360°

Focusing on the evidence

Andrew Jackson
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For professional investors only

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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

"The deepest sin against the human mind is to believe things without evidence." Aldous Huxley

Given the way the asset class has been portrayed over the past decade or more, you'd be forgiven for assuming structured credit investors spend their days stroking a white cat and plotting global Armageddon. In reality, structured credit is a useful tool for managing risk whose reputation is undeserved.

Much has been written about structured credit over the past two decades. In particular, several excellent books were written (and movies made) about its role in the global financial crisis (GFC). It's important to remember, though, that no matter how good Christian Bale's acting is, most of us don't really believe that Batman fights crime in Gotham city. Nor should we believe that everything we've seen or read about structured credit is an accurate depiction of what happened – much less that it should be applied to the whole asset class.

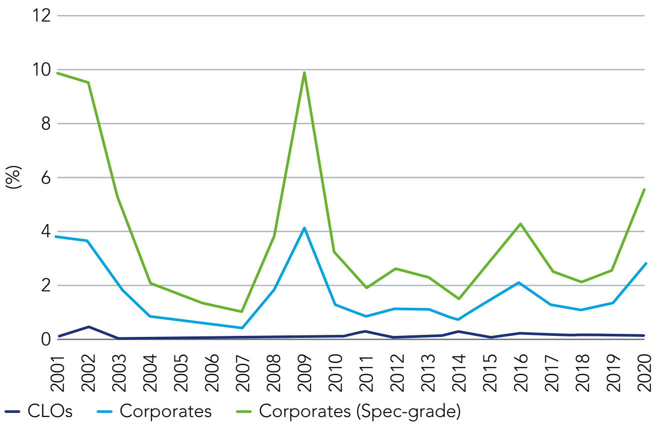
I have been involved in structured credit since it emerged as an asset class in Europe. I worked on the early UK 'tobacco bunkering' transactions and travelled to the US to learn about the technology. I reviewed HUD-1s (a standardised mortgage lending document, see 'The Big Short') and Fair, Isaac and Company (FICO) credit scores. I built bespoke modelling languages for collateralised debt obligation (CDO) modelling, wrote rating criteria for the early European residential mortgage-backed security (RMBS) transactions, rated the first ever African securitisation, then went on to trade all forms of structured credit from both the long and the short side. Those of you who have read all our 360s will never have seen me list my experience in such a vain and crude manner, but I feel I must do so to justify making this bold statement:

Structured credit is NOT a 'financial weapon of mass destruction'

The underlying concept behind structured credit is to aggregate pools of collateral and enable the tranching of risk. As well as providing some diversification benefit, this allows investors to select the concentration of risk they seek exposure to in a more nuanced way, which leads to a lower weighted average cost of funding. That's it. The assumption that any jiggery pokery on any financial instrument can turn risk into riskless is to believe in alchemy. As with all investments, start from a position of doubt. Question that which you do not understand. Remain rational, with a healthy dose of scepticism. And if I have learned one thing from working through at least four financial crises, do not rely on history as the perfect predictor of the future. Keep in mind that if X has occurred less than 100 times, the relationship between X and Y cannot be established with any meaningful level of statistical significance.

In the words of English writer and philosopher, Aldous Huxley, "Facts do not cease to exist because they are ignored." So, let's look at the facts.

Figure 1. Comparing annual global default rates from 2001 to 2020 shows that the risk of default is far higher for corporates than for collateralised loan obligations (CLOs)

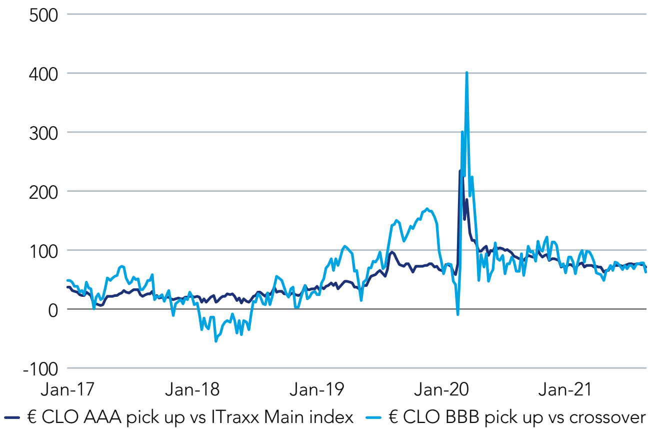


Source: Standard & Poor's as at September 2021

The above comparison shows that defaults in structured credit are far less frequent than for commensurate rating bands in the corporate space. Of course, this is not the complete story when it comes to securitised products, but I think it is important to understand the historical facts, especially as many people's perception would be that the relationship is the inverse of what the data indicates.

So, how does this reduced credit risk exposure translate into returns? If we have apparently less risk, then the assumption would naturally be that we are compensated less for the risk that we are taking.

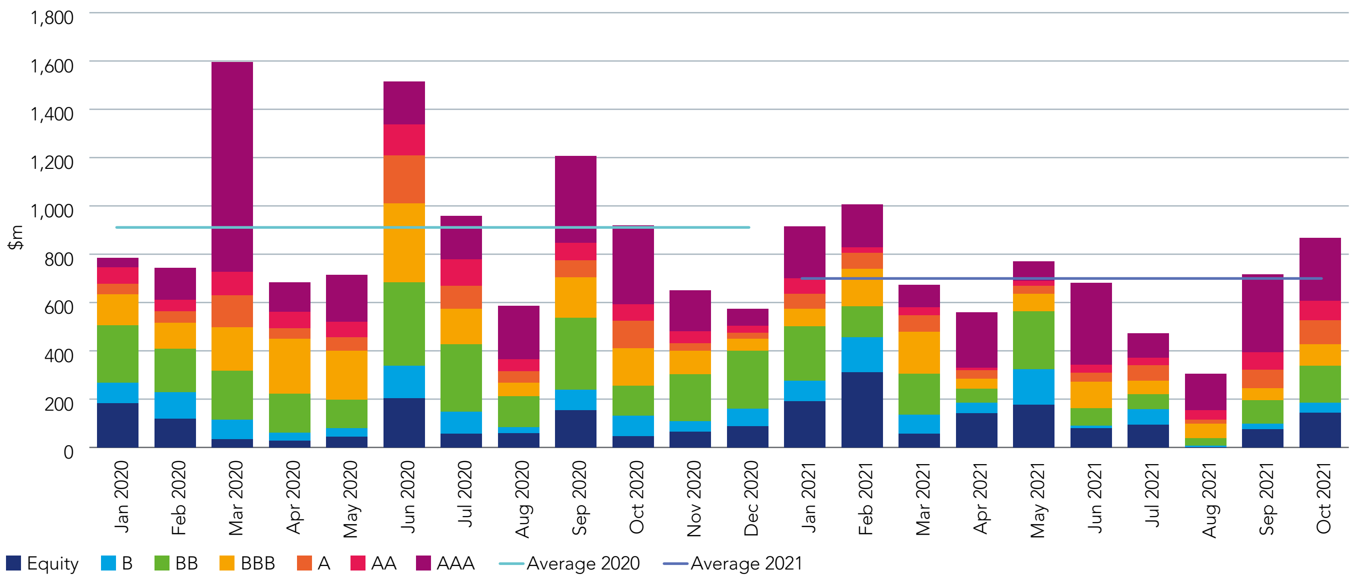
Figure 2. In terms of relative value, structured credit offers more spread for each rating than other asset classes



Source: Citi, Bloomberg, as at October 2021

Again, while neither of these 'snapshots' represents the full picture, it's immediately evident that structured credit, and in particular CLOs, offer significantly more, not less, spread for each rating, despite the historically lower default rate for each rating category. This residual return must be assigned to illiquidity and complexity, on which we have published a number of papers.[1] Our relative value framework incorporates an assessment of these factors both in terms of current embedded premia and, perhaps more importantly, the premia that exist during periods of stress. Structured credit is undoubtedly a less liquid asset class than similarly sized corporate issuance, particularly under stress, something that was most evident during the GFC. However, it's probably significantly more liquid than most people would perceive. The chart below illustrates the level of trading activity in 'normal' conditions and during the Covid-19 period.

Figure 3. Trading activity in terms of bids wanted in competition (BWIC) in normal conditions is higher than most people would expect



Source: Citi Velocity as at November 2021

It is possible to reduce this illiquidity risk slightly, though perhaps not materially, through diversification across variables such as geography, rating, sub-asset class and vintage. However, like subordinated financial debt (another relatively unloved asset class whose beta is magnified through regime shifts), structured credit tends to grow and shrink in liquidity (and price discovery) in a rather non-continuous fashion; essentially it is either very liquid or not liquid at all, with little or no intermediate state. One would therefore be very naïve to ignore the conditioned response that people have to the asset class – many investors, regulators and other financial market practitioners are 'once-bitten, twice-shy' when it comes to structured credit, which is perhaps understandable.

To dismiss this factor and focus only on the likely real, terminal losses only really works as a risk management approach if you are prepared to hold, and account for, these assets to maturity. In my experience almost no one actually

[1] See for example: "Illiquidity – Understanding the premium in fixed-income markets," published by Federated Hermes International as at September 2019; "Harnessing the illiquidity premium: Managing liquidity risk in multi-asset credit portfolios," published by Federated Hermes International as at December 2019.

does. The best portfolio managers in flexible credit solutions and within structured credit acknowledge the existence of 'tourists' within the structured credit space. Often, they have been attracted by the opportunity to eke out extra juice in their hunt for yield (the longer the market stays in a low-volatility, low-spread period, the more likely this is to occur). Furthermore, these portfolio managers are constantly and critically assessing the current levels of risk appetite, liquidity and relative value, the forward issuance profile and the nature and risk tolerance of their fellow investors, both within and across the pockets of the asset class. The best example of this is perhaps within CLOs, where the universe of AAA investors is very distinct in constitution and in nature to the universe of 'BBB' and sub-investment grade investors. Those able to consistently make these assessments well and execute on them effectively will significantly and consistently outperform their peers, both in terms of upside capture and risk mitigation.

As a business, there are three further observations that we would make about this fascinating asset class:

1. There tends to be more premium and more alpha within structured credit during periods of low volatility and lower risk premium within broader markets, making the asset class incredibly valuable for portfolio managers.

2. Correlation between securities (both in terms of terminal loss and volatility) increases as their rating increases.

3. Being a complex and unloved asset class – and therefore 'cheap' – does not imply that it should by definition be added to portfolios. Detailed analysis and understanding are required and should be a meaningful contributor to portfolio allocation decisions (in particular, when assessing the relative value of structured versus corporate credit).

Structured credit plays a part across all the flexible credit strategies we manage. During periods where the value within corporate credit is at the lower end of the scale (as is the case now), allocation to structured credit tends to increase, as does the alpha that we seek to source. Our analysis approach and investment philosophy rarely lead to a 'trading' mindset. Instead, detailed analysis built on solid, robust and conservative fundamental assumptions gives rise to portfolios that evolve over time and express views about structure, underwriting quality, economic and fundamental factors and, critically, our assessment of ESG factors.

There are occasions, however, when we feel a more radical shift in capital is appropriate. One of these came during the depths of the crisis last year when, in our opinion, structured credit 'overshot' during the broader market sell-off. Many of you will have seen the note we sent out to investors at that time discussing the gap between the implied risk within this asset class and the fundamentals we saw in existence. At this juncture it's worth mentioning that structured credit is also a 'high touch' asset class in terms of execution, rewarding patience, clarity of thought and a deep understanding of the technicals.

Our view remains that structured credit benefits from its rather unloved status, that much of the antipathy towards it is unwarranted and that allocating capital to it rewards hard work and rigorous analysis. With that in mind, we have devoted a more significant part of this 360 to this asset class. I hope you enjoy it.

Structured credit

Having weathered the Covid-induced crisis well, the structured credit market is seeing reinvigorated interest from investors seeking useful diversification into consumer assets with minimal interest rate exposure. While not without risk, structured credit has provided strong returns to market participants with the requisite knowledge and experience.

The team at Federated Hermes has been active in the asset class since the early 2000s giving us a strong perspective on investing in structured credit over cycles and through crises. Our investment philosophy is to analyse the risks for the life of transactions, which can be several years, regardless of our holding period.

Structured credit has come a long way from being the pariah of asset classes following the GFC. What started as a credit issue within the US subprime residential mortgage market ended with almost every corner of the financial markets being rocked. Securitisation as an approach was seen as being at the root of the problems, but that is a huge oversimplification. The experience of European structured credit was significantly more positive than most people realise, but it has taken over a decade to persuade investors and regulators of the merits and robustness of securitisation.

As highlighted by Andrew Jackson in the introduction to this newsletter, structured credit provides a significant pick-up compared to corporate credit risk; for those investors who have the knowledge, experience, and capability to invest in structured credit effectively, the returns have been attractive. Seeking exposure to the asset class also with potential diversification. With most asset-backed securities (ABS) consisting of consumer assets – residential mortgages, auto loans, auto leases, credit cards and consumer loans – they can enable an investor to pivot away from pure corporate risk within a credit portfolio. Another feature that should not go unnoticed is that almost the entire European ABS and CLO markets are floating rate, allowing investors to manage their interest rate exposure while still running credit risk within their portfolios.

Securitisation is essentially a way of transforming illiquid assets into liquid, tradable securities. There are two fundamental reasons for securitising assets: firstly, to free up balance sheets by transferring risk; and secondly, for funding arbitrage. Herein lay the genesis of the subprime lending problem: financial institutions were lending to borrowers who would most likely be unable to meet their payments, but this didn't matter to lenders as they were already selling on the risk before the problems started to mount. It also meant they could use the proceeds to lend further to more borrowers, compounding the problem.

One of the regulatory responses to the more unscrupulous lending practices seen during the pre-GFC era was to introduce risk retention. European originators of assets are required to hold 5% of the risk of a securitised portfolio and share in any of the losses that result from the underlying assets. The result is to align the interests of the originator with those of the end investor in ensuring the assets have been underwritten thoroughly, are serviced correctly and will perform.

Another beneficial regulatory requirement was added on the investors' side too. In the post-mortem following the GFC it became apparent that a number of investors had been 'buying the rating', i.e., investing in securities based on high ratings and returns without understanding the investment itself or the underlying assets. This eventually led to the introduction of the European Union's Securitisation Regulation on 1 January 2019 for new and existing securitisations, which was also adopted in the UK. The Regulation requires issuers and investors alike to meet an extensive list of requirements for an investment to be considered eligible as a securitisation. That de facto applies strict criteria to address the issue of people buying into structured credit without understanding and evaluating the risks. As for the underlying assets that go into typical securitisations, there has always been considerable regulation and strict guidelines around these in Europe as they tend to be loans made to consumers.

Structured credit has therefore seen a number of significant developments for the better since the GFC. However, investing in the space is not without its risks. It requires an experienced manager with the intimate knowledge of the assets, structures and market dynamics needed to navigate the asset class effectively.

In the following sections, we will provide an update on the state of the ABS and CLO markets, as well as demonstrating our capabilities in the space – not least our focus on environmental, social and governance (ESG) issues within structured credit.

ESG in structured credit

We outlined our approach to ESG in structured credit back in 2019. Federated Hermes has a long history in ESG investing and we have developed a platform which draws on our considerable in-house resources to support our efforts in investing responsibly. We implemented a methodology for comparing the ESG credentials of investments across the structured credit asset class, from residential mortgage-backed securities (RMBS) to CLOs. Individual frameworks for the type of underlying assets backing a securitisation are used to score every investment we buy into our portfolios. The E, the S, and the G are all scored separately over a range of considerations pertinent to that type of deal, with weightings assigned to each ESG factor depending on its relevance and importance to the underlying assets and the structure.

In discussing ESG with issuers and CLO managers, we have designed a range of pre-investment questions to probe their lending and investment practices. The questions not only focus on factors relevant to the assets that go into the structures we buy, but also on the business practices of the originators and CLO managers themselves.

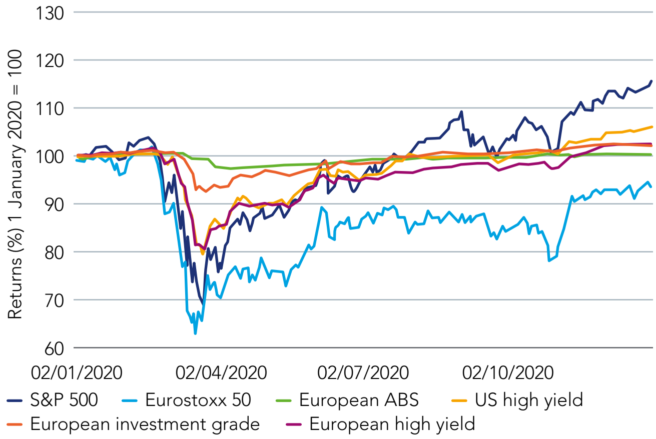
Thanks to our internal expertise and experience, we have made significant strides in a fraction of the time it would take if we were starting from scratch. We are therefore now able to review our frameworks and revise them, having applied them to every investment since we established the methodology. We have taken into account not only our learnings, but also developments in the market. For example, the vast majority of RMBS deals used to score, on average, a three for collateral when the market standard was to have no disclosure of environmental data on the underlying mortgages. However, this information is now readily available, so we would penalise originators not disclosing Energy Performance Certificate (EPC) ratings in the loan-by-loan data tapes.

Our ESG framework will continue to evolve, increasing in scope but also in richness of data. We are able to add more quantitative rigour to the outcome as more sources of data become available; for example, through our fixed income engagement team we are working to encourage issuers to augment disclosure levels.

State of the ABS market

The Covid-19 crisis saw a significant sell-off in risk assets, albeit a short-lived one when compared to the GFC. This time around, securitisation made few headlines and fared the storm well; price action was limited in ABS, although more volatile in CLOs. There is no tradeable European ABS index, but using the Bloomberg Pan European Floating ABS Bond, the sell-off in European ABS was less than -2.5% since January 2020.

Figure 4. The European ABS market avoided a significant sell-off during the Covid-19 crisis

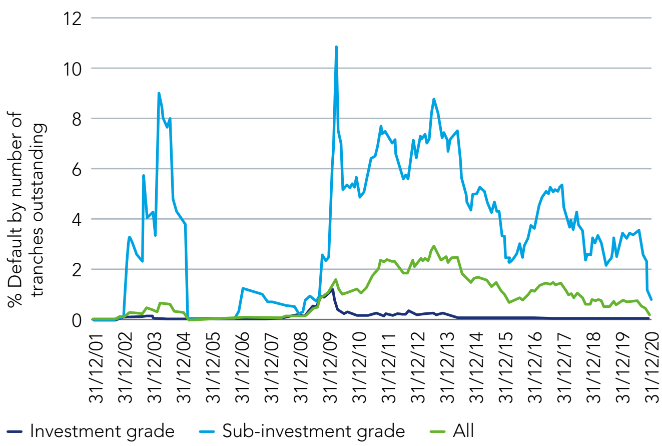


Maximum drawdowns (since 1 January 2020)	
S&P 500	-31.32%
EuroStoxx 50	-37.10%
European ABS	**-2.47%**
US high yield	-20.67%
European investment grade	-7.26%
European high yield	-19.50%

Source: Bloomberg as at September 2021.

The feared wave of downgrades and defaults never materialised, putting paid to concerns that had circled the asset class since the GFC – namely that structured credit would suffer again in another similar event. In fact, defaults are tracking at lower levels than they have for a number of years, even in sub-investment grade tranches. This is testament not only to the robustness of the structures employed but also the creditworthiness of the underlying assets.

Figure 5. Structured credit default rates are tracking at long-term lows



Source: Standard and Poor's, as at September 2021.

The combination of muted price action during the wider risk sell-off and the soundness of the credit fundamentals has resulted in a reinvigorated interest in the structured credit asset class. Demand for assets has far outstripped supply – a story that has played out across the capital stack but is particularly pronounced in investment grade mezzanine tranches that are smaller in size. Here, it is not unusual to see tranches more than five times subscribed, while in some cases tranches have been up to 10 times subscribed. With such demand outweighing supply, spreads have inevitably tightened.

ABS primary market

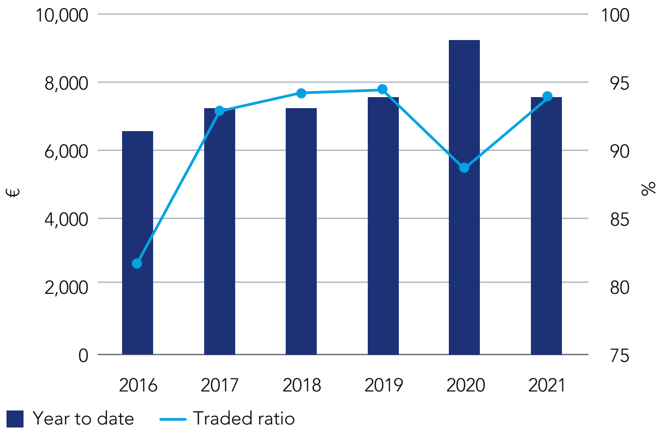
Year-to-date issuance for the European ABS market stands at €142.6bn[2], split between distributed issuance of €56.1bn and retained issuance of €86.5bn (retained issuance typically comprises securitisations that are structured by financial institutions and used as collateral at the central banks' repo window). The distributed year-to-date issuance for 2021 is tracking well ahead of 2020's figure; this stood at €35.6bn[3] at the same time last year, reflecting the total lack of issuance in the months following the worst of the Covid-19 crisis.

Despite this increased level of issuance over 2021, investors have experienced a dearth of some products coming to the ABS market. Most notably there has been a shortage of prime RMBS, which are mortgages underwritten to the better quality borrowers in the market. The lack of supply stems from the fact that banks and building societies underwriting these mortgages currently have access to other, cheaper funding sources, including central banks. However, the squeeze in supply doesn't alter the demand for such assets, which have a deep and broad investor base. As a result, spreads are moving to post-GFC tights. Meanwhile, in terms of issuance, the gap left by prime issuers has been more than filled by specialist lenders in the residential mortgage market, across both buy-to-let and non-prime mortgages.

ABS secondary market

Following the GFC, the ABS and CLO markets predominantly moved to a system of trading in the secondary market known as bids wanted in competition (BWIC). This is a way for investors to put dealers directly in competition with each other, whether they are bidding for their own book or showing in client bids. This system was largely designed by investors in response to the GFC, when dealers and brokers who were willing and able to provide liquidity were doing so while sitting on large bid offer spreads. Bid-offer spreads do widen in times of market stress, and we saw this during 2020. However, BWICs are a way of keeping buyers and sellers more connected, resulting in increased transparency into market clearing levels. They also provide a means of tracking the volumes of secondary market trading activity. According to J.P. Morgan, after a spike in activity in 2020, BWIC volumes for 2021 have returned to normal levels, with the traded ratio also tracking levels seen over 2017-2019 (not every bond that appears on a BWIC ends up trading, typically depending on the seller's reserve levels). In 2020 there was a dip in the traded ratio, reflecting the sometimes distressed bidding levels shown by some buyers during the crisis and the market finding the clearing prices for bonds.

Figure 6. Activity and trading volumes on the BWIC market have returned to normal levels in 2021



Source: J.P.Morgan as at September 2021.

State of the CLO market

Despite a record pace for primary activity, the CLO market has held up well, especially as it was simultaneously dealing with dynamics around investor rotation at the top of the stack. For buyers of loans, fundamentals and ratings account for the positive stories so far this year. At the end of September 2021, the S&P European Leveraged Loan Index (S&P ELLI) reached 98.90 – its highest level since November 2018. The recovery of the European leveraged loan market was driven by several factors:

- **Fundamentals:** The European default rate in the S&P ELLI has continuously decreased since October 2020, from 2.61% by principal amount then to 0.85% in September 2021 – when it fell back below its pre-Covid level (0.97% in February 2020) for the first time. Similarly, the default rate from the 'CCC and below' bucket of the index decreased from 8.58% to 6.69% over the same time period.
- **Significant loan supply, albeit at a tightening yield:** At the end of the third quarter, 2021 has been one of the busiest periods since the GFC (€107.3bn of total leveraged loan volume) and has experienced a significant tightening in yield, which decreased from 4.93% at the end of Q2 2020 to 4.22% at the end of Q3 2021.[4]
- **Change in the 0% Euribor floor value:** The embedded 0% floor in a leveraged loan creates additional relative spread and commensurate loan value. Despite the recent flattening of yield curves, the Euribor floor still has 'extra' value compared to its value pre-Covid, albeit less so on longer durations.

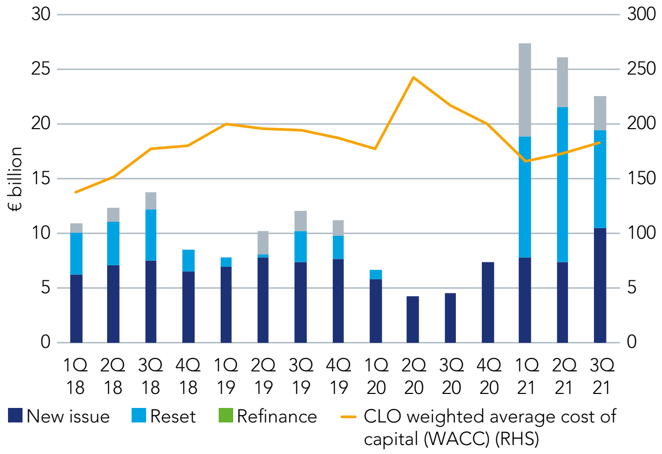
[2,3] Source: J.P. Morgan as at September 2021
[4] Standard and Poor's, Leveraged Commentary and Data (LCD)

CLO primary market

The CLO market has been very busy, closing the first three quarters of 2021 with €28.3bn of new-issue deals from 69 transactions (compared to €16.8bn from 50 transactions last year). In addition, the market saw €16.6bn of refinancing from 53 transactions (there was no refinancing activity last year), along with €35.9bn of resets from 86 transactions (against only €0.9bn from two transactions last year). So, what are the reasons for such high activity levels?

- During the 2020 downturn, a sizeable proportion of the leveraged loan market traded at stressed levels, and it was therefore a good opportunity to open CLO warehouses. In a CLO's lifecycle, the warehouse stage typically lasts six to nine months – those deals therefore arrived in 2021.
- These 'Covid-CLOs' which closed from Q2 to Q4 2020 had atypical structures: (i) to avoid warehouse liquidations, transactions were smaller – €200-250m compared to more typical figures around €400m; and (ii) they had a one-year non-call period (usually two years) which gave them the ability to reset or refinance more quickly.
- The CLO weighted average cost of capital has materially decreased, from 243 basis points (bps) in Q2 2021 to 183 bps in Q3 2021 – a level close to the tight of Q1 2021 (which itself hadn't been reached since Q2 2018). This spread tightening led to an opportunistic momentum for deals to either refinance or reset.

Figure 7. European CLO market activity (€bn) versus weighted average cost of capital (bps)



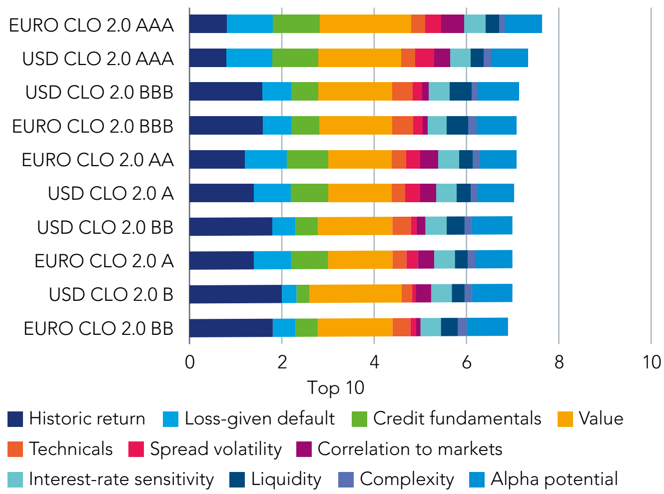
Source: Standard and Poor's as at 30 September 2021

Relative value analysis in structured credit

Within structured credit, our ability to invest across ABS and CLOs, across the capital stack in both, and across different asset types within ABS has led us to apply a similar methodology to relative value intra-sector. That allows us to identify the best opportunities within our investible universe. We look at historic returns, loss-given defaults, credit fundamentals, value, technicals, spread volatility, correlation to markets (investment grade and high yield corporates), illiquidity, complexity and alpha potential. These are inputted individually into the relative value model, with different weightings assigned to each attribute. The result ranks the various asset types and tranches against one another according to the attributes that make up the overall weighted-average score per line item. Regardless of an individual mandate's risk and return profile, we have a ranked list of investment opportunities. We can then tailor and use this list for the various portfolios we have that invest in structured credit.

Our current top 10 rankings in structured credit are set out in Figure 8 below:

Figure 8. Based on our relative value analysis, the top 10 opportunities within structured credit are dominated by CLOs

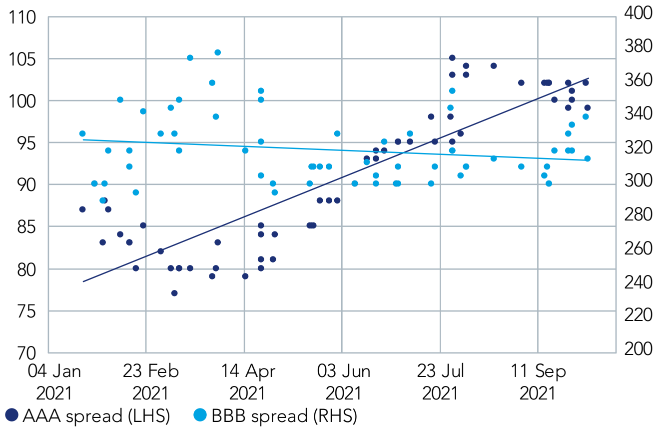


Source: Federated Hermes as at 30 September 2021

The current list is dominated by CLOs and doesn't include any tranches of ABS. This reflects our view that we see better relative value in the CLO stacks – both in the US and Europe – when compared to European ABS, which has seen significant spread tightening across all tranches. CLOs enjoyed a buoyant start to 2021, with spreads tightening as investors sought floating-rate exposures amid a rising inflation environment and expectations of rising rates. CLO managers and the bank arrangers responded to these tighter spreads by turning on the supply taps, not only in new issue but also in refinancing and resets. Initially, the market absorbed this supply well, however, indigestion began to set in during Q1 2021, most notably with AAA investors, and continued until September. The result was that spreads on AAAs backed up and deals began to print outside of +100bps, having touched tights inside of +80bps earlier in the year. In the absence of Japanese anchor investors, the number of investors with pockets still to fill dried up and a lot of new money was required to come in to meet the supply.

However, that's not the entire story for CLOs, as the intra-deal dynamic is more complex. As AAAs moved sideways then wider (and have, most recently, come off their wides), BBBs have been steadily tightening. One of the cathartic impacts of the Covid-19 crisis in the European CLO market was the return of manager tiering. CLO investors need to have a full understanding of a manager's strategy and investment style and need to see this in action to verify that the intention is commensurate with the outcome. In 2021, the European CLO market started to integrate these factors, particularly at the mezzanine level. For example, BBB spreads in new issues ranged from 290 bps to 378 bps. As one would expect, the spread between the widest and the tightest discount margin is more exacerbated at the BB level (182 bps) and the B level (204 bps).

Figure 9. European CLO new issue spreads 2021 year-to-date (AAA vs. BBB in bps)



Source: Standard and Poor's as at 30 September 2021

Generating alpha in Q4

Whilst we continue to run a significant allocation to European ABS within our multi-asset credit portfolios, we are focused on navigating the CLO market successfully for the rest of the year. Our views hinge on five areas:

1. Will defaults and downgrades stay away for another few months?

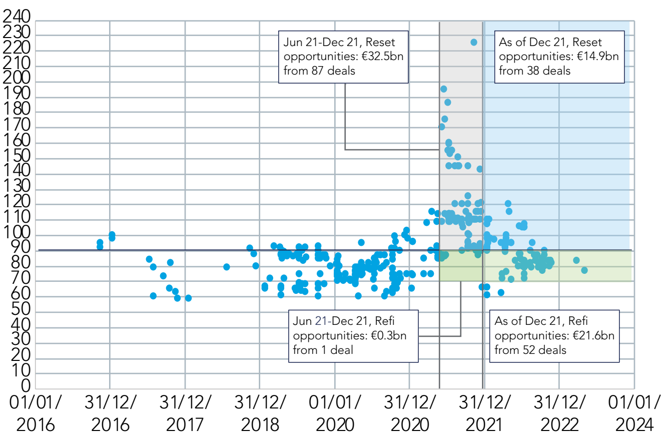
We believe that the upgrade cycle is coming to an end, and that corporate welfare will be more tested as governments roll back their financial largesse. However, for the most part, companies have done enough to their balance sheets and business flexibility to weather this change, and there is evidence of pent-up consumer demand that will create turnover uplift. Whether this demand can be met with the right level of supply considering the cracks in the supply chain ('pingdemics' and the like affecting human and commodity provision) will be a key issue to monitor.

2. Will the loan and CLO markets continue to be as active?

We believe CLO supply will remain elevated for the following reasons:

- **Ample primary activity of loans:** The underlying loan market should enjoy strong supply at attractive prices thanks to the significant amount of dry powder from European sponsors (close to $250bn as of August 2021[5]). M&A activity was quiet in 2020 as many private equity funds thought they had to preserve liquidity for their existing holdings. The various support plans from European governments enabled sponsors to retain cash, which is now ready to be put to work. We also expect a wave of upsizing and refinancing activity of loans, since at the end of June 2021 roughly 10% of single B-rated loans were trading above par and were priced at E+425 or higher.
- **The arbitrage is attractive:** Despite the new peak reached by the S&P ELLI (98.90), there is still convexity in the loan space. Indeed, the price distribution of the underlying loans differs from the situation pre-Covid, as more than 59% of the index was trading above par in January 2020, whereas that figure was only 21% at the end of September 2021. Currently, 67% of the facilities are trading between 98 and par, compared to 29% in January 2020. This should help par build and create incentive to open new warehouses.
- **CLO refinancing and resets:** The decision to refinance or reset a CLO transaction is mainly driven by the AAA spread level (as this represents around 60% of the entire capital structure). When looking at the AAA level and the corresponding call date, the wave of refinancing and resets observed in 2021 should continue; we identified €21.3bn of potential resets from 58 deals so far in H2 2021, together with €8.7bn of potential refinancing from 21 deals, even at current softer levels.

Figure 10. Potential resets and refinancing: AAA CLO level (in bps) vs. non-call date



Source: Intex, Federated Hermes as at September 2021

[5] Standard and Poor's, Leveraged Commentary and Data (LCD)

3. Will investors remain available for the high level of issuance?

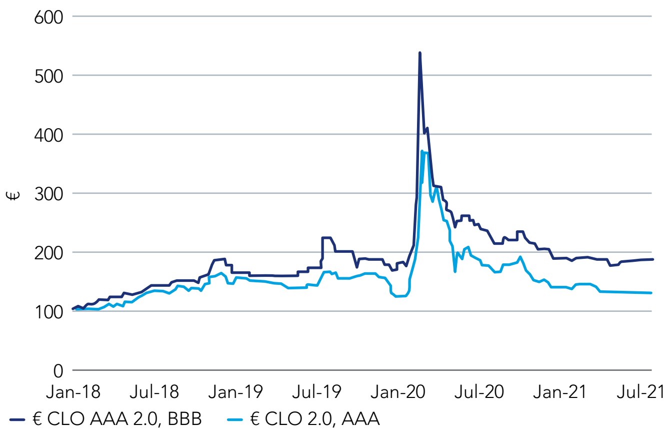
One significant change post-Covid is that we feel the structured credit asset class has regained credibility after its poor reputation following the GFC. Credit enhancements and documentation features, constructed to allow managers the flexibility to extract value while at the same time providing a framework to prevent uncontrolled poor performance, seem to have worked well. We would caution that the fiscal manoeuvres and global coordination of the central banks did prevent a lot of defaults; we would therefore continue to be wary of the solidity of structures in extreme cases (they are after all rated B and BB at the lower levels and so would be expected to incur losses in a systemic crisis). Nevertheless, anecdotal evidence suggests that this episode has led to more investors returning to the structured credit space to make use of the complexity, illiquidity, structuring premium.

4. Capital structure technicals:

We believe market liquidity is more prevalent in AAA and BBB tranches so we will focus our comments on those two parts of the capital structure.

As mentioned previously, AAAs have been widening since the beginning of the year. The transactions which closed before the summer break continued to print at wide levels (low 100s compared to high 70s in March 2021). We closely monitor this asset class for a buying opportunity as we think bigger accounts will return, driven by the appeal of the spread and floor in the context of a rise of negative yielding euro debt (this stands at close to $13tn at the end of September 2021, the highest level since February).

Figure 11. AAA and BBB CLO spread evolution since Jan 2018



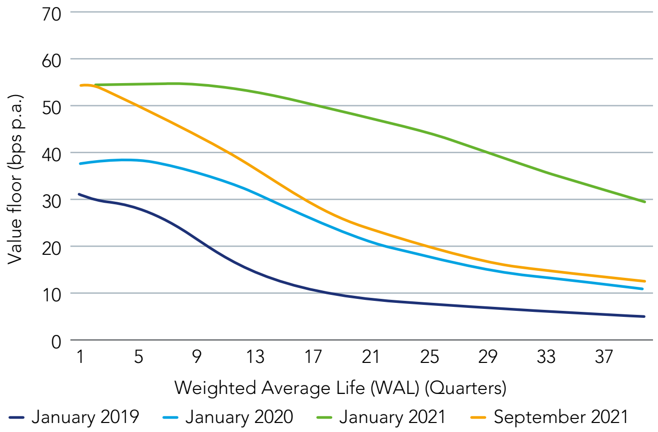
Source: Citi as at 30 September 2021

- Investors continue to support CLO BBBs driven by (i) manager tiering and the ability to grow exposure to dynamic-but-performing managers at attractive levels (spreads up to around 340-350bps) and (ii) a residual relative value compared to other credit assets as well as versus January 2018 levels, where we reached the historical lows of European CLO 2.0 spreads.

5. Will the Euribor floor keep contributing to the relative value of CLOs?

As Figure 12 illustrates, the shape of the Euribor curve has evolved over the past couple years. As can be expected, it was offering the most spread pick-up in January 2021 when it was more negative and flatter, resulting in the higher value shown in dark blue. Whilst the curve has steepened in more recent times and will give less overall value than in January, it is still more negative at the front end than it was in January 2019 or January 2020, thereby providing more contribution to CLOs' discount margin. This is a greater relative contribution – and therefore matters more – when thinking of AAAs than other lower tranches down the stack.

Figure 12. Comparison of percentage Euribor floor value term structure in Jan 2019, Jan 2020, Jan 2021 and Sept 2021



Source: Bloomberg, Federated Hermes

In conclusion, the leveraged loan and CLO markets have been extremely busy since the beginning of the year. We have observed various dynamics at different levels of the capital structure, and we think that the party is not over yet for the following reasons:

(i) Loans should continue to print given strong M&A pipeline;

(ii) There is still convexity in the underlying loans, which should incentivise managers to open warehouses, creating par build and additional value for equity returns;

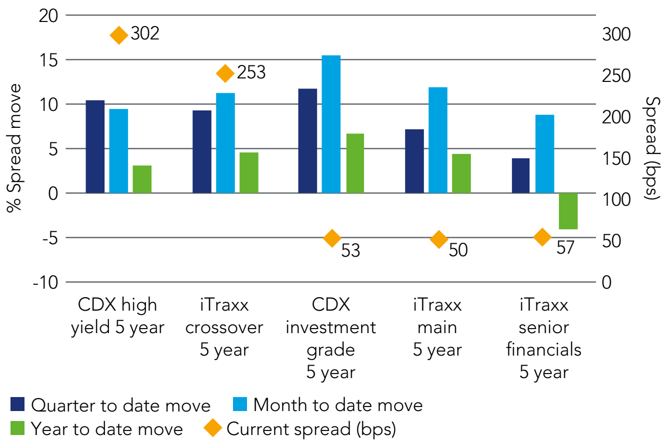
(iii) We expect a strong potential pipeline for CLO resets and refinancing. We see opportunities to generate alpha either in the near term in BBBs or in due course in AAAs. In a challenged but stable fundamental credit environment, the lower sub-investment grade tranches of the stack also present compelling carry features.

Relative value

Public credit spreads moved wider in September while private credit, remained relatively unchanged. Despite the wider spreads in public credit, our relative framework continues to favour exposures that offer an illiquidity and complexity premia which can boost yield.

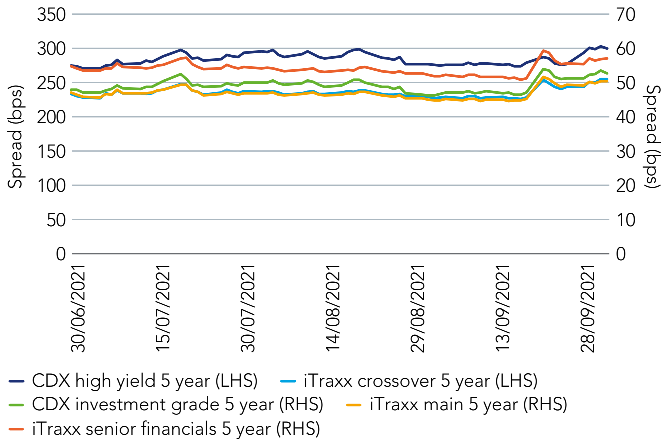
The third quarter ended with all the major spread indices moving wider, as markets digested the Evergrande crisis, questioned whether inflation would prove transitory and anticipated increased rates volatility as central banks signal tighter policy. iTraxx Xover finished the quarter at 253bps, while iTraxx Main was at 50bps. This leaves all indices wider on the year, with the exception of iTraxx Senior Financials, which was 4% tighter at 57bps.

Figure 13: Percentage spread moves for the major liquid CDS indices, Q3 2021



Source: ICE indices, Bloomberg as at 30 September 2021.

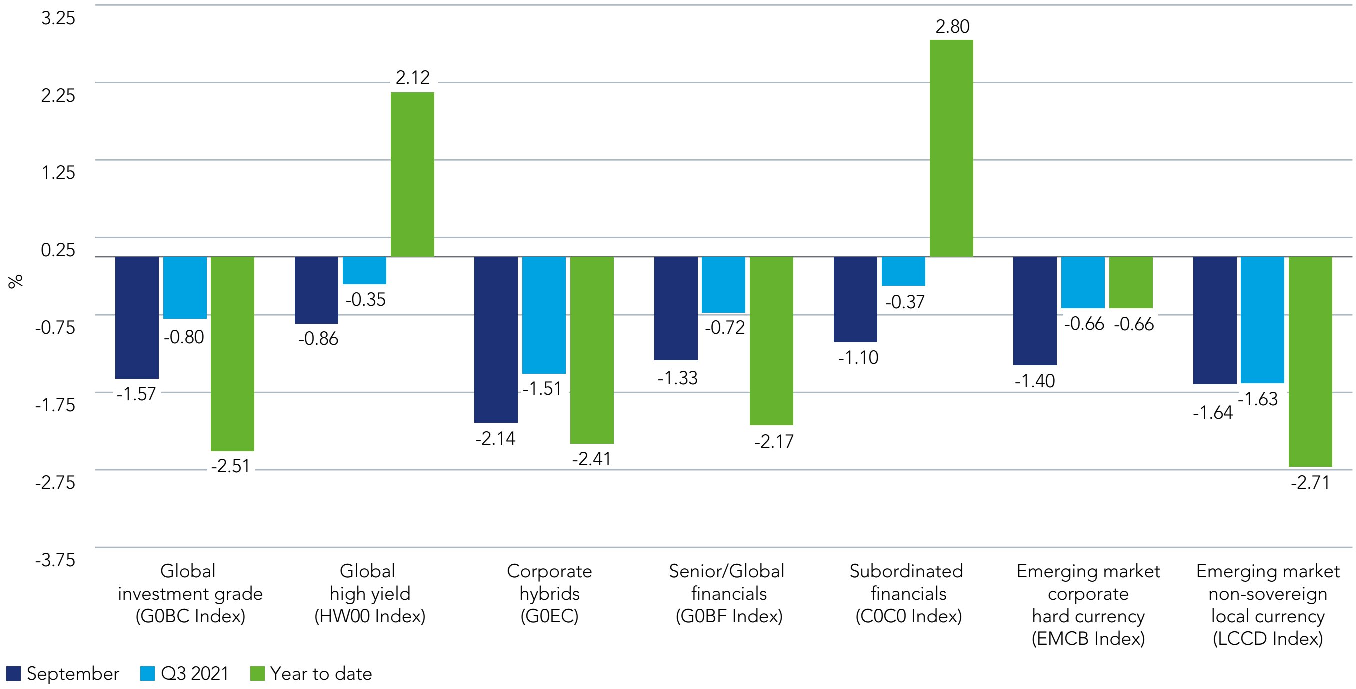
Figure 14: Spread moves for the major liquid CDS indices over Q3 2021



Source: ICE indices, Bloomberg as at 30 September 2021.

Looking at the major ICE US Treasury cash bond indices, underperformance in September resulted in negative performance for the quarter. This leaves only global high yield and subordinated financials delivering positive year-to-date returns.

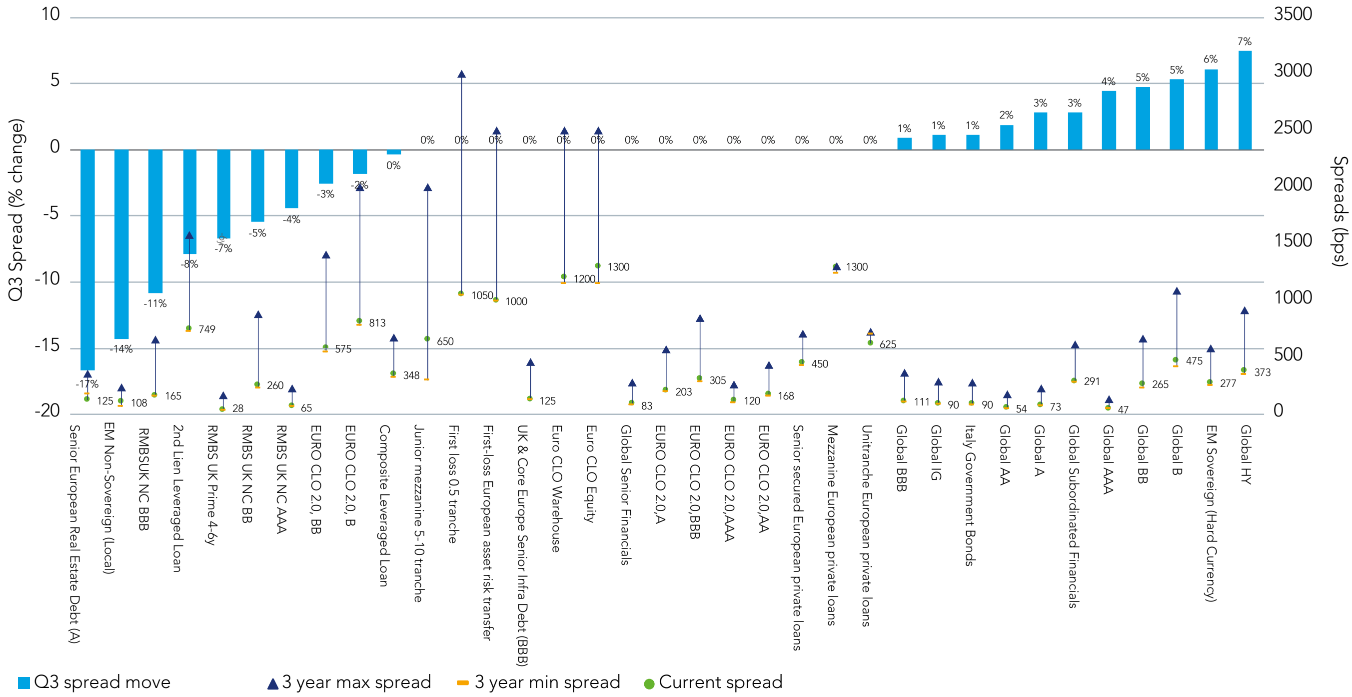
Figure 15: Total return on selected major cash credit indices, September 2021, Q3 2021 and 2021



Source: ICE indices, Bloomberg as at 30 September 2021.

Expanding our focus beyond traditional liquid credit exposures to the broader credit spectrum, the risk-off sentiment and move wider in September is not yet observed (see Figure 16). The only exception in public credit was emerging market (EM) local currency credit, which had previously lagged developed markets; it moved 14% tighter over Q3, but remains one of the few exposures still pricing wider than its three-year tight levels. In structured credit, which often lags corporate credit markets, investment grade CLO spreads remained unchanged for the quarter, while sub-investment grade tranches have moved tighter. Meanwhile, for ABS both senior and mezzanine exposures moved tighter. Finally, in private credit, there was no change in pricing over the quarter, with the exception of real estate debt financing prime assets, where spreads narrowed by 17%.

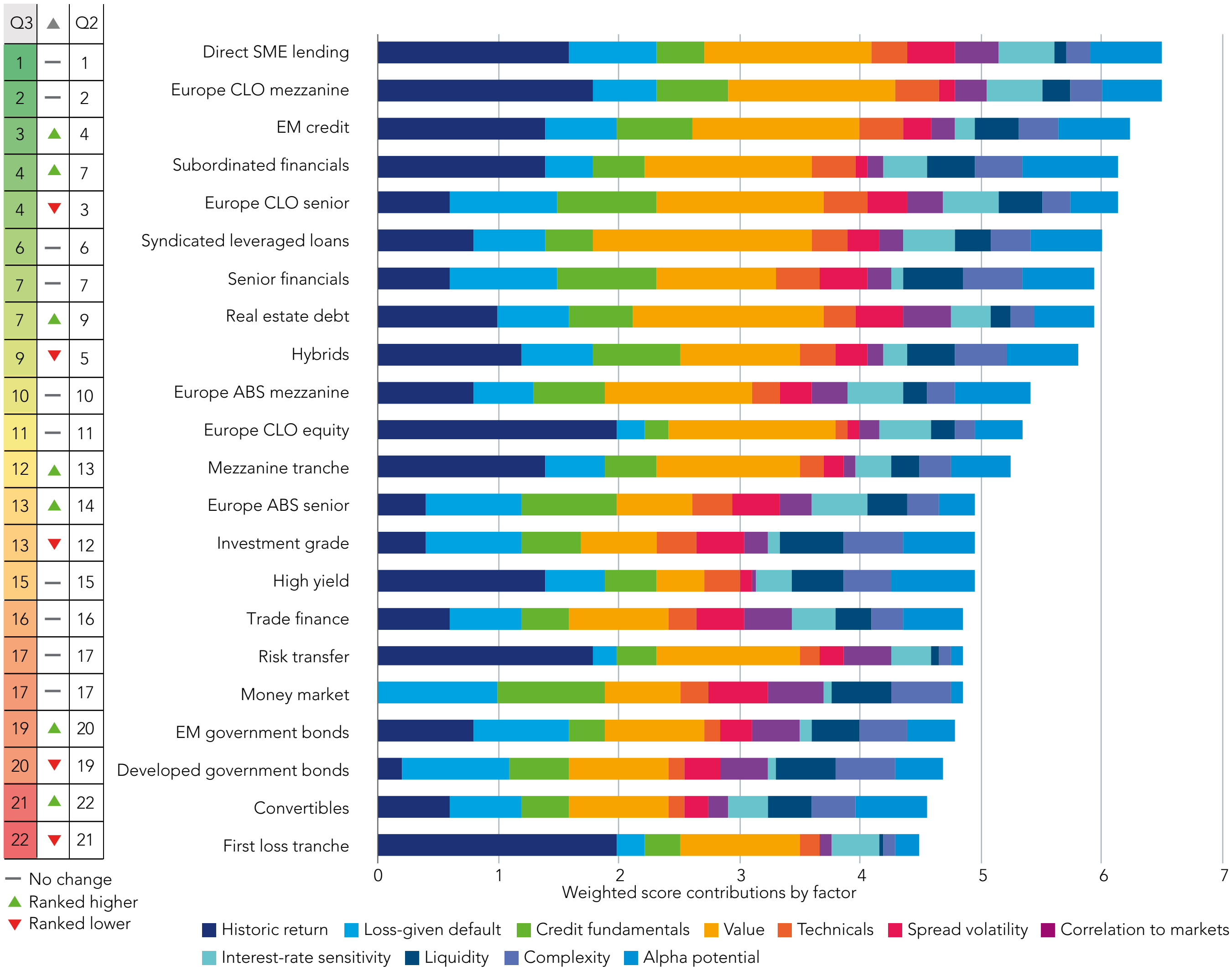
Figure 16: Current spread levels versus three-year minimum and maximum (right-hand y-axis), ranked by Q3 percentage spread moves (left-hand y-axis), for selected multi-asset credit exposures



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

Taking into account these valuation changes, along with other factors we include, we refreshed our view on relative value at the end of Q3 with an updated capitalise (MAC) Relative Value Framework (see Figure 17). The changes in the rankings have been more muted this quarter.

Figure 17. Our latest MAC Relative Value Framework



Source: Federated Hermes, as at 30 September 2021.

The main influences on the changes in rankings this quarter have been changes to the value score of public credit exposures, based on the widening in September discussed above. However, these moves wider have not been sufficient to reduce the attractive illiquidity and complexity premia on offer from private credit and structured credit exposures. For this reason, direct lending retains the top ranking, while we also see real estate debt move up from ninth to seventh.

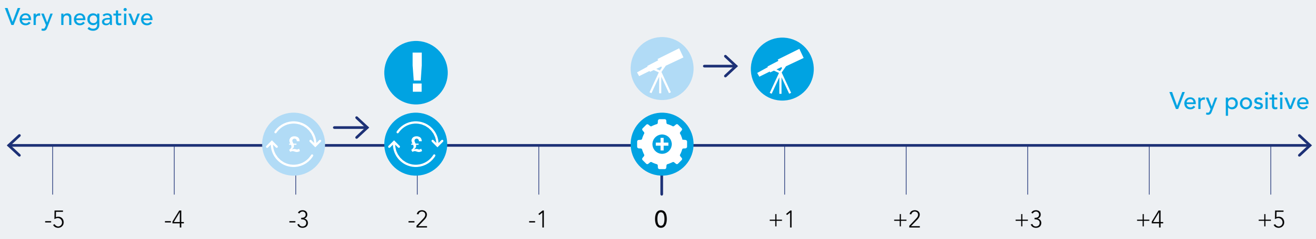
Europe CLO mezzanine exposures retain second place in the rankings. This is because they continue to offer an attractive spread premium over equivalent rated corporates, have floating rate coupons and continue to be in demand from investors. For example, relative to equivalent rated corporates, BBB Europe CLOs offer a 207bps spread premium, while BB-rated tranches offer a 341bps premium. Europe CLO AAAs moved down from third to fourth position, having been displaced by emerging markets (EM) credit moving up the rankings. However, we still see very good value in these exposures on a risk-adjusted basis and expect a strong buyer base in Q4 at these levels. Within structured credit, we see less value in senior ABS, where spreads are at very tight levels, although they moved up one place as a result of investment grade corporates moving down the rankings.

Within public credit, the moves wider resulted in a boost to the value scores for EM credit and subordinated financials; this drove their move up the ranking to third and fourth position respectively. We remain constructive on EM credit and do not currently feel there will be contagion from the Evergrande crisis. Closer to the bottom of the rankings, the value score for EM sovereigns was increased after their move wider over the quarter. Finally, a pullback in the equity markets has resulted in the value of the equity option looking more attractive for convertible bonds; this has resulted in an increase to their value score and lifted them off the bottom of the rankings. Meanwhile, both corporate hybrids and investment grade corporates move down the rankings, following decreases in their value scores.

First loss tranches now sit bottom of the rankings; as with risk transfer exposures in this late stage of the credit cycle, we do not feel these exposures accurately price in the possibility of idiosyncratic credit issues, instead being priced according to the levels of optimism at the systemic level.

Finally, we should stress that risk management is currently just as important as allocating based on relative value. Given the downgrade on the economic outlook and concerns for credit fundamentals as well as potential tail risks, we are reducing the risk exposure in our multi-asset credit portfolios while also employing tail risk hedging strategies, where we currently favour options.

Q3 2021 score card



Economic outlook

- **Move from 0 to +1**

Economic data and earnings seem to have peaked and there is a growing risk that inflation may not be transitory.

Credit fundamentals

- **Stay at 0**

Fundamentals are solid with higher earnings and lower leverage levels. But earnings growth is expected to moderate, while labour shortages, inflation and supply chain issues create the risk of misses and lower forward guidance into next year.

Valuations and technicals

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

Spreads remain at tight levels but the widening in public credit markets in September has improved value.

Tail risks

Stay at -2

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

- The power supply shock and rising energy prices reduce productivity and impact corporate earnings – this could persist because transition policies reduce investment in oil and gas while renewables cannot currently deliver the output required.
- Rising inflation proves not to be transitory and labour shortages and increasing input costs lead to stagflation.
- More hawkish or muddled signalling from central banks driven by inflation concerns causes a disorderly sell-off.
- Slowing Covid-19 recovery with the spread of vaccine-resistant virus variants.

Contents

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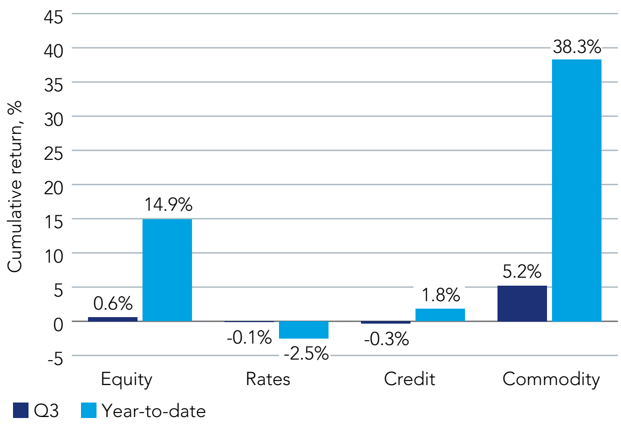
Multi asset

With expected GDP trending moderately down, and expected inflation trending moderately up, our Multi Asset Model positioning favours significant overweighting in credit and commodities, with substantial underweighting in rates.

Commodities continued to generate strong returns in Q3 2021, albeit at a slower pace than during the first two quarters, with the asset class year-to-date performance standing at 38% as the third quarter ended. September proved difficult for other asset classes, wiping out the quarter's gains for both credit and rates. In contrast, equities produced a 60bps return for the quarter, contributing to a year-to-date performance of 14.9% (see Figure 18).

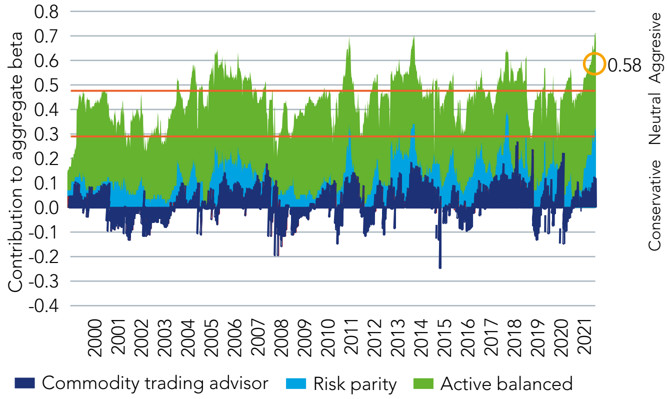
Figure 18. Asset-class performance 2021, Q3 versus year to date



Source: Bloomberg, Federated Hermes as at September 2021.

In terms of the positioning of active funds, our aggregate beta to the MSCI World Index (measured across active investors like commodity trading advisers, risk parity strategies and mutual funds) is currently at 0.58. This indicates aggressive positioning, although we have seen the figure come back down over the quarter to similar levels to the end of June, having reached highs of 0.71 (see Figure 19).

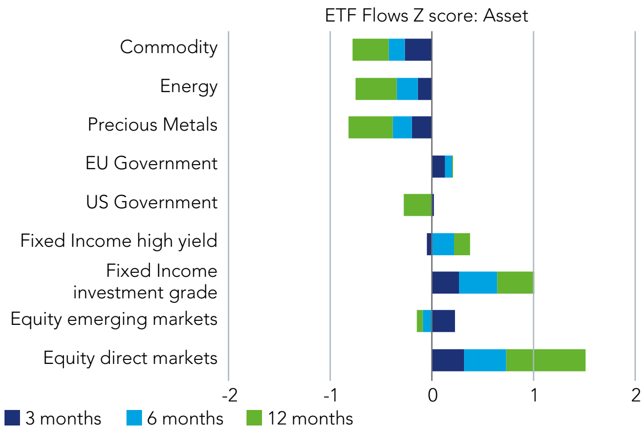
Figure 19. Active investors' aggregate beta to equity



Source: Bloomberg, Federated Hermes as at September 2021.

Our exchange-traded fund (ETF) Flow Z-score shows us the combined Z scores[6] of ETF flows for each asset for the last three-, six-, and 12-months. Investment-grade fixed income and developed market equities show overall inflow trends over those timeframes, while commodities, energy and precious metals have experienced outflow trends.

Figure 20. ETF Flow Z-score by asset class over three-, six- and nine-month periods to end of Q3 2021

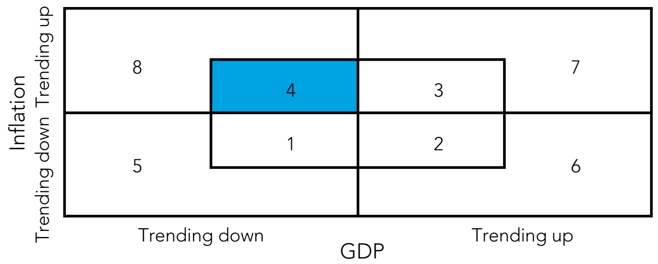


Source: Bloomberg, Federated Hermes as at September 2021.

[6] A numerical measure describing the relationship of a given value to the mean of a group of values.

For a forward-looking perspective, we use our economic scenario analysis to first determine where the global economy is expected to be. We then identify the best investments for that scenario. At the start of October, the global economy had moved to quadrant four, wherein expected GDP appears to trend moderately downwards while inflation is trending moderately upwards. This remains the relevant quadrant for the final quarter. The best assets to invest in for this scenario would be credit, commodity carry, treasury inflation-protected securities (TIPS) and government bonds (see Figure 21).

Figure 21. Our economic scenario analysis shows the global economy in quadrant four at the end of Q3 2021

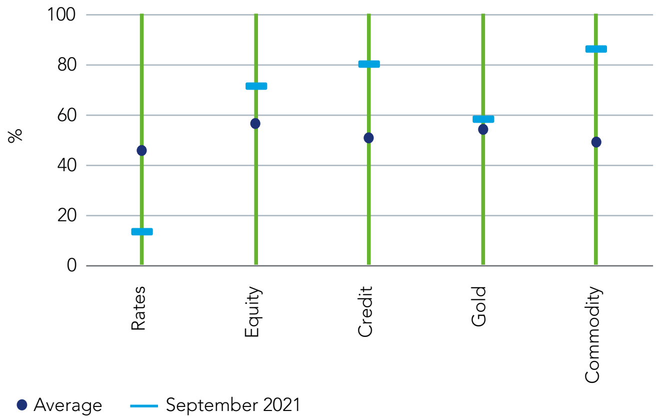


S/N	Q4 top 10	Q4 bottom 10
1	Commodity carry	EU steepener
2	US 7-10 year inflation-protected securities	US credit quality
3	Canada Government 7-10 year	EU credit quality
4	Belgium Government 7-10 year	US small cap
5	UK Government 7-10 year	S&P Financials SPDR
6	US Government 7-10 year	Coffee
7	France Government 7-10 year	National gas
8	Italy Government 7-10 year	US steepener
9	Netherlands Government 7-10 year	Aluminium
10	Germany Government 7-10 year	USD/CHF Cross rate

Source: Bloomberg, Federated Hermes as at 30 September 2021. Based on Bloomberg pooled economists' one-year forward forecasts for both GDP growth and inflation. These forecasts are then compared to their respective six-, nine- and 12-month averages to determine the current trend. These trends are then bucketed into eight quadrants. For example, 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 two-factor regression analysis.

To seek out the best investment opportunities, we use our Multi Asset Model positioning to identify which assets are most attractive. This 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 be significantly overweight in credit and commodities, and significantly underweight in rates. The allocation to equity indicated is less than last quarter (see figure 22).

Figure 22. Multi Asset Model Positioning, September 2021 versus average



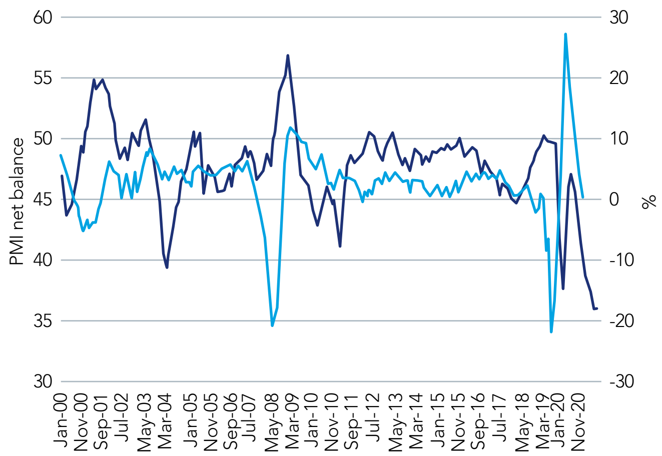
Source: Federated Hermes as at September 2021.

Economic outlook

The global economic recovery looks set to continue, albeit at a slower pace, while ongoing higher inflation still looks to be essentially transitory. However, several more concerning factors mean other scenarios are possible.

The global recovery from the Covid-related crisis continued over Q3, albeit with a slower momentum. The slowdown partially reflected a normalisation in growth rates, as the initial impact from economies reopening and the sugar rush from fiscal stimulus started to fade. However, some other, more concerning factors have been at play – notably the rise of the Delta variant, turmoil in the Chinese property sector, persistent supply constraints, and more recently the energy crisis in Europe and China.

Figure 23. Supply disruptions have hurt manufacturing

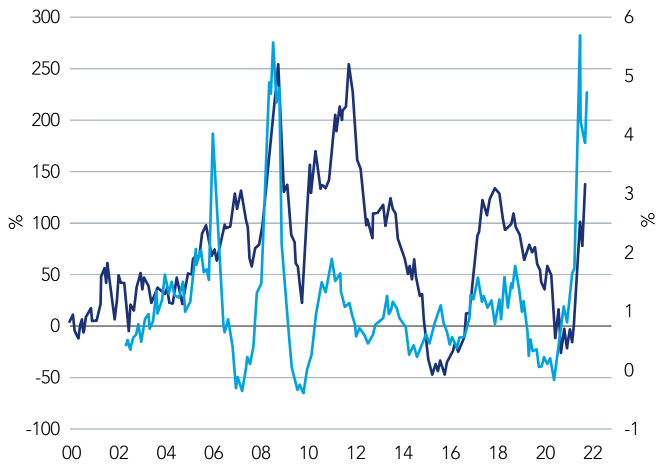


— Global manufacturing Purchasing Managers' Index (PMI), suppliers' delivery times (LHS)
— Global IP, 6-month seasonally adjusted annualised rate (SAAR) (RHS)

Source: Refinitiv Datastream as at October 2021.

Supply constraints have proved more persistent and pervasive than initially expected, which is a concern for the growth and inflation outlook (see Figures 23 and 24). The Delta variant played a role, as it unsettled reopening dynamics in the summer months and disrupted global supply chains especially in Asia. In addition, it is possible that Covid-related dynamics in the form of the demand surge after the acute phase of the crisis exposed some brewing structural supply issues in the energy sector. Renewable sources are not yet fully dependable – partly due to issues concerning the storage of energy – while poor returns and decarbonisation efforts have resulted in under-investment in capital expenditure (CapEx) for energy commodities for several years. This at least partially explains the current gas and electricity crisis in Europe and China. Meanwhile, the slowdown in China has intensified in recent months, due to the lagged impact from policy tightening earlier this year, a regulatory crackdown affecting several sectors and what looks to be the start of a structural correction in the property sector.

Figure 24. Price rises due to the gas crisis are set to drive up inflation in the UK and elsewhere, including mainland Europe and China



— UK, headline consumer price inflation (CPI), year-on-year, (RHS)
— UK electricity prices (Amsterdam Power Exchange, 30-day moving average (MAV)), year-on-year (LHS)

Source: Refinitiv Datastream, as at October 2021.

Going forward, the generally accommodative policy setting should continue to support the recovery, while the pandemic heads towards endemic equilibrium. Demand should stabilise, and supply constraints should ease. The recovery should therefore continue next year at a slower and less volatile pace than in 2021, and inflation should start a gradual descent after the winter. However, alternative and less benign scenarios are possible. Protracted supply constraints and elevated cost-push inflation during winter months have the potential to derail the recovery, paving the way for stagflation scenarios. It is also possible that inflationary dynamics spread to expectations and the labour market, thus becoming ingrained, which would call for tighter monetary policies.

In general, risks to the baseline scenario are skewed to the downside, due to residual uncertainty about the evolution of the virus, persistent divergences across countries and regions, and political and policy risks. While the eurozone is now outperforming among developed markets, reflecting catch-up dynamics, EM have continued to lag behind. An uneven recovery is inherently fragile, as lower vaccination rates in emerging countries could result in the rise of new mutations of the virus. That in turn would lead to the continuation of a stop-start expansion and more protracted supply disruptions. In addition, policy uncertainty – notably concerning fiscal policy in the US and structural and regulatory policies in China – has been on the rise. Political deadlines across several key countries over the next year will compound the issue; these include general elections in Japan and France, mid-term elections in the US, and China's 20th National Party Congress.

Central banks are in an awkward position, as they face slowing growth, high inflation, and an unclear picture for the labour market. Our base case scenario is still that monetary policy will largely remain accommodative to support the recovery, while the transitory narrative for inflation is still valid and there is still slack in the labour market. However, central banks across the board are about to embark on a gradual reduction of emergency measures that were introduced in response to the Covid-19 crisis; most notably, the US Federal Reserve (Fed) looks set to start tapering its asset purchases by the end of this year. In addition, there has been a growing divergence between developed and emerging economies, with some central banks in Latin America already resorting to aggressive interest rate hikes to rein in inflation and safeguard their credibility.

Finally, while the market is focused on the impact from Fed tapering, there is a sharp fiscal cliff baked in for 2022-2023 as emergency measures expire. According to estimates by the Brookings Institution, the US fiscal stance turned contractionary in the second quarter of this year and is expected to remain a drag on growth for the next two years, based on current policies. There are nonetheless important mitigating factors. Households in developed countries have built up a significant excess savings buffer (as large as 11% of 2019 nominal GDP in the US), which should support consumption in the short to medium term. In addition, emergency measures should be replaced by more structural spending plans such as the Build Back Better Act in the US and the NextGenerationEU strategy, at least to some extent.

Fundamentals

Supply chain disruption is acting as a drag on earnings recovery for corporates. This, coupled with ongoing higher inflation, could mean negative guidance revisions and earnings misses in the Q3 2021 earnings season. With the prospect of increasing amounts of issuance attributable to leveraged buyouts and acquisitions with loose covenant terms, we think credit investors should be cautious.

Q3 2021: Earnings recovery expected to continue, but at a moderating pace

Earnings grew more than 100% year-on-year in the second quarter[7] as post-Covid rebasing continued. Earnings are expected to continue growing, albeit at a more moderate pace of 30% year-on-year. Energy, materials and industrials are expected to lead consensus earnings growth, while defensive sectors such as utilities and consumer staples are expected to grow earnings the least. Over the last year investors have become somewhat accustomed to positive earnings surprises and upward guidance revisions, however, we believe the third quarter requires more caution. Over the last few months, the operating environment has become more challenging, mainly due to supply shortages and inflation. We therefore expect to see more negative guidance revisions, as well as potential earnings misses, than were seen in the last few earnings seasons.

Inflation and supply chain issues starting to impact corporates more visibly

While the energy and mining sectors continue to benefit from the multi-year highs for commodities such as crude oil and natural gas, cost and wage inflation, as well as supply chain issues, are starting to negatively impact corporates. Even before the reporting season had begun, companies in various sectors had started flagging these issues, signalling what to expect for the broader corporate universe as reporting season kicks in:

- Four of the biggest US manufacturers of cars and trucks experienced a decline in sales amid a global semiconductor shortage which has impacted production in the sector. General Motors' sales declined 33% year-on-year, with the company selling 447,000 vehicles, compared to 665,000 a year ago. Honda reported an 11% decline in sales for the quarter (largely due to a 25% year-on-year decrease in September) while Stellantis and Nissan suffered a 19% and 10% drop in sales respectively. However, extremely strong pricing has offset reduced sales somewhat, with the average selling price of a new vehicle in September close to $43K, a 38% ($12,000) increase from a year ago.
- Unable to cope with rising gas prices, fertiliser companies in jurisdictions such as the UK have announced intentions to reduce production by as much as 20%, or even shut down their plants in some cases. Natural gas is used as a feedstock, as well as for heating and producing electricity in the manufacturing process.
- Warehousing giant Costco recently joined a number of retailers commenting on increasing shipping prices and supply chain issues. According to Bank of America, the cost of getting a 40-foot container from Shanghai to New York has increased eightfold in the past 18 months, from about $2,000 to around $16,000. Costco described freight costs as 'permanent inflationary items', while also noting higher labour costs, rising demand for transportation, computer chip shortages, and higher prices for oils, chemicals and other commodities – all of which are being passed on to customers.

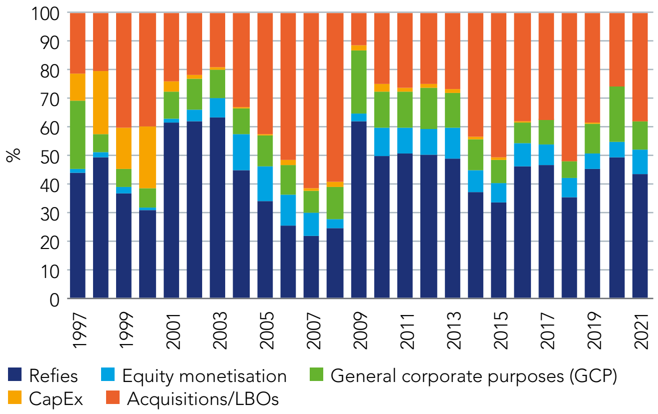
In our recent issuer interactions, such as deal roadshows, we are hearing similar commentary from issuers: that they are able to pass through costs via price increases, thus managing to offset the impact of these issues on credit profiles. Nonetheless, over the upcoming weeks we will be watching additional commentary from companies in cement and downstream/specialty chemicals sectors in particular regarding their ability to pass through costs and navigate an increasingly complex environment.

Acquisitions and leveraged buyouts grow as a percentage of total issuance

Issuance related to funding acquisitions and leveraged buyouts (LBOs) has picked up substantially this year. Year-to-date issuance stands at $330bn – slightly more than in 2007, a record year for leveraged buyouts. Given historically low rates, the significant amount of capital accumulated by sponsors and wide-open capital markets, this is not entirely surprising. As an example, the acquisition of healthcare name Medline Industries by private equity sponsors for $34bn saw issuance of $7bn of term loans, as well as close to $8bn of bonds. That represented one of the biggest leveraged buyouts in more than a decade but was easily absorbed by the markets. Our team have been busy analysing the increase in deals, with concerns over covenants something of a consistent theme.

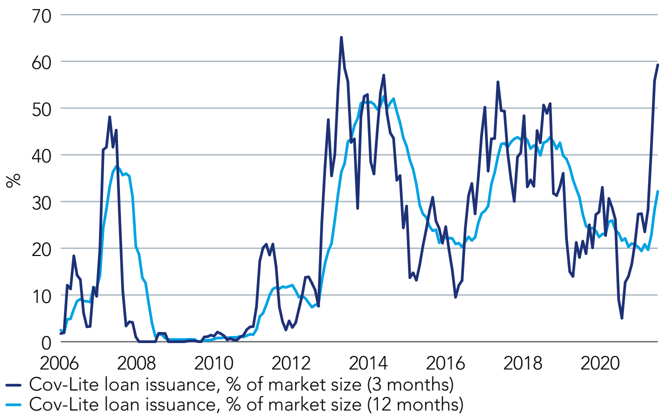
[7] On an earnings per share basis, for Russell 1000 companies.

Figure 25. Acquisitions and leveraged buyouts are growing as a percentage of issuance



Source: BofA Merrill Lynch Global Research as at September 2021.

Figure 26. Cov-lite issuance is on the rise



Source: BofA Merrill Lynch Global Research as at September 2021.

Sustainable finance

For the Sustainable Finance section of this issue of 360 we present the key insights from a paper by experts across our Fixed Income, Equity and Engagement teams explaining why financial inclusion is an economic opportunity for all. The full paper can be found in the Q3 2021 edition of our Spectrum newsletter, which brings together sustainability focused insights from across our investment floor.

The pandemic has exacerbated problems for those outside of the mainstream financial system

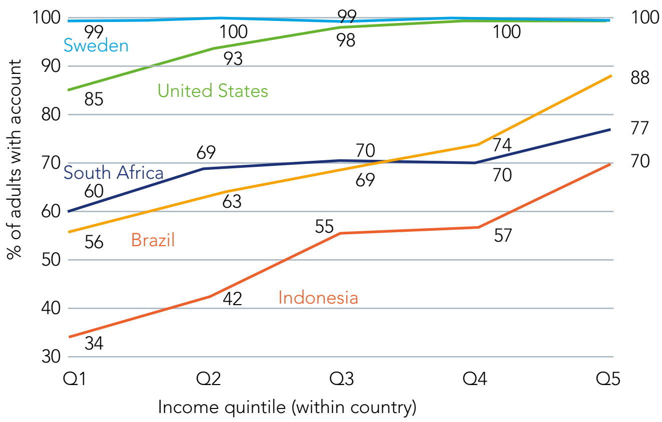
Despite considerable progress on reducing absolute global poverty over the last 20 years, worldwide, billions of people remain unbanked, uninsured and without assets or savings. In the midst of the global pandemic, those without access to formal financial services have suffered disproportionately. In the developed world, the working poor – whose numbers have increased as overall poverty has gone down[8] – have been most vulnerable to job losses during the pandemic[9], at the same time as being the least well protected from the consequences.[10] According to the World Bank, global extreme poverty worsened in 2020 for the first time in a generation, with about 120 million additional people joining the ranks of the poor worldwide.[11]

Almost a third of adults globally (about 1.7 billion people) remain unbanked.[12] Many more are unable to access basic financial services like loans. Being excluded from the formal financial economy, or at least from access to credit facilities which could be deemed 'reasonable and fair', often creates a vicious circle, trapping people in a cycle of debt.

Bringing people into the financial system creates economic opportunities for all

Financial inclusion represents a significant economic opportunity. International Monetary Fund (IMF) studies show a strong association between extending traditional financial services to low-income households and small businesses operating in the informal economy and reducing income inequality (see Figure 27). As well as bringing up to 1.7 billion people into the financial system, it has the potential to generate 95 million jobs and boost global GDP by a massive $3.7tn by 2025.[13]

Figure 27. Financial inclusion by income quintile varies considerably by country



Source: International Monetary Fund (IMF) as at January 2020.

What can society do to solve the problem?

Digitalisation & financial inclusion: Fintechs are playing a major role in improving access to financial services. Mobile distribution is particularly relevant for reaching the underserved, since two thirds of unbanked adults globally own a mobile phone.

Governments can take the lead: Potential actions include supporting financial education; legislating to ensure more transparent information is available to consumers; subsidising rural broadband to enable internet access; and lowering the regulatory requirements for bank accounts.

Collaboration between all: It is vital that governments, corporates and banks all play a constructive part in addressing the challenges to increasing financial inclusion. Pandemic responses show that this is possible.

[8] See for example: https://www.jrf.org.uk/data/workers-poverty; https://ifs.org.uk/uploads/WP201912.pdf; https://www.bls.gov/opub/reports/working-poor/2018/home.htm

[9] See for example: https://www.ilo.org/wcmsp5/groups/public/@dgreports/@dcomm/documents/briefingnote/wcms_767028.pdf; https://www.pewresearch.org/social-trends/2020/09/24/economic-fallout-from-covid-19-continues-to-hit-lower-income-americans-the-hardest/

[10] See for example: https://www.ons.gov.uk/peoplepopulationandcommunity/personalandhouseholdfinances/incomeandwealth/articles/financialresilienceofhouseholdstheextenttowhichfinancialassetscancoveranincomeshock/2020-04-02.

[11] https://www.ons.gov.uk/peoplepopulationandcommunity/personalandhouseholdfinances/incomeandwealth/articles/financialresilienceofhouseholdstheextenttowhichfinancialassetscancoveranincomeshock/2020-04-02.

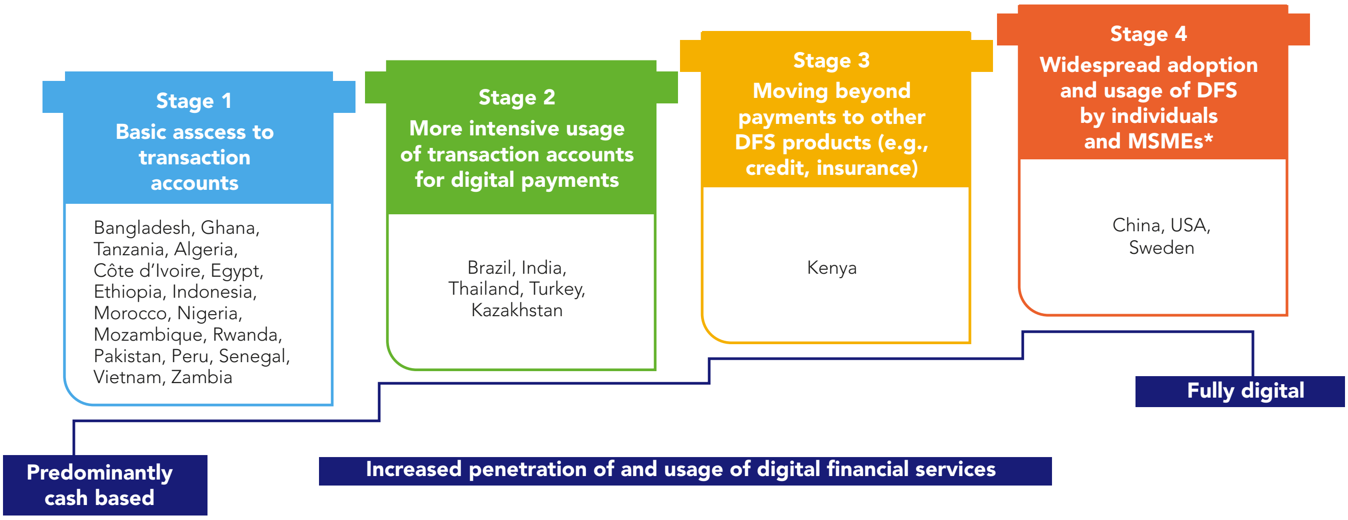
[12] World Bank Group, Findex report, 'The Unbanked' (2017)

[13] International Monetary Fund (IMF) – Finance and Inequality (imf.org) – January 2020.

Lower barriers to financial inclusion: Incomes are often seen as too volatile or too low to allow access to credit; geographic distances make traditional banking difficult; and higher operating costs of traditional banks put many services out of reach. These barriers need to be lowered.

The private sector can facilitate change (and reap the benefits): Innovation can improve access to a firm's products and services. Peer-to-peer payments, crowdfunding, virtual currencies, AI-assisted credit modelling, robo-advisers, auto-underwriting and blockchain bonds are just some examples of financial innovation which are both increasing inclusion and driving growth.

Figure 28. The four development stages of digital financial services



Source: World Bank Group as at April 2020.

Why invest in financial inclusion?

Firstly, investing in financial inclusion offers diversification. The types of businesses which can form part of a financial inclusion-focused portfolio include banks, insurers, homebuilders providing affordable housing, credit bureaus and of course fintech, which is providing innovative solutions to some extremely entrenched issues.

Secondly, financial inclusion represents an opportunity to unlock unsaturated economies and access cheap, accelerating growth while building long-lasting relationships with consumers and communities.

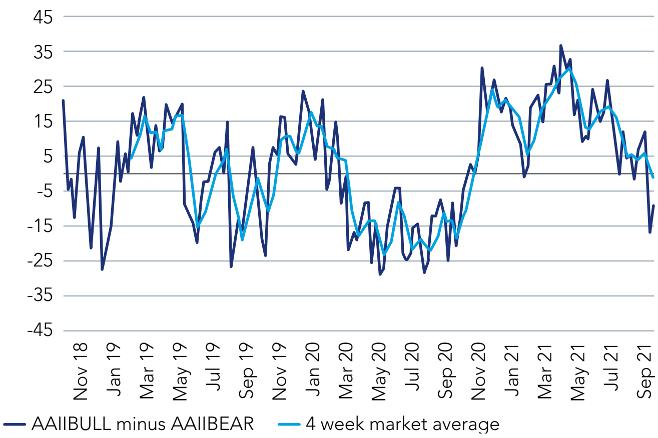
Thirdly, within a wider portfolio, financial inclusion offers a great complement to broader sustainability themes. Many healthcare and environmental names sit on lofty multiples which acknowledge the significant total accessible market ahead of them. In contrast, banks and insurers exposed to emerging market growth often trade on low teen multiples, making them less susceptible to valuation risk in an inflationary or rising rate environment.

Valuations and technicals

September saw a shift in investor sentiment driven by concerns around negative corporate earnings, which began to be reflected in credit index positioning. ESG issuance continued to rise in Europe and emerging markets but lagged in the US.

After months of strong recovery, concerns around how rising energy prices and supply chain issues might play out in corporate earnings brought the third quarter of 2021 to a more cautious end. We note a shift to a more risk-off mood, with our main indicators pointing towards greater fear among market participants.

Figure 29: The American Association of Individual Investors (AAII) Investor Sentiment Survey (investor view over next six months) turned bearish in September



Source: The American Association of Individual Investors (AAII) as at 30 September 2021.

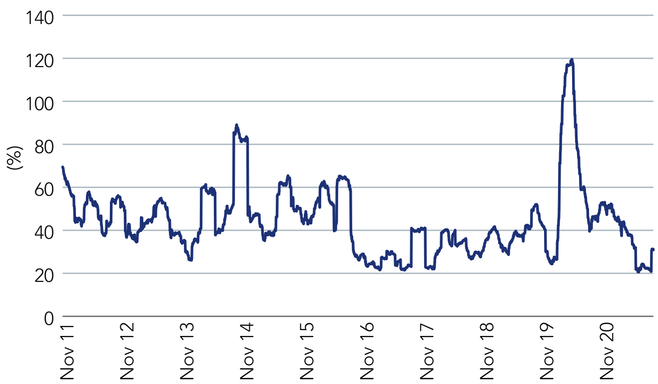
This has also started to appear in credit index positioning, where we have begun to see investors reducing the risk they are taking. In Europe, investors have increased long positioning in the investment grade iTraxx Main index but decreased exposure in the high yield iTraxx Xover, suggesting they are concerned about risk but are keen to maintain long exposure.

On the issuance side, we note European investment grade bonds are in a sweet spot from a technical perspective at present, with net negative supply and steady inflows. Overall gross supply is down 26% versus 2020, with the European Central Bank continuing to absorb net supply. In high yield, recent issuance has been much stronger, continuing the trend for the year. With high volumes expected to continue in the fourth quarter, we may start to see premiums increase in the market.

Through 2021 ESG issuance has also continued to rise, especially in Europe. In European credit, the proportion of ESG-labelled issuance year-to-date has been around 20% for both investment grade and high yield. The US has lagged behind on this measure, with labelled issuance at about 3% of total new issuance. However, similar growth has been visible in EM, where ESG-labelled issuance over H1 2021 already surpassed the total volume for the 2020 financial year.[14]

Despite lifting slightly into quarter end, credit market volatility has fallen year-to-date and continues to be low relative to history. As a result, bid-offer spreads from dealers remain very tight, keeping the cost of trading credit relatively low.

Figure 30. iTraxx Crossover 30-day volatility remains low relative to historical levels



Source: Bloomberg as at 30 September 2021.

[14] Data in this paragraph is sourced from Bank of America Merrill Lynch (BAML).

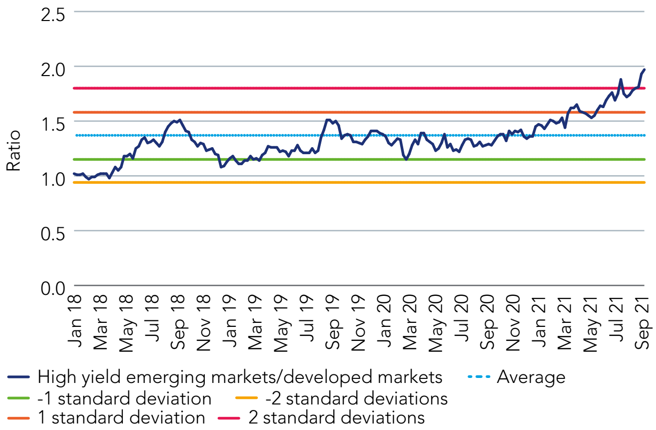
Public credit

Q3 2021 was weak for public credit, particularly investment grade. Issues in Chinese high yield are likely to continue in Q4 but should not affect the rest of EM high yield. The noticeable outperformance of long-end bonds, coupled with their higher sensitivity to a raise in interest rates, means we favour bonds in the mid portion of the curve.

The third quarter of 2021 was a weaker one for credit markets, with global high yield declining 0.35% and the more rate sensitive global investment grade falling 0.80%. From a relative value standpoint, many of the same trends we saw last quarter continue to be true, with BB-rated credit continuing to be attractive relative to BBB- and B- and CCC-rated credit.

Regionally, there is little difference between European and US high yield from a valuation perspective, although we maintain a preference for European high yield given the more attractive convexity profile. Material issues in the Chinese real estate sector, with several high-profile developers experiencing stress, drove emerging market high yield wider over the month, creating a further divergence between emerging and developed markets. With markets remaining closed to all but to the most high-quality issuers in Chinese real estate, we think the issues in Chinese high yield will likely continue into the fourth quarter of 2021 as more developers experience liquidity stress. However, we do not expect spill over into the rest of EM high yield.

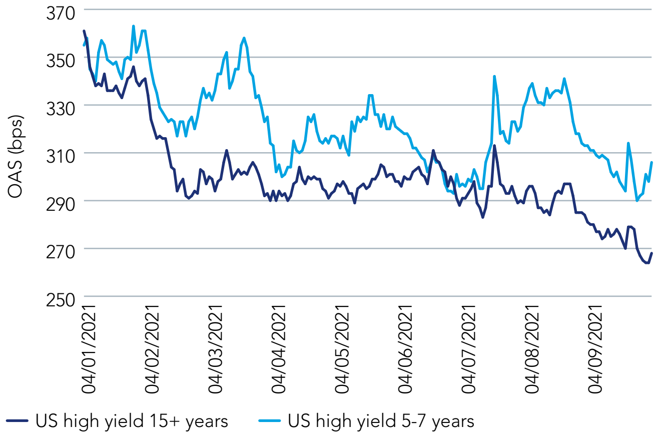
Figure 31. Option-adjusted spread (OAS) ratio of EM vs. DM high yield over time



Source: ICE indices as at 30 September 2021.

From a curve perspective, long end bonds have noticeably outperformed the rest of the credit curve year-to-date (especially the five-to-seven-year portion shown below). That has lead to a divergence in value between long- and medium-term bonds, an effect seen in both the US and Europe but which has impacted the former more profoundly. This valuation distortion, coupled with the fact long-end bonds are more sensitive to a raise in interest rates, means we favour bonds in the mid portion of the curve.

Figure 32. Spread performance comparison of medium- and long-term US high yield bonds



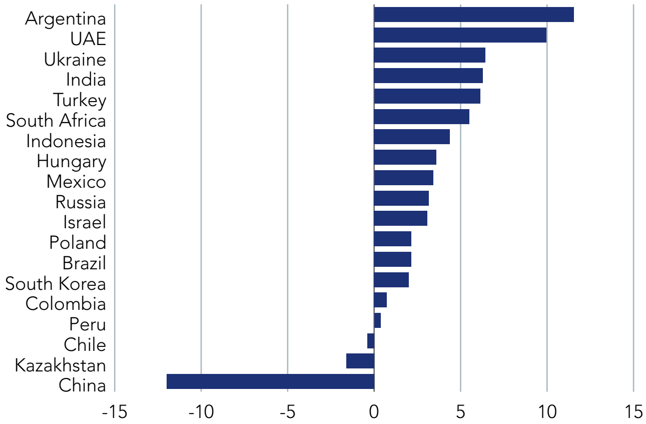
Source: ICE indices as at 30 September 2021.

Breaking down EM high yield corporate returns

Overall, EM corporate high yield has returned 0.86% year-to-date, which is still below the 4.91% generated by US high yield. As with US high yield, however, the CCC component has outperformed the other high yield segments with a total return of 7.78% year-to-date. Given relatively tight spreads, total returns for EM corporate high yield in 2021 should be in the low-single digit range.

Chinese high yield continues to be the weakest performer (although it did stage a mini rally in August), with a total return of -16% year-to-date. Total new issuance for the year from EM corporates as a whole has been more skewed to investment grade, which has accounted for around 62% of overall issuance. The EM default rate for the last 12 months is at 3.3%; if we exclude distressed exchanges this drops to 2.4%. However, this will go up should certain of the highly levered Chinese property developers formally default, as currently seems expected by the market in the near-to-medium term.

Figure 33. EM corporate high yield percentage returns by country, 2021 year-to-date



Source: ICE indices as at 30 September 2021.

Leveraged loans

Healthy levels of market activity in the third quarter, driven by both fundamentals and technicals, look set to continue to the end of the year.

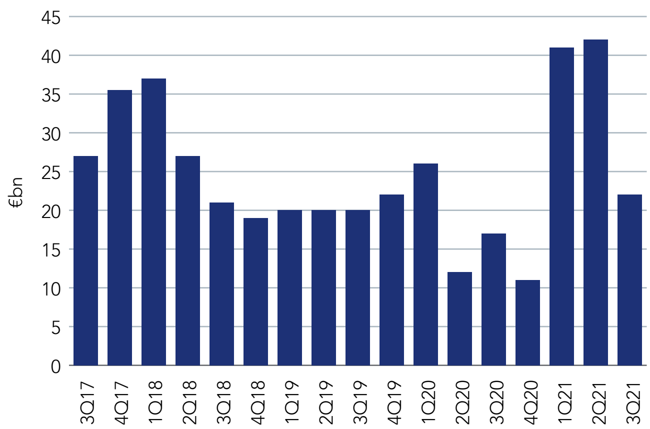
The S&P European Leveraged Loan Index (S&P ELLI) continued to increase through the third quarter of 2021. It reached 98.9 by the end of September – a first since November 2018 – returning +4.25% since the beginning of the year. That performance was driven by both fundamentals and technicals.

On the fundamental front, the index default rate continued to decrease, falling below its pre-Covid levels by principal amount for the first time (0.85% compared to 0.97% in February 2020). Similarly, the level of 'CCC+ and below' loans in the index reduced to 6.97% at the end of September 2021 from a peak of 9.22% observed in November 2020. Consequently, the S&P ELLI distress ratio (the percentage of facilities trading below 80) is now 0.36%; this compares to 1.30% at the beginning of the year, and 4.79% at the end of Q3 2020.

On the technical front, the leveraged loan market is always driven by the balance between loan net supply (new issues minus repayments) and CLO issuance. The two markets have been extremely busy, with the balance alternately positive and negative over the quarter. It ended on a shortage, with CLO issuance €3.17bn higher than loan net supply on a rolling three-month basis. The need for CLOs to ramp up their loan collateral supported secondary and S&P ELLI leveraged loan spread levels.

Q3 was also driven by a strong pipeline in new issues. Although European leveraged loan volume was down from Q1 and Q2 (mainly due to the traditionally quieter market in August) there were still €22.1bn of new issues; that compares to €40.8bn in Q1 and €41.3bn in Q2.

Figure 34. European new issue leveraged loan volume in Q3 remained strong, although down on H1

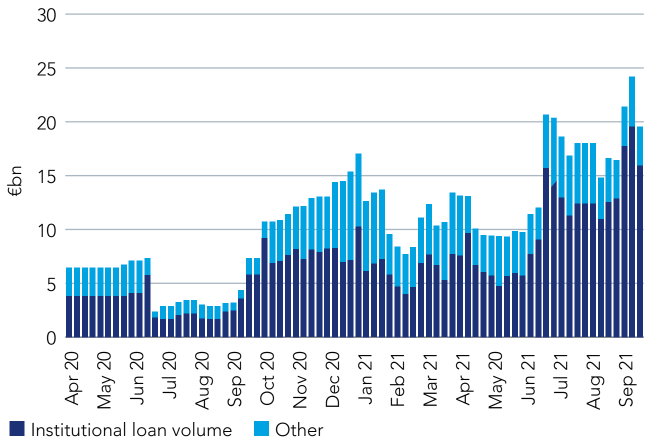


Source: Standard and Poor's – Leveraged Commentary and Data (LCD)
Data as at 30 September 2021.

Unsurprisingly, M&A and dividend recap have been the main drivers of 2021 issuance, at 60% and 17% of the volume respectively. This reflects the level of cash held by private equity sponsors as well as the current appetite for leveraged loans. The flourishing activity led to an increase in yield, which went up from 4.04% in Q2 2021 to 4.20% in Q3. This was driven by three key factors: firstly, the abundance of deals allowed loan managers to be selective; secondly, the need for extra spread for M&A (especially public to private deals) and dividend recap activities; and thirdly, the need for CLO arbitrage to work in an environment where the spread on AAA CLOs widened (at least until mid-September).

The forward European leveraged loan volume was a healthy €19.5bn at the end of Q3. Given that private equity sponsors still have plenty of dry powder, it appears 2021 activity is not over yet.

Figure 35. Forward European loan volume is looking very healthy



Source: Standard and Poor's – Leveraged Commentary and Data (LCD)
Data as at 30 September 2021.

Private credit

The small- to medium-sized enterprise (SME) lending market across Europe has recovered well after the Covid-19 pandemic, with strong deal flow being soaked up by lenders keen to deploy. Yields have stabilised and defaults are at low levels, however, in the background plenty of risk factors are at play.

The SME lending market has bounced back since the height of the pandemic and is now buoyant. Across Europe deal flow is particularly strong, with the M&A pipeline fuelling much of the activity and refinancings making up the rest. This is a reflection of transactions which were on hold now proceeding as the markets have reopened, coupled with companies seeking to refinance their loans in the current positive environment. The German market continues to be the most buoyant in Europe, although both the French and UK markets are quickly catching up in number of transactions. Deal flow is also strong in southern Europe.

Yields have stabilised as the deal flow has been met with lenders keen to deploy. Competition is centred on loan terms rather than pricing, as unitranche lenders have very little margin to cut pricing due to their return targets. Nordic loans still provide the most generous yields in northern Europe and represent the best risk return value in our opinion. A rise in defaults in the short-to-medium term could mean that yields rise, although defaults have remained low to date. Increased pressures on supply chains has called into question the 'just in time' approach favoured by many European companies and remain a risk factor going forward. The increasing price of oil and gas is also a cause for concern, while a reduction in government support now that European economies are reopening could have an impact on credit quality – this will be something to look out for over the next year.

The focus on ESG continues to grow among direct lenders. Some have adopted a reward-based approach by reducing loan interest charges for borrowers with good ESG behaviours. Others prefer to use the stick by documenting required behaviours to ensure ESG risks are managed. It is Federated Hermes' view that the 5-15bps reductions in loan yields some direct lenders are offering does not guarantee improved ESG behaviours. We therefore prefer to clearly set out required changes in behaviours in the loan documentation, to make sure these happen and our investors are protected from ESG risks.

Finally, it is worth noting that despite aggressive structures being offered to borrowers, significant risk remains in the market.

Asset-based lending

Sustainability is starting to have an impact on the real estate market in more ways than one. Recent research offers strong evidence that 'greener' real estate assets can command higher rents, while the green credentials of underlying assets are also being taken into account by lenders.

At Federated Hermes we have long believed that 'greener' assets should perform better than 'brown' assets. In private markets it can be difficult to back up such assertions with data, however, recently published research[15] has provided evidence that green certification does indeed improve rents. The report showed that a Building Research Establishment Environmental Assessment Method (BREEAM) Outstanding rating can account for 12.3% higher rent in office buildings, controlling for other variables.

The data shows that sustainability is a key determinant of demand from commercial tenants. The savings in utility costs alone typically offer a payback against the higher rent cost within five years; with many commercial leases still routinely covering more than a five-year period, picking the more sustainable office becomes a financially attractive proposition.

In the lending market, the sustainability credentials of underlying assets are also starting to make an impact on lenders' willingness to provide aggressive terms. Having said that, we continue to see attractive opportunities to finance such properties at rates that deliver excellent relative value.

We have seen a particular pick-up in activity in the market for development loans for offices, although it remains a small part (13%) of the overall real estate finance market. On speculative development, margins have increased by more than 150bps, which compares favourably to the more modest 11bps increases for fully pre-let commercial developments.

Other sectors that continue to see strong activity are the retail warehouse sector and of course the industrial sector, where we seek to gain exposure against the right assets. As yields remain near historic tights on real estate equity, lending against core assets provides a more appealing risk-adjusted return.

[15] Knight Frank, 'The Sustainability Series: How BREEAM certifications impact prime Central London office rents' (September 2021).

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Federated Hermes
International

Federated Hermes

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

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

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

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

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- **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
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