Hermes Fixed Income Quarterly Report
Q1 2019

For professional investors only

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HERMES
INVESTMENT MANAGEMENT

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CRUNCH TIME? NOT YET, AND OPPORTUNITIES PERSIST

Turbulence, disruption and uncertainty have always provided instances of opportunity for the savvy fixed income trader. Paradoxically, the main sources of uncertainty – Brexit, protectionism, political upheaval, end-of-cycle angst – have become almost constants in the investment universe. This calls for a more nuanced and forensic approach to generating returns.

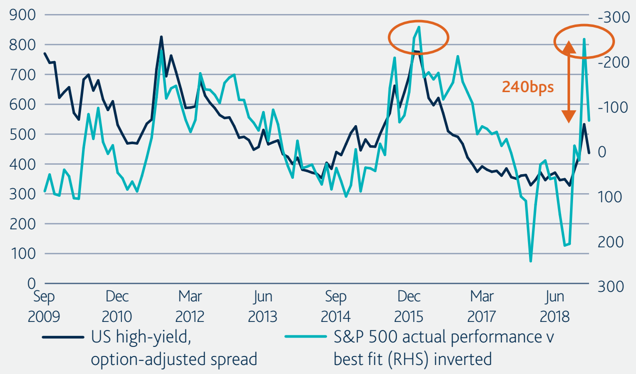
End-of-bull-market rumours are greatly exaggerated

Superficially, much had changed in the last three months of 2018: parts of the US yield curve have inverted (albeit briefly); price-to earnings (PE) multiples collapsed (albeit back to historical norms); and all markets had undergone a fairly material sell-off. However, at a more fundamental level, things have not changed: we still don't know what form Brexit will take; the European political backdrop is still far from clear; and the rise of protectionism still hangs like a dead weight around the neck of global GDP growth.

Some of the more effusive commentators variously described Q4 2018 as a catastrophe and a blood bath (their responses to January's bounce-back have been equally hyperbolic). This has left many investors scratching their heads as to what exactly has changed. My short answer is that nothing actually changed: we just noticed that the emperor was somewhat under-dressed. But it could have been much worse…

At times like this, it is important to put into context what we have seen. The chart below shows the relationship between US HY and the S&P 500. In dark blue we have the spreads on the ICE BAML US High Yield Index since September 2009. In lighter blue, we plotted the difference (inverted) between the actual level of the S&P 500 index and best fit line for the S&P 500 from September 2009 until January 2019. This shows that, as expected, large drops in the S&P 500 are accompanied by commensurate spread widening in high yield bonds. But if we focus on the Q4 move in equities, we note that, while being long corporate bonds was unpleasant, the scale of the move was more muted than post-crisis history would suggest. A ball-park estimate indicates that we could have been another 240 basis points wider.

Figure 1. In Q4, the movement in US high-yield spreads were muted relative to US equities



Source: Hermes and Bloomberg as at 31 January 2019.

We should also take account of the fact that, since the end of the financial crisis, central banks have been conducting the largest experiment in financial history. The signs that we are emerging from an end to quantitative easing (QE) happen to coincide with rising protectionism and uncharted geopolitical territory as US-China tensions increase. Simultaneously, end-of-market-cycle conditions are on the horizon. Given all that, we should perhaps be relieved that the sell-off in Q4 was so mild and that the recovery has been relatively broad-based and rapid. There is no doubt in my mind, however, that some scar tissue has been created and that investors' positioning will be more cautious for some time to come.

Below the macro surface, a few more nuanced shifts have also occurred

The quiddity of liquidity

Below the macro surface, a few more nuanced shifts have also occurred. These are reflected in the moves that we have seen in our relative-value map. Most notable is that illiquidity premia have shrunk – this normally occurs in rapid moves of the kind which we have seen. Liquid markets depress asset prices (or widen spreads) and, to start with, these movements are not quickly reflected in private and less-liquid parts of the fixed income market. Only the passage of time or a further deterioration in liquid markets triggers a repricing in the illiquid spaces, but this is often a rather violent correction when it does occur. Mathematicians would observe that the distribution of returns is discontinuous in illiquid land.

When considering an approach that mixes liquid and illiquid products, these differences in sub-asset class biorhythms are vital considerations – as is, of course, the skew or basis when considering index-based hedging in a more liquid approach. We will be publishing more thoughts on the topic of illiquidity premia over the coming months, with a particular focus on: measurement, modelling, historical averages, sub-asset class differences and the impact of various stages in the cycle.

The second trend that went broadly unreported was the meaningful out-performance of emerging market (EM) credit in the fourth quarter. Clearly, part of this out-performance is due to the fact that the sub-asset class delivered the opposite result in Q3 but even this is further evidence of the benefit of a flexible approach to allocation, all other things being equal. Broadly speaking, our view on EM credit is that it should not be seen through the same lens as EM equities even though it suffers from many of the same issues in terms of end-client flows.

This means that this sub-asset class has the potential to yield nuggets of value for those who have the capability and determination to search for these opportunities during or after periods of stress.

Protect and survive

In the last issue of *360°*, we reported that we saw value in fixed income markets but were cautious about the amount of tail risk that existed. We were keen to emphasise that investors should not panic during sell-offs and highlighted how cheap we felt protection was for those capable of using it, particularly through options. This approach would have served investors well through that period and has certainly borne real fruit in the first weeks of 2019 as markets began the year in a rather bullish mindset. The ability to hold on to positions during sell-offs, when bid/offer costs grow and panic sets in, can be very helpful for long-term returns. Given the strength of the early-2019 rally, participating in the beta of the market and, in particular, holding some of the positions that were most hurt in Q4, would have been hugely advantageous, particularly if it were possible to 'trade' some of those positions through the volatility. On several days during Q4, fund flows, trading volumes and the inability to find reasonable bids had a very sobering effect. But even during the darker days there were bright spots. One very surprising observation during Q4 was that we saw several extreme BWICs (bids wanted in competition) for European asset-backed securities (ABS). In each instance, the auctions were smooth, displayed remarkable levels of liquidity and traded at levels that were by no means 'stressed'.

Risks worth taking

Looking forward, we do not see a huge reduction in tail risk despite the easing in some of the rather over-stretched technical indicators. The long-term fundamental issues in the world remain unchanged and the headwinds of protectionism continue to influence our thinking. We also think it is vital to caution that this sell-off was not the big one; at no time during the sell-off did I feel that it represented anything more significant than a slight correction in the huge bull run that has endured far too long. Our equity colleagues saw much worse than we experienced but, with the utmost respect, I feel that there were a few very obvious bubbles out there that needed to deflate a little. They have, and we feel that markets are more balanced as a result.

So where should investors currently be looking for value and how aggressive should they be in their positioning? Our core views are as follows:

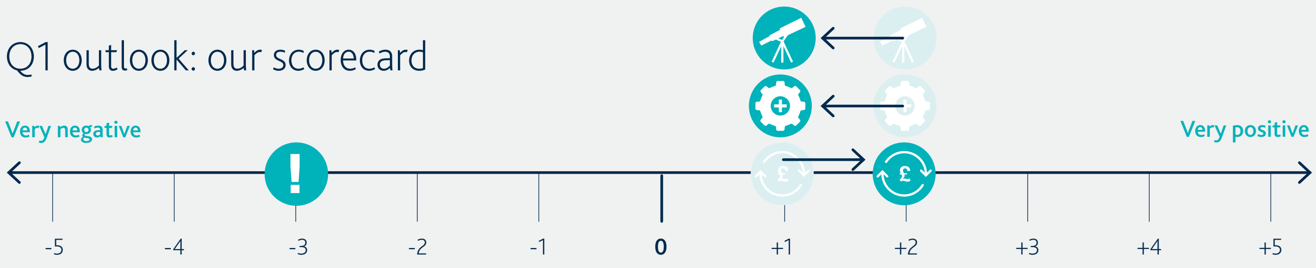
- We continue to see value in credit markets and as a result would hold a meaningful net long position
- The reduction in illiquidity premia means that value is easier to find in liquid spaces and particularly in the more defensive parts of the markets
- Residual scar tissue from the Q4 sell-off means that we continue to be tactically underweight UK assets which offer a 'Brexit premium' versus our long-run average holdings, but we do see longer-term value in UK ABS
- An analysis of the constituent parts of the EM, European and US high-yield markets inclines us to rank them in that order of preference but we see this aggregation as too blunt an instrument. Now, more than at any time over the last few years, we believe caution and discipline in terms of individual name and security selection will be valuable
- Higher all-in yields make credit a more attractive long-term investment at these levels and, given that global growth is likely to be sluggish, we see the medium-term picture for fund flows into credit as positive

And, finally, a few notes of caution:

- The weight of low-rated investment-grade credit that could transition to high yield is a major worry in terms of technical assessment (GE being by far the most worrisome name in this regard). It is not inconceivable that the high-yield market could be bigger than the investment grade one in a few years!
- Tail risk remains elevated and while recent talk from the US Federal Reserve (the Fed) is verging on dovish, we don't think that we have seen the end of the end of QE
- The repricing of equity markets is positive for forward-looking sentiment but the speed of the retracement in January is slightly less healthy
- Having been battered once in Q4 2018, market participants in less-liquid areas may be less willing to sit on their hands if we see another major test of resolve in the near term

Last but by no means least, my personal favourite long-term worry for credit markets is now climate change. More on this in future issues.

Q1 outlook: our scorecard



Relative value between asset classes

- Credit repriced in the final quarter of 2018, with high yield showing the greatest widening in spreads. In contrast, private credit showed little movement apart from a narrowing of mezzanine and unitranche spreads
- Relative value has shifted towards liquid assets, reflecting an easing of the return premium that compensates investors for illiquidity
- Hybrids now lead our relative-value rankings. We have upgraded the historical return potential of hybrids, as well as their value scores, reflecting the expansion of the asset class

ESG

- We continue to take the view that credit risk is inextricably linked to ESG integration and engagement
- Successful ESG engagement generates holistic returns through lower capital costs, supported investment performance and positive societal impact

Economic outlook

- **Change in score from Q4: +2 to +1**
- With economic growth losing momentum, we forecast that global growth is on track to slow down to 3.25% in 2019 from 3.5% in 2018
- Convergence is likely to reassert itself in 2019. The US economy will slow down as the fiscal stimulus fades and trade tensions persist
- Central banks are gradually normalising monetary policy as inflation has been effectively contained. Central-bank balance sheets will remain large

Credit fundamentals

- **Change in score from Q4: +2 to +1**
- While we expect slower earnings growth and a deteriorating macroeconomic picture, we remain supportive on credit fundamentals
- The outlook for liquidity is positive, with double-digit earnings growth running ahead of the single-digit increase in debt
- Dovish comments from the Federal Reserve point to an easing of rate hikes and credit tightening

Valuations and technicals

- **Change in score from Q4: +1 to +2**
- The deterioration in sentiment at the end of last year caused by inversion of the US Treasury curve has been reversed. Risk-demand indicators suggest we are back at a neutral position
- Outflows from high yield and EM credit are being partially reallocated to money market funds as LIBOR pushes towards 3%
- Nine-year low cash prices for global credit suggests superior convexity in the market

Tail risks

- **No change in score from Q4**
- Rise of populism in European Parliamentary elections
- Protectionism could stymie growth if the US's trade disputes with China and Europe continue to escalate
- Uncertainty about Brexit as the UK's 29 March date of departure approaches
- Unknown impacts of normalising extreme monetary policies

Opportunities

Public credit

- EM credit has outperformed developed markets on the back of supportive technical and strong fundamentals, reversing the underperformance in much of 2018
- We consider European high-yield corporates to be attractive compared to US high yield and financials
- Low quality CCC-rated credit looks unattractive given the inferior risk-adjusted returns on offer in a slowing global economy

Leveraged loans

- The Q4 2018 rally in loans was short-lived with sell-offs ramping up in November and December, driven by instability in US high yield and deepening economic gloom in Europe
- Syndications became harder during Q4 2018 as upward price flexes increased while reverse flexes declined
- CLOs were adversely affected by declining sentiment resulting in fewer deals and impaired arbitrage opportunities. The cheapening of collateral is welcome as long as the cost of liabilities is normalised

Structured securities

- Regulatory uncertainty around the implementation of the European Union (EU) Securitisation Regulation has seen the spreads on ABS assets widen, despite their usual resilience in the face of market volatility
- Dutch residential mortgage-backed securities (RMBS) and European auto ABS fared worst over 2018 as the European Central Bank (ECB) capped its purchasing programme
- Investment grade tranches of ABS and collateralised loan obligations (CLO) remain well-protected in terms of interest coverage and freedom from over-collateralisation

Private lending

- Subdued deal flow has led to increased competition in certain markets – primarily Germany, the UK and France
- We see continued value in Scandinavian loans, where the originating banks continue to control the market and lender protection rights are relatively strong
- Pockets of value in stable credits are emerging in the UK, combining the benefits of an increased sterling premium and a strong legal environment

Asset-based lending

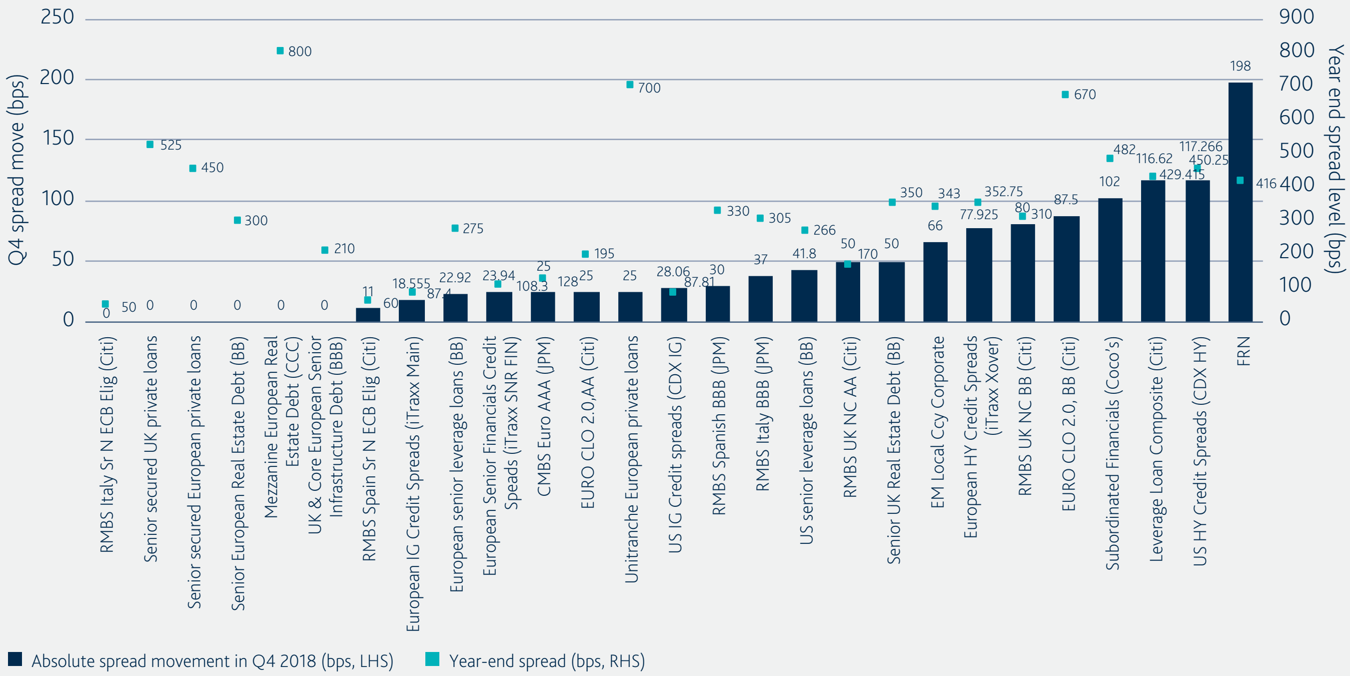
- The outlook for UK retail property investment remains bleak, with shopping centres as a sector expected to show negative returns equating to -1.3% over the next five years
- UK offices outside of central London and the south east are forecast to be the best performers, followed closely by the industrial sector
- We continue to see good value in loans used for capital expenditure investment for transitioning assets in secondary locations

Relative value between credit markets

Relative value has shifted towards liquid assets as the illiquidity premium shrinks following a widening in public asset spreads. Private credit spreads remain relatively stable.

At year-end, spreads for the quarter were generally wider across the board with the exception of private credit.

Figure 2. Sting in 2018's tail: spread movements



Source: Hermes, Bloomberg, Citi and JPM as at 31 December 2018

Credit finally re-priced in the final quarter of 2018, despite credit markets managing to shake off the equity malaise for most of the year. The largest absolute spread moves were in high yield where Europe widened 150bps and the US by 220bps – with US CCC-rated instruments the largest mover pushing out 430bps. Similar moves were seen across other corporate credit exposures with US leveraged loans off 115bps, subordinated financials off 100bps and investment grade moving out by 45bps and 40bps in US and Europe respectively. Emerging market corporates outperformed developed markets in relative terms, moving 65bps wider on the quarter.

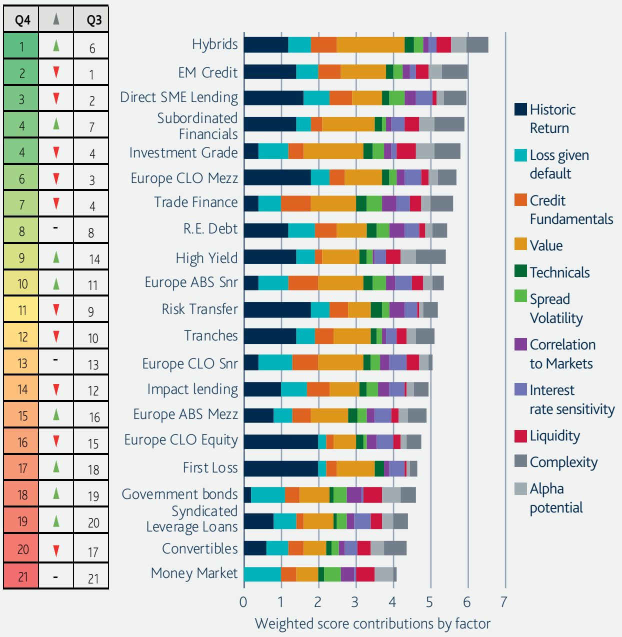
Structured credit, normally resilient during times of market volatility, widened over the quarter in line with corporate credit. We believe this was due to the uncertainty created by new securitisation regulations which came into effect on 1 January of this year. Within ABS, AAA tranches widened by between 20 and 45bps, a significant move in percentage terms as spreads increased by between 50 and 130bps while mezzanine widened by between 35 and 90 bps. In Euro CLOs, AAAs moved from 100 to 125bps over the quarter, BBBs from 325 to 380bps and single-B instruments from 800 to 960bps.

In contrast, private credit didn't see the same movement in spreads – indeed, in most cases, spreads didn't move at all over the quarter. In some cases, transactions were actually completed at narrower spreads, such as unitranche (-50bps) and mezzanine private loans (-20bps). Relative value shifts towards liquid assets, reflecting a reduction in the return premium that compensates investors for illiquidity.

Encouragingly, some of the themes from our relative value framework in Q3 played out in the relative performance of assets in Q4, such as EM over high yield and a preference for direct lending.

When we refreshed our year-end view of relative value, these movements in spreads had an influence on the new rankings. Current value is the dominant factor but the final rankings are not driven solely by such considerations. The influence of other factors – in particular historic return potential – can act as a dampener on market moves. We consider this important when applied to multi-asset credit portfolios that are targeting superior returns over the medium to long term. Figure 3 shows the contribution of each factor to the overall score in each asset class.

Figure 3. Our relative-value spectrum, following Q4 2018



Source: Hermes as at 31 December 2018

Following the widening of their spreads over the quarter, liquid credit classes – benefitting from higher value scores – dominated the top of the relative value framework, with hybrids leading the ranking. Hybrids are an evolving asset class. It is only over the last year that they have been issued in the US and they are benefitting from the positive influence that subordinated financials have had on investor comfort levels in longer-dated, higher-yielding credits. While the expansion of the asset class allows us to upgrade its historical return potential, hybrid spreads widened further in Q4, continuing the trend seen over 2018, which lead us to upgrade their value scores as well.

As a result, hybrids had a large move from sixth in Q3 to first at year-end, which managed to displace emerging markets credit to second place. As an asset class, EM continues to offer good relative value despite having had a more resilient Q4 compared to developed corporates. There were other large moves up the ranking table as a result of stronger value scores following Q4 sell-offs: these were for subordinated financials, up from seventh to fourth place, and for high yield which climbed into the top half of the table, from 14th to ninth position. Syndicated leveraged loans moved up to 19th from 20th as they now offer marginally better value following some repricing. However, low fundamental and technical scores continue to weigh on the asset class.

Despite scoring less favourably relative to liquid asset in terms of value, direct lending still ranks highly due to its high historic return potential and low interest rate sensitivity. More importantly, it is worth noting that the scores we assigned to this asset class were based on Hermes' conservative approach to direct lending. Hence, fundamentals and loss given default scores are higher than the general direct lending market would justify. Other illiquid assets, such as trade finance and risk transfer, moved down the rankings as they, too, were displaced by liquid assets.

ESG

Integration and engagement on environmental, social and governance (ESG) factors in fixed-income investing is a core principle for Hermes. While this view is not universal, we believe that the interests of long-term shareholders and creditors are more often than not in harmony.

Just as we do not separate ESG integration from credit risk, we do not separate engagement from ESG integration. The many benefits of engagement include:

- bringing static, third-party ESG assessments and scores to life
- allowing a better sense of a company's commitment to changing its behaviours
- reducing uncertainty in understanding across operational and financial activities

Bondholders and long-term shareholders are entitled to engage on ESG issues since the returns on both debt and equity instruments are ultimately linked to the performance of the underlying company itself.

Shareholders and creditors also seek the same fundamental outcomes for companies in which they invest: stable, sustainable growth and enterprise value creation for the long term. This alignment of interest allows them to jointly engage companies. Hermes believes that successful engagement generates holistic returns by achieving a lower cost of capital, supporting investment performance and having a more positive impact on society.

Figure 4. The influence of ESG factors on fixed-income asset valuations

Source: Hermes. For illustrative purposes only.

Engagement case study: Gazprom

Hermes is an investor in Gazprom, the Russian Government-owned energy company. Our ESG analysis highlights shortcomings in its governance framework – specifically the composition and effectiveness of its board. The engagement specialists in Hermes EOS raised these concerns at a meeting in December 2018 with an independent director of the company, in which we pressed for disclosure about Gazprom's climate-change strategy and governance. Hermes EOS sought clarification about the competencies of board members and possible gaps in their knowledge and experience. The team also challenged the company about the lack of gender diversity on its board.

The director pointed out that board nominations are controlled by the Russian government but assured us that the company's board was adequately skilled to discharge its duties. Disappointingly, he seemed dismissive of our concerns about the absence of women on the board.

More positively, the director highlighted the company's investment in new technologies for the production and distribution of gas. He also emphasised that Gazprom was upgrading old pipelines to avoid leaks and reduce power consumption at pumping stations. Encouragingly, he informed us that the board regularly discusses the company's carbon footprint and methane emissions, having recently signed up to the Climate & Clean Air Coalition's guiding principles on reducing methane emissions across the natural-gas value chain.

The team continues to see huge potential for Gazprom to increase shareholder value. We will therefore continue to engage and challenge the company's board seeking face-to-face contact whenever possible, in order to promote stronger corporate governance in areas such as gender diversity and director experience.

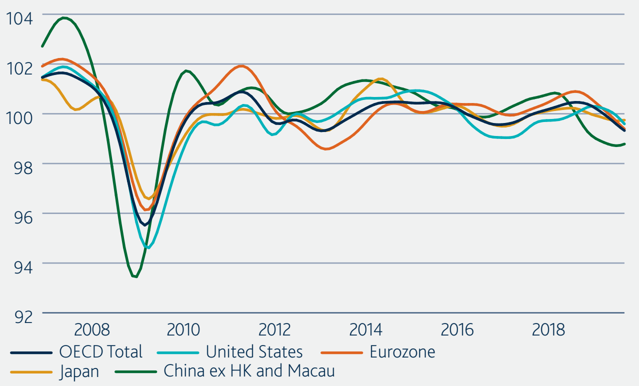
Economic outlook

Desynchronisation is set to fade in 2019 as the US economy shows clear signs of slowing down.

Economic growth lost momentum globally over 2018 and the trend is likely to persist in 2019, judging by surveys of economic activity. The global composite PMI ended 2018 on a weak note; it fell to 52.7 in December, matching the lows for the year, and forward-looking components (i.e. orders) remained weak. Global growth is on track to slow down to around 3.25% in 2019, from 3.5% in 2018.

In addition, growth was de-synchronised in 2018, as the US economy accelerated over the year, bucking the trend in other major countries. However, such growth divergence is not sustainable and it is likely that convergence will reassert itself this year in the form of a US slowdown as the fiscal stimulus fades and trade tensions persist.

Figure 5. Convergence is about to reassert itself, judging by OECD leading indicators



Source: OECD as at November 2018

Central banks: playing it safe

Policymakers, particularly the Chinese authorities and major central banks, have taken account of the trend towards global slowdown and are already starting to respond. The People's Bank of China (PBoC) cut the reserve requirement ratio (RRR) for all banks by 100bps in January 2019, releasing about RMB 800bn (almost $120bn) of net liquidity, demonstrating its willingness to address downside risk in the economy.

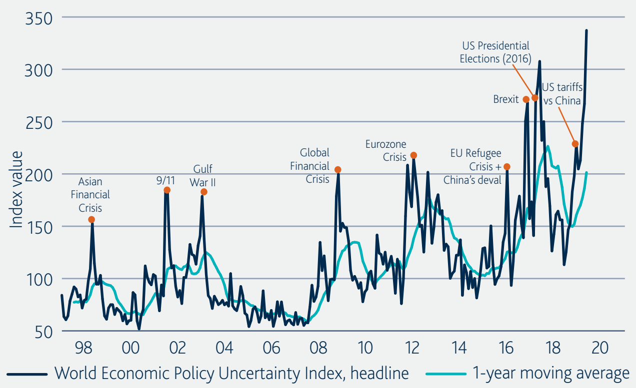
Central banks are normalising monetary policy gradually, having successfully contained inflation. They will probably remain cautious, however, given protectionist risks and market volatility. Following nine rate moves since December 2015, the Fed is now likely to slow down or even pause its hiking cycle. Tightening financial conditions and faltering global growth would justify that caution at a time when the policy rate (currently 2.25-2.5%) is at the bottom of the range of Fed's estimates of neutral (2.5-3.5%).

For the European Central Bank (ECB), monetary policy normalisation has become less of a priority. Forward guidance still points to lift-off around September 2019, but economic conditions have become more challenging, hence the likelihood of a postponement. Importantly, central banks' balance sheets are set to remain large, providing another source of support. The Fed's quantitative tightening (QT) is likely to continue on autopilot in 2019 but it is doubtful whether it will be continued thereafter. The ECB and the Bank of England (BoE) will maintain their stocks at current levels, and the Bank of Japan (BoJ) will probably continue to add to its assets. In this scenario (assuming a stable dollar), central banks' balance sheets in the G4 (US, Eurozone, Japan and UK) will probably end 2019 at around $14.5tn, down from a peak of close to $16tn in Q1 2018.

Geopolitical risks to remain elevated

Trade tensions between the US and China are likely to intensify causing structural frictions to persist. The recovery in Europe has been slow and uneven with Brexit adding to the strains. The next economic crisis could be hard to manage: monetary policy options have been exhausted and there is no common fiscal tool to respond to asymmetric shocks. Meanwhile, the rise of populism is a significant obstacle to deeper political and fiscal integration. Populist success in May's European elections could further erode the authority and effectiveness of European institutions.

Figure 6. Geopolitical risks are likely to remain high



Source: Reuters Datastream, www.PolicyUncertainty.com as at December 2018

Credit fundamentals

Earnings growth will be slower in 2019 but we see reasons to be cheerful on both liquidity and the release of credit.

In the last issue of *360°*, we slightly downgraded our macroeconomic outlook. This was predicated on the impact of changes in global trade policy; rising uncertainty in global trade; slowdown in China; the rising rate environment and the rising cost of labour. Since then, we have indeed seen declines in key macro indicators such as the global PMIs. Although we expect slower earnings growth – and further deterioration in the macro picture – in 2019, we remain fairly supportive on credit fundamentals.

From a liquidity perspective the picture is positive. Earnings growth, in double digits, remains ahead of growth in debt, which is in single digits. Further, based on data from the Fed, banks in the US are continuing to lend, despite debt capital market activity being rather muted in Q4 2018. Meanwhile, dovish comments from the Fed point to an easing back on both rate hikes and the tightening of credit. The announcement that China is cutting the amount of cash that banks must hold shows a similar move to release credit (although it does raise concerns about the releveraging of the country's banks).

Figure 7. Growth of earnings and debt, Q4 2017 – Q4 2018

Growth of earnings

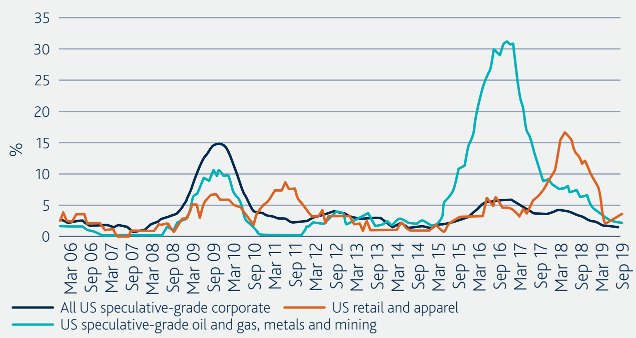
Sector (GICS)	EPS CQ4 17	CQ1 18	CQ2 18	CQ3 18	CQ4 18
All Securities	12.30%	22.49%	24.49%	24.29%	15.98%
Energy	53.94%	61.15%	98.82%	98.60%	67.41%
Materials	41.85%	31.85%	43.81%	28.34%	4.03%
Industrials	5.39%	24.90%	17.46%	17.10%	25.43%
Consumer Discretionary	9.47%	14.07%	20.00%	22.72%	28.43%
Consumer Staples	7.32%	10.14%	10.82%	8.83%	13.08%
Health Care	8.85%	14.20%	13.04%	14.44%	8.99%
Financials	1.03%	26.55%	22.66%	30.63%	0.00%
Information Technology	20.83%	28.38%	32.09%	25.35%	12.76%
Communication Services	19.78%	23.28%	37.61%	27.52%	13.11%
Utilities	11.46%	13.89%	12.96%	14.06%	-6.70%
Real Estate	10.16%	8.22%	6.71%	8.93%	9.10%

Source: Bloomberg as at December 2018

Growth of debt

Source: Bloomberg and US Federal Reserve as at January 2019

Figure 8. Overall, defaults should decline as the year progresses



Source: Moody's Investors Service; issuer-based default rates; October 2018 – September 2019 is projected

As we have stated in the past, based on reports from Moody's, we expect a reversal in default rates in 2019, but a modest one. The latest credit cycle has lasted 10 years, allowing companies to refinance their balance sheets and thereby pushing out debt maturities at very attractive levels.

In summary, we are encouraged by the prospects for credit fundamentals in 2019 despite some headwinds. It is these headwinds that preclude us from taking on excessive equity-like risk in credit.

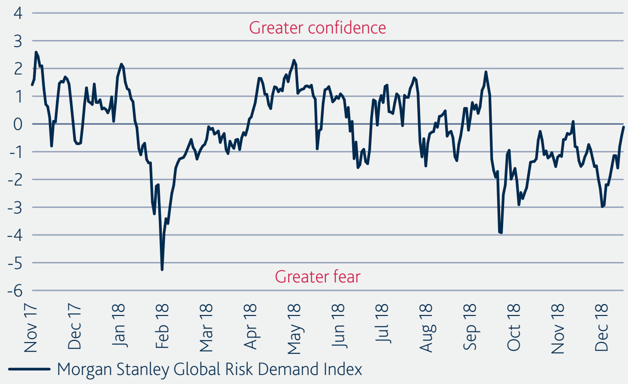
Valuations and technicals

Despite cash prices at their lowest in a decade and negative net supply, sentiment has recovered since the turn of the year.

Sentiment

Inversion of the US Treasury curve and increased worry around the end of the US cycle led to a deterioration of sentiment towards the end of 2018. However, the situation reversed at the start of the year as progress in US-China trade negotiations led to risk demand indicators suggesting that we are back to a neutral stance.

Figure 9. In the balance: the tension between investor confidence and fear

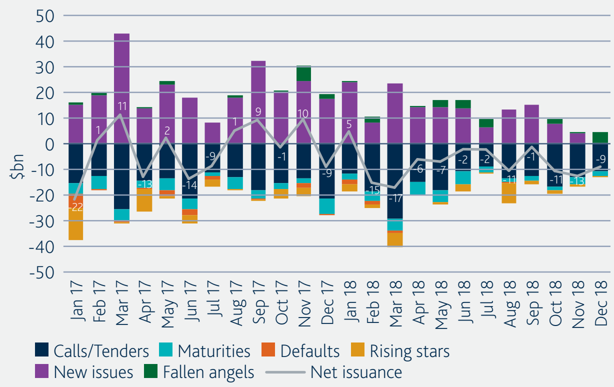


Source: Bloomberg as at January 2019

Asset flows

Outflows continued in Q4 across both high yield and EM credit. This was partially offset by continued lack of primary issuance, leading to negative net supply in Q4 (see figure 10). Part of the capital was re-allocated to money market funds with LIBOR continuing its ascent towards 3%.

Figure 10. Investor flows across credit markets

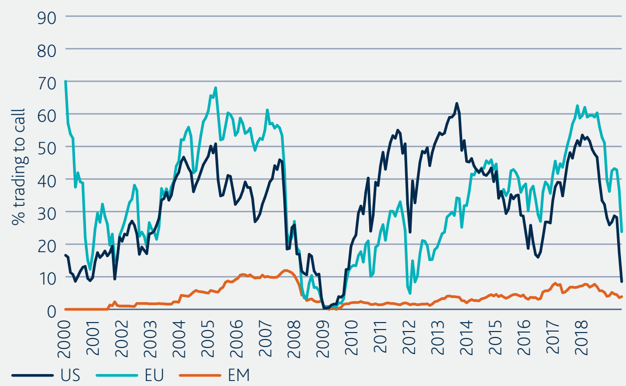


Source: Bank of America Merrill Lynch as at January 2019

Valuations

Cash prices for the global credit market are at nine-year lows and the share of the market trading above call price for the majority of the market is at similar lows. This suggests superior convexity in global credit at the present time.

Figure 11. Convexity is on the rise in high-yield market, except in EM



Source: Bank of America Merrill Lynch as at January 2019

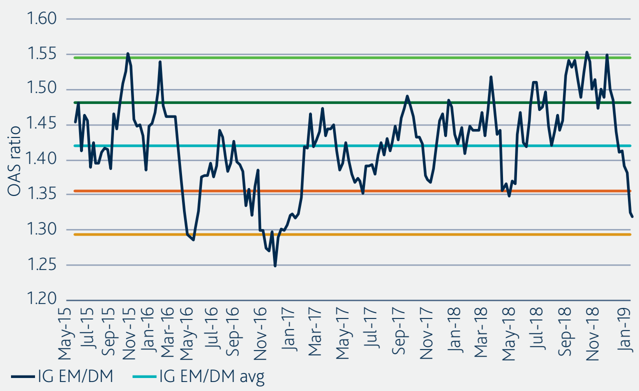
Public credit

The dynamic duo of emerging-market credit and European high-yield corporates continue to look more attractive than the US, as shown by the evidence below.

EMs bounce back

On the back of supportive technicals and strong fundamentals, EM credit has outperformed developed markets, reversing most of the underperformance we saw in Q1-Q3 2018.

Figure 12. EMs looking cheap vs developed markets

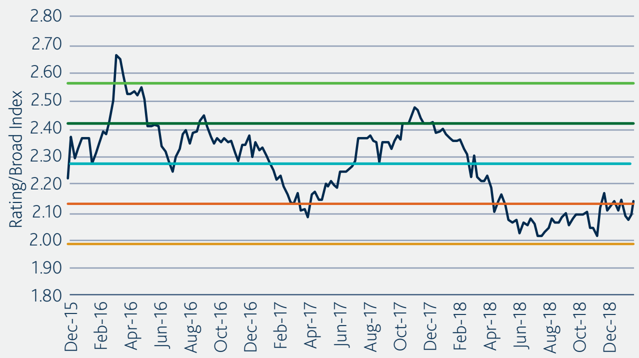


Source: Bloomberg as at January 2019

Low-quality credit is unattractive

Instruments rated CCC offer inferior risk-adjusted returns within the global credit market, given the slowdown in the global economy.

Figure 14. CCC-rated credit: performing poorly relative to its history

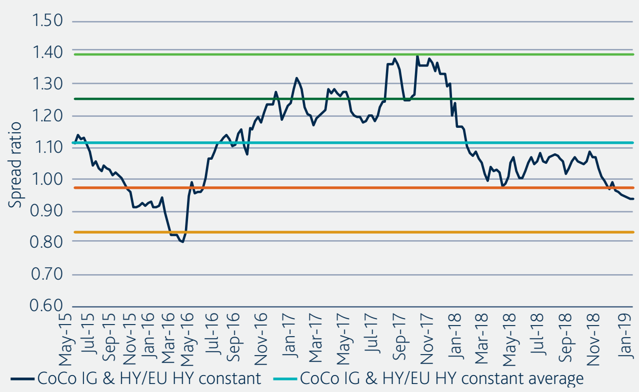


Source: Bloomberg as at January 2019

European high-yield corporates are attractive

Contingent capital securities (CoCos) had outperformed corporate high yield in Europe during Q4, making European high yield more attractive relative to CoCos but also US high yield and financials in general.

Figure 13. European CoCos are rich v European High Yield

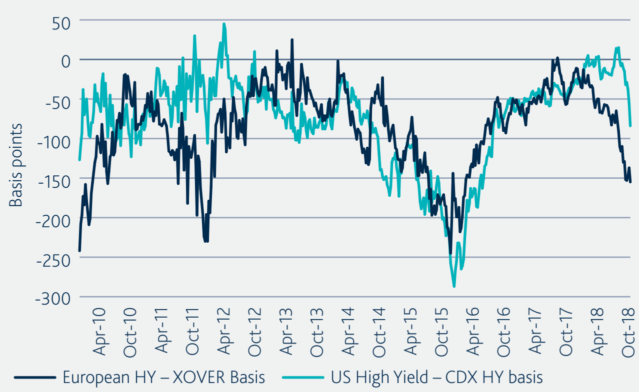


Source: Bloomberg as at January 2019

Cash bonds v synthetic instruments: which offers better value?

The basis between the cash and the CDS markets moved significantly in Q4. For example, in Europe it is now close to the negative basis levels we experienced in the periods of market stress in 2011 and 2016. This creates an opportunity to switch from CDS into cash in order to optimise the risk-adjusted return profile of a credit portfolio.

Figure 15. Cash bonds are king for now



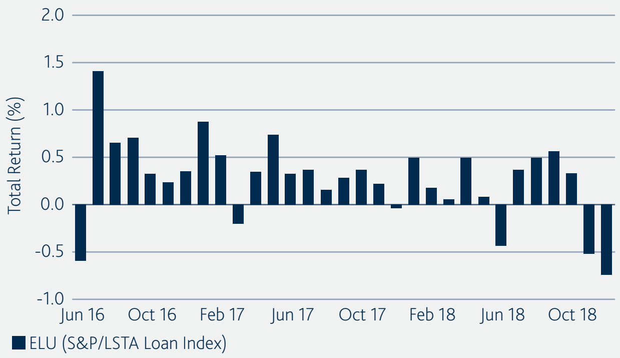
Source: Bloomberg, Hermes as at December 2018

Leveraged loans

The risk appetite for loans has declined, syndications are getting tougher and arbitrage opportunities are on the wane. On the plus side, the effect of making collateral cheaper will be welcomed.

In a volatile environment, loans were the slowest to react to the worsening conditions, making a strong start to Q4 2018 thanks to a series of syndications which boosted sentiment and brought a mini-wave of opportunistic recaps and refinancing. This outperformance was short-lived and the sell-off started in mid-October, becoming amplified in November and December. This was initially driven by instability in the US high-yield market, but then accelerated after deepening economic and political gloom spread across Europe and beyond, causing a rapid decline in risk appetite. As a result, the weighted average bid of the S&P European Leveraged Loan Index slipped from a post-summer high of 99.28 on 9 October, to 97.33 by 31 December.

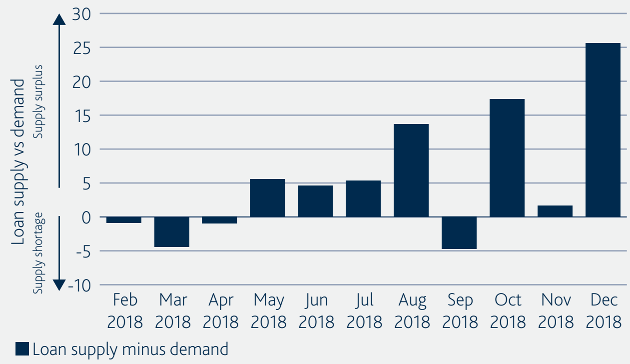
Figure 16. Leveraged-loan returns weakened in Q4 2018



Source: S&P European Leveraged Loan Index as at December 2018

This also affected primary syndications and their pricing. From a yearly high of 4.34% in July, average yields for single B credits in euros fell to a post-summer low of 3.82% in October before shifting back to 4.64% at the end of December. Syndications became harder as Q4 progressed with the market experiencing a number of upward price flexes in November and a corresponding decline in the reverse-flexes. Proportion of reverse-flexes was at its highest in October, at 89%, and gradually fell to 53% in November, and then 33% in December.

Figure 17. The European leveraged-loan market is experiencing strong supply



Source: LCD, an offering of S&P Global Market Intelligence as at December 2018. Based on (a) new issuance minus repayments minus (b) CLO issuance and prime fund inflows

CLOs were also affected by the decline in sentiment. Few deals were concluded towards the end of the year: arbitrage opportunities faded away when liabilities became more expensive earlier and faster than the commensurate move in the underlying loans. There are still many warehouses in ramp-up mode and the cheapening of the collateral will be welcomed – as long as a desired normalisation in the cost of the liabilities materialises in time. The implementation of the EU Securitisation Regulation in the structured credit space has also led to uncertainty in issuance requirements (see below).

Structured securities

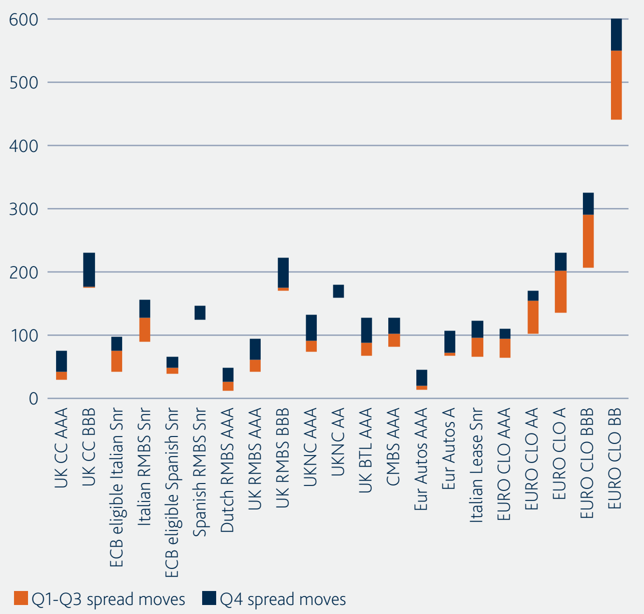
Uncertainty around new regulations and the curbing of the ECB's purchase programme is having a negative impact in the short term but the pent-up supply of new issues can be expected to hit the market mid-year.

With the implementation of the long-awaited Securitisation Regulation on 1 January 2019, the structured credit market has entered a new post-crisis phase in its development. The new regulation places an increased burden of data provision on issuers, which in some cases is proving very problematic. Certain issuers rushed to market in 2018 rather than waiting to issue in 2019 under the new requirements, despite the weakness in the market. Investors, particularly those who are subject to capital charges resulting from the designation of simple, transparent, standardised (STS) ABS versus non-STS ABS, were seen selling down reasonable sizes of ABS prior to the 1 January go-live date. Whilst ABS is usually particularly resilient in times of wider market volatility, the increased regulatory uncertainty played on people's fears and the asset class widened in step with credit.

The asset types that fared worst over the course of 2018 were those that benefitted the most from the support of the ECB's purchase programme, namely Dutch RMBS and European auto ABS, having reached post-crisis tights earlier in 2018. Dutch RMBS AAAs spreads finished the year around EURIBOR plus 50bps, roughly a 300% widening from their January 2018 starting level. Similarly, European auto ABS widened over 200% to EURIBOR plus mid-40s bps over the course of the year. While it's difficult to ascertain the exact impact of the ECB's tempering of its purchase programme on spreads in the context of overall market widening, it is telling that these two asset types saw the most dramatic percentage widening of spreads versus all other asset types across ratings. With an estimated €6-8bn of maturities and redemptions over the course of 2019, there will still be demand from the ECB for ABS assets to go into the purchase programme in order to maintain the current balance of purchases, so further support, albeit capped now, will be available over the coming year.

Although it is very early days, the fears around the new Securitisation Regulation seem to have given way to a more business-as-usual attitude, especially for investors. There has been reasonable two-way flow for the first few real trading days of 2019 although volumes so far have overall been on the low side. Issuers are approaching the new year and new regulations with great caution. Various CLO managers are lined up to issue in the coming weeks, but issuance is likely to be subdued for the foreseeable future – due to a combination of a widening of the liability stack eating away at the arbitrage, warehouses being underwater, and the new regulatory environment causing headaches. This lack of supply has the potential to result in a technical squeeze. The impression is that banks continue to run lean inventory coming into 2019 so, with a lack of primary supply and low bank trading book inventory, any investor purchases over the coming weeks will likely result in a tightening of spreads (notwithstanding the macro headwinds). As the remaining wrinkles in the Securitisation Regulation are ironed out, there is potential for a glut of supply in Q2 / early Q3 as the pent-up supply of new issues finally comes to market.

Figure 18. European credit spreads, across the board



Source: J.P. Morgan as at December 2018

Proceed with caution would be the best approach considering all the uncertainty around. However, the repricing of 2018 has created lots more interesting opportunities across the ABS and CLO space, with wider spreads paying investors more for the same level of risk as previously. Credit fundamentals remain stable and strong in ABS (supported by low unemployment and low interest rates) while the loosening of lending standards, predominantly cov-lite structures, and the increase in leverage multiples in the leveraged-loan space could provide some problems for lower-rated CLO debt and equity tranches, should defaults start to tick up from current lows. However, the investment grade tranches remain well protected from an over-collateralisation and interest-coverage perspective.

Private lending

As deal flow has slowed to a trickle, competition for opportunities in major European markets has intensified. Scandinavian loans seem to offer good value for creditors.

With volumes of M&A transactions across Europe falling, and uncertainty in the UK market as a result of Brexit and a weakening economy, deal flow has been far more subdued in the last quarter. This has led to increased competition in certain markets – primarily Germany, the UK and France – for the better transactions seeking financing. Competition for the better credit opportunities is now primarily centred on loan terms and structures, with unitranche lenders increasingly accepting much diluted protections. There have been increased examples of cov-loose lending structures in the SME markets; EBITDA add-backs are becoming more aggressive and leverage levels are therefore increasing as a result. Portability clauses in loan documents are now increasingly common. The banking market has continued to push back on some of the more aggressive demands of lenders and this is the main reason that unitranche lenders have been able to expand their market shares in markets like Germany, for example. As a result, loan origination remains the main challenge for many alternative lenders.

Hermes continues to see value in Scandinavian loans where the banks continue to control the market and the alternative lenders have not made much headway. Relatively strong lender protection rights, good credits and favourable legal environments for creditors make this region very attractive over other parts of Europe, especially southern Europe. France remains the least attractive market; diluted loan protection rights coupled with a weak legal environment mean that, in Hermes' opinion, investors are not adequately remunerated on a risk reward basis. The UK is increasingly showing pockets of value in stable credits which are benefitting from an increased sterling premium coupled with the strong legal environment.

This is clearly a time to take a very disciplined approach to the SME lending markets.

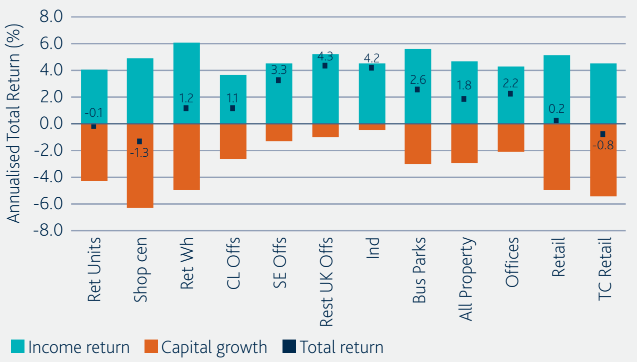
Asset-based lending

The outlook for the Brexit-risk-battered retail property market is bleak but offices outside London and the South East offer better opportunities. As the UK property cycle matures, downside risk mitigation is critical with loan underwriting focused on possible capital-value declines.

Real estate debt

Last quarter we discussed relative value across European jurisdictions. This quarter, with Brexit looming large as the UK prepares to leave the EU on 29 March, we're focusing on the UK real estate market, looking at how real estate equity returns will fare over the short- to medium-term and the resulting implications for lenders.

Figure 19. Forecast returns in the real-estate equity market



Source: PMA as at December 2018

Figure 19 illustrates sub-sector total return forecasts for direct property investments in the UK over the next five years under the PMA's (Property Market Analysis) main scenario. This base case is similar to the consensus of economic forecasts whereby a deal on an EU withdrawal treaty is agreed, consumer spending is subject to a slowdown, inflation rises and political uncertainty stalls business investment.

Under the main scenario, the outlook for retail remains bleak. Shopping centres are expected to continue to be the hardest hit with total returns equating to -1.3% a year over the next five years. Rising costs, an increasingly discount-led competitive landscape, and declining store sales – further compounded by weak investor sentiment – are some of the key drivers behind this outlook. However, there will be selective opportunities to identify mispriced retail assets – at attractive discounts – in need of intensive active management and repositioning over the coming years. On the other hand, UK offices outside of central London and the South East are expected to be the best performers, closely followed by the industrial sector, which has had and continues to experience phenomenal growth through sustained occupational and investment demand. Despite the volatility in current markets, overall outputs remain positive in nominal terms for all sectors other than retail.

For those of us who view the current UK cycle as increasingly mature, downside risk mitigation is a critical consideration and, as a result, the relative value of real estate debt versus real estate equity investment becomes increasingly attractive. Loan underwriting should now place much more emphasis on possible capital value declines. Higher exit loan-to-value metrics imply increased risk for which lenders would want to be compensated. In contrast, mainstream bank lending margins continue to tighten, making it harder to compete in areas of the markets where lenders are price-takers (prime). However, we continue to see good value in loans utilised for capital expenditure investment for transitioning assets in secondary locations, where rents still have growth potential and asset improvements can help outperform wider market movements.

Structured transactions

With regard to capital relief transactions, where banks are looking to transfer first-loss risk to other parties, there is an ongoing trend for banks to amend their requirements so that transactions are more effective at providing risk-weighted asset (RWA) relief. This has led to a removal of any subordination and a thickening of the tranche. While the latter provides effective deleveraging, the former creates a much higher likelihood of some losses being incurred. Given the dedicated cash pursuing these opportunities, this trend has yet to result in wider spreads. As the asset class has yet to experience a full downturn, we are more cautious based on the above developments.

We are similarly more prudent on CLO warehouses at the moment. The underlying loans have repriced significantly and the terms available for warehouse funding have not worsened commensurately. This makes the carry available on the trade more attractive. However, the instrument depends on execution risk: the combination of new regulations, expensive liabilities and reduced arbitrage creates uncertainty on exiting the warehouse within the expected timeframe.

OUTCOMES BEYOND PERFORMANCE

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