COVID-19 INVESTMENT UPDATE: GLOBAL CREDIT TEAM UPDATE – 1 JUNE 2020

The last two weeks has seen a pronounced rally across risk markets with significant spread compression. The lockdown releases are combining with a reappraisal of default expectations. Some highlights:

1 Oil has continued tracking higher with supply and demand support. On the supply side Saudi Arabia is selling it at a higher price than previously and on the demand side the short-term depression of last month seems to have passed, possibly as more and more countries increase their strategic reserves. Natural gas prices have also rebounded. This means the energy sector has been a remarkable outperformer over the last month, rebounding 13%. Gas prices were depressed prior to the pandemic and are now well above those levels so many gas producers' bonds are trading significantly up on the year. We have been adding some of the recent fallen angels in the energy sector as we think these larger companies have an array of options to delay default, even in a 'lower for longer' oil price environment.

2 We've seen an array of companies reporting with increases in liquidity via both public sector facilities (especially in Europe) and private sector bonds (more in the US). Overall the intention of even the most levered companies is one of seeing the pandemic as a one-off event that needs to be navigated and for some an opportunity to buy bonds back cheaply. This week we saw Cirsa (a Spanish gaming company that we have exposure to) announce that its private equity owners have been able to buy almost 30% of its most depressed subordinated notes in the market. They issued these bonds just last year (to pay a dividend) and were attracted by buying back at a 60 point discount. The reaction to the news was that the companies senior bonds were up by 10 points as market default expectations were reassessed. These episodes confirm our view that default rates will be lower than market expectations.

3 High yield Issuance continues unabated with almost $40bn in May to add to the $36bn in April. Most of this is now flowing to companies to allow refinancings with a resumption of activity that had been paused in February. We have seen a marked skew towards the US with few European companies using the market. A major reason is the use of public sector liquidity facilities. We've seen CMA in France (a French shipping company) obtain a governmental facility which will allow it to refinance its near-term maturity (its 2021 bonds). This bond was trading at a stressed level even before the crisis so it's a surprise to see this 'bail out'.

High yield spreads are now at 590bps; using our excess spread estimates implies that market (cumulative 5 year) default expectations are at a 21% level (assuming 30c recovery, 300bps excess spread). A few weeks ago (14th April) we were estimating that the excess spread was 350bps, but we think this has compressed to 300bps as liquidity has normalised. So spreads are close to our fair value estimate and hence the market seems to be at a reasonable value after being excessively cheap (the market at its peak was pricing in a 50% cumulative default rate!). There is a self-fulfilling element which is where the optimism comes in – as spreads fall, the cost of capital falls, and liquidity is bolstered, deferring defaults further. We think spreads can tighten on this basis but ultimately if the oil price stays in the current range we struggle to see defaults fall materially.

Outlook

With lockdown openings without major issues in those countries that were ahead of the curve (mainly continental Europe) and policy support being gradually wound down we see reasons for short-term optimism. However as the rise in cases in Latin America shows the pandemic is not under control (clearly it's a lot harder to have lockdowns in large, less developed economies). So the tail risk remains of a second wave of infections later in the year or indeed outbreaks causing localised lockdowns.

The consequence of all of this is that those sectors directly impacted – airlines, travel, leisure, retail and autos – will face considerable disruption and muted revenues through this year and well into 2021. Social distancing measures will reduce foot traffic and demand materially. So we remain sceptical of the rally in these sectors.

What has changed, however, over the last two months are two material default factors: 'ability' and 'intent'. We've continually reminded our readers that these are the two drivers of defaults. First, has the company got the liquidity (and so the ability to survive a period of muted revenues) and second, has it the willingness (do the management and owners believe the company can transition to a better situation and reduce debt or grow earnings materially). The pandemic has increased 'ability' materially (the Fed's actions have allowed liquidity to be gained for most of our challenged issuers) but importantly we have also seen signalling of intentions. Those intentions have been signalled by a mix of raising liquidity, buying back debt and selling assets. As a result, in any second wave investors have more information to assess the survivors and the likely defaulters, and this will make it difficult for default expectations to get as dire as they did just a few weeks ago.

Activity

We remain bullish on credit but recognise that risks remain elevated after the recent rally so our strategies continue to focus on capturing idiosyncratic risk opportunities.

Issued June 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