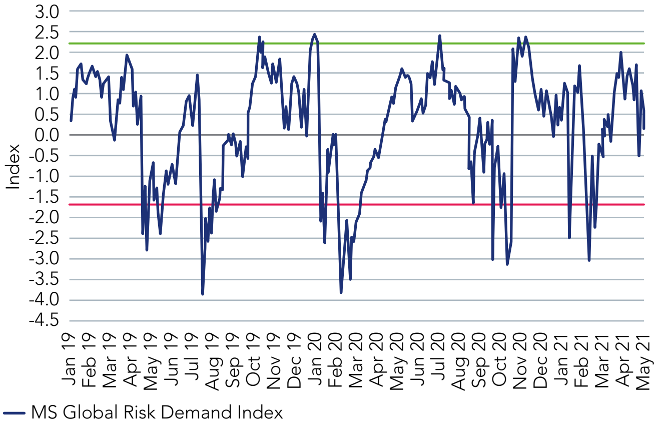
Valuations reflect improving fundamentals, with limited upside right now

Given that markets are forward-looking, valuations are already pricing in improving fundamentals as spread levels are historically tight, thus offering limited upside from here. In light of the uptick in re-leveraging LBO activity, we remain cautious and see more downside risk on aggregate form here. However, there are still opportunities in picking individual credits, and our team remains busy looking for and analysing improving credit stories and rising-star opportunities across sectors.

Valuations and technicals

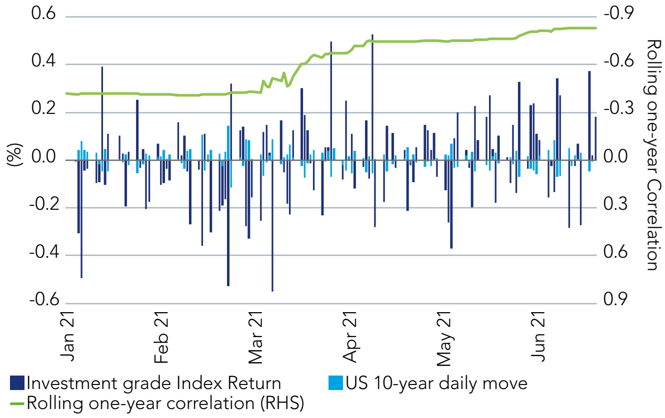
Volatility has fallen this year. Investors are showing a preference for floating-rate assets, with interest-rate risk coming into focus.

Figure 20: MS Global Risk Demand Index



Source: Bloomberg, Morgan Stanley, as at 30 June 2021.

Figure 21. Increasing correlation between rate moves and investment-grade returns



Source: Bloomberg, ICE Bond Indices, as at 30 June 2021.

Risk demand normalised in the second quarter of 2021 as a relatively tranquil market drove implied volatility lower. The Chicago Board Options Exchange Volatility Index (VIX) continued its year-to-date decline, reaching 15.8 on 30 June.

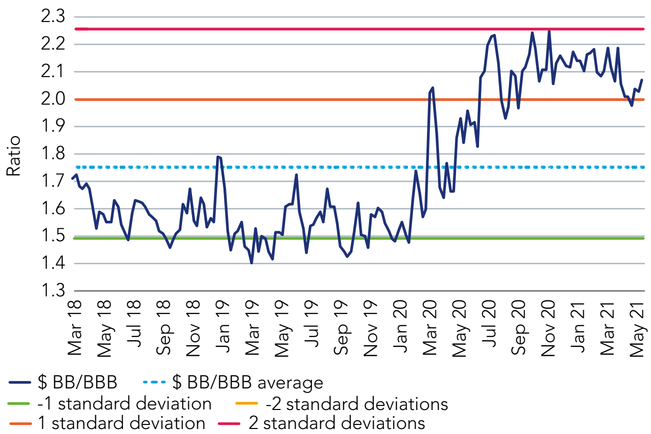
In terms of asset flows, investors' appetite for loans picked up while flows into high yield continue to be weak, apparently signalling a preference for floating-rate assets. Flows also returned to investment grade during the quarter, but we also note an increase in correlation between investment-grade returns and 10-year Treasury yields. At the end of June, the correlation stood at -83% (negative because of the inverse relationship between yields and bond prices), having risen significantly since the crisis in the first quarter of 2020. This correlation has the potential to continue to rise as historically tight spreads and longer duration increasingly focus investment-grade investing on managing interest rates rather than credit spreads.

Public credit

Credit markets performed well in the second quarter, with lower-quality issues outperforming. The underperformance of EM credit has been stark.

Credit performance was strong across the board over the second quarter. Global investment grade delivered 2.72% to recover some of its first-quarter losses while global high yield returned 2.56%. From a rating perspective, we continue to see the sweet spot for relative value in the BB part of the market in both the US and Europe as central-bank buying limits the attractiveness of BBBs and rates volatility has led to the outperformance of lower-quality credit. Regionally, we continue to prefer the European high-yield market over the US given a more attractive convexity profile. Meanwhile, EMs appear cheap compared with their DM counterparts.

Figure 22. USD BB vs. BBB



Source: ICE Bond Indices, as at 30 June 2021.

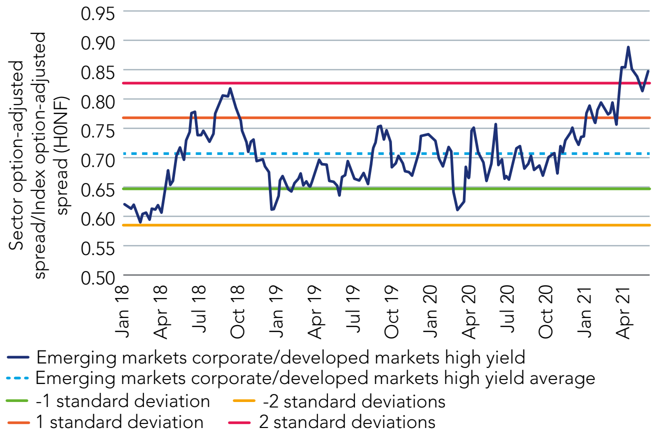
EM credit has starkly underperformed DM credit this year

Over the year to date, hard-currency EM corporate credit has returned just 0.62%, and EM sovereign bonds are still down 1.14%. This compares with a positive 2.48% total return for global high yield. Currently, EM corporate-bond spreads are two standard deviations cheaper than spreads for DM high-yield bonds – a theme not seen for the past three years. The pandemic has clearly hit EM countries hard, and the recovery will not be an easy one, with many countries facing massive fiscal and healthcare restraints.

Although weaker fundamentals and the prospect of a slower recovery explain part of the EM underperformance, it is also important to remember that almost two-thirds of the hard-currency EM corporate and sovereign benchmarks are investment-grade-rated and have therefore been subject to far more rates volatility than DM high yield has over the year to date.

You may ask why we compare EM corporates with DM high yield and not DM investment grade; the reason is that most investors will analyse EM corporates in a way that is more akin to high-yield analysis given the more comparable risk and fundamental prospects of the issuers. The underperformance of EM corporates also creates an opportunity for investors. We think it makes sense to look for those EM issuers that have strong fundamentals and are more export-oriented (so less focused on the domestic recovery and more exposed to the US/European recovery).

Figure 23. EM corporate bonds versus DM high yield

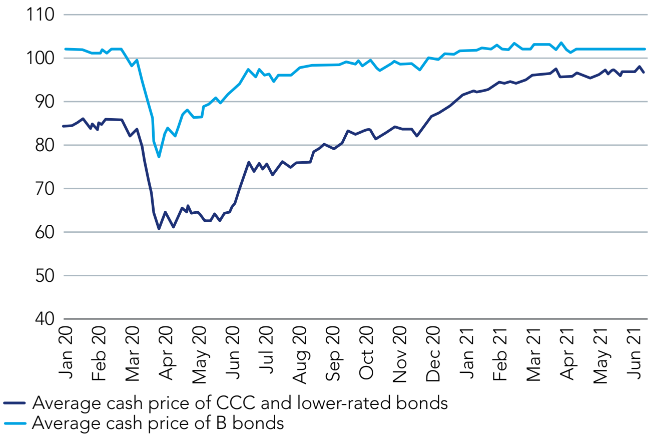


Source: ICE Bond Indices, as at 30 June 2021.

High cash prices in CCC bonds

As macroeconomic and corporate fundamentals have strengthened through 2021, default rates have fallen rapidly, and investors have become more comfortable reaching into low-rated credit in search of better yields and relative shelter from rates volatility. This has driven a sharp rally in CCC credit. For the year to date, the total return of just the CCC and lower-rated segment of the global high-yield market is 9.12%, compared with 2.48% for the high-yield asset class as a whole. This rally has meant that the average cash price of CCC and lower-rated bonds has increased meaningfully, from a low of 61 cents in March 2020, at the height of the sell-off, to 98 cents now. The average cash-price differential between bonds rated CCC or lower and bonds rated B has also narrowed, from 17 cents in March 2020 to just 4 cents. Investors will be acutely aware that if volatility increases when a large part of the market is trading above call, it increases the risk of extension, i.e. many bonds are now trading to their next call date rather than to maturity. This means that security selection becomes even more important, and investors should be mindful of misleadingly low volatility when sizing positions.

Figure 24. CCC average cash price

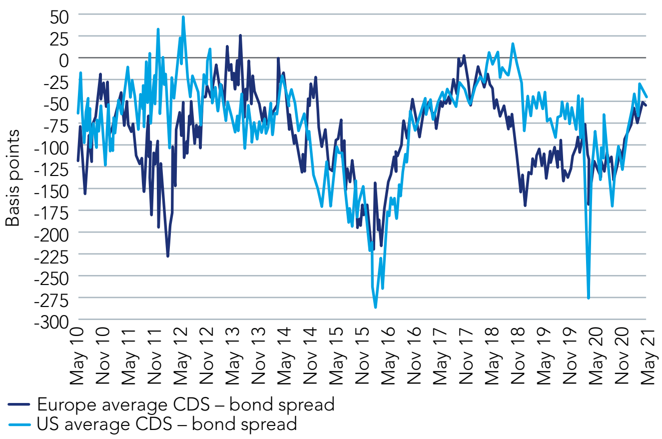


Source: ICE Bond Indices, as at 30 June 2021.

Cash not always king

Last year, investors had a strong preference for owning and trading cash bonds as the ability to raise cash became very important. This resulted in an underperformance of CDS as the market rallied in the second half of the year. As the basis has narrowed (i.e. the relative attractiveness of owning a cash bond over a CDS has fallen) and even become positive in some places, this has created some attractive opportunities for us to switch into CDS instruments.

Figure 25. CDS bond spreads



Source: Bloomberg, ICE Bond Indices, as at 30 June 2021.

Leveraged loans

The leveraged-loan market has performed well and is now ahead of its pre-pandemic levels. Supply is now outstripping demand, which could bode well for investors.

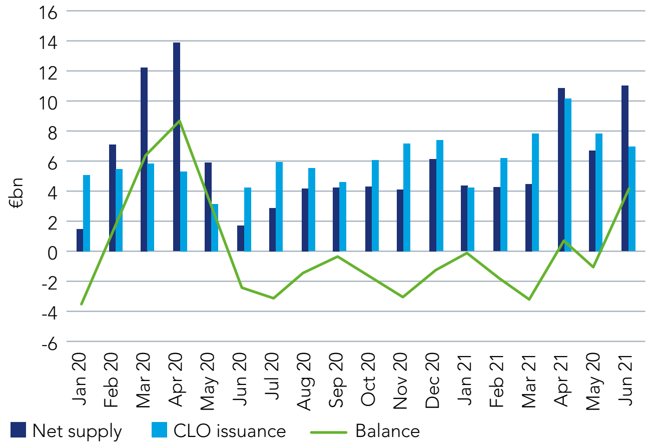
The leveraged-loan market continued to be strong in the second quarter, with the S&P European Leveraged Loan Index (ELLI) returning 1.09%. June was the fifteenth consecutive month in which the S&P ELLI showed a positive return. Notably, the index returned 9.91% for the last 12 months, mainly driven by single-B (+8.98%) and triple-C (+24.28%) rather than double-B (+5.27%).

Over the quarter, the secondary market continued to be active as the S&P ELLI increased from 98.41 to 98.76. The index is now higher than it was in January 2020 (98.59). Yet the price distribution of the underlying loans is different as more than 59% of the index was trading above par in January 2020, compared with 14% at the end of June 2021. Currently, 73% of the facilities are trading between 98 and par, compared with 29% in January 2020. This is driven by high activity in the leveraged-loan primary market and by portfolio managers rotating their holdings.

The average spread for new-issue single-B paper has significantly tightened since last year, decreasing from 417 bps at the end of the second quarter of 2020 to 379 bps at the end of June 2021 (with a peak of 429 bps at the end of the third quarter of 2020). This environment encouraged issuers to come back to investors with opportunistic transactions, and the volume of refinancings has reached €27.0bn since the beginning of the year (compared with €15.4bn in the first half of 2020, €3.3bn in the first half of 2019 and €7.5bn in the first half of 2018).

Consequently, the level of supply has significantly increased and is now surpassing issuances of CLOs (with a balance of €4.2bn), at a level that hasn't been reached since April 2020.

Figure 26. Supply outstrips demand



Source: S&P LCD, as at June 2021.

Although the market is absorbing new issues easily at the moment, the heavy supply could in time lead to a more investor-friendly environment with two features:

- a resistant level in new-issue leveraged-loan spread: the second-quarter number for this year is in line with last year's equivalent (379 bps vs. 380 bps)
- an increasing original-issue discount: the yield to maturity at issue increased from 3.92% in the first quarter of this year to 3.99% in the second.

Structured credit

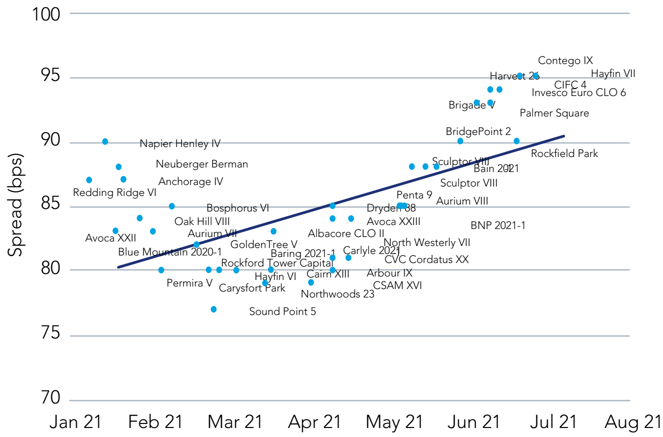
As the perceived risks from Covid-19 recede, investors have been hunting for yield. Spreads on CLO AAAs have widened for technical reasons, but are likely to tighten soon.

Although the world is yet to return to any sort of post-Covid normality, with further waves of infections possible, the perception that risk has largely receded for now has very much been a theme throughout the markets, resulting in tight spreads across credit markets and causing investors to look for yield. The demand for ABS and CLOs has been strong, and although spreads seem tight on an absolute basis within the asset class, on a relative basis, structured credit still offers investors a decent pick-up in spread for any given level of risk.

As discussed in the previous 360, the compression in spreads across the CLO stack has led to a significant volume of deals being reset, as well as the new-issue market continuing apace. The level of issuance in the CLO market over the first half of the year was unprecedented, with many of the predictions from arrangers indicating that 2021 will see the highest level of issuance in the European CLO market yet.

However, the volume of resets hitting the market in the first and second quarters from deals that were printed in 2018–2020 has resulted in an interesting technical situation. Large Japanese anchor investors that were active two to three years ago in buying AAA CLOs are currently not investing. They have been using the reset wave to delever their exposures, leaving the supply of AAAs in resets and the new-issue AAAs to be met by demand from other investors. Although this supply was easily digested by a deep investor base in the first quarter, the picture appears to have been more challenging in the second as the active investor base for AAA CLOs has reduced, possibly because investors have filled their boots already. While mezzanine tranches continue to be well bid, AAAs softened over the course of the second quarter. At the time of writing, the first deals to breach the 100bps level have printed with a reset of Goldentree IV. New issues are currently pricing in the mid-90s, having fallen below 80bps in the first quarter.

Figure 27. AAA spreads widen



Source: Federated Hermes, Intex as at 30 June 2021.

Investors should not expect the supply to continue at this pace, with spreads on AAAs continuing to widen. There are two reasons for this. First, the number of deals up for refinancing or reset has been greatly diminished already this year with the reset activity. Second, as spreads on AAAs widen, thereby changing the cost of the liability stack, the economic motivation for resetting a deal reduces. If resetting no longer results in a lower cost of funding on the debt stack, then fewer deals will come to reset. Typically, we can expect lower supply to lead to a stabilisation and tightening of spreads, and wider spreads on AAAs can also attract investors back to the space.

Away from CLOs, the other notable trend in the sector has been the re-emergence of commercial mortgage-backed securities (CMBS). As banks look to reduce their exposures to commercial real estate loans, the CMBS market has re-ignited, and issuance currently stands at over €3bn across UK and European CMBS deals, with the assets backing the deals ranging from big-box retail to last-mile logistics. The latter continues to be sought after by investors, with those deals printing at much tighter levels than the rest of the CMBS market as people continue to support the Amazon/home-delivery business model in this new age of increased internet shopping.

Private credit

Private credit has been buoyant as vaccines have brought optimism about the outlook. But risks remain in the background.

With optimism growing because of the vaccination rollout in the UK and mainland Europe, coupled with policies to reopen economies, the market has been very buoyant. Transaction flow is at an all-time high across Europe. With significant 'dry powder' available from lenders, however, competition for transactions has become intense.

Unitranche lenders have sought to win back market share from the banks by competing on loan structures. Some extremely aggressive structures have been proposed by these lenders, with leverage levels in excess of 7x, but, so far, their success at winning these transactions has been limited. This is primarily due to the fact that most borrowers, especially those in non-cyclical sectors, remain more focused on the cost of borrowing than the ability to use leverage. This could change over the course of the year as acquisition enterprise values grow and shareholders seek to enhance returns on their investments by increasing the use of leverage.

In the senior-secured space, yields have remained steady and are falling marginally in the unitranche space. A rise of defaults in the short-to-medium term could mean that yields rise, although defaults have remained low to date. Reduced government support could, however, have an impact on credit quality, and this will be something to look out for over the next three quarters. Although the market is very buoyant, participants are all aware of the uncertainty and risks lurking in the background.

At the international business of Federated Hermes, we continue to see value in the creditor-friendly northern European jurisdictions, despite the current uncertainties surrounding the possible reduction of government support for borrowers, which could impact credit quality. Similarly, senior secured lending is the key area of focus in a market that requires discipline in lending practices.

Asset-based lending

Real estate is recovering, and senior loans backed by property look attractive following margin widening.

With Covid-19 restrictions in daily life now largely lifted, one could be forgiven for thinking that the pandemic is behind us. Real estate investors in the UK continue to suffer the effects of the eviction moratorium, but, in most cases, tenants are back in occupation and paying rent, and businesses are in full recovery mode.

Lenders to real assets can look back on very successful investment performance over the last 18 months. Loan enforcements have been low, and lenders have been largely understanding of their borrowers' difficulties. Interest collections have shown the stability that is expected of the asset class in tough times.

The ability of senior and whole loans to continue to deliver stable returns – thus uncorrelated to the other asset classes that have seen such volatility during the pandemic – shows their value not just in delivering a premium over more liquid assets, but as diversifiers in their own right. Although the reaction has been muted, margins on senior loans have gone up, which has squeezed equity returns. On a relative-value basis, real estate loans therefore look attractive at the moment, with the possible exception of mezzanine loans, which suffer from a lower supply of loans and a high supply of capital seeking to deploy there.

The lack of large-scale losses on loans does mean that we are unlikely to see a major retrenchment of banks (and also the associated additional margin rises that we saw in the aftermath of the global financial crisis). Instead, relative value will be driven by modestly higher margins and the fact that the collateral has seen capital values adjusted to post-Covid trading conditions. Though not the windfall we saw in the early 2010s, this is nonetheless an opportunity for a countercyclical push into lending secured on real assets.

Sustainable finance

Assessing companies' decarbonising efforts can be challenging. Our framework offers a solution.

Investment and sustainability analysis of corporates' carbon-intensive activities

Propelled by a myriad of forces from regulators to investors, the economy is irrevocably shifting from 'brown' to 'green'. In response, banks and corporates are lowering their carbon footprints by winding down or divesting carbon-intensive activities. However, we have observed that these decarbonisation strategies are not as straightforward as they might seem. They can have meaningful – and sometimes contradictory – effects on companies' sustainability credentials and financial strength, and on the wider green transition itself.

For example, how should we score a company that decarbonises quickly by selling its carbon-intensive activities to an aggregator that will inject capital expenditures into that activity? On the face of it, the company is decarbonising, but with a new owner, the effects on the wider fight against climate change will worsen. Or, though a wind-down could be the most responsible treatment of a carbon-intensive asset, what does that imply for the financial strength of the company?

To address these complexities, the Sustainable Fixed Income team collaborated with Hermes Credit analysts to develop a framework to assess and score the impact on sustainability and financial strength of companies that pursue corporate actions to decarbonise. If these conclusions lead to changes in investment and sustainability scores, then portfolio managers respond by adjusting positions to reflect the team's updated views. We summarise this framework below.

The framework

As a first step in the analysis, we ask whether the company is winding down or divesting the carbon-intensive activity. Once we have the answer, we run through the framework to understand the benefits and drawbacks of the chosen approach. We aim to determine the following:

1. Financial impact: how material is the net effect of the wind-down or divestment to the financial strength of the company?
2. Sustainability impact: how responsible is that treatment of the carbon-intensive activity, both in the context of the company itself and in the wider economy?

Once we have assessed the direction and materiality of both the financial and sustainable impacts, we can then adjust the investment and sustainability scores for the relevant company.

Figure 28. Summarised assessment of process for analysing wind-downs and divestments

Source: Federated Hermes, as at June 2021

1. Wind-down

In a wind-down scenario the parent company, seeking to reduce its carbon footprint, opts for a gradual, controlled reduction of a particular brown activity. The carbon-intensive activity remains on the balance sheet.

Figure 29. Framework of impacts for consideration in a wind-down

Wind-down	Positive	Negative
Financial	• Re-allocation of opex/capex to growth • Retains benefits of positive cashflows • Market may reward company for decarbonisation efforts	• Possible moribund activity stays on B/S • Operation could drain value • Investors 'screen out' company because it retains 'brown' activity • Risks causing an impairment change
Sustainable	• Actively reducing GHG emissions • Supports decarbonisation trend • Opportunity for positive social impact through job retention/retraining	• GHG emissions still being produced • Possible negative social implications if action generates significant job losses

Source: Federated Hermes, as at June 2021.

2. Divestment

In a divestment scenario, the parent company removes the carbon-intensive activity from its balance sheet through a sale or demerger. The company abdicates responsibility for the management of the carbon-intensive activity, which is no longer recognised in its financial statements.

Figure 30. Framework for impacts for consideration in a divestment

Divestment/demerger	Positive	Negative
Financial	• Proceeds in consideration of a sale • Removal of moribund/slow-growth business from the balance sheet • Could be positive for WACC • May reduce risk of being 'screened out' with departure of the activity	• Potential loss of mature, but cash-generative activity • Risk that legacy environmental and other liabilities remain with company
Sustainable	• Immediate, positive impact on carbon footprint of the company • Potentially avoids negative social impact of job losses • Clean break may allow management to focus on strategic 'green' activities	• Carbon-intensive activity ports to an entity that may perpetuate/accelerate the activity • Leads to job losses with no social safety put in place • Risk of reduced governance/responsible oversight under a new regime

Source: Federated Hermes, as at June 2021

As mentioned at the outset, assessing the net effect of the treatment of a carbon-intensive activity in the context of a decarbonising company is complex. Second-order effects on the sustainable and fundamental character of the company must be considered. Overall, the framework reflects a holistic approach that takes into account the wider impact of a company's strategy for decarbonising its assets. At the same time, it fully respects the principles of the investment process.

Real estate debt: climate-change impact

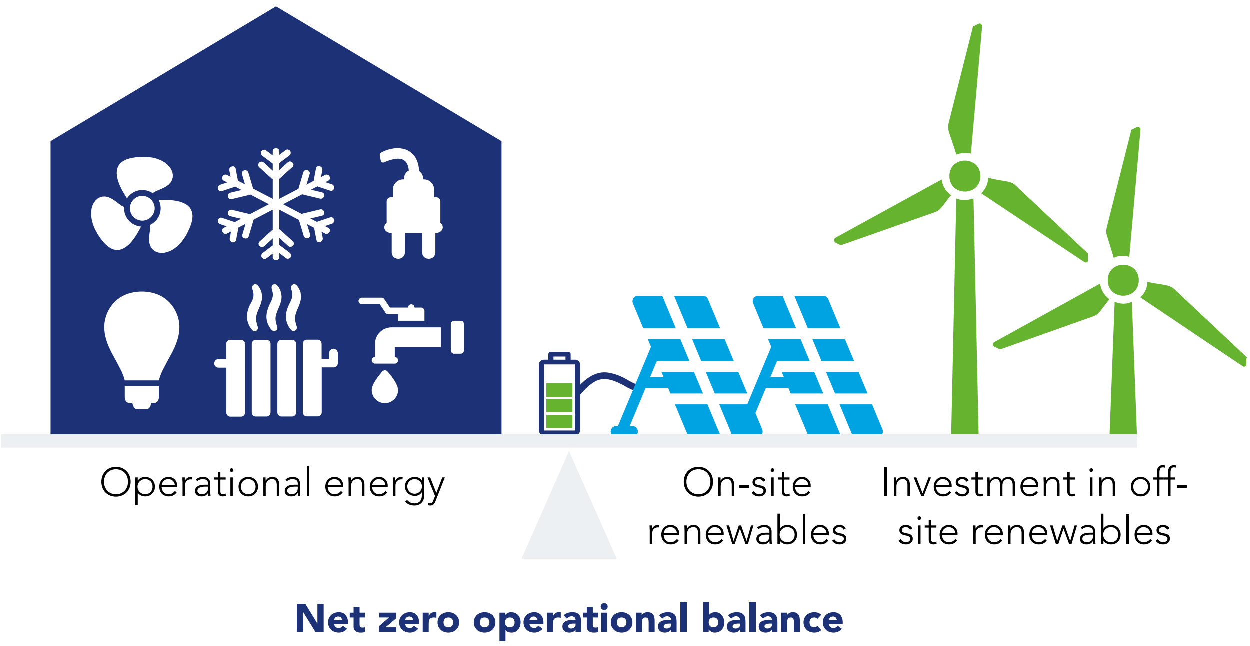
We have a responsibility to mitigate the climate impact of our built environment. Tenants, borrowers and lenders can work together to reduce the carbon emissions from real estate.

Old-fashioned real estate developers will gladly talk about their legacy. This legacy, we are led to believe, consists of many a great building with their name on the façade and the architectural prizes to prove it. Lots of bricks and mortar, or, these days, more likely steel and glass. There is an alternative view. "What you leave behind is not what is engraved in stone monuments but what is woven into the lives of others".[3] We can weave into the lives of others a different vision for the future and a different interaction with the built environment; the current momentum behind climate-change mitigation affords us this opportunity.

If we can entertain the notion that there is no such thing as a side-effect (either something is the effect of something else, or it is not),[4] it becomes easier to take into account those effects that were previously just unintended consequences. This may seem like mere semantics, but the term side-effect implies a lower importance whereas some of these unintended consequences are very significant; pollution from the use and construction of buildings is one such example. According to the World Green Building Council,[5] approximately 39% of global greenhouse-gas emissions can be traced back to the construction and operation of property. This does not take anything away from the positive output from buildings; if nothing else, it provides us with shelter from the elements, homes to raise our families in, offices to work in and stores to shop in. It also provides us with economic assets that generate stable incomes over several decades. But knowledge of the obvious negative impact does give us a responsibility to mitigate this where possible.

The great challenge before us is thus the transition of the global building stock to be compatible with a net-zero-carbon economy. Despite fossil fuels being a limited resource, we knew as much as two decades ago that "the stone age did not end because the world ran out of stones, and the oil age will not end because we run out of oil".[6] As the cost of renewable energy is falling and its supply is increasing, building owners could soon source most (if not all) of their energy needs from renewable sources. A combination of on-site electricity generation and acquisition of green energy from the grid should be able to achieve this. However, for the majority of the building stock to get there, significant investment is required in the coming years.

Figure 31: Operational next zero in real estate



Source: Better Buildings Partnership, pathway to net zero framework.

[3] Pericles according to Thucydides in his History of the Peloponnesian War (book ii.43.3).
[4] John D. Sterman: Reflections on Becoming a Systems Scientist, Page 505 sdr261.dvi (mit.edu).
[5] World Green Building Council, 2019.
[6] 1999 July 24, The Economist, Fuel cells meet big business, pre 59, Economist Group, London, England.

To maintain best value for investors and highest utility for occupiers, property needs continuous improvement. As more evidence emerges that greener buildings generate higher rents and trade at tighter yields, that investment becomes an easier pill to swallow, even if the benefits of lower emissions predominantly cover a period beyond the likely hold-period. In the tenant, the landlord/borrower and the lender, there are three key stakeholders who can jointly create significant impact. At the international business of Federated Hermes, we are aware that the improvements needed may be substantial in the case of some assets, and that brings with it a considerable capital requirement. Working together with borrowers, we can help assets to transition into low-carbon compliance. Whether the loan is long term or not, the asset-management plan for the property will need to consider its full life-cycle to ensure that the right investment is made, at the right time. The ability of the property to generate a stable income from which interest can be paid depends on its continuous improvement.

One additional consideration for real estate developers is how to deal with embodied carbon. The carbon emissions from non-recurring activities such as construction or refurbishment cannot be offset by investing in renewables. Of the 39% of global greenhouse-gas emissions that come from property, almost a third is related to embodied carbon.[7] While progress is being made in lowering the amount of carbon emissions from construction (through better construction materials, production methods, etc), some emissions will remain that can only be offset by removing carbon from the atmosphere. This can be done in a variety of ways, though tree planting is probably the most intuitive one. Taking less productive farmland and changing its use to forestry, ideally for bio-diverse native woodlands, can sequester significant amounts of carbon. If properly accounted for, these plantations can offset embodied carbon associated with specific real estate investments. These nature-based solutions can have multiple benefits beyond carbon sequestration. The same way we looked at pollution from real estate as an effect rather than a side-effect, the biodiversity gains, cleaner air and possibly flood prevention that can be achieved through tree planting are real effects of a nature-based solutions strategy. Some of these impacts may create tradeable, or monetisable, outputs, whereas others do not. Whether intended or unintended, whether positive or negative, our investment decisions can trigger very real-life impacts that we would do well to take fully into account.

Our Real Estate Debt strategy seeks to deliver stable uncorrelated returns to clients. Doing so in a responsible way, considering the impact on both our built and natural environment, should give clients the comfort that profits are delivered sustainably and not to the detriment of the world we live in.

[7] World Green Building Council, 2019.

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International

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

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

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

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

Our investment and stewardship capabilities:

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

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