360°

Dissonance, dampening and diversification

Fixed Income Quarterly Report

Q2 2022

Federated Hermes Limited

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Commentary

The mark of a great manager is knowing when and how to exploit the dissonance between the news flow and market performance – as recent events have reminded us.

Studying finance in college, I was mesmerised by economic theories about asset values and pricing models that explained everything in the financial universe. My initiation into the real world of markets was therefore somewhat shocking, since the moves I witnessed as a young investor often contradicted the news flow accompanying them. It turned out that technical factors were as important as academic concepts, if not more so, and that economic theories – if discussed at all – were predominantly used only to rationalise market moves retrospectively.

Understanding that long-term values are driven by fundamental theories but that short-term market moves are often technical is all the more valuable in volatile times such as these. Not only should this be factored into any investor's analysis framework, but the tools available to the portfolio manager should allow for these anomalies to be effectively exploited.

Most markets have experienced large moves in 2022 so far; those that benefit from inflation have experienced positive performance but for most it has been a difficult start to the year. Despite this, there have been periods where markets bounced, sometimes even on 'bad news'. Rate hikes were bad, but not bad enough, for example, or the Russian invasion was atrocious and a human disaster, but its global repercussions were initially more muted than feared.

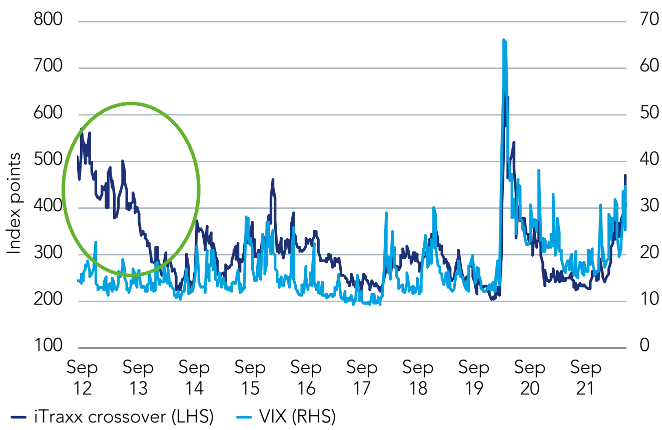
This back and forth between bad news and quick, violent market moves makes me think about how the great fund managers act. The best are attuned to the rhythms of the market, creating a mosaic formed in part by flows, colour from the street and the actions of other investors – the technicals that can so bizarrely discount the most positive or negative news. They understand these blips can be a source of alpha.

We wanted to explore whether there are periods of cheap credit versus expensive hedging and vice-versa, and whether such dislocations create meaningful signals. To do this, we started with the assumption that the Chicago Board Options Exchange Volatility Index (VIX)[1] is a reliable indicator of the cost of credit-implied volatility.

Looking at an extended history of the VIX versus the iTraxx Crossover Index[2] (see Figure 1a below), we can see that there is some form of correlation, although the early years after the global financial crisis show a disparity. We believe this may be related to the brutal nature of the crisis, and the fact that credit was at its epicentre; it is therefore likely that, while equity markets hinted at a new normal, credit market participants were still dealing with reduced capital allocations and a more conservative stance. The low VIX levels continued until 2014, by which time credit caught up.

Figure 1: Disparity between the VIX and the iTraxx Crossover is visible post-GFC

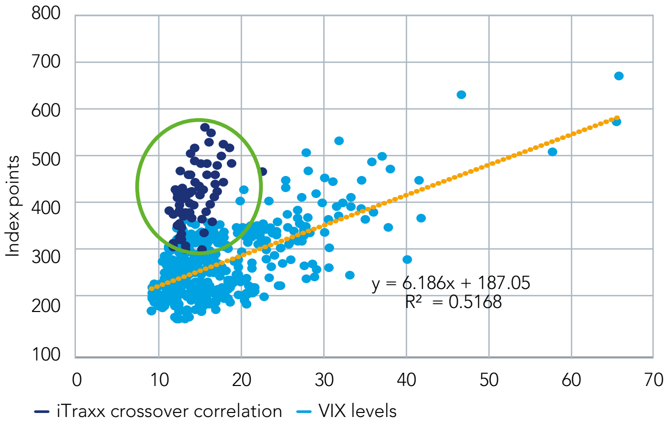
1a: iTraxx crossover and VIX levels since 2012



Source: Bloomberg, as at 10 May 2022.

[1] The VIX measures the stock market's expectation of volatility based on S&P 500 index options.
[2] An index of the 75 most liquid sub-investment grade tradable credit default swaps.

1b: iTraxx crossover correlation versus VIX levels

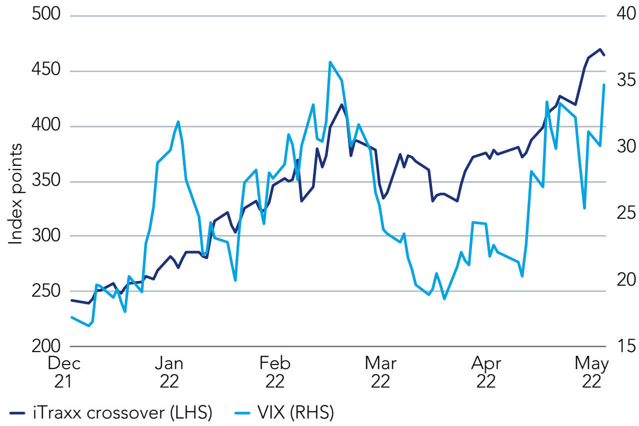


Source: Bloomberg, as at 10 May 2022, FHL.

In Figure 1b, we can see a scatter chart of the VIX versus the iTraxx Crossover throughout the same period. We have highlighted the period up to 2014 where, as we stated, the relationship between VIX and credit seems to be dislocated (light- versus dark-blue dots). If we include that data, the resulting R-squared value suggests the relationship is not meaningful. If, however, we focus on the period since 2014, when the aftershocks of the global financial crisis had vanished from credit markets, the relationship grows in significance. That scenario results in an R-squared value above 0.5 and suggests that on average the iTraxx Crossover is expected to move by six times the change in the VIX.

The interesting angle therefore is to look at smaller time lapses and see if we can obtain a signal from this relationship (with all the obvious caveats this should be read with).

Figure 2: Comparison of VIX and iTraxx crossover in 2022



Source: Bloomberg, as at 10 May 2022

Looking at the relationship so far in 2022 (see Figure 2), it appears there are times when equity market volatility acted as an early warning sign, albeit one which credit ignored for a while. However, once the spike in January had abated, both credit and volatility started a slow journey wider. This suggests that if VIX is expensive and credit hasn't moved a general risk reduction is needed, as opposed to purchasing expensive protection.

Credit spreads then plateaued from mid-March, resisting a return to tighter levels, while options continued their grind tighter. With hindsight, if we simplify the analysis, this discrepancy calls for active hedging through what would at that point be cheaper hedges – and the subsequent widening of spreads and rise in implied volatility would suggest a healthy contribution from these trades.

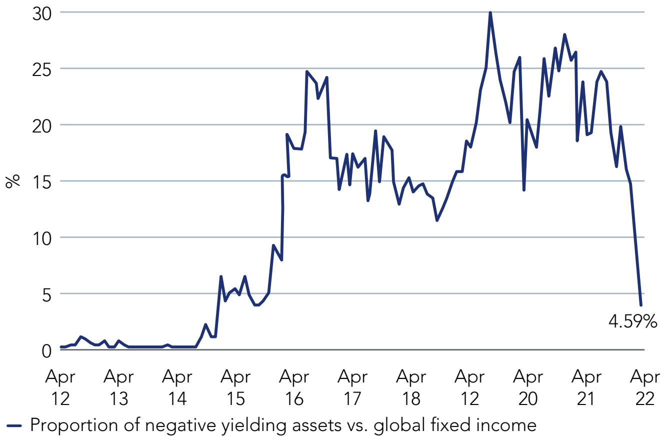
None of this is simple, and if we know one thing from markets, doing what worked well last time can often be a recipe for disaster. However, reflecting on how technical factors can alter expectations from the fundamental news flow shows us that markets often appear to be behaving irrationally in the short term. In such a scenario, the ability to analyse when markets are likely to mean-revert – as opposed to the situation representing a 'new normal' – and having the tools available to reflect these views in your portfolio, is more critical than ever.

Market value

A first-quarter selloff has improved value and offered more upside. In public credit the US outperformed Europe, while energy benefited but telecoms and broadcasting suffered.

The selloff in the first quarter of 2022 has improved value in fixed income, with the percentage of negative-yielding assets falling significantly. It has also improved the convexity picture, meaning there is more upside on offer for bond investors.

Figure 3: The percentage of negative-yielding fixed income assets has fallen significantly



Source: Bloomberg, 1 April 2022.

From a technical perspective, the volatile start to the year has meant new issuance volumes in credit have been very low. This has been especially true in high yield, where according to Goldman Sachs, volumes have fallen over 70% versus last year. Low net supply has been met with outflows from investors, leaving a relatively balanced supply/demand picture for the asset class. In terms of investor positioning, as sentiment worsened, we saw credit investors pivot from multiyear longs in credit default swap index positioning to large net short positions in a matter of weeks. However, the situation has now normalised, with improving confidence leaving investors again positioned net long.

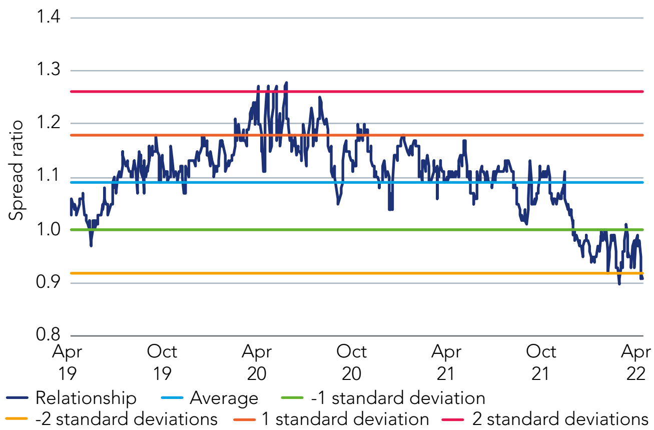
Public credit relative value

The year got off to a volatile start in public credit markets, with already sharply-rising inflation exacerbated by the consequences of Russia's invasion of Ukraine. This has left investors caught between rapidly rising prices, a sharp selloff in rates, increasing recession risks and of course the threat of escalating geopolitical tensions in Europe. Whilst challenging for anyone involved in the markets, the volatility has opened up some differences in relative value under the surface that can offer opportunities for those with a flexible mandate.

From a regional perspective, the US has significantly outperformed Europe in both high yield and investment grade, leaving Europe trading over two standard deviations cheaper on a three-year relative basis. Meanwhile, emerging market credit continues to be weak relative to developed markets, although the gap has narrowed slightly given the weakness in developed markets year to date. We continue to favour Europe on this basis; however, we remain cautious on emerging markets, which are likely to be under pressure for some time.

Figure 4: The US has significantly outperformed Europe in high yield

High yield: US vs. EU

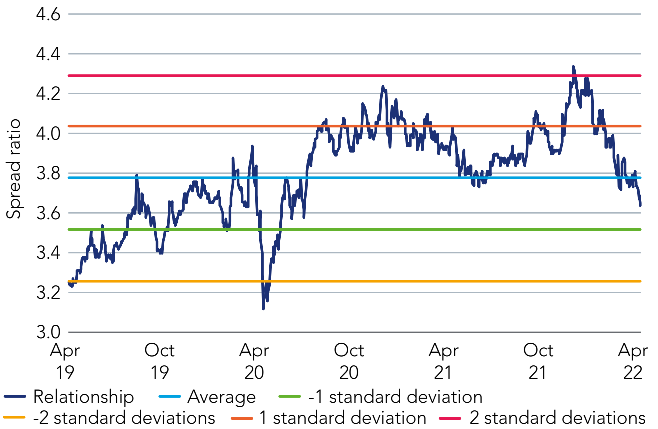


Source: Bloomberg, 1 April 2022.

Looking at credit quality, unsurprisingly, bonds with a greater sensitivity to rates have been underperforming as investors looked to shield themselves from expectations of rapidly rising interest rates. Weakness in investment grade has meant the relationship with high yield has normalised year to date, from high yield trading very cheap to both markets trading in line with historical averages. We expect this weakness in investment grade to continue in the near term. However, slowing global growth will likely benefit higher quality credit in the medium term, with more risky areas of the high-yield market heavily exposed to weakening fundamentals and rising financing costs.

Figure 5: The relationship between investment grade and high yield has normalised

Global credit: High yield vs. investment grade

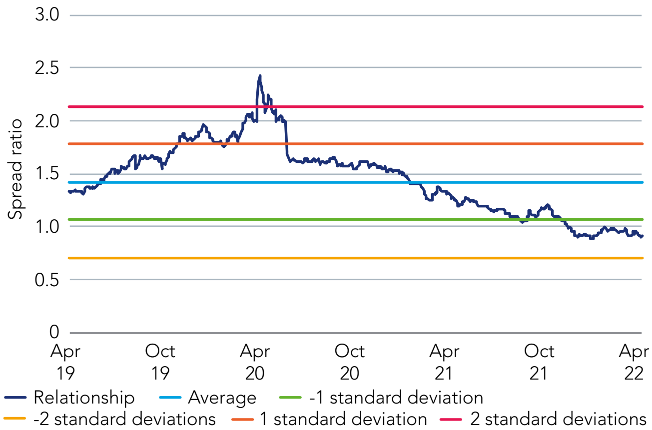


Source: Bloomberg, 1 April 2022.

From a sector perspective, energy continues to benefit from the steep increases in global prices and a relatively low sensitivity to interest rate rises. This has left the sector trading at tight levels relative to the high yield market. In contrast, sectors such as European telecommunications and US broadcasting have weakened in the volatile environment and are now trading relatively cheaply compared to historical levels.

Figure 6: Energy has been trading at very tight levels relative to high yield

US HY: Energy vs. global high yield



Source: Bloomberg, 1 April 2022.

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Economic outlook

With the war in Ukraine inflicting a stagflationary shock on the global economy, central banks risk being caught between a rock and a hard place.

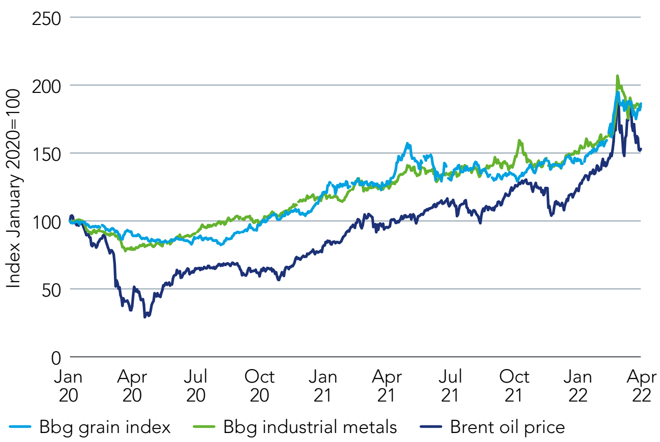
In the three months since our last quarterly update, the global economic outlook has deteriorated significantly. The Russian invasion of Ukraine that began at the end of February is first and foremost a humanitarian tragedy, but it has had a significant negative impact on the global economy. The war amounts to a stagflationary shock, in that it is driving higher cost-push inflation while weakening growth.

Russia and Ukraine jointly account for only about **2%** of global GDP, but they play a far more significant role in the commodity space than that might imply.

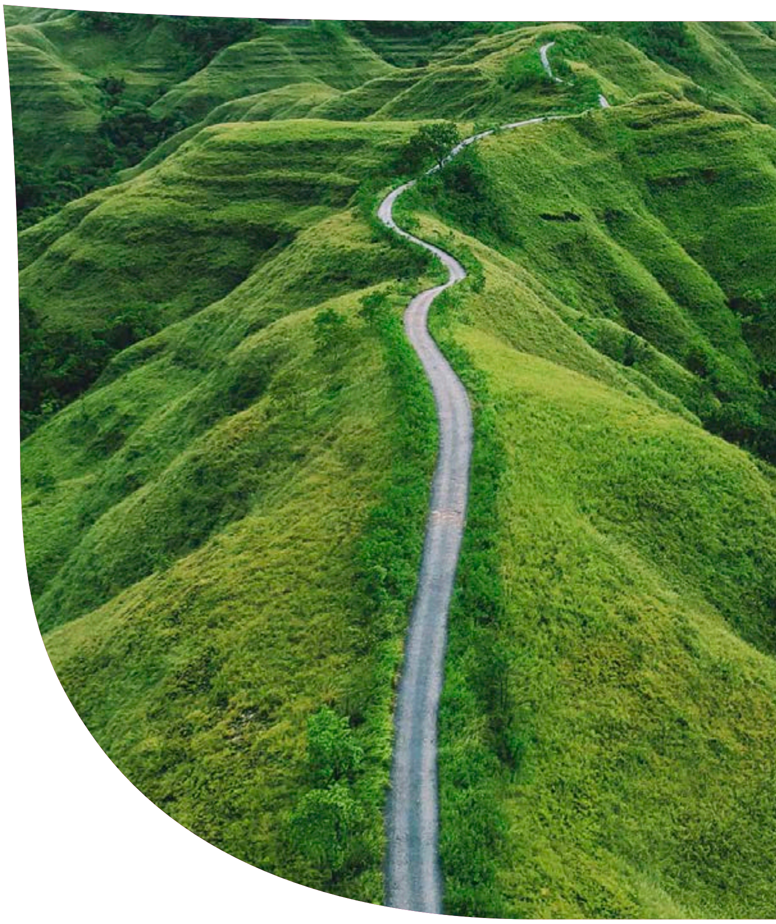
Russia and Ukraine jointly account for only about 2% of global GDP, but they play a far more significant role in the commodity space than that might imply. Russia in particular is a large producer of energy commodities, accounting for more than 10% of global oil production and about 17% of global gas production. It is therefore unsurprising that the war triggered a significant increase in commodity prices, with oil up about 50% since the beginning of the year at the time of writing, while grains and industrial metals also spiked (see Figure 7).

Figure 7: Commodity prices are at almost double their pre-Covid levels

Note: indices rebased to January 2020 = 100.



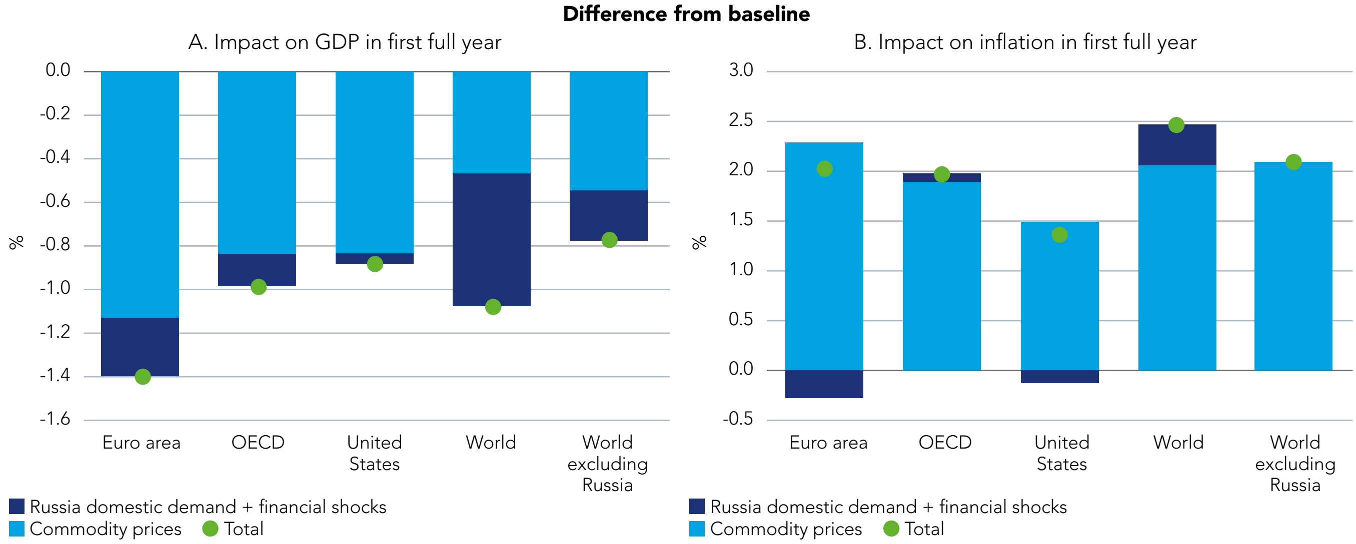
Source: Bloomberg, as at 8 April 2022.



Higher energy prices driven by sanctions on Russia have been the main cause of disruption to the global economic outlook so far. However, this is not the only issue. Russia and Ukraine jointly account for about a third of global wheat production, while Russia and Belarus account for about a third of global potash production – which is a critical ingredient of fertiliser. As a result, global food inflation is also set to rise sharply, bringing the risk of social instability in emerging markets – particularly in the Middle East and Northern Africa.

The outlook for the global economy, which was previously fairly positive, now hinges on the evolving situation in Ukraine and its implications. According to recent estimates by the Organisation for Economic Co-operation and Development (OECD), if the commodity and financial market shocks seen in the first two weeks of the conflict persist, global growth could be over 1% lower and global inflation 2.5% higher in the first full year after the start of the conflict (see Figure 8).

Figure 8: According to the OECD, the conflict in Ukraine implies a stagflationary shock



Source: OECD Economic Outlook, Interim Report, as at March 2022

Looking forward, there are both upside and downside risks: on the one hand, the conflict might be at least partially resolved over the course of the year; on the other hand there could be further escalations leading to further sanctions and retaliatory measures. Whatever happens, the negative repercussions of the conflict, including elevated commodity prices, are likely to drag on to some extent through the rest of the year and possibly beyond.

Growth fundamentals were solid before the war, and household and corporate balance sheets in particular remain in good order. A recession is not therefore our baseline scenario yet, but recession risks are clearly present and should not be ignored. These include persistent cost-push inflation eroding real incomes, further disruptions to global supply chains, monetary policy tightening creating possible turmoil in financial markets, and the potential for a confidence shock.

The impact is likely to vary significantly across regions, which will in turn determine the policy response. Europe stands out as highly vulnerable – mainly due to its reliance on Russian energy commodities – while energy independence insulates the US from the crisis. As a result, the eurozone is more exposed to the risk of a recession, although a new round of fiscal easing should prop up growth. European national governments have announced temporary measures to cushion consumers from the blow of higher utility and petrol prices. These would amount to around 1% of GDP, assuming they are eventually extended until the end of the year. However, discussions on new and more ambitious EU-level spending plans have stalled and are unlikely to progress unless there is a further deterioration of the outlook.

Regarding monetary policy, all central banks have experienced a sharp deterioration of the situation they have been facing in terms of growth-inflation trade-offs. With a tight labour market creating the potential for second-round effects, the US Federal Reserve will focus on inflationary risks. That means they are likely to hike rates significantly in the short term, while also using balance sheet shrinkage as a tool to remove stimulus. In the longer term, the pace of monetary tightening will depend on how the inflation-growth trade-off evolves. Central banks in Europe will be more cautious, resorting to two-way optionality and flexibility as they implement gradual policy normalisation.

In China, President Xi is set to seek an unprecedented third term at the 20th National Party Congress in the autumn. Faced with the challenges of a structurally slowing economy, Chinese policymakers are likely to provide ample fiscal stimulus to support short-term growth and foster stability in the run-up to the vote. However, China's zero-Covid policy means recurrent and pervasive restrictions to activity and consumption are likely to persist. At the same time, Chinese exports (one-fifth of which head to the eurozone) will continue to be hit by the war in Ukraine. That means it will be hard for China to meet its official growth target of 5.5% this year.

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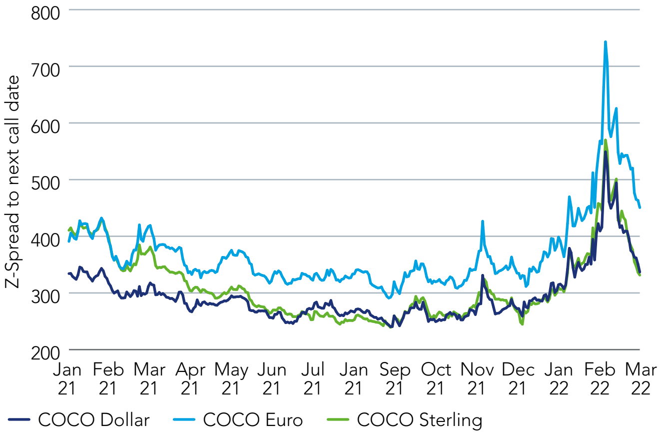
Financials

Higher inflation means higher interest rates, which are fundamentally positive for the financial sector. With this in mind, the current vintage of financials looks broadly attractive.

Q1 2022 was an interesting period for financials. The unexpected invasion of Ukraine led to a significant widening in the market, which was followed by a natural hiatus of new issuance a couple of weeks later. However, a degree of stability was found in March (see Figure 9).

Figure 9: AT1 Z-Spread development, January 2021 to March 2022 (bps)



Source: CS Index Plus as at 4 March 2022. AT1s (Additional Tier 1 bonds) are Contingent Convertible ('Coco') bonds issued by banks that contribute to the total level of capital they are required to hold by regulators.

As a result, we saw a series of new deals coming to the market. Following on from what we saw after the series of selloffs in early 2016, 2019 and Q2 2020, on the whole this looks like an attractive vintage of bonds across the capital stack.

The unexpected invasion of Ukraine led to a significant widening in the market, which was followed by a natural hiatus of new issuance a couple of weeks later.

Importantly, between February and March we saw eight AT1 calls. This removes the call risk for 2022, and we believe that a proportion of this money will be reinvested back into the sector, creating a supportive backdrop in both primary and secondary markets. That largely reflects the strength of this 2022 vintage of bonds: even after the recent widening, calls still look to be economic, with an average reset (spread after the first call date) of 640bps for euro-denominated bonds and 511bps for those in dollars.

The other key feature of the current macroeconomic situation is the presence of persistent higher inflation, which is in turn leading to higher interest rates. This is generally positive for financials, which benefit from increased profit margins as a result. However, there are a few caveats we need to bear in mind:

i) Higher food & commodity prices dent household budgets and increase the risk of economies being tipped into recession, particularly in the eurozone;

ii) The potential for the West to become 'trigger happy' in relation to China creates a tail risk;

iii) Higher dollar rates may create 'butterfly effects' in emerging markets.

An indirect consequence of the conflict in Ukraine, which is more evident in Europe than in the US, is a slowdown in the release of Covid-19-related reserves. Anecdotally, some of the banks most exposed to Russia have also – understandably – paused their share buyback programs.

Financial firms' Russian exposures will have been classified as Stage 2 in Q1 2022 to recognise the significant increase in credit risk presented by the fallout from the war in Ukraine. At some point in Q2 2022 it will be decision time for financials – mostly eurozone banks – with material Russian exposures. They will be faced with a difficult choice between walking away (and booking an average 100bps loss) or recapitalising their Russian subsidiaries.

Credit fundamentals

With margins and cashflow under pressure, deleveraging is likely to slow. That makes us more cautious on fundamentals, but global default rates should stay relatively low this year.

Commodity price increases and additional supply chain disruption triggered by the war in Ukraine are exacerbating inflation at a time when corporates were already facing elevated cost pressures. As this stagflationary environment continues, we expect negative revisions to annual outlooks, with margins and cash flows being pressured. Deleveraging is therefore likely to slow, after a period of improving credit metrics. That makes us more cautious on corporate fundamentals. However, we note that while global default rates are expected to tick up over the next 12 months, they are still below long-term averages.

As noted elsewhere in this report, events in Ukraine have not only resulted in tragic loss of life, but also triggered substantial price increases and supply issues. As well as oil, gas, and fertiliser, affected commodities include wheat as well as raw materials for silicon chips such as neon gas and palladium. This is driving further business disruption and even higher costs for corporates, at a time when companies were already facing rising cost pressures.

Margin and cash-flow pressure will see negative guidance revisions

Before the conflict, credit profiles were benefitting from strong profits which improved cashflows and balance sheets. With demand remaining buoyant, so far companies have largely been able to pass through increased costs to customers. However, going forward there is a greater risk that slowing demand will reduce corporates' ability to pass through costs, putting margins and cash flows under pressure.

We are already seeing some concerning data points and cautious commentary from companies. European car registrations, for instance, fell 19% in March as a lack of semiconductors disrupted production, while major miners described the current inflationary environment as unlike anything seen since the 1970s oil crisis. In Figure 10 we highlight the negative impact of the current environment on many sectors, but also how some industries stand to benefit.

Figure 10: Sectors most impacted by the inflationary environment

Negatively Impacted Sectors	
Sector	**Impact**
Packaging	**Glass:** The overall outlook is negative due to high energy prices. In the US, the situation should be manageable due to a stronger pass-through timeline embedded in contracts and lower than average natural gas prices. In Europe, pass-throughs are usually lagging, while a more fragmented wine industry has less pricing power to pass on higher packaging costs. **Plastics:** Higher energy prices will increase margin pressure due to higher resin cost. Lots of resin capacity has so far meant rises in resin prices have been muted, but pressure remains –and 2022 could prove to be a re-leveraging year for plastic makers on lower EBITDA.
Specialty chemicals	Companies in the specialty chemicals sector typically have oil- or gas-linked input costs (for feedstock and/or energy). They often do not have strong contractual pricing pass-throughs, and so must pass through cost inflation by negotiation. We see risks from factors including delayed or partially realised price pass-throughs, higher working capital requirements drawing down cash flows, and demand destruction due to higher prices. Exposure to cyclical end markets such as autos is another concern, while European manufacturing could also suffer from energy scarcity in the region.
Autos	Fundamentals are unchanged for autos, as pricing power continues to offset weaker volumes. These should nonetheless recover from 2021's low levels, albeit at a slower pace than initially expected pre-conflict. Higher fuel prices mean closely monitoring product mix, as any shift away from more expensive SUVs could trigger an outlook downgrade.
Auto parts	For auto parts, fundamentals will remain challenged in an inflationary environment where volumes fail to recover as fast as expected. Input cost inflation is still skewing margins to the downside in 2022; that represents a re-leveraging event for most auto parts suppliers, some of whom may be looking to transition their portfolio faster into EVs. M&A risk therefore remains high for this subsector.
European utilities	Skyrocketing prices mean a higher likelihood of political and regulatory intervention for European utilities (but are otherwise a positive), while potential input disruption (gas or coal) is an issue.

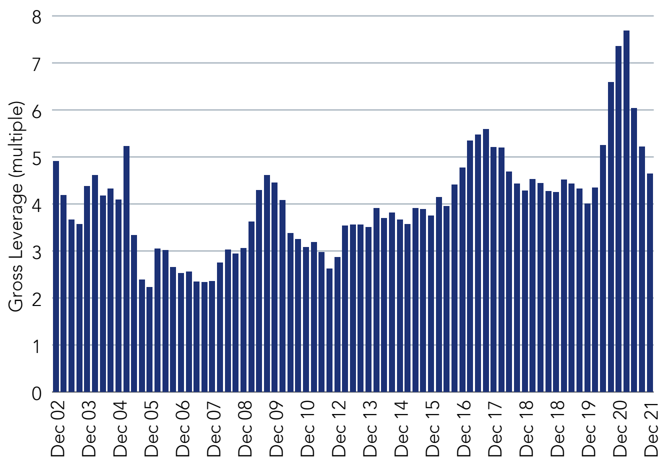
Positively Impacted Sectors	
Sector	**Impact**
Energy	Higher commodity prices are boosting margins and free cashflow in the energy sector. Cashflows are further supported by capital discipline. Balance sheets are de-levered and so companies will return capital to shareholders, but not to the detriment of credit metrics. The EU-US LNG deal is long-term positive for the upstream and midstream US natural gas supply chain.
Metals and mining	Prices are up across the board on a year-on-year basis. Mining capex remains at 'recessionary levels', and underinvestment was already expected to lead to supply shortages. The risk to Russian supply from sanctions has further pressured the supply side. Demand is still expected to be robust, although potential demand destruction due to the high-inflation environment creates downside risk. However, in the first instance miners should benefit from inflation, at least until demand destruction as a second order effect starts to affect volumes.
Fertilisers	The fertiliser market was already looking very tight going into 2022; geopolitics have added to supply-side pressure. Much of European nitrogen capacity remains offline due to high gas prices, which are making ammonia production uneconomical in Europe. By comparison North American producers are much better positioned.

Source: Federated Hermes

The deleveraging trend will slow down

Post-pandemic, credit metrics have improved as earnings have recovered and companies focused on paying down debt and improving their balance sheets (see Figure 11). Now, with pressure on margins and earnings potentially increasing, we see a greater risk of weakened cashflows. That is likely to slow down the trend for deleveraging.

Figure 11: After a period of improving credit metrics, we expect deleveraging to slow down



Source: Deutsche Bank as at 31 December 2021

Moody's forecasts global defaults to increase from

2% on a rolling 12-month basis in February 2022 to

2.8% by the end of February 2023.

Default rates are expected to tick up but remain below the long-term average

Moody's forecasts global defaults to increase from 2% on a rolling 12-month basis in February 2022 to 2.8% by the end of February 2023. However, this is still below the long-term average of 4.1%. In Europe, eight out of ten February defaults came from Ukrainian banks. As the region most impacted by the conflict in Ukraine, European default rates are expected to increase from 2.1% in February 2022 to 3.1% by January 2023.

Sustainable finance

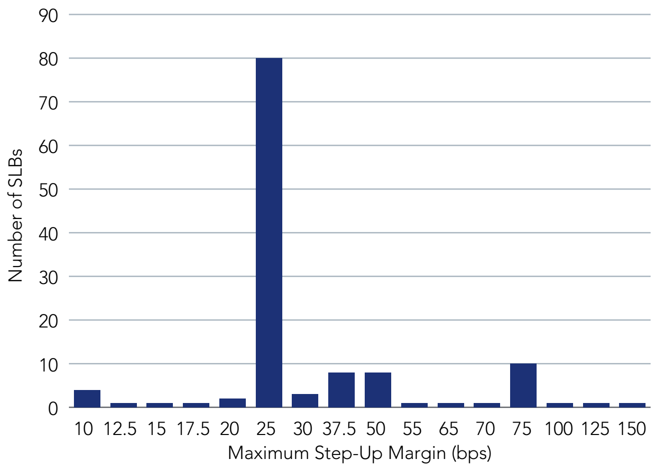
Do sustainability-linked bonds (SLBs) have a step-up problem? In this issue of 360 we suggest a new approach to structuring coupon step-ups for this asset type.

After record issuance in 2021, the green, social, and sustainability bond (GSS) market has grown to a market capitalisation of just under $2tn.[3] Sustainability-linked bonds (SLBs) are the fastest growing GSS asset class, accounting for over $120bn of that total.

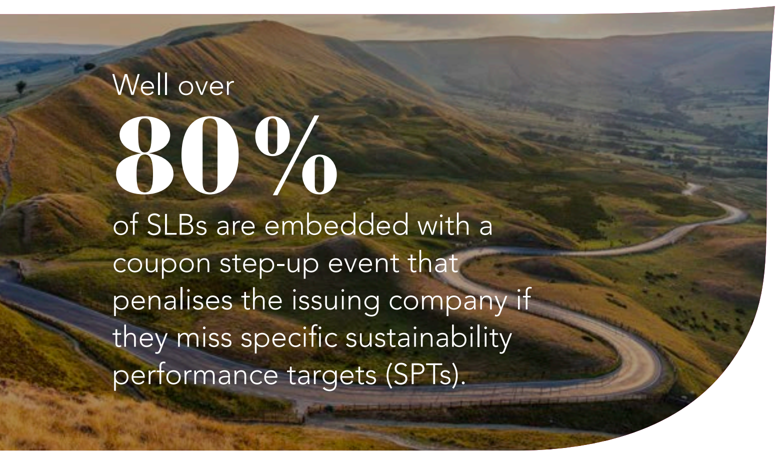
Well over 80% of SLBs are embedded with a coupon step-up event that penalises the issuing company if they miss specific sustainability performance targets (SPTs). Inexplicably, the market appears to be consolidating around a step-up amount of 25bps (see Figure 12).

Figure 12: Most SLBs embed a coupon step-up of 25bps tied to sustainability performance targets

2021: Maximum coupon step-up



Source: Bloomberg as at 31 December 2021



Stepping into the debate on step-ups

On aggregate, over 60% of SLB step-ups are set at 25bps, which is rapidly becoming the market norm. However, employing a standardised, fixed level for the step-up fails to consider various unique factors, including company size, coupon size and the credit risk of the issuer. These factors will affect the materiality of a 25bps step-up, so that it will have an unequal effect as an incentive; for example, an investment grade company that misses an SPT may face headline risk, but no financial risk, whereas a high-yield company could face both.

A new approach: Scale the pain to create positive change

In our view, the coupon step-up needs to balance two factors: materiality and credit risk. On the one hand, a step-up should have a material impact, but on the other it should not put unnecessary credit-deteriorating pressure on the overall cashflow of a business.

To facilitate the growth and protect the health of the SLB market we therefore suggest replacing the fixed 25bps step-up with a feature that flexes the step-up in line with the scale of the issuing company. Calculating the step-up as a percentage of earnings before interest, tax, depreciation and amortisation (EBITDA) makes a lot of sense for this approach, since it is a measure of cash flow – an essential factor in credit analysis – and it rises and falls with the scale of a business. The step-up feature would thus expand and contract elastically based on the size of the company and its cash generative abilities, ensuring its materiality remains proportionate.

We believe SLBs have enormous potential to help companies deliver on financial and sustainability goals. However, insouciant acceptance of a 25bps step-up as a norm could eventually undermine investors' confidence in the SLB market, thereby weakening the ability of the asset class to align capital markets with corporate sustainability. As such, changes need to be made.

This section summarises a previously published take note which includes more details on this proposed approach – you can find the full text here.[4] We also refer you to the website of the International Capital Markets Association (ICMA), which has published several excellent SLB framework documents and definitions.[5]

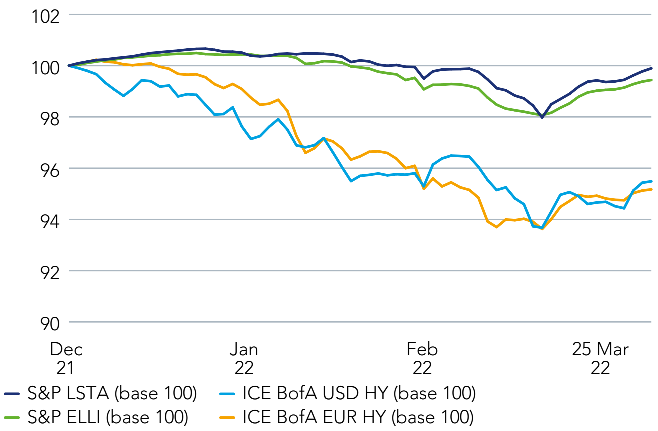
[3] Natixis. Credit Research: Green & Sustainable Outlook 2022 (January 2022).
[4] https://www.hermes-investment.com/uki/insight/fixed-income/sustainability-linked-bonds-like-marmite-for-markets/.
[5] Sustainability-Linked-Bond-Principles-June-2020-171120.pdf (icmagroup.org).

Leveraged loans

Despite recent developments, European leveraged loans were relatively robust in Q1 2022. Key indices outperformed high yield bonds in both Europe and North America.

In a volatile environment, the illiquidity feature of leveraged loans acted as a useful buffer. The S&P European Leveraged Loan Index (ELLI) ended the quarter at 97.32, having dipped somewhat to a low of 96.12 in mid-March. The ELLI returned -0.56% over the quarter, easily outperforming the ICE BofA Euro High Yield Index, which returned -4.83% over the same period. It was a similar story in North America, with the S&P/LSTA US Leveraged Loan Index returning -0.10%, compared to -4.51% for the ICE BofA US High Yield Index (see Figure 13).

Figure 13: Leveraged loans outperformed high-yield bonds in Q1 2022 in both in the US and Europe (% return)

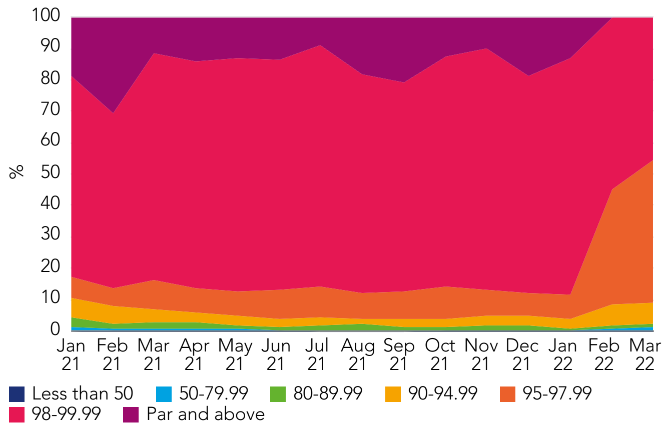


Source: Bloomberg as at 31 March 2022

Given the uncertainty, primary issuance has largely been on hold, with just €0.39bn of leveraged loans printed in March. That compares to €12.82bn of new issuance in January and €5.59bn in February. This hiatus means there has been only €18.79bn of syndication year-to-date, compared to €40.8bn in Q1 2021 – a 53.94% decrease.

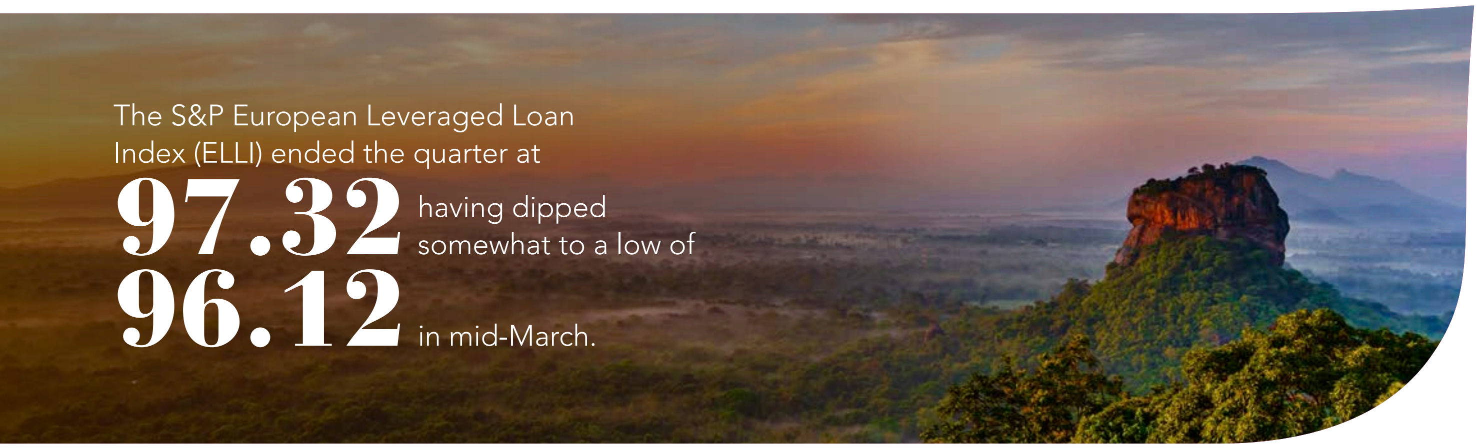
The recent underperformance of high-yield bonds eased the attractiveness of leveraged loans in an unconstrained strategy. However, CLO and loan-only managers observed an increasing intrinsic value of loans. As shown below, the percentage of the ELLI trading between 90 and 98 increased from 10.32% at the end of 2021 to 52.26% at the end of March 2022. Meanwhile, the percentage of the index trading above par dropped from 18.84% to 0.00%.

Figure 14: S&P European Leveraged Loan Index (ELLI) price distribution, January 2021 – March 2022



Source: S&P as at 31 March 2022

This recent change in price distribution marked an opportunity for CLO managers to open new warehouses. Even though there has been a pause in primaries, the weighted average cost of capital for European CLOs remains tighter than Q3 2020 levels and the arbitrage should favour new CLO prints.

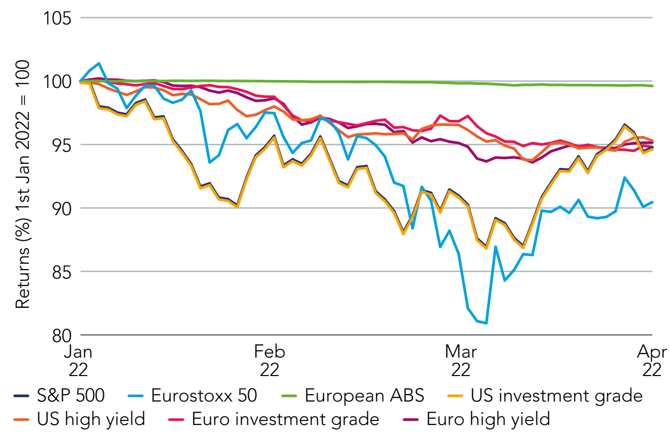


Structured credit

The dampening effect of the tendency for long-term allocations in asset-backed securities has made them a useful diversifier once again through recent market volatility.

Just as we saw in the Covid crisis, structured credit, especially the asset-backed securities (ABS) segment, has proved to be a useful diversifier in the face of raised risk premia and volatility across markets in recent months. This is because the investor base and the highly rated nature of the structured market tends to lead to more long-term allocations to the asset class, thereby dampening reactions in times of increased turbulence. Figure 15 uses the Bloomberg Barclays Pan-European Floating ABS Bond Index as a reference to indicate the types of price action seen in European ABS.

Figure 15: Asset-backed securities have proved a useful diversifier in 2022



Source: Bloomberg as at 1 April 2022.

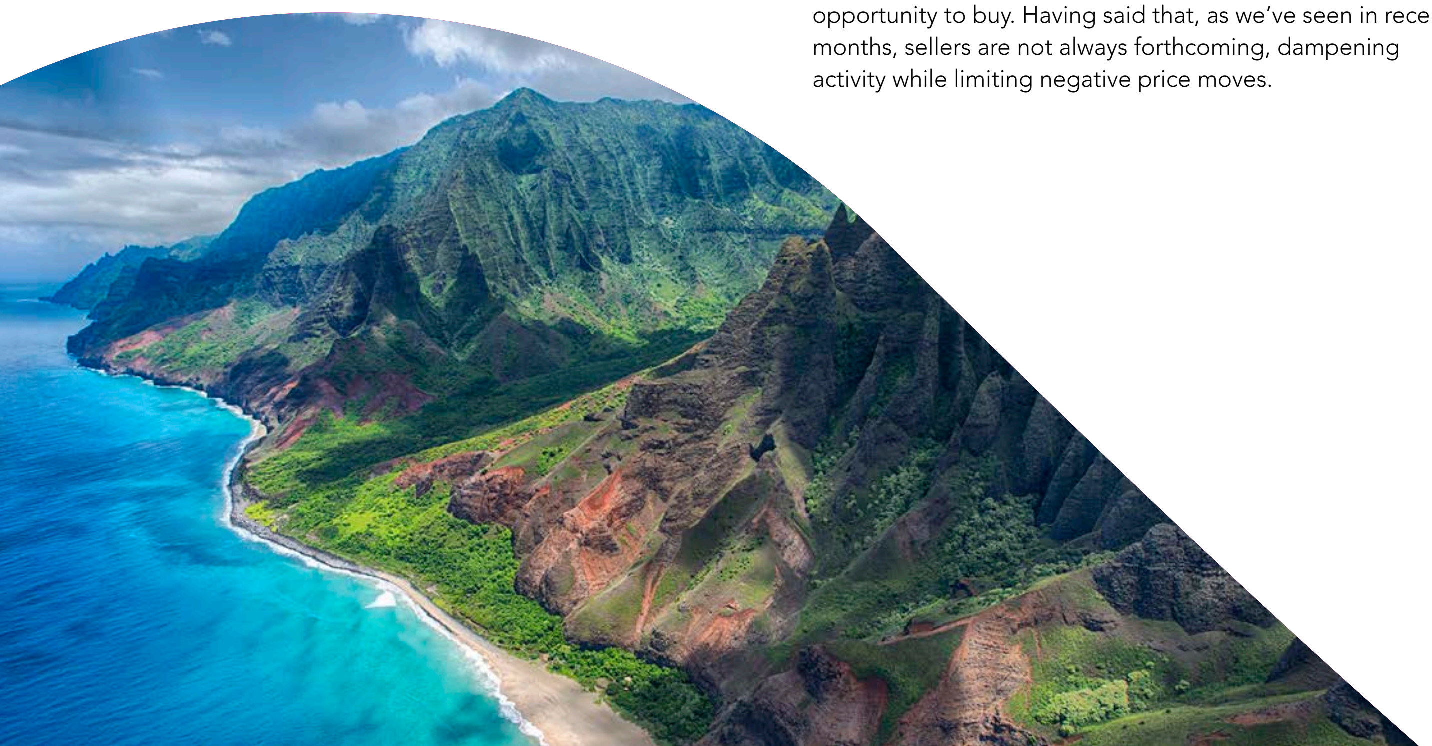
Figure 16: Maximum drawdowns for asset-backed securities were much lower than for other asset classes

Maximum drawdowns (since 1st Jan 2022)	
Eurostoxx 50	-19.08%
S&P 500	-13.05%
US IG	-13.05%
Euro HY	-6.41%
US HY	-6.24%
Euro IG	-5.50%
European ABS	-0.39%

Source: Bloomberg as at 1 April 2022

It should be noted that the Index does not include collateralised loan obligations (CLOs) and is predominantly comprised of AAA-rated ABSs. It's fair to say that the European CLO market has reacted more to the recent moves in the wider markets, albeit as a lagging asset class. That in itself has created interesting trading opportunities for our portfolios that allocate to structured credit alongside high-yield and investment-grade corporate bonds.

Issuance volumes have been somewhat stymied by recent volatility and increased concerns around both geopolitical events and the economic outlook. However, the demand for structured credit remains strong, as the floating-rate nature of the asset class is attractive to those seeking more inflation- and rates-neutral investment opportunities. Given that a much-expanded investor base is active in the asset class, we can expect any downside price action to be used as an opportunity to buy. Having said that, as we've seen in recent months, sellers are not always forthcoming, dampening activity while limiting negative price moves.



Asset-based lending

Recent discussions within asset-based lending have shifted from the threat to rental collections presented by Covid to the implications of the macroeconomic picture.

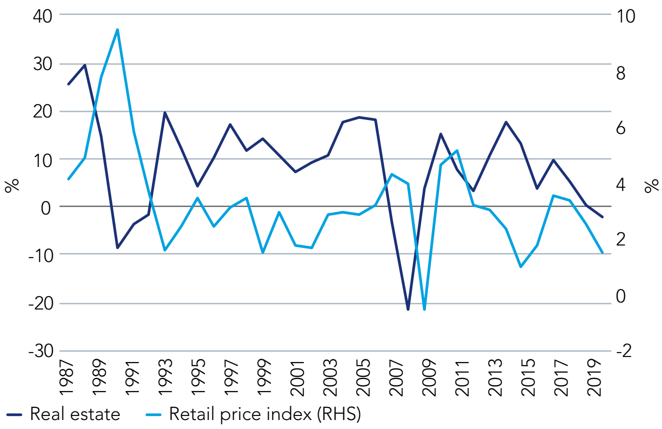
Supply chains were already suffering long delays and cost inflation prior to Russia's invasion of Ukraine. The war has made the situation considerably worse, particularly in relation to oil prices but also the cost of many other raw materials.

We therefore find ourselves facing the highest levels of inflation since the fall of the Berlin Wall, while simultaneously experiencing relatively low economic growth. The supply-side inflation that all policy makers had hoped would prove transitory is embedding itself more permanently into the system. This begs the obvious question: are we entering a period of stagflation, and how does real estate behave in such a scenario?

Real estate makes intuitive sense as an inflation hedge in a high-growth and high-inflation environment; with high demand, rental growth prospects look good. We are less convinced this works during periods of stagflation. Looking at the last 35 years of data from the UK, we see that real estate returns and inflation are not actually highly correlated. In fact, as you can see from Figure 17, the correlation is as often negative as it is positive. Yet despite this, real estate is often thought of as an inflation hedge.

Figure 17: Real estate correlation with inflation is as often negative as it is positive

Real estate returns vs. inflation (%)



Source: PMA as at 31 March 2022.

It is important to remember that real estate delivers returns from both income and capital growth. We have commented before that the majority of total returns from real estate come from income. Its response to changing inflation environments may therefore be more heavily impacted by its income characteristics, rather than its equity characteristics.

If that is the case, there is some reason to be skeptical about real estate's ability to serve as an inflation hedge in the medium term. Cost inflation with low economic growth makes rent increases less affordable than in a high-growth inflationary environment, so the developing situation is not a positive one for income.

Additionally, the risk-free rate needs to increase in a high-inflation environment. That puts upward pressure on real estate yields, and thus downward pressure on values. As a result, not only is there a risk that real estate fails to perform as an inflation hedge on the income side, but there is also the risk that it is negatively correlated to inflation on the capital side in the short term.

We need to reflect these risks in our underwriting, where rental growth assumptions are being paired back. This potentially makes real estate debt investments very attractive in comparison. Floating-rate loans secured by commercial real estate are a more obvious inflation hedge, with interest returns directly linked to the risk-free rate to which interest calculations refer. The key is to ensure that SPV[7] borrowers in non-recourse financing structures have appropriate hedging in place. This should guarantee interest affordability on their side and avoid them getting squeezed in between higher interest rates and limited rental growth.

In conclusion, over the long term, real estate equity has consistently outperformed inflation; however, in the short-to-medium term a heavier allocation to senior and whole-loan real estate debt could prove a more useful inflation hedge.

[7] Special Purpose Vehicle.

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