Long Term Valuations Can't Be Ignored

INSIGHT

April 1st, 2020

Executive Summary:

- In our opinion, corporate credit markets have faced three large shocks: volatility, convexity and liquidity. These have rarely coincided
- Globally, economic forecasts are still unstable and being revised downward almost on a weekly basis. We now believe that an exceptionally deep, but hopefully short recession is priced in
- Monetary policy has been reactive with swift rate cuts and record quantitative easing programs which have yet to kick in
- Fiscal policy is taking shape with significant stimulus programs planned globally
- Banking support (particularly in Europe) is crucial through cheap financing and loan guarantee schemes
- Corporate credit fundamentals have deteriorated but corporates are under pressure to improve credit metrics
- Large corporate credit outflows have temporarily weakened technicals
- Corporate credit spreads now incorporate a significantly higher risk of default or downgrade (fallen angels) and reflect an exceptionally high liquidity premium
- Total return outlook for corporate credit has been historically positive when spreads have reached such crisis levels

Corporate credit markets are currently facing a critical valuation and liquidity challenge, as spreads have widened towards levels not seen since the Great Financial Crisis in 2008-2009. After positive inflows in 2019 and the beginning of 2020, outflows over the past few weeks have pushed back spreads to a decade high. No fixed income asset class or credit quality bonds have escaped the selloff. In our view, it is now time to look through the current price dislocation in an attempt to grasp the historic opportunity in spreads and the strength of the policy responses against the economic consequences of COVID-19 outbreak.

Unprecedented Stimulus Packages and Policy Response

The policy responses are being built based on three pillars:

- Monetary policy
- Fiscal policy
- Protecting the banking sector

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Portfolio Manager & Head of Public Markets

Michael manages the Muzinich Global Tactical Credit strategy. Prior to joining Muzinich in 2012, Michael was president and Head of the High Yield Division at Seix Advisors, Inc. At Seix Advisors, he was the founding partner of the high yield strategy that grew to over $13 billion under his leadership. Previously, Michael served in various research and portfolio management capacities at American General Corp. and at Capital Holding Corporation. He earned a BA in Management Science from the University of California, San Diego and an MBA from Rice University.

Erick Muller, MBA
Director of Product & Investment Strategy

Erick joined Muzinich in 2015. His responsibilities cover macro and fixed income markets strategy and product management as well as client relationships across institutions, global distribution platforms and global private banks. He joined from JP Morgan AM, where he spent nearly four years as Senior Client Portfolio Manager. Prior to that he spent over four years as Head of Fixed Income Product Management at Fidelity Worldwide Investment and before he spent eight years as Global Head of Capital Market Research at Crédit Agricole CIB. Erick has an MBA in Finance – Marketing from the ESLSCA Business School and a degree in Economics from the Université Panthéon-Assas.

Monetary policy has been the more reactive part, with generalized policy rate cuts and immense liquidity provisions through either bank refinancing tools (Targeted Longer-term Refinancing Operations - TLTRO in the Eurozone) or specific liquidity programs (Commercial Paper Funding Facility, Primary Dealer Credit Facility, Money Markets Mutual Fund Liquidity Facility). Monetizing the expected extra deficit through quantitative easing is also in motion, but the calibration of these programs will continue to evolve: firstly, as the size of the extra deficit to be financed is still to be calibrated; secondly, as the eligible assets must be in the appropriate size to solve the challenges; thirdly, as the legal framework needs to be adapted; and finally, as the credibility of Central Banks over the long term needs to be preserved. However, we believe the various measures already decided on by a number of Central Banks, including the Federal Reserve program on corporate bonds, is undeniably providing a liquidity backstop.

Fiscal responses are also now taking shape and, although they tend to vary country to country, are providing a relatively consistent backdrop. This is namely by addressing the following: financing the healthcare challenge; implementing measures to avoid a default chain reaction (e.g. tax deferrals, part time work, unemployment support); loans to guarantee schemes to help mitigate the credit risk from the banks' balance sheet; and domestic demand stimulus (e.g. crisis aid, checks directly paid to individuals, specific aid to small and medium-sized enterprises (SMEs)).

In our view, banking sector support is particularly important, even more so in Europe where a majority of lending to corporates goes through this channel. The state guarantee schemes are critical for the credit risk to be transferred from the banks to states and is being widely adopted across Europe with the European Central Bank (ECB) having recently loosened the rules for Non-Performing Loans (NPL) and provision accounting.

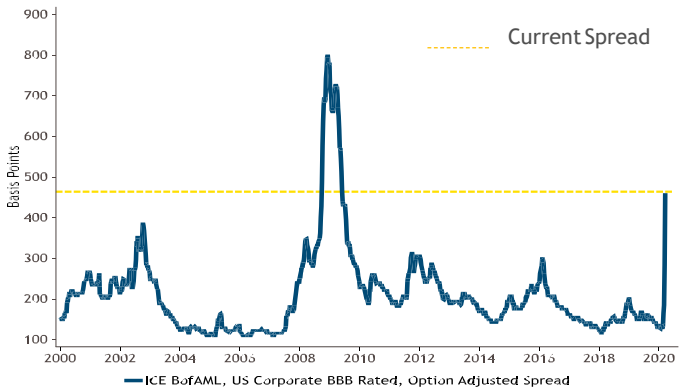
Capital buffers could be used to support lending activity (BoE, ECB for instance). The stimulus bill, pending finalization in the US, contains powerful measures which should help the Federal Reserve to activate corporate bond purchase programs at a much larger scale than the one announced on March 23, 2020, directly impacting corporate financing and reducing the burden on the banking sector to support businesses.

What You See Now is Credit Spreads with Historically Wide Valuations

We believe credit markets faced three large shocks: volatility, convexity and liquidity. We believe this rare combination explains the current crisis in valuation levels. Looking at long-term valuations of credit spreads, it appears that current levels have materially surpassed the most recent crisis tops, be it the internet bubble in 2002-2003, the Euro sovereign crisis in 2011, oil crisis and China hard landing in 2014-2015 and trade tensions climax in Oct-Dec 2018. It has reached almost two thirds of the spreads back to 2008-2009 during the Great Financial Crisis.

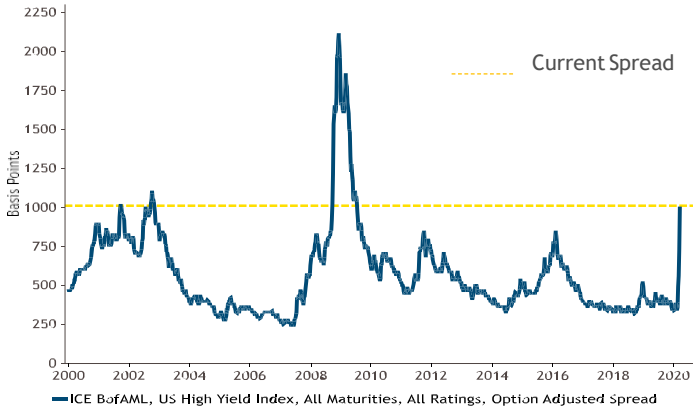
Figures 1 to 4 show US and Euro Spreads for Investment Grade and High Yield.

Fig. 1 – US Investment Grade Option Adjusted Spreads



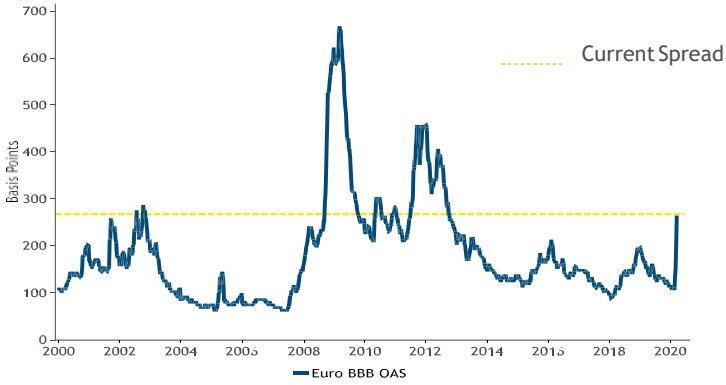
Source: ICE BofA US Corporate BBB Index (C0A4). Data as of March 23rd, 2020.

Fig. 2 – US High Yield Option Adjusted Spreads



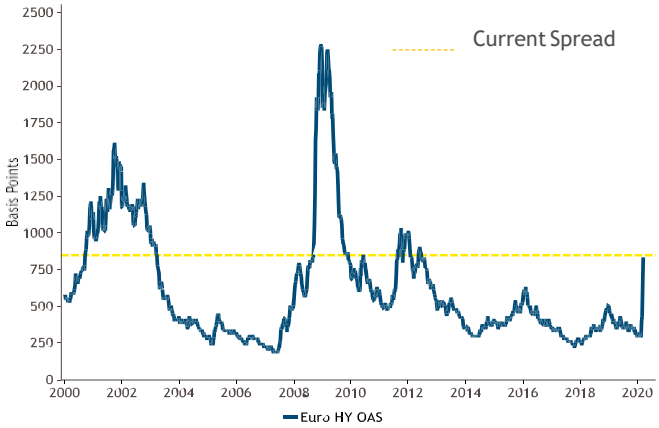
Source: ICE BofA US High Yield Index (H0A0). Data as of March 23rd, 2020.

Fig. 3 Euro Investment Grade Option Adjusted Spreads



Source: ICE BofA BBB Euro Corporate Index Index (ER40). Data as of March 23°, 2020.

Fig. 4 Euro High Yield Option Adjusted Spreads



Source: ICE BofA Euro High Yield Constrained Index (HEC0). Data as of March 23rd, 2020.

We believe these spreads are now pricing a deep recession for the first two quarters of 2020 and a significantly higher risk of default or downgrade. In our view they also reflect an exceptional liquidity premium. Whether these valuations are large enough to enter back into the market should be put into perspective with fundamental analysis and technical factors.

Fundamentals Have Deteriorated But Corporates Are Under Pressure To Improve Credit Metrics Going Forward

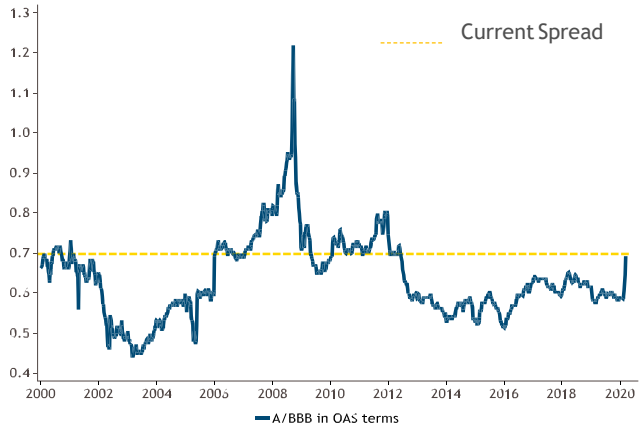
Forecasts for global economic growth are being revised down every day and cannot be stabilised before tangible signals that the pandemic has peaked. Our consensus view is that the recession shock will be severe but temporary and that there will be no permanent loss to potential output. A supply disruption, but no supply destruction. The energy sector, which represents a significant portion of the US credit market, has also been impacted by the decline in oil price as a result of the Organization of the Petroleum Exporting Countries (OPEC) failure to agree to production cuts. It would be naïve to think that the default rate will not rise. It will. But, for many corporates, balance sheet management will look very different going forward.

In our view, quantitative easing with low interest rates have encouraged many Investment Grade companies to leverage their balance sheet, accepting a lower rating, in order to finance share buy- backs or acquisitions, benefitting from benign market conditions. The sudden and unexpected stop in activity and the refinancing needs at a time of market stress reveals the fragility of such "capital optimization" and is likely to force balance sheet contraction and the preservation of bond holders' interest to survive such a severe crisis. That is why, in our view, portfolio positioning today must focus on the strength of balance sheet or on the room available to strengthen it and the capacity to resist a potential big loss of revenues and earnings.

Many market participants have focused recently on credit quality, fearing an avalanche of downgrades in the BBB segment. In contrast with 2019 where rising stars outnumbered fallen angels in USD terms, in 2020 it is estimated that there will be more than US$200 bn of fallen angels[1]. In our view, the widening of BBB spreads versus A spreads has already priced in this outcomes. On the other hand, companies belonging to the most impacted sectors can be hit more severely and be downgraded by several notches, while many "frontier" companies belonging to defensive sectors or those able to adjust their balance sheet rapidly may fair relatively better.

[1]Source: JP Morgan Credit Research. Eric Beinstein as March 2020.

Fig. 5 A issuers on BBB issuer spreads US IG market



Source: ICE BofA US Corporate Single-A Index (C0A3), ICE BofA US Corporate BBB Index (C0A4). Data as of March 23rd, 2020.

Some sectors are being hurt more than others, which in our view leaves little hope of improvement. Airlines, energy production, offline gaming/casino, leisure, and hotels are directly affected.

The severity of the macro shock on corporate balance sheets due to the spread of COVID-19 will force the corporates to focus tomorrow on the consolidation of their credit metrics, which may trigger a positive momentum on fundamentals.

Unprecedented Outflows Have Weighed on Technicals Which Are Expected to Improve as Quantitative Easing Programs Step In

The high level of inflows seen last year in fixed income markets, especially in investment grade and emerging market bonds, was the reason for the credit spreads compression to tight levels and a dominant theme in portfolio positioning. This trend has reversed in 2020 as a result of the impact of COVID-19 outbreak and the fall in oil prices, which has had a devastating impact in investors' risk appetite and flows direction.

Data from Emerging Portfolio Fund Research (EPFR) shows the outflows from corporate bond funds had accelerated in the last weeks, particularly impacting not only passive funds (Exchange-Traded Funds) but to some extent active funds. The implementation of quantitative easing programs takes time, but once it is done it will eventually provide some support. In the Eurozone, the embedded flexibility in the Pandemic Emergency Purchase Programme (PEPP) suggests the more vulnerable segments will be supported first. In the US, the opportunity for the Fed to address liquidity and price dislocation in credit markets has now taken the form of a temporary credit facility, which, with calibration, can be enhanced.

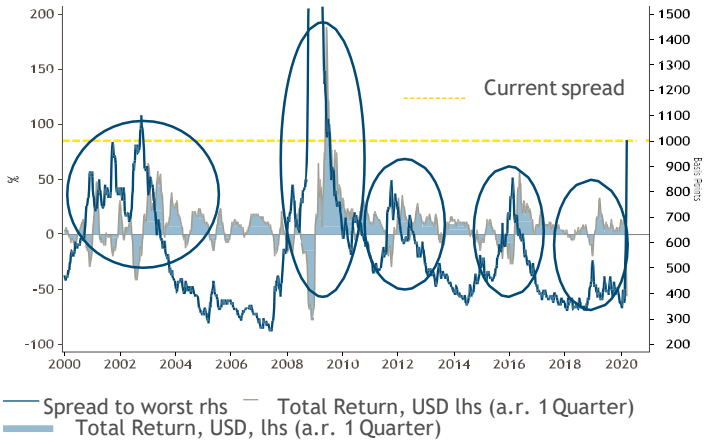
On the supply side, the low interest rates and low yields regime over the last few years has encouraged issuers to lengthen their maturities. This suggests that there are no maturities that will further stress the credit markets in the short term. Such assessment may evolve if market conditions remain poor for a prolonged period of time, but we take comfort in the fact that some investment grade new issues have met some demand last week, albeit with significant concessions. For corporates with more pressing financing needs, the banking sector may offer some bridging capacity with the support of loan guarantee schemes implemented by the various governments.

Total Return Outlook Has Been Historically Positive when Spreads Have Reached such Crisis Levels

If history is a guide in terms of return expectations, markets can recover quite quickly after a significant widening in spreads. The figures below shows annualized rolling quarterly total returns for high yield and investment grade credit markets. Waiting for all the conditions to be met before entering the market can represent a significant opportunity cost, as markets can move with the same violence on the upside as on the downside.

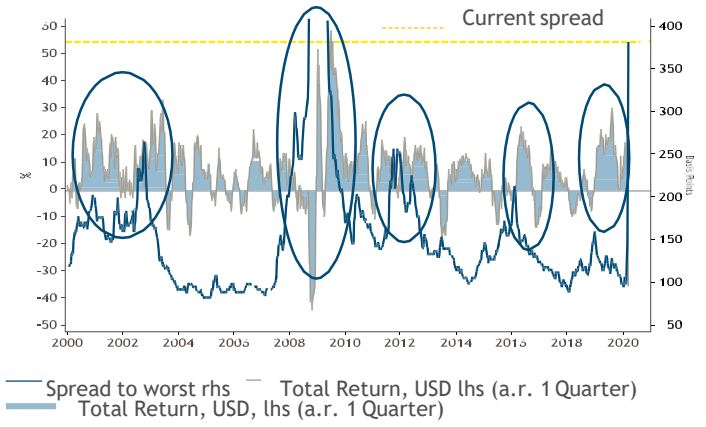
We believe that once markets grasp the magnitude of the global policy response and the concrete implementation of the central banks actions in financial markets, return expectations may rapidly reverse into positive territory for the rest of the year.

Fig. 6 Spread to worst for US High Yield and rolling 3mnth total return annualized



Source: ICE BofA US High Yield Index (H0A0). Data as of March 23rd, 2020.

Fig. 7 Spread to worst for US IG and rolling 3mnth total return annualized



Source: ICE BofA US Corporate Index (C0A0). Data as of March 23rd, 2020.

There is a high level of uncertainty in the development of COVID-19. The timing and length of the measures to control the spread of the virus play an obvious role in the speed and magnitude of market recovery prospects. While the value of the credit market is widely acknowledged today, the need for catalysts is clear. In our view, the policy responses put in place by governments around the world will eventually be one major catalyst when finalized. We believe the return of liquidity will be eased in encouraging investors to benefit from this potential valuation opportunity.

As ever, timing exposure to the credit markets is impossible with any degree of certainty, but history strongly supports the thesis that, in the medium to long term, owning credit at these spread levels has empirically led to what we believe to be superior returns.

Index descriptions:

C0A4 - The ICE BofA ML BBB US Corporate Index is a subset of the ICE BofA ML US Corporate Index (C0A0) including all securities rated BBB1 through BBB3, inclusive.

H0A0 - The ICE BofA ML US High Yield Index tracks the performance of US dollar denominated below investment grade corporate debt publicly issued in the US domestic market. Qualifying securities must have a below investment grade rating (based on an average of Moody’s, S&P and Fitch), at least 18 months to final maturity at the time of issuance, at least one year remaining term to final maturity as of the rebalancing date, a fixed coupon schedule and a minimum amount outstanding of $250 million.

ER40 – The ICE BofA ML BBB Euro Corporate Index is a subset of the ICE BofA ML Euro Corporate Index (ER00) including all securities rated BBB1 through BBB3, inclusive.

HEC0 – The ICE BofA ML Euro High Yield Constrained Index contains all securities in the ICE BofA ML Euro High Yield Index (HE00) but caps issuance exposure at 3%.

ICE BofAML Single-A US Corporate Index (C0A3) ICE BofAML Single-A US Corporate Index is a subset of ICE BofAML US Corporate Index including all securities rated A1 through A3, inclusive.

C0A0 - The ICE BofA ML US Corporate Index tracks the performance of US dollar denominated investment grade corporate debt publicly issued in the US domestic market. Qualifying securities must have an investment grade rating (based on an average of Moody’s, S&P and Fitch), at least 18 months to final maturity at the time of issuance, at least one year remaining term to final maturity as of the rebalancing date, a fixed coupon schedule and a minimum amount outstanding of $250 million.

You cannot invest directly in an index, which also does not take into account trading commissions or costs. The volatility of indices may be materially different from the volatility performance of an account or fund.