US Long Short Credit Webinar Q1 2021

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EM: We are currently in an unusual situation with the market and economy where the US is extremely strong while Europe is still playing catch up. What does this mean for you and your risk appetite? Do you feel this has already been priced in?

BL: We believe in the reopening of economies and the reopening trade, but we are concerned with valuations and how much has already been priced in. We are cautiously optimistic from a macro perspective, and that leads us to be cautious with positioning given valuations in fixed income, US high yield (HY) particularly. We are positioned slightly more conservatively from a duration and net exposure perspective. We believe we should be more invested, but it is about the right kind of investment, such as reopening and pair trades.

EM: With the reopening there is expectation that inflation is moving up, and a recovery in the US led to a decisive move in US yields in Q1. What does that mean for the duration of the strategy, and what is your expectation on yields?

BL: Around November we started significantly shortening duration, as originally valuations were the concern, not reopening risk. We took a step back and questioned how we should be positioned with these competing forces, as the strategy moved quite a bit from mid-high duration to worst. As we are not beholden to just having a long position, we can change the net exposure of the strategy and shorten duration quite a bit, using cash shorts and reducing cash longs. In March, the interest rate volatility did not impact us in the same way as it did others, as we were already set up for this scenario. The hard part now is knowing when to move on, from the long and short side.

EM: If we continue to have strong GDP numbers for the next few quarters there is a risk of rising inflation, but we do not know to what level. As you are close to analysts, what is the feeling on supply chain problems? Any purchasing issues? Are prices moving up? Fundamentals could derail credit markets given tight valuations.

BL: There is a balance to be struck between market forces moving and central banks, which do not always move in the same direction. Cyclical analysts say there is quite strong demand for products, and certainly in commodities, autos etc. demand seems to be there. The issues and concerns are more around people and labour, and whether there will be wage inflation. Do you need to incentivise the labour force to meet this demand? We have to follow the commodity side closely. Our perspective is we see some glimmer of modest cost pressure.

This is different to Q4 2018 in that we have high growth expectations, low Treasuries, and it is a balance for fixed income investors to navigate. With central bankers, there is the question of what inflation might mean, but they are fairly cautious at this point, and we are not there just yet. As we learned from March last year if you are not early you are very late. We are going to continue to be cautious, given we do not believe there is enough spread to absorb a significant rate move if it

happens. It is good to see growth, and there are pockets of cost pressure, so the demand side is positive. We are conservative in our net long.

EM: Spreads are tight despite yields rising and the credit market has been resistant to shocks in yield, but it started from such a low point that perhaps it will take longer to bite. Valuations are now tight, so how do you navigate this, and where do you find value in sector allocation/rotation? You said throughout 2020 that the arbitrage book was important, can you update us on it?

BL: We agree – valuations feel snug now. With respect to the four books our position has evolved, and duration has been shortened, primarily from the long book. We are more heavily weighted in the belly of the curve, around 5-6Y paper, from a maturity perspective. This has been a large move which we started in Q4 2020 and continued into this year. From a sector perspective, we are involved on the long side in a pro cyclical trade – in metals, mining, steel, autos etc. We are significantly overweight the index by multiple amounts, despite not being an index strategy. That has been our largest sector move.

The other major sector is energy, with respect to the long book, where we have turned over quite a bit and the energy weighting in the strategy has come down. We were able to take advantage of some unique opportunities and underlying commodity moves. With ratings we are more CCC heavy, as we have been in a compression trade for the better part of six months, we have recently started winding it down so the weighting has moved from about 15% of the strategy to about 10%. Any CCC exposure is about selecting credit. We are more heavily weighted towards those in better sectors and higher quality defensive sectors, but with not as strong balance sheets.

We made big changes on the long book regarding sector/rating/duration. With the short book it turned over a bit, and we were short a handful of low coupon long duration bonds, which were able to protect capital during the first couple of weeks in March when the interest rate volatility was high. Whilst others were experiencing a double point move, our peak to trough was around 4bps. If you pay the bid-ask spread, you must pay attention upfront, and focus on liquidity on the way in as you will pay on the way out.

With the short book, we took a negative convexity trade, which was more thematic given interest rate moves. Reopening risk has evolved – whilst initially we felt valuations on the reopening trades ran a bit too much, curves are now flattening. This makes us consider pair trades – hospitality, leisure, entertainment etc – pairing off within sectors and against high quality short duration bonds. Gross exposure in the short book has come down quite a bit, as we have monetised some and paired a lot up.

The arbitrage book has ebbed and flowed – we often describe it as a revolving door. Some metals, mining, and energy trades have monetised recently, and there are some new trades more on the reopening side with leisure and entertainment etc. Given how far the market has moved, where do we think fundamentals will go? We have started to see dispersion of returns and dislocation. On aggregate our net exposure is higher, on a beta adjusted basis it is slightly lower, and we continue to turn over and rotate out of certain shorts whilst focusing on increasing the gross exposure of the arbitrage book, trying to monetise trades when they happen (as they are happening quickly).

EM: How has your cash position evolved over the past few weeks/months?

BL: We have seen a tonne of new issues and now have a huge glut in supply, which has soaked up a fair amount of the market's cash. We had a pretty high cash balance in the strategy (high single digit/low double digit), but we found some unique short duration opportunities and select new issues. People are now selling some recent new issues in order to make room in the calendar. This is the first time we have seen market cash balances not quite as high as they were, as price moves on recent new issuance and short duration. We want to be on the other end of people selling short duration to buy new issuance, as we can do both.

Our cash balance is now lower than it has been (mid-single digits) but it is temporary given the flexibility we have. We have a handful of short duration bonds to be called within the next few weeks, so each week we will deploy cash, which we view as an asset. We are paid to stay in the front end, and are selective with opportunities further along the curve and new issues.

EM: The technical factors on the short end of the curve are positive. Do you think companies will continue to raise cash this year; we have seen an enormous amount in Q1 which does not feel sustainable? What do you think about the demand side and supply side, given there still seems to be an enormous amount of money not invested?

BL: On the supply side we have seen outflows from ETFs, mutual funds etc. In Q1 2021 US HY did not see huge inflows We were surprised by the amount of supply in Q1, but we are starting to see a change from what it was.

For the rest of the year, we will see COVID-19 rescue financing deals in the short-term, which will come to market and take care of older tranches. We will see a fair amount of supply due to this dynamic, and we want to follow the flows right now. With our cash balances a little lower, we will rotate out of short duration and some recent new issuers.

The technical is still supportive, and you see a buy-the-dip mentality. The volatility from interest rates in March only lasted three weeks, and it is hard to turn over the strategy in that time, especially when you feel there may be more room to run. The composition of that supply will change, as many companies that wanted to tap into low coupon long dated paper have done so, and we expect to see changes in 10Y paper, to focus more on 5Y or 8Y.

We are more selective on new issues than in the past, with valuations where they are, and asking whether it is worth it and whether the upside/downside is skewed in our favour. How are we being compensated to part with cash? If it does not meet our criteria, we will sit in cash until we see the right opportunity.

EM: One opportunity we see is loans – is this trade exhausted?

BL: The large change in the loan book, and part of why our net exposure is higher and duration lower, is that we increased our loan exposure quite a bit. If you have valuation concerns from fixed rate products, if you have interest rate concerns, but believe in the economy, reopening trades and global growth, loans seem to be the right place. That was our mindset. Select loan issuance made a lot of sense for us, and we increased our position quite a bit.

There are some constraints with loan products, given callability etc., and we try to find the right opportunities to get in and stay invested, but we are not afraid to rotate out as we can with bonds. The core base of long holdings in the strategy, certain names reach a peripheral level (e.g. above

par) and are no longer benefitting us with carry, as we are taking on too much risk. We plan on maintaining high loan exposure (within our guidelines) for the foreseeable future and need to keep underwriting credit in the right way. There will be a rotation/turnover, but we will keep core holding on the long side with respect to loans.

EM: We have seen a change in volatility in the last few weeks; is it cheaper to hedge, or to be long volatility through different option strategies?

BL: We are volatility buyers – we do not write uncovered calls for example and take a measured approach to hedging and risk management. Over the last few weeks, we have taken advantage of lower volatility by adding to hedges – not a lot, but given the position on the cash bond side, simple put spreads and CDX HY volatility is cheaper, everyone is looking to unwind hedges.

We are long from a notional perspective but shorter on duration, more conservative. We are balancing our overall risk budget against how we are positioned on the cash side – we have started to add hedges over the past couple of weeks, as volatility is cheap, and it made sense. A good way for us to balance that out is adding select new issues, and credit selection against the market short.

Volatility came in quite a bit (with the exception of today [20th April 2021]), so it made sense to redeploy our hedges. March went through boom and bust very quickly, and there were unique opportunities to counterbalance against the rest of the strategy position. We will continue to monitor our hedges, as we have to trade, not just set and forget.

We are shorter than we have been in the past; January 2020 was about as cheap as it got, we are not quite there yet but nearly back to pre-COVID-19 levels. This wiggle room makes our positions feel OK for now, trying to navigate risk and generate return.

EM: There is very active management in this strategy, with the overlay portfolio. Regarding the global part of your portfolio, where do you see relative value? What are your thoughts on the US vs. Europe? Your fund can also invest in EM, what is your outlook?

BL: There is a difference in the economies in Europe versus the US, when it comes to reopening versus lockdown. We, perhaps incorrectly, made the decision to reduce our allocation to European HY, and from the end of last year until now that allocation has been roughly halves. We were concerned the fundamentals did not seem as good, the European Union seemed blocked over the vaccines, and where the valuations were, we did not feel incentivised to stay. That was our biggest change in allocation. With the dollar/euro hedging costs low we did not feel we were getting bang for our buck and redeployed into US short duration. At the moment we do not really have any EM exposure, and typically if we did it would be paired. We are very comfortable right now with our bend towards the US, given what we have discussed and valuations.

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