COVID-19 INVESTMENT UPDATE: GLOBAL CREDIT TEAM UPDATE – 15 JUNE 2020

We've overused the word extraordinary in these missives but the last fortnight has seen extreme price actions. The rally that began in mid-May took an extra charge into the first week and a half in June, with spreads retracing back to 490bps and taking fund returns into the -2% ytd return territory before a reversal in the last few days leaving us at 552bps and most of our strategies -3% ytd. Why have we retraced? What are the arguments for valuations currently? Well we will get to that, first some highlights of the last two weeks:

1. The 'Robin hood' rally or short squeeze extraordinaire? We've seen Hertz issue $1bn in equity instead of a senior loan to fund its bankruptcy. A first for a company about to restructure its debt (and wipe out most of its equity) as its equity rallied 500% over the last few weeks. Incidentally we saw distressed equities rally remarkably in a number of names that face imminent default. It's not something we have ever seen before and makes little sense as Hertz and others are already on the route to restructuring through a bankruptcy process but it is good for creditors (its bonds rallied by 13 points to 50 cents on the news). What it also shows is that retail investors can be incredibly powerful and given Ford is now in our index and has 900,000 retail shareholders (up 300% ytd) we wonder if this is a whole new deleveraging route!
2. CMA and Jaguar Landrover, two companies that were facing likely bankruptcy pre-Covid as they couldn't get new issues completed, have accessed government funding facilities at below market rates. Corporate moral hazard has thus already begun. We still think this is the lesser of two evils compared to even higher unemployment (both of these companies are large employers) but it makes us wonder if post Covid this default discount will continue to exist for companies of this nature.
3. Sigs 2% deal – normality has returned, we saw a European BB packager issue a new bond with a 2.125% coupon. Demand was robust and the bonds remain above issue price even though the issue was in the midst of the equity and credit sell-off.

The pullback

We aren't surprised that markets have pulled back in the last few days. We moved 200bps tighter to 490bps very quickly (in three weeks) on optimism about reopening economies. Whilst this is validated by the experience in Europe and China we are still seeing localised outbreaks in the US and in most of Latin America and South Asia. Covid hasn't gone away and markets had started to price in a lot of good news. Also the oil price has also fallen in the last few days as the Saudis have used the oil rally to increase prices, signalling their intent to ensure oil stays in a range. Unfortunately this is a range that does not work for many oil high yield credits and the wave of defaults in this sector are likely to begin soon.

Direct Covid facing sectors have also rallied hugely on reopening optimism and yet the first few companies have been killing the optimism. Over the last week we've heard from Golden Nugget (owners

of restaurants and casinos in Las Vegas) indicating that reopening has been well below expectations in terms of customer numbers.

So with spreads at 550, what are the reasons to be optimistic? And what are the worries?

Optimism for current valuations

We like to break spreads into compensation for defaults and 'excess spread'. Both these measures have arguably reduced significantly in the last few weeks and should make us reset our fundamental targets lower.

Default expectations should be even lower than a few weeks ago as companies continue to garner liquidity and can refinance at similar levels to prior to the crisis. Policy support means we struggle to see meaningful defaults outside the energy sector. We think the five year cumulative default rate could be in the high teens as opposed to the low twenties that we were forecasting just a few weeks ago.

The excess spread is the premia for holding high yield for its volatility. Direct policy support is unprecedented and so we think this means that the excess spread for the asset class has fallen significantly. The historical median has been 280bps, prior to Covid it was at 150bps and we would argue that in March this got to 500bps. It's not unreasonable to estimate this could get back to pre Covid levels by year end as March's volatility has left an impact but the Feds actions have almost entirely mitigated this.

When we use this framework the only factor left is recoveries for bond defaults. We've estimated 30% recovery (10% below historical levels) as recoveries really are dependent on the nature of the credits and the environment, we think a crowding of energy defaults in a low oil price environment will depress recoveries in this sector and see more normalised recoveries in other sectors.

When we put this picture together we get a year-end target of 150bps excess spread plus 17% cumulative defaults with 70% losses giving a default spread of 1190bps/5 years = 238bps. This gives us a revised year end spread target of c. 390bps

Reasons to be cautious

A look at the only significant prior pandemic of last century (1918) shows that a second wave is inevitable (We highly recommend a read of John M. Barry's 'The Great Influenza'). What that episode showed is that the severity of a second wave is impossible to model. In 1918 when the virus returned it was more severe in some locales and much milder in others. We are left with huge uncertainty and will be until we get an effective vaccine. A severe second wave would likely mean renewed lockdowns and that would mean that many high yield capital structures (even with policy support) would become over levered and so their intention to survive would be likely challenged even if they have the liquidity. This would likely reset cumulative defaults 10% higher than our estimates and so add 170bps to our year-end target but more importantly might cause renewed volatility which should be reflected in the excess spread - the downside is thus likely to be c. 660-700bps.

So with our market at 550bps delicately poised in the midst of this range (390-700) we think there is still value in market beta here, but the stronger value is finding idiosyncratic opportunities as the volatility in this market has and will continue to create good opportunities.

Activity

In our short duration fund we continue to reset risk as we lose bonds to refinancings. Our focus in this strategy is to cut extension risk so that we don't repeat March's volatility. We see no risk of any default/significant credit loss in this strategy in line with our historical record (going back to 2003).

In our global high yield fund we have been taking profits on names that had rallied too far (mainly gaming and cinema names). We sold our Boyd gaming bonds that had rallied back to 100. These bonds traded at 65 in March. We've been reinvesting into new issues in non Covid areas (e.g. cable, telecom infrastructure) at similar spread levels. Our aim is to keep the yield on the fund above the market but benefit from the much lower defaults through credit selection and higher recoveries through careful covenant analysis. We estimate our cumulative fund default loss rate will be less than 5% compared to our market estimation of 17%.

In our multi asset credit fund we have been recycling our more Covid exposed high yield risk into subordinate European CLO tranches. We think that default rates are going to be significantly lower in Europe than in the US and the BB tranches in these capital stacks are incredibly cheap at 700-800bps as they are pricing in cumulative default rates and losses more in line with the energy heavy, more subordinated US high yield market.

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.

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