COVID-19 INVESTMENT UPDATE: GLOBAL CREDIT TEAM UPDATE – 29 JUNE 2020

A fortnight which has displayed the fine balance markets are currently at with fears from the ever present risks of COVID continue to conflict with the ameliorating impacts of policy. With high yield spreads at 520bps we've gone sideways over the last two weeks but seen significant issuance across all markets.

Key events

- Policy support exhibit 'a' – the Fed stepped in at the beginning of last week to announce it was reconfiguring one of its investment grade bond buying programs to allow it more flexibility to buy bonds in the open market. The timing (the first significant equity/credit sell-off in a few weeks) makes us feel a little queasy as we think the Fed should be dealing with tail risks and not trying to prevent every sell-off. Markets, however, cheered the behaviour with spreads correcting their descent.
- Policy support exhibit 'b' – we had the Bank of England expand its QE/monetary financing by £100bn. We saw some strange headlines post an interview the new Governor gave (about how the U.K. almost 'ran out of money'). Monetary financing of the deficit is completely possible if you have a sovereign currency so we are a little puzzled by the new BOE governor perpetuating the household/corporate analogy. Irrespective it emphasises that interest rates across the yield curve are likely to continue to be repressed for some time.
- We saw increased COVID case counts across states in the US that have reopened and across many parts of the developing world. Interestingly death rates are much lower in the US in these states (a combination of a younger demographic getting the virus and better medical knowledge of treatment). As a result of the resurgence some US states (Florida, Texas) are backtracking on the shape of reopenings with bars and restaurants being told to reshutter.
- We saw large financings for pre COVID LBOs – Eldorado and Thyssenkrupp. Eldorado is a gaming acquisition that required $8bn of financing and Thyssenkrupp was a leveraged buyout of an elevator business with another $8bn of debt. Both these deals accessed both the leveraged loan and high yield bond markets. Interestingly absolute pricing was at similar levels to what we would have expected in the pre COVID period and yet the deals were multiple times oversubscribed (Thyssen is set for completion early this week but market soundings show it is going extremely well). With these jumbo LBOs we are seeing a reversion of the loose covenant trend pre COVID. These deals were also notable as they had significant CCC tranches (a combined total of over $3bn) and eye watering leverage levels. With deals like these thriving we really don't think the Fed needs to add more fuel to the fire here.

What makes us worried here?

There are a few warning signs of the Feds interventions skewing behaviour – we've seen ETFs almost double in market cap and this does make us nervous as ETFs are mechanistic volatility extenders for our market. We don't think high yield ETF Growth is something to be welcomed and hope the Fed's actions in re-examining its investment grade ETF buying is replicated in high yield markets.

We now have sufficient evidence from differing types of lockdowns that consumer behaviour seems to have front-run many lockdowns. Equally the devastation we are seeing in Brazil and many other developing countries shows us that in many countries with informal economies there is no alternate to a reopening of some economies. In the developed world where there is much more consumer choice we think it will take some time for people to normalise their behaviours in many instances and so are still cautious on the restaurant and retail sectors. We think partial reopenings may actually cause more damage to some of these companies as policy support is withdrawn.

What makes us more comfortable?

Policy, policy, policy - the stimulus remains unprecedented and it's good to see the Fed re-examine its programs. The US Congress is debating another stimulus bill (albeit the bar may be higher to getting it passed this time). Central banks are debating yield controls and other repressive measures which all augurs well for risk assets.

Corporate activity – markets are back to their pre COVID habits with an acceptance of high leverage and loose covenants for low compensation (by historical terms). Spreads are higher but yields are essentially flat.

The amount of bonds trading at stressed levels continues to decline. We currently have just 10% of the core market trading at under a cash price of 90 (and just 3% trading below a cash price of 80). We think this is the best proxy for the expected default rate and suggests that default expectations continue to fall in high yield markets. The positive feedback loop of lower yields begetting lower defaults begetting lower yields continues.

Activity

We've spent a lot of time over the last few weeks looking at new issues for MAC fund and our Global High Yield Fund. In some cases we have been enthusiastic cheerleaders: VTR finance – a Liberty media owned (Chilean) Cable Company – came and refinanced its 2024 maturity with new 2027 bonds with a 6.375% coupon in USD. With others we've been bemused: chipmaker AMS is financing the purchase of Osram, an auto supplier – we didn't think the business combination made much sense and would leave it over levered and hence quite risky, given its high exposure to one major customer (Apple). Headlines around a regulatory investigation on the day that this deal was to price left us puzzled that this deal was pricing at less than 7%.

Refinancings continue to drive our short duration fund. We've seen more than a fifth of the fund redeem over the last few months attesting to how aggressively companies are using the market to extend out their maturities.

Please note that this is a fast moving environment and markets and impacts on portfolios are changing. Opinions contained in this document represent views of our fund managers at time of writing, and performance numbers are estimates and not audited.

Reported yields reflect RLAM's current perception of market conventions around timing of bond cash flows. Heightened uncertainty due to the COVID 19 crisis may impact these timings for bonds with callable feature

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For more information on the fund or the risks of investing, please refer to the fund factsheet, Prospectus or Key Investor Information Document (KIID), available via the relevant Fund Price page on www.rlam.co.uk.