COVID-19 INVESTMENT UPDATE– 25 SEPTEMBER 2020.

AZHAR HUSSAIN, HEAD OF GLOBAL CREDIT: INVESTING IN A COVID ENVIRONMENT SIX MONTHS ON

In the last few weeks we have seen the first real pullback in credit spreads since March (+70bps wider so far to +510bps for our core BB/B GHY index). What is interesting is that flows have almost entirely been dominated by ETFs.

Unpacking the technicals

First, it's worth a reminder that ETFs probably increased liquidity in the crisis period at the cost of greater volatility. We saw volumes in the market rise markedly in March (by a factor of three) and undoubtedly the forced price discovery increased the volatility we saw in March. This led to the quickest sell-off ever (the market went from 330bps to over 1000bps over four weeks). We think this speed of sell-off led to the unprecedented policy response from the Federal Reserve as they worried a credit crunch would result. As a result, their intended support included high yield ETFs, recognising the important part these instruments play in transmitting volatility across the high yield market. The unintended consequence of this Fed action was that the AUM of ETFs increased markedly. We saw the largest high yield ETF (JNK) double its AUM, in fact even compared to prior to the crisis assets were 50%+ larger at $31.5bn by the end of July compared to $19.3bn at the beginning of the year. Staying with JNK the AUM has fallen by $5bn over the last month to $26bn, with $3bn exiting this last week alone. In the context of a $1.2 trillion US high yield market (and a $2 trillion Global high yield market) this ETF is insignificant, but ETFs are important as their flows tend to be lumpy, with that $5bn accounting for almost half the monthly average trading volume in US high yield.

Six months on – the fundamentals

It's worth taking stock six months on since markets lows and infection highs. What have we learnt from the last six months and how does it help us going forward?

1. The virus hasn't gone away but we seem to have learnt how to cope better with it. The numbers of deaths are lower, as there is evidence that we've learned to medicate better and shield the vulnerable more effectively, and government measures are less draconian as alternatives to lockdowns are being used such as test and trace, rule of six, and localised lockdowns.
2. Policy support remains high across most economies – in the US, dry powder remains from the first CARES act and whilst the US election is likely to delay further support there is broad consensus that it is needed even if there is disagreement over the exact details.
3. There has been a serious economic impact with a good bounce back for most sectors of the economy but second order impacts are still there – it's going to be a slow recovery back from here so we have to deal with unemployment in the 7-9% range as opposed to the 3-5% we had got used to.

4 Central banks recognised the importance of credit markets early and responded appropriately; markets have done much work themselves in the last six months with over $160bn of high yield issuance alone.

5 Defaults have been delayed and in some cases eliminated. The worst case assumptions we saw outlined by market spreads and many commentators haven't played out. Defaults are likely to peak in the high single digits and are focused on energy companies rather than the wider market constituents.

6 Financial repression has begun. The Fed has signalled it will ignore short-term inflation and so the hurdle for interest rates to rise is much higher.

So putting these six ingredients together we have an environment which is entirely conducive for credit investing. The impact of the virus is more predictable, growth is more muted, labour is cheaper, policy support is plentiful. Whilst political risks still abound they are lower than just a year ago. When we look at valuations – credit markets should be trading tighter now than at the beginning of the year but are 50% wider in spread terms.

So what are people worried about:

1 A second wave – the case numbers are rising in Western Europe and the U.K.

2 We've never had credit spreads this tight when unemployment was so high or when leverage was so high.

3 We are 50 days or less from a presidential election like no other where the incumbent is already saying there will be no transfer of power.

4 Brexit..

We find these arguments unconvincing because of policy support and market support. The political risks are the only ones we would really consider and even then there is as much chance of a Biden landslide as there is of a contested race. We actually think the political risks are that the Democrats get a clean sweep and end up holding all three branches of US government, leading to a much more radical agenda that impacts the private equity industry and corporate taxation levels, ultimately lowering corporate valuations. However, even this outcome is much worse for equity markets than credit markets. Brexit risks have resurged but we still see a hard Brexit as a lower probability outcome and importantly with a smaller impact (for Europe) than it would have been a year ago.

As credit investors, dealing with asymmetric payoffs, we are natural pessimists. It's rare that we have an environment which is so conducive for investing. We remain bullish in all of our strategies. Our own default outlook that we published in April has come true and we think the big change for the market (And indeed our own assumptions) is now acceptance that our tail risk has been capped by central banks. We still think this trade is not at its end as valuations are still pricing in what happened in March rather than what happened in April. The excess spread in the market is still at elevated levels and doesn't factor in the extraordinary policy support that exists.

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

Past performance is not a reliable indicator of future results. The value of investments and the income from them is not guaranteed and may go down as well as up and investors may not get back the amount originally invested. Portfolio characteristics and holdings are subject to change without notice. This does not constitute an investment recommendation. For information purposes only. The views expressed are the author's own and do not constitute investment advice.

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.

Issued September 2020 by Royal London Asset Management Limited, Firm Registration Number: 141665, registered in England and Wales number 2244297; Royal London Unit Trust Managers Limited, Firm Registration Number: 144037, registered in England and Wales number 2372439; RLUM Limited, Firm Registration Number: 144032, registered in England and Wales number 2369965. All of these companies are authorised and regulated by the Financial Conduct Authority. Royal London Asset Management Bond Funds Plc, an umbrella company with segregated liability between sub-funds, authorised and regulated by the Central Bank of Ireland, registered in Ireland number 364259. Registered office: 70 Sir John Rogerson's Quay, Dublin 2, Ireland. All of these companies are subsidiaries of The Royal London Mutual Insurance Society Limited, registered in England and Wales number 99064. Registered Office: 55 Gracechurch Street, London EC3V 0RL. The Royal London Mutual Insurance Society Limited is authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority. The Royal London Mutual Insurance Society Limited is on the Financial Services Register, registration number 117672. Registered in England and Wales number 99064. Ref: O RLAM EM 0010