360°

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Head of Fixed Income

OUTCOME #06

Creating a pricing model to quantify the contribution of ESG risk to credit spreads allows greater insight of ESG influence on credit instruments and can help to identify possible outperformers.

Hermes Fixed Income Quarterly Report
Q3 2018

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HERMES
INVESTMENT MANAGEMENT

Andrew Jackson,

Head of Fixed Income

As Head of Fixed Income, Andrew leads the strategic development of Hermes' Credit, Asset Based Lending and Direct Lending investment teams, and its Multi- Asset Credit offering.

Don't panic

When I started writing this launch issue of *360°*, I aimed to provide catchy, easy-to-understand predictions followed by non-consensus opinions that would grab your attention. Unfortunately, I can't give you either: disappointingly, my core views are currently profoundly vanilla.

A summary of my core views is as follows:

- Credit fundamentals and affordability are positive
- Having been stretched, valuations are now more attractive and the relative value of credit against equities appears favourable
- Technicals are severely stretched in certain credit sectors, but are broadly neutral or positive
- The complexity and illiquidity premia of certain sectors and instruments still offer significant value for investors with the required access and tolerance for risk

None of these views are controversial, but it is important to emphasise that we currently see real value in credit markets. However there are a couple of significant caveats. First, although my views are broadly consensual, the processes and approaches taken by Hermes' Fixed Income teams are absolutely non-consensual, which means that our exposure to major downside risks is limited. Second, we feel that the market is very complacent about tail risk.

I believe that our approaches go against consensus for the following reasons:

- ESG analysis is at the forefront of our approach, not a post-script
- Eschewing market silos, favouring an approach which allows us to see the bigger picture
- Avoiding overcrowded trades and owning the market – consciously or not
- Assessing the broad Fixed Income market, not merely looking at familiar territory

Even though I do not describe potential horror stories in this issue, I have not started seeing silver linings on every cloud. Across the corporate world, I see evidence that balance sheets look robust, leverage is not imperiling companies and interest coverage ratios are good – even when likely interest-rate increases are taken into account. True, the financial state of the UK high street is ugly, but I do not think that its current wave of defaults and restructurings is a forerunner of the much-anticipated end of the credit cycle. We may have to wait longer before that happens.

One of the most telling graphs I have seen lately, and which ran counter to my own intuition, attempted to measure the 'shareholder friendliness' of lending. Despite what we tend to read, the vast majority of lending still supports credit fundamentals – such as investment, capex, refinancings – not dividend recapitalisations or share buy-backs.

I like this credit environment – so much so that I believe in being almost fully invested, but not exposed indiscriminately across the market. I see significant value in the following parts of the market:

- Long-dated lending to corporates ranked BBB to BB. Credit curves are steep and we are confident in lending to issuers we like for longer
- Credit assets that have cheapened with the strengthening dollar, and which are supported by improved corporate fundamentals
- Esoteric sectors in which banks are struggling to lend because of regulatory constraints
- Senior-secured lending on property or on cash flows with low loan-to-value ratios or leverage, and in jurisdictions that are likely to be creditor-friendly
- Short-dated, non-banked and non-traditional lending to corporates where short tenors can compensate for low liquidity
- Flexible and dynamic mandates capable of capturing mispricings

And, in order to confirm that vanilla is not the only flavour of the quarter, I think that markets are very complacent about tail risks. Asset prices suggest that the probability and likely severity of any tail event are both incredibly low. I can agree with the former, but cannot ignore the potential impact of:

- The rise of populism and the huge uncertainties in geopolitics, currently headlined by trade disputes
- A disorderly end to central banks' zero-interest-rate policies and quantitative easing
- Supposedly liquid leveraged loans being sold *en masse* as investors realise that making a profit is probably quite a good thing after all!

Given the fact that markets appear highly complacent about the potential for any major downturn and that implied volatility is incredibly low, most investors could consider out-of-the-money options to mitigate the risk of loss in tail events[1].

In summary, I see value across credit markets but perceive the best opportunities to exist in difficult-to-access sectors. There are also parts of the credit market, both liquid and less liquid, with little or no long-term value and where the supply-demand dynamic has pushed markets too far, resulting in stretched valuations. There is little doubt in my mind that the comfort provided by a relatively naïve and unsophisticated out-of-the-money options program allows investors to be more confident in mitigating tail risk – thereby funding itself by allowing investors to be more fully invested.

Next quarter, I expect to find reasons to be in a more colourful mood.

1 For more on this topic, see Why I'm worried: I'm the only one worrying, by Saker Nusseibeh, CEO of Hermes, and Stay cool as markets run hot, by Tommaso Mancuso, Head of Hermes Multi Asset.

Outlook Scorecard

Relative value between asset classes

- Private debt offers attractive relative value by offering illiquidity and complexity premia
- In public corporate debt, YTD spread widening in EM credit and European financials and investment-grade credit presents tactical buying opportunities
- With expectations of further rate hikes, we favour floating-rate instruments: syndicated loans, direct lending and real estate debt
- Spreads on leveraged loans and HY bonds have both widened this year, however loans offer higher recoveries
- Esoteric and less banked sub-asset classes offer significant value to compensate for lower liquidity

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Economic outlook

- Economic data supports continuing growth
- Volatility inches higher
- Wage inflation determines policy tightening approach and flattening yield curve
- Protectionism creates uncertainty
- Tighter global financial conditions

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Credit fundamentals

- Corporate earnings recover; positive operating cash flow
- Growth cools after strong 2017
- Leverage levels rise, gradually
- High interest coverage ratios
- Low default rates point to benign credit risk environment
- Shareholder-friendly activity low but set to rise

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Valuations and technicals

- H1 volatility stokes bearish sentiment
- Good liquidity helps ease technically-driven sell-offs
- High cash balances; excess demand supports credit
- HY records significant outflows; IG sees positive flows, while EM has been negative recently
- Strong dollar reprices EM debt adding to convexity

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Investment opportunities

Public credit

- Steeper credit curves support longer-dated higher quality securities
- Improved convexity
- Similar value in the US and Europe. In EM, dollar strength has created value
- Companies with improving ESG exposures provide opportunities
- We like the cable, paper and telecommunication sectors, but see less value in chemicals and consumer discretionary retail

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Private credit

- We prefer UK to Europe due to large yield premiums
- We favour Northern over Southern Europe as spreads provide insufficient compensation for less creditor-friendly regimes
- We prefer senior to mezzanine or second lien debt and truly private to quasi-liquid loans
- Defensive leveraged loan sectors such as Healthcare, Consumer Staples and Utilities stand out.
- CLOs continue to drive markets

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Asset-based lending

- Asset selection is key: margins in Europe are below those in the UK, but pockets of value can be found for the right asset and sponsor
- Favour transitional real estate debt, where asset management can add value
- Avoid assets in secondary retail and mass market core senior CRE debt priced out
- Focus on UK ABS: UK non-conforming and buy-to-let
- Watching future of ECB's ABS PP

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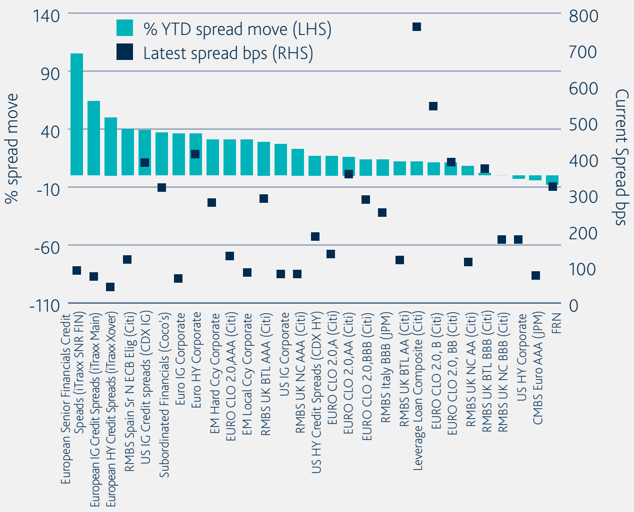
Tail risks

- Unpredictable geopolitics (particularly in US, China, Russia, Iran) and the rise of populism
- Protectionism could stymie growth if US, China and Europe tensions escalate into a global trade war
- A prolonged period of subdued volatility creates an illusion of stability and encourages borrowing
- Unknown impacts of normalising extreme monetary policies
- Markets appear very complacent

Relative value between asset classes

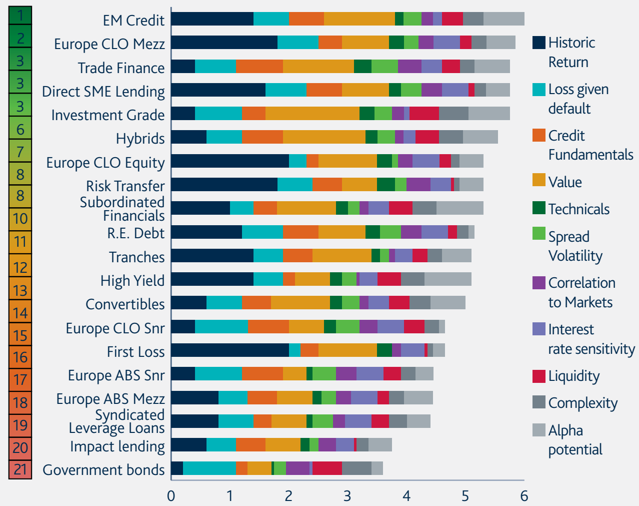
After repricing earlier this year, emerging-market debt provides the best relative value, offering more liquidity with less complexity than other credit markets.

Figure 1. Credit spreads started to widen this year, after narrowing steadily since 2016



Source: Spread data as of 30/06/2018. Sources Bloomberg, Citi Velocity, JPM.

Figure 2. Relative-value across the credit spectrum



Source: Hermes, as of 30/06/2018.

In the **liquid corporate-debt** space, European Financials spreads widened the most (105%) followed by investment-grade debt–especially in Europe, where the ITraxx Main has moved 64% year-to-date compared with 36% for the CDX NA IG, which covers North America, presenting buying opportunities in the right instruments

Spreads on **EM credit** have widened by approximately 31%, weighed down by a stronger US dollar and geopolitical factors. However, EMs continue to offer diversification benefits and this sell-off presents a tactical buying opportunity, particularly among those names where we believe ESG risks are mispriced. Geopolitics are, however, unpredictable and headline risk is high. Investing in EM credit may require long-term thinking and a strong constitution.

Spreads on both **leveraged loans and HY** have widened year-to-date. We believe that loans can provide better value due to the potential for higher recovery from greater security. In HY, we will opportunistically pursue certain bonds – preferably rated BB, where we see value that is supported by solid ESG fundamentals – that have been impacted by rates moves and currently provide positive convexity. However, we will avoid lower-quality CCC-rated bonds which have rallied year-to-date.

With rate hike expectations rising, we favour floating-rate exposures through **structured credit, syndicated loans, direct lending** and **real estate debt** as they provide credit spread exposure with less volatility.

In our relative value analysis framework, **public corporates stand out** as they provide liquidity and less complexity. However, this can come at a cost, as they have generated lower historical returns than other credit sectors.

Private loans represent good relative value for mandates that can support them due to an additional illiquidity premia and lower volatility. We expect this to continue, while factors, such as regulation, will restrict traditional lending activity.

Structured credit offers lower volatility as well as diversification benefits. Technicals are driving discount margins lower on senior European Central Bank (ECB) eligible paper, which is indirectly impacting demand for non-eligible securities including **UK RMBS** and **CLOs**. At present, we are more prudent when selecting mezzanine pieces. We do not believe that we are being paid for subordination risk.

Non-banked and less banked strategies look like a good hunting ground for medium- to long-term opportunities.

While volatility remains low on a historical basis, we see value in maintaining a defence against broad, adverse market moves and providing convexity to a portfolio by buying **credit index option payers**.

Economic outlook

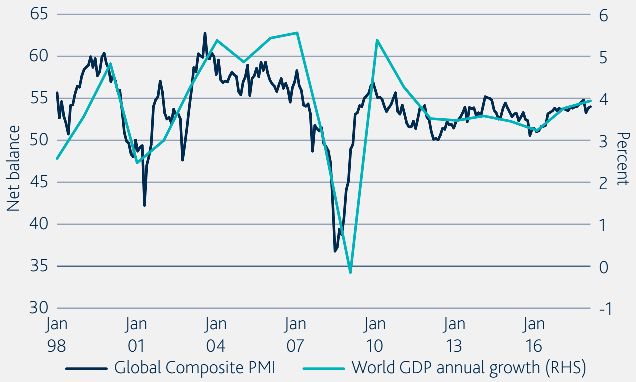
Growth continues to be steady but has become desynchronised across large economies, with an escalation in trade tensions between the US and China being the major risk.

Macro context

So far this year, economic data have been cautiously positive, with global growth now back at the levels that prevailed last year. However, the balance of risk is skewed to the downside: global growth has desynchronised, China's economy is continuing to slow, protectionism is on the rise, and the risk of a global liquidity squeeze is growing.

The global composite **Purchasing Managers' Index** (PMI) has rebounded to 2017 levels, when global output expanded by 3.7%. However, global growth is no longer synchronised: growth momentum is positive in the US, while it has faded in the eurozone, Japan and China.

Figure 3. Stronger global PMI as economies move out of lock-step



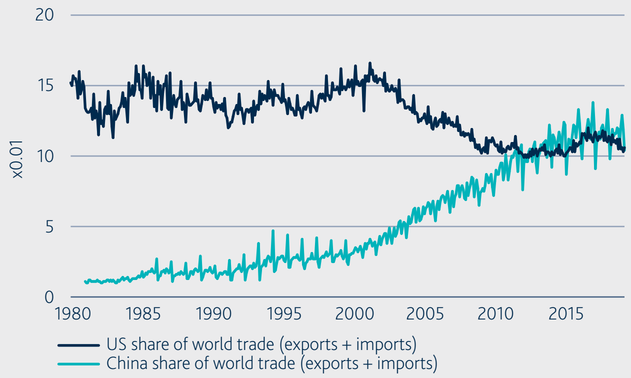
Source: Markit/JPM, IMF as at March 2018

Central banks have done a good job in phase one of the QE unwind. In June, the ECB announced that, after September, it would reduce the monthly pace of net asset purchases subject to its inflation outlook at the end of the year. It also signalled that rates will remain at current levels at least until mid-2019. Credit markets interpreted this as a positive signal, given the clear visibility of low rates for longer.

The US Federal Reserve and the ECB have also managed to provide clarity through forward guidance. This may be more difficult in the future and markets may, as a result, become more skittish.

Protectionism is the main risk clouding the growth outlook. China's share of international trade now exceeds that of the US, making trade tensions between the two countries inevitable and a geopolitical risk going forward. The macro impact of measures announced so far is marginal, but a broad-based retaliation would have vicious consequences.

Figure 4. Global trade heavyweights: China overtakes the US



Source: Reuters Datastream and IMF as at February 2018

Global financial conditions have tightened reflecting higher rates/yields, a stronger US dollar and higher oil prices. A decline in global M1 growth suggests that the impact of global monetary tightening and a US dollar shortage are causing a **global liquidity squeeze** – and EMs are the most vulnerable.

Figure 5. Is declining money supply a sign of a global liquidity squeeze?

Source: Reuters Datastream and OECD as at April 2018

Credit fundamentals – credit risk appetite

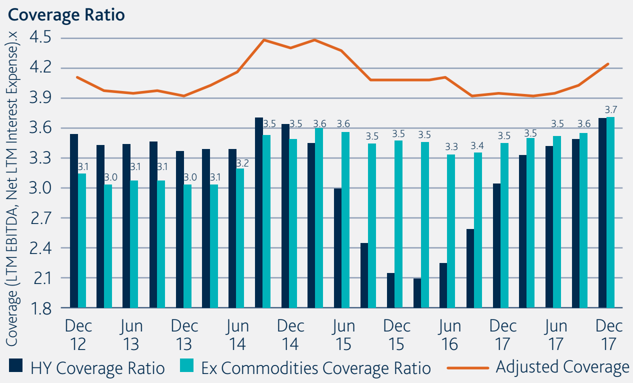
Credit fundamentals are good: leverage is stable, interest coverage high and default rates low.

Fundamentals

Global default rates should remain benign. The global speculative default rate stood just above 3% at the end of May, according to Moody's Investment Service. Going forward, Moody's expects global default rates to remain muted, with the one-year outlook for the global default rate falling just below 2%. We do not expect a significant rise in default rates for another 18 to 24 months.

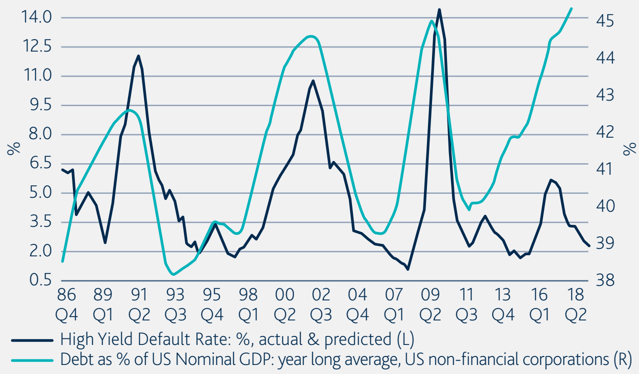
Financial leverage is rising in the US. Although financial risk has calmed (see figure 6), balance-sheet leverage is rising in the US despite a stellar H1 earnings season. That's because debt rose faster than earnings during a period of unprecedented liquidity which, alongside the aggressive US fiscal policy, is encouraging companies to borrow at low rates to spend high (see Figure 7).

Figure 6. HY issuers largely have their interest payments covered



Source: Bank of America Merrill Lynch as at December 2017

Figure 7. Default rates are at record lows, while corporate borrowing is at a record high versus GDP



Source: Moodys as at June 2018

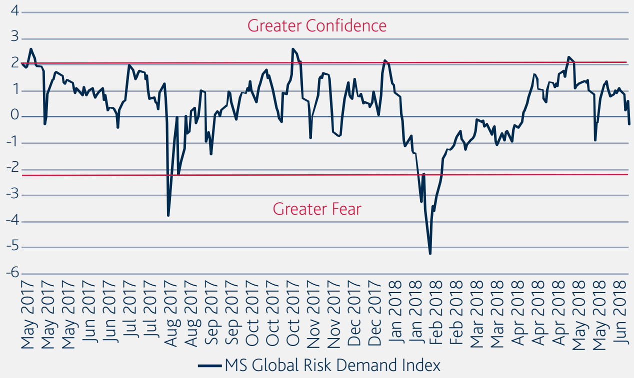
Valuations and technicals

Investor sentiment is turning negative, reflected by outflows from the high-yield market.

Sentiment

Confidence has declined and remains in broadly neutral territory. That's because the robust risk appetite following strong H1 earnings was impacted by volatility from US-China geopolitical tensions, as well as upcoming elections in EMs.

Figure 8. Geopolitical risk is a constant weight on investor sentiment

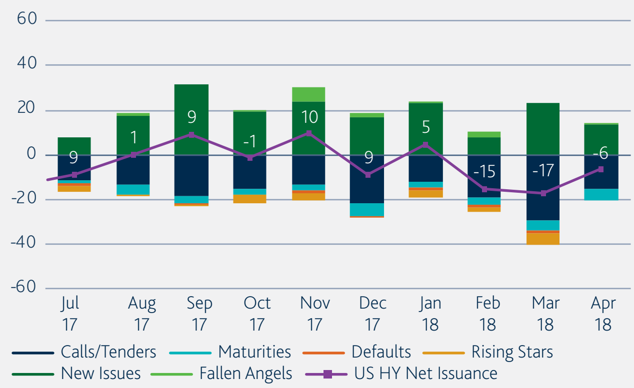


Source: Bloomberg as at June 2018

Flows

Flows are negative year-to-date but this is being partially offset by a re-allocation into unconstrained strategies and weak net supply, particularly in the US. HY strategies experienced outflows in the US and Europe in H1, while flows into IG products were positive and EM turned negative recently.

Figure 9. New HY issuance has diminished in 2018

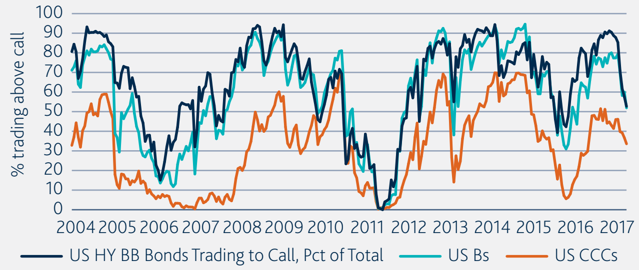


Source: Bank of America Merrill Lynch as at April 2018

Value

Convexity has improved, reflecting higher rates and wider spreads. The potential for capital appreciation in the HY market has increased, thanks to rising interest rates and the number of bonds trading below their call prices. This is evident in Europe and EM, where spreads have widened.

Figure 10. Opportunities emerging: EM spreads have declined, but areas of value persist



Source: Bank of America Merrill Lynch as at May 2018

Public credit

We favour higher quality securities with longer maturities, preferably from European or emerging-market issuers. Trade tensions have triggered repricing, with many sectors offering attractive valuations.

Liquid credit

We prefer higher credit quality. CCC-rated securities are two standard deviations more expensive than B-rated bonds. This is largely driven by the outperformance of lower quality bonds in 2018 amid a hunt for yield by investors. This suggests that there is now limited upside for CCCs. As such, we prefer to allocate capital away from this part of the market.

Figure 11. After a strong run, CCC-rated bonds are now expensive

Source: Bloomberg as at June 2018

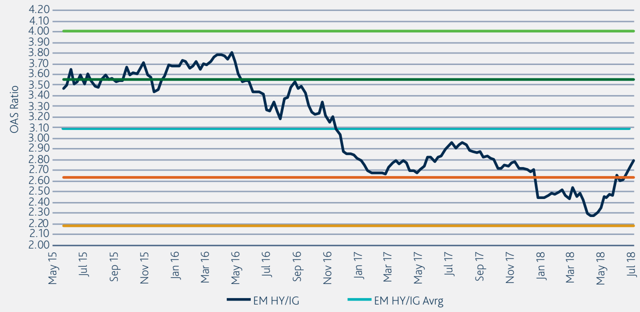
As credit curves have steepened, we prefer longer maturities. At the long end, there is an attractive combination of relative under-ownership, superior roll-down and convexity. In order to capture this value at the long end, we have optimised our positioning accordingly.

Figure 12. Going long: there is value at the far end of the US HY credit curve

Source: Bloomberg as at June 2018

Within EM, we prefer investment grade to high yield. Since 2015, there has been a lack of dispersion risk priced in to EM high yield compared to EM investment-grade credit. As a result, we prefer investment-grade to high-yield EM issuers, particularly when the company demonstrates improving ESG fundamentals. At a regional level, the underperformance of Latin America on a year-to-date basis creates an opportunity for tactical allocation of capital to this region.

Figure 13. Opportunities emerging: EM spreads have declined, but areas of value persist



Source: Bloomberg as at June 2018

Cable and Satellite is one of our preferred sectors, as we believe secular changes will impact companies across the quality spectrum. In turn, this creates opportunities to invest in issuers with appropriate capital structures and enough levers to weather the storm.

Figure 14. Weathering the storm: Cable and Satellite look attractive

Source: Bloomberg as at June 2018.

Private credit

We prefer senior loans in northern Europe, while leveraged loans continue to demonstrate strengths relative to high-yield corporate bonds.

Private debt

UK and European yield premiums are shrinking due to stronger UK growth. There has also been a significant improvement in the UK mid-market M&A pipeline, causing pricing competition to fall and mid-market loans are now providing a yield premium of about 85-100bps relative to euro-denominated loans. The retail and hospitality sectors, which are currently experiencing some stress, remain a concern in the UK private debt market. This has led to a rise in loan defaults.

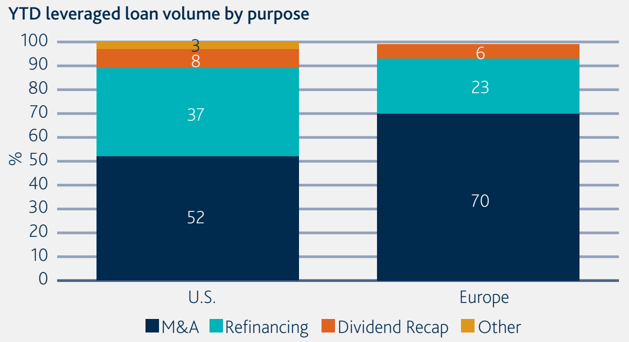
We prefer Northern to Southern Europe, where yields are too low to compensate for higher legal risks. Alternative loan deal flow remains strong in Scandinavia, France, Germany and, increasingly, Italy. In France and Italy, banks are returning more aggressively to the loan markets, which has pushed yields down. This means that investors are not being compensated for the legal risks in these two creditor-unfriendly countries.

There's value in senior versus mezzanine or second lien loans. Mezzanine loan issuance remains very light in Europe and second lien is increasingly replacing the traditional mezzanine tranche in structures. This means that there is still value in the senior loan space.

Leveraged Loans

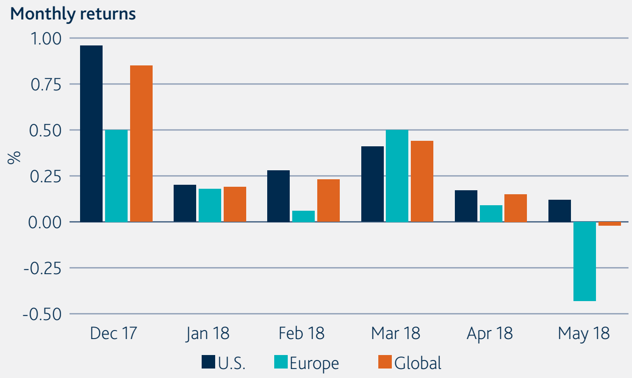
There's better value in the US than Europe. The new-issuance loan volume remains buoyant, fuelled by M&A-driven financings rather than refinancings. The US LSTA Leveraged Loan Index has continued to outperform the European index, and presents better value for investors due to higher base-rate earnings, which have resulted in better liquidity and improved earnings.

Figure 15. Deal-driven deal flow: greater M&A has increased loan demand



Source: LCD, an offering of S&P Global Market Intelligence as at June 2018

Figure 16. Leveraged loan returns in 2018 so far



Source: S&P/LSTA Leveraged Loan Index, S&P European Leveraged Loan Index, S&P Global Leveraged Loan Index as at June 2018

Loans look attractive compared to high-yield bonds, due to their higher recovery rates and stronger returns. The European Leveraged Loan Index and the US LSTA Leveraged Loan Index have continued to outperform the European and US high-yield indices. Similarly, the US LSTA Leveraged Loan Index outperformed its European counterpart on a year-to-date basis, which represents a reversal of the same period in 2017.

Figure 17. US and European Loans are outperforming their respective high-yield credit markets

Returns

	Jun-18	YTD 18	YTD 17
European Loans	-0.43%	0.90%	2.65%
US Loans	0.12%	2.16%	1.91%
Global Loans	-0.02%	1.84%	2.10%
European HY	-0.46%	-1.69%	4.10%
US HY	0.33%	0.06%	4.91%

Source: S&P European Leveraged Loan Index, S&P/LSTA Leveraged Loan Index, S&P Global Leveraged Loan Index
**European & Global Index returns exclude currency fluctuations*

Asset-based lending

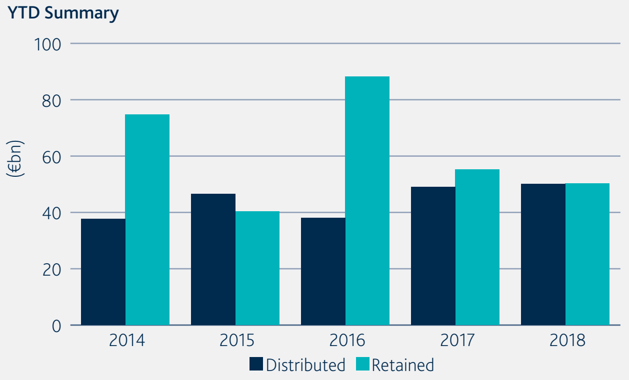
The UK market continues to offer the best value for investors in RMBS and in private, commercial real-estate-debt transactions.

Structured Securities

The new-issue pipeline has been strong this year and this volume is expected to continue as the UK and Europe wind down their QE programmes. Distributed new issues, which are backed by a wide variety of asset types, were launched in Q2 2018. Most notably, the re-emergence of commercial mortgage-backed (CMBS) securities as an asset class has continued in Q2 2018, with a number of deals across Europe.

However, we have not seen issuance to fund energy-efficient projects in the first half of the year, since the category has not yet been standardised across Europe.

Figure 18. Distributed, i.e. tradable, structured-credit issuance has been strong in 2018



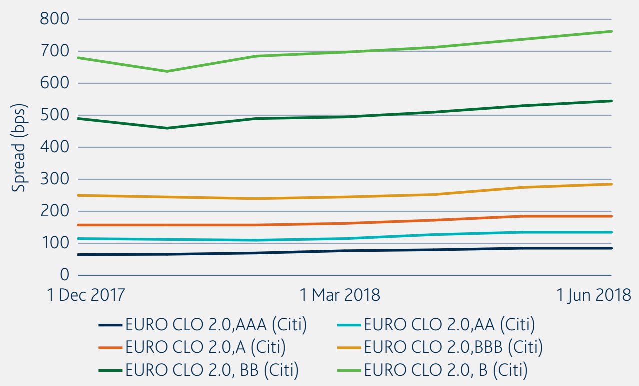
Source: J.P. Morgan International ABS & CB Research

Stable spreads for asset-backed securities (ABS) as UK residential mortgage-backed securities (RMBS) provide better relative value. While spreads in the majority of ABS across the capital stack have traded marginally tighter or sideways in Q2, peripheral paper experienced some weakness, due to political upheaval in Italy. On a relative value basis, UK issuers continue to look more attractive than their European counterparts. Select UK non-conforming and buy-to-let RMBS deals offer reasonable returns.

We are mindful of the possibility of a sell-off should the UK leave the EU with a no-deal Brexit. We would see this as an opportunity to buy.

Widening of CLO spreads likely to continue in the short term amid increased supply. CLO spreads widened in Q2 due to increased issuance and a number of refinancings and re-sets of existing deals. The large number of outstanding warehouses continues to weigh on investor sentiment. AAA-rated securities are now printing in the low 80s on a spread basis – a price level which appears to be supported by Japanese investor demand. Meanwhile, down the stack, BB-rated instruments have widened by 35-50bps, with new issues currently pricing in the mid- to high-500s on a spread basis.

Figure 19. Widening CLO spreads year to date

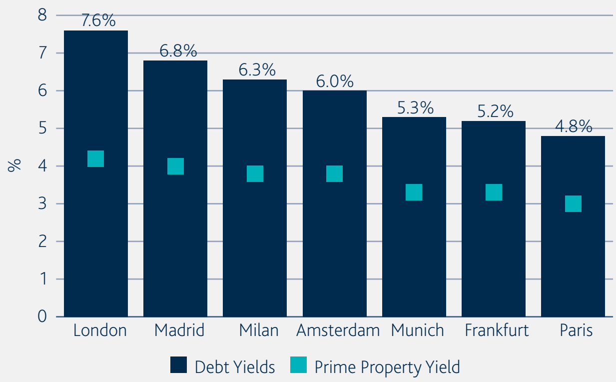


Source: Citi Velocity as at June 2018

Asset-based lending

We focus on asset selection to source the right risk. The **UK real-estate debt** market continues to look more attractive than its European counterpart, providing opportunities to lend against sustainable assets. However, the retail property sector continues to suffer in the UK due to the weakness of the high street. Development loans in the commercial property sector look attractive. So does the residential market, where the end product appeals to the mass market and is located in a strong urban location outside London and the south east.

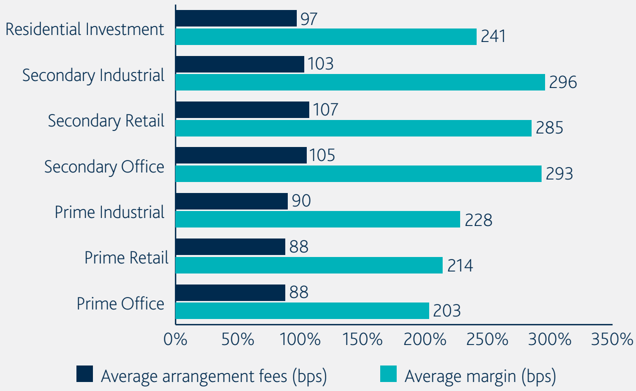
Figure 20. London generates strong real-estate debt yields



Source: Cass Real Estate Lending Survey Presentation (YE 2017) and Cass Commercial Real Estate Lending Report (YE 2017) as at Dec 2017

Achieving the right reward. By supporting existing borrowers with new opportunities, it is possible to drive a pricing premium in the current market. That's because borrowers are content to pay for a strong lending relationship and certainty above delivery in what is still a competitive equity market. This is particularly relevant in markets where domestic banks are struggling.

Figure 21. Average loan terms (MY 2017)



Source: Cass Commercial Real Estate Lending Report (YE 2017) and Cass Commercial Real Estate Lending Report (MY 2017)

We still favour illiquid and non-standard assets: As the issuance of CMBS increases, a clearer view of the liquidity premium in the real-estate debt market is emerging. When more data becomes available, we believe the premium will still be in excess of 100bps. However, this is not always the case for comparable assets. The collateral for securitised deals is generally different from those financed purely through the loan market. But whether the two collateral pools would behave similarly in a downturn is not obvious.

OUTCOMES BEYOND PERFORMANCE

HERMES INVESTMENT MANAGEMENT

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Credit
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Multi asset
Multi asset inflation

Stewardship
Active engagement, advocacy, intelligent voting and sustainable development

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