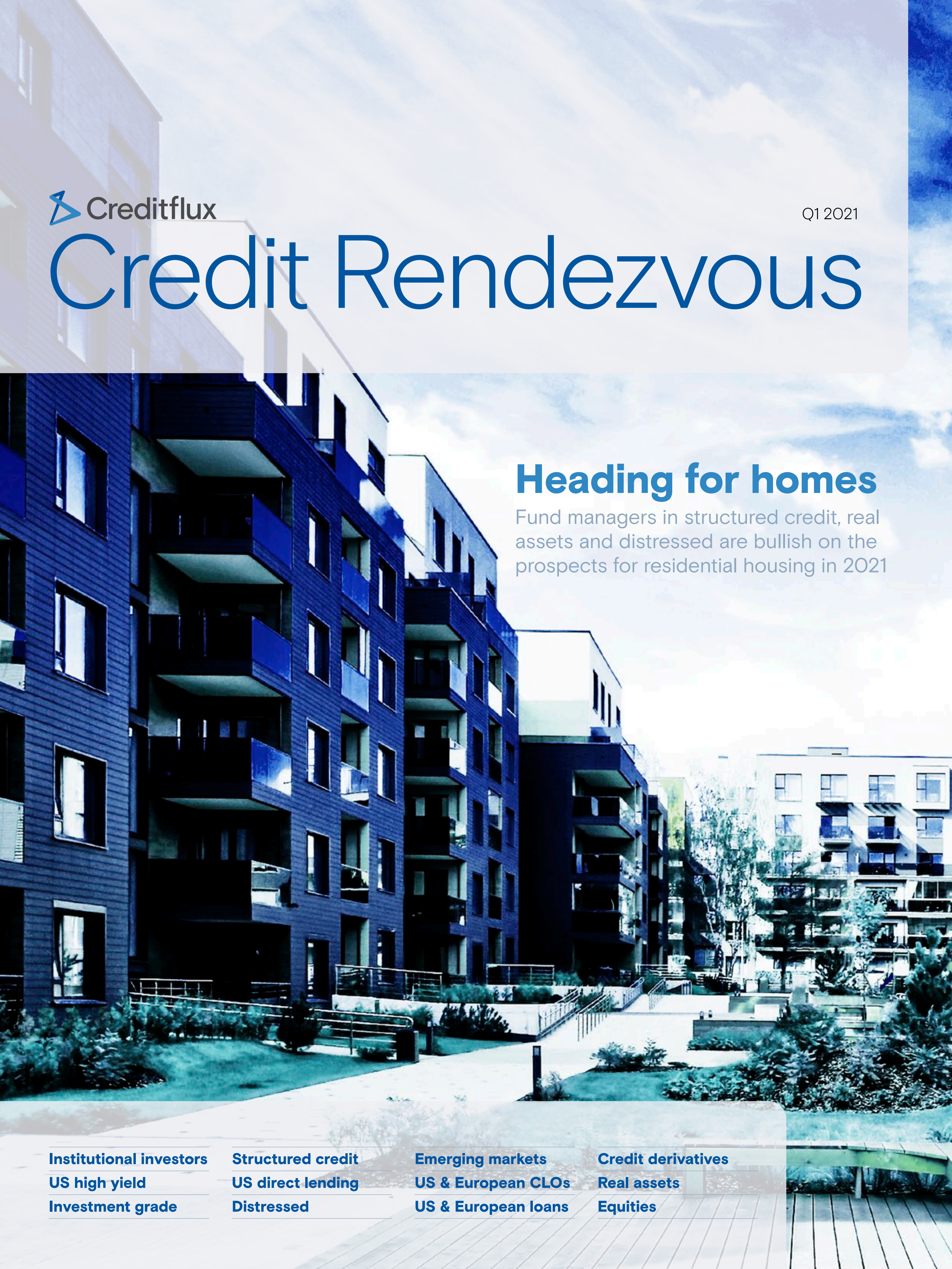
Creditflux

Q1 2021

Credit Rendezvous



Heading for homes

Fund managers in structured credit, real assets and distressed are bullish on the prospects for residential housing in 2021

Institutional investors
US high yield
Investment grade
Structured credit
US direct lending
Distressed
Emerging markets
US & European CLOs
US & European loans
Credit derivatives
Real assets
Equities

Institutional investors

High quality private credit is the sweet spot after a resilient 2020

Christine Farquhar

Global head of credit investment group at Cambridge Associates

Bullish

Senior direct lending

Bearish

IG credit

Greatest challenge

Investors to hold faith in private, less transparent assets

> **There is interest in niche strategies linked to tangible assets that provide a steady income**

Investors have moved away from the highest quality, investment grade liquid credits closest to central bank buying programmes. Instead, those who can have stepped into lock-up, illiquid and diversifying strategies, says Farquhar. These themes have been present for the past few years but accelerated in 2020.

The low levels of stress reported by private credit managers has given added impetus to the migration away from liquid credit. Investors and consultants agree that stress has been more moderate than feared, and has stayed in line with historic levels.

Within private credit, investors still like high quality assets. For this reason, there is a definite bias towards better quality borrowers and situations where private equity sponsors are willing to step up with additional capital, says Farquhar.

She says that the greatest challenge for investors is to keep believing such trends will persist in less transparent strategies, such as private credit, and to be patient in harvesting returns.

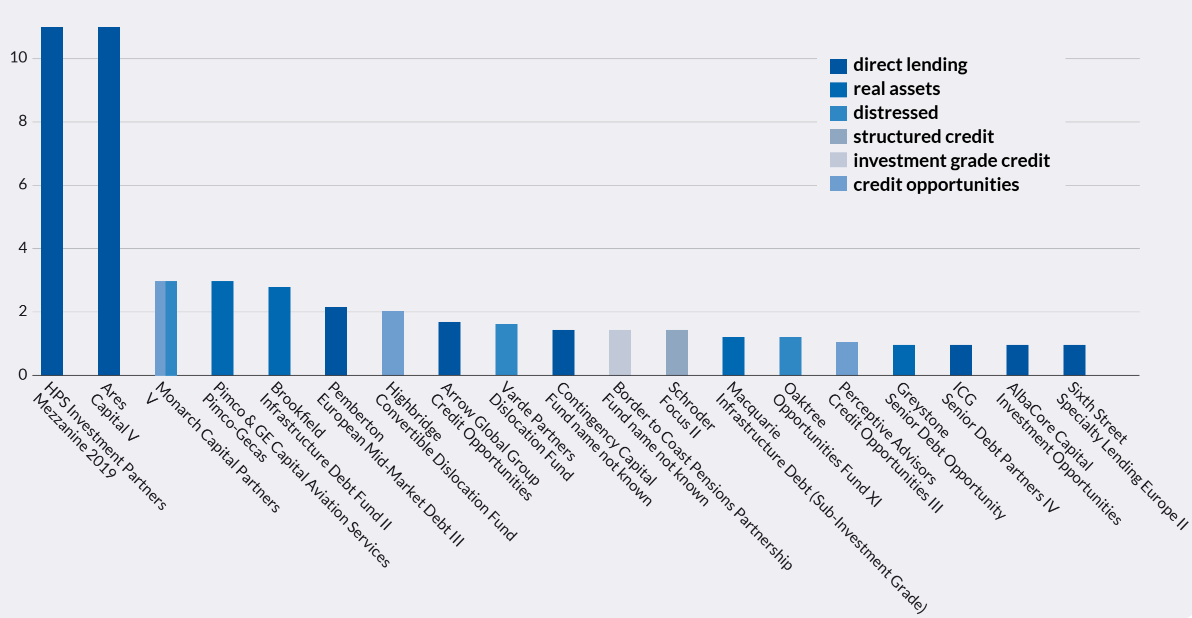
On the flip side, distressed debt has lagged given the scale of central bank intervention, which has boosted corporates. There is demand for distressed, sources say, but it is focused on niche strategies, particularly in physical assets, such as aviation debt.

There is also interest in niche strategies which are linked to tangible assets, but which provide steady income. Farquhar says that royalties-based strategies, for example, are attractive, especially in the pharmaceutical sector, rather than in the music industry.

Managers in the past have taken advantage of dislocations in energy. But Farquhar says that sector is a puzzle, especially for a European client base figuring out where it will fit in the context of sustainability and ESG issues.

≫ more

Largest funds in Q4 2020 ($bn)



Source: Creditflux

HPS closed its mezzanine fund at over $11bn with $9bn of that being equity commitments. Ares raised €7bn on the first close of its European direct lending fund and latest filings suggest it has gone beyond €9bn in 2021.

US high yield

Technicals matter even when dispersion ticks up

Jason Horowitz

Head of US high yield bond investments at CIFC AM

Bullish

Bonds with significant convexity, specifically non-callable bonds of certain fallen angels from 2020

Bearish

Call-constrained bonds of cyclical companies

Greatest challenge

Discerning how long the US Fed will aggressively support financial markets

One must understand the technicals of the market as well as where pockets of liquidity exist

2021 is shaping up to be another abundant — if volatile — year for high yield bonds. Against a backdrop of $14 trillion of negative yielding fixed income securities around the world, high yield bonds should continue to prove an attractive investment alternative, says CIFC's Horowitz — but he warns of dispersion in 2021.

"There are over 2,000 unique securities from nearly 1,000 issuers in the US high yield market, and they can move in price for a multitude of reasons," Horowitz says.

Numerous factors influence the dispersion in bond prices, and while the company guaranteeing the notes is paramount, other important factors are maturity date, call structure, yield, covenants, sector, ratings, issue size, price point and whether or not the bonds are included in exchange-traded funds.

"While fundamental research is critical, of course, given the significant dispersion amongst securities, we believe one must understand the technicals of the market as well as where pockets of liquidity exist," says Horowitz.

"With the right understanding of market technicals, we expect there to be terrific long and short opportunities to exploit in 2021 amidst the dispersion and inefficiencies of the high yield market."

The market received a jolt in 2020 as the Federal Reserve took the unprecedented step of propping it up by purchasing ETFs that hold the bonds. Horowitz says the timing of the Fed's moves to wind down this support is a major unknown risk.

≫ more

US high yield credit (CDX NA HY)

Source: IHS Markit

The typical post US presidential election rally, boosted further by news of covid vaccines took spreads from 421.26bp on 30 October to 293.23bp by end of year. That's a far cry from the 866.45bp print on 23 March.

Investment grade

Energy and financials offer opportunities, but there's little wiggle room

Kurt Halvorson

Portfolio manager, Western Asset Management

Bullish

Sectors that are deleveraging; energy, banks, metals/mining

Bearish

Media, retail, consumer cyclicals

Greatest challenge

Low margin for error in credit spreads

> **Credit spreads have narrowed so dramatically that there is simply not much cushion for investors if and when they make mistakes**

The Barclays Credit Index currently sits at 90 basis points over US treasuries, almost exactly where it was a year ago. This underlines the remarkable rally that credit markets have gone through since coronavirus-induced volatility began.

Halvorson says the biggest challenge for the investment grade market is the low margin for error in spreads. "Credit spreads have narrowed so dramatically that there is simply not much cushion for investors if and when they make mistakes," he says. He also points to the potential risk of inflation rising and causing a hike in interest rates, which would lead to the fixed income asset class being "out of favour".

But Halvorson points to certain areas such as energy, banks and metals and mining, where spreads could continue to compress, particularly in comparison to other sectors that seem rich on a historical basis.

The investment grade market's fundamentals are holding strong, according to Halvorson but he does expect companies to keep a larger amount of cash on their balance sheets "as an added comfort in light of potential economic volatility".

Structured credit

Expect performance to vary as rapid 2020 recovery becomes K shaped

Liza Crawford

Head of securitised research at TCW

Bullish

Residential structured credit, especially the single-family rental sector

Bearish

Certain parts of the CMBS market, especially in retail and pockets of hotel, like NYC upscale

Greatest challenge

How quickly spreads returned to pre-crisis levels

Structured credit weathered the covid-19 storm in 2020 fairly well, on both an absolute and a relative basis. Crawford says this performance demonstrates that the improvements and regulations brought in after the 2008 financial crisis are working.

"It feels close to business-as-usual for many segments of the market already, aside from most participants still working from home and certain segments of the market that will take longer to recover, such as aircraft ABS," Crawford says.

"To point to a newer theme in the market, we expect more originators and borrowers will diversify their funding away from bank warehouses into more structured credit solutions to avoid the mark-to-market risk that characterised much of the March sell-off — a positive for our little neck of the woods as investors."

Crawford says that one of the biggest challenges is how quickly spreads remediated to pre-covid levels, especially for more generic assets and structures. "It's up to the manager to do the right credit work, build relationships and hustle to create opportunities rather than wait for them to come to you."

Despite the rally in risk assets and support from low rates, TCW is projecting a K-shaped recovery in

> **We expect more originators and borrowers will diversify their funding away from bank warehouses**

commercial real estate and CMBS, with weaker assets struggling through this year and beyond.

An increase in updated appraisals significantly lower than at-origination values and high severities on many liquidations is also being factored in, especially in retail.

≫ *more*

US direct lending

'Entrepreneurial spirit' will drive lower mid-market revival

Patrick Turner

Managing director
at VSS

Bullish

Tech-enabled growth sectors such as healthcare IT and digital/education

Bearish

Potential economic drag due to expected tax hike

Greatest challenge

Ability of businesses most affected by covid-19 to resume operations

The lower middle market was hit by the pandemic in 2020, but demand for flexible capital is expected to strengthen this year as restrictions are lifted.

Turner says the entrepreneurial spirit that is core to the US economy will drive the recovery, adding that many companies have turned to private credit funds to access capital through the pandemic. "Perhaps not surprisingly, we saw a lot more lower mid market businesses get interested in flexible, private capital solutions in 2020 as access to public market capital and financing programmes remained limited for many," he says.

VSS tends to hold minority stakes in the companies it invests with, and the flexible capital approach is viable alternative for business owners looking to keep leverage low and retain ownership while participating in the growth of their business, Turner says.

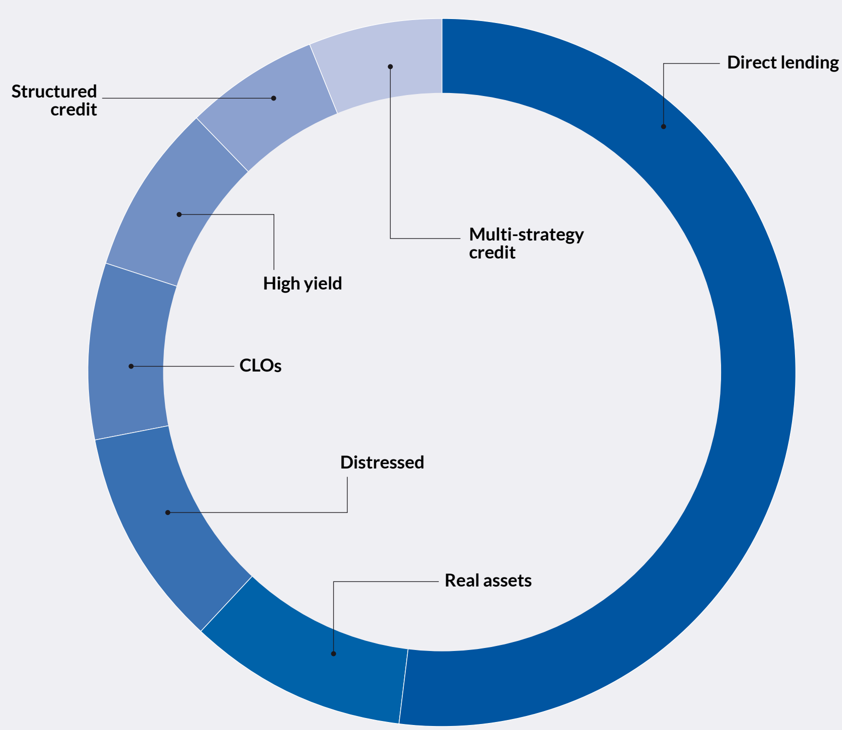
"I anticipate 2021 will be a year of opportunity for new investments and add-on acquisitions, also because of favourable demographics in relation to generational transfer of assets," Turner says. "Outsourced business and information services will continue to serve as a business model that reduces costs and improves efficiency, which, together with improving technology and AI, should continue to be strong drivers of the economy as it is bolstered by secular tailwinds."

> **I anticipate 2021 will be a year of opportunity for new investments and add-on acquisitions**

While VSS is predicting a busy 2021, Turner says the greatest challenge is in businesses and sectors worst affected by the pandemic, whether in resuming operations or in transforming themselves. In addition, state and local funding is particularly challenging in the US.

≫ more

Direct lending dominates Q4 fundraising*



* Number of funds globally raising funds in Q4
Source: Creditflux

Allianz, Barings, Bain, Carlyle Monroe and Neuberger Berman were among those to raise funds for corporate direct lending, but other forms of private debt were also popular. Real estate, distressed and CLO funds accounted for about a quarter of total funds launched.

Distressed

Window may have closed after rapid recovery

Ryan Mollett

Global head, distressed and corporate special situations,
Angelo Gordon

Bullish

US residential housing (particularly new home construction) and gaming

Bearish

Secularly challenged sectors: brick and mortar retail, energy (difficult to ascertain fundamental value) and airlines (huge operating leverage, unclear how they look post-covid)

Greatest challenges

Maintaining discipline when deploying capital

Distressed debt funds raised a colossal amount of capital in 2020 as the 12-month global speculative-grade default rate peaked at 6.6%, according to Moody's.

Distressed managers had been waiting for over a decade for an opportunity set as large as the one presented last year, but Mollett believes the distressed cycle has come and gone, and defaults in 2021 will be significantly reduced. (Moody's forecasts the default rate to drop to 4.7% in its base case.)

Distressed managers need to maintain discipline and recognise the difference between businesses that have cyclical issues that capital can help fix versus secular issues, he says. The market is baiting managers to chase returns by going outside their risk spectrum and investing lower in the capital structure at higher loan-to-value ratios.

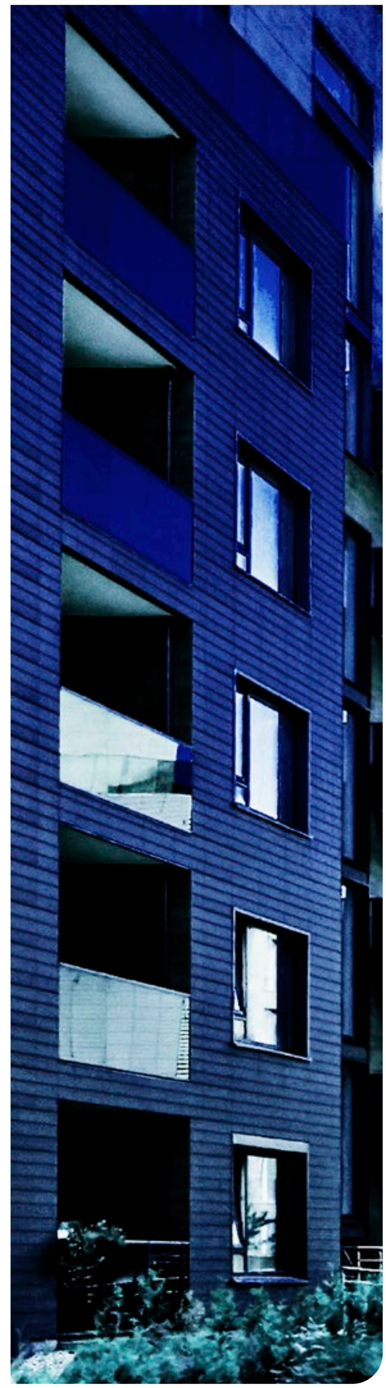
US residential housing has been a surprise beneficiary of the pandemic. Mollett says this is a result of a lack of supply of new homes, coupled with a huge uptick in demand (as people move out of the city and into the suburbs while working from home), as well as low interest rates.

Regional gaming also looks attractive as this does not require people to get on a plane. The sector has historically proven to be profitable at much lower revenue rates and many of these businesses can adjust their expenses and their business model.

Generally, sources say the best opportunities lie away from liquid high yield and centre on privately negotiated financings. Here, lenders can sit high in the capital structure and get high single-digit coupons, with OID and call protection.

≫ *more*

> **The market is baiting managers to chase returns by going outside their risk spectrum**



Emerging markets

China has weathered the effects of covid and the country's real estate is in good shape

Anthony Kettle

Senior portfolio manager, BlueBay Asset Management

Bullish

HY, Chinese real estate, Turkey, Argentine blue-chip companies trading at double digit yields, Latin American quasi-sovereign type risk, oil and gas

Bearish

South Africa (rising debt); potential downgrades, Colombia for example

Greatest challenge

IG because of the convexity challenge and US rates

Emerging market corporates seems to be in good health and the US change in administration points to lower geopolitical risk, while, with Democrats taking control of both houses, a larger fiscal stimulus should come through. Kettle says this combination will drive risk taking in other markets and the structural dollar weakness means there could be outperformance from EM local markets and, in particular, FX markets.

Also, countries such as China have controlled the pandemic better than others and they drive a lot of emerging markets growth.

Kettle agrees with the overall consensus in credit that high yield offers better opportunities than investment grade credit. In emerging markets, high yield has wider spreads than IG, and in a risk-on environment, where US treasury yields would be expected to trade higher, he expects

High yield offers better opportunities than investment grade credit

to see more spread compression in HY markets than in IG. Corporate default rates in EM high yield were less than 3% in 2020 and recoveries were higher than US high yield.

Real estate has been cited as attractive in structured credit and the same applies to emerging markets. Kettle says the Chinese real estate market represents attractive relative valuations. Although there is a lot of government influence, he thinks it is preferable for the government to have a stable real estate sector.

Many of the policies China has been putting into place aim to limit growth and that might be a challenge for equity markets — but for credit markets, having a stable sector which is growing slowly and gradually deleveraging is compelling.

Turkey could also provide investment opportunities, Kettle says. Several corporates and financials in Turkey are good companies but have suffered under poor sovereign policy, and spreads have widened as a result. But the government has now started to follow a more stable, traditional monetary policy and has hiked interest rates significantly — good for both the sovereign level and, by extension, corporates.

Argentina restructured debt last year and has an extremely poor policy mix, says Kettle, but the country does have mid-term elections coming up towards the end of the year.

In terms of absolute levels of yield, blue chip corporates are returning 10-15% and sovereign bonds are trading around 40 cents on the dollar, which is already close to historical recovery values despite minimal near-term default risk.

On the flip side, sovereign defaults approached 15% last year with big countries such as Ecuador, Argentina and Zambia defaulting.

Kettle says he is shying away from Sri Lanka, which is expected to go through some sort of debt reprofiling. Ecuador is also a concern for him. Despite the fact cash prices are quite low due to a restructuring, there is an election coming up in February and there is a potential for a hard left government to take power.

Ecuador restructured last year due to low oil prices, but the new administration may be less willing to work with the IMF. On the flip side, a market-friendly government is also a possibility and if this were to happen, Ecuador would likely be one of the best performers.

» *more*

European CLOs

Double Bs have tightening potential, but some deals face OC pressure

Simon Gold

Portfolio manager, ISP Group

Bullish

Triple Bs, double Bs and some single Bs

Bearish

Equity will have winners/losers

Greatest challenge

Interest rates and broader macro credit effects

AnneMarie Flynn

Head of structured investments, AIB

Bullish

Triple A and new issue equity

Bearish

Equity and junior mezzanine notes of seasoned deals

Greatest challenge

Supply at the top of the cap stack remains challenged given large AAA/AA anchor investors in H2, but resets and refinancings should offset this

After a sharp decline in March, the European CLO market lagged the rally in broader credit markets, but they came good in the end. By the end of 2020, primary triple A notes were pricing at 105 basis points in three-year deals, which is about 15bp wide of early 2020 prints.

Looking ahead, seasoned European CLO equity and mezz may face pressure with deals susceptible to further stress in underlying portfolios as a result of on-going lockdown restrictions and a protracted vaccine roll-out.

Flynn says there is potential for OC test breaches resulting in cash distributions to equity being switched off, and interest deferrals on the junior mezzanine notes.

Gold agrees that equity has moved into a zero-sum-game type of environment, where winners and losers will be more distinctly evident in 2021. He says ISP remains invested in CLO equity but is focused on the potential for changes in the yield curve and broader macro implications.

New issue equity, however, looks attractive according to Flynn, with deals benefiting from cleaner asset portfolios with higher spreads relative to seasoned deals and continued tightening in liability spreads. Triple As are also cheap relative to comparable fixed income asset classes, and they benefit from embedded Euribor floors.

For Gold, mezzanine, in particular CLO double Bs, looks relatively attractive on a long-term basis, with longer duration risk trading well into the 600s on a discount margin basis. "The tights for this product were 460-490 DM in 2017 and over several years," he says. "Double Bs have only traded wider than 700 DM for relatively brief periods post financial crisis."

> **Mezzanine, in particular CLO double Bs, look relatively attractive on a long-term basis**

≫ *more*

CLO funds raised in 2020

Fund	Manager	Curr.	Amount raised (m)	Target size (m)
Arcano CLO Opportunity Fund	Arcano	EUR		
High Grade Structured Credit Fund	Capital Four	EUR		
Structured Credit Opportunities	Capital Four	EUR		
Descartes Euro High Grade CLO	Cartesia	EUR	-	200
Five Arrows Global Loan Investments	Five Arrows	EUR	230	
ISP CLO Opportunity Fund	ISP	EUR		
Inaugural standalone CLO fund	Kartesia	EUR		
Monega Investment Grade Liquid Alternative Fund	Monega/ Infinigon	EUR		
Alegra CLO Opportunities Fund	Alegra	EUR		
Alcentra Structured Credit Opportunities Fund IV	Alcentra	USD		500
AAF First Priority CLO Bond ETF	Alternative Access	USD	-	
CLO Opportunistic Secondary Tranche Fund II	CFI Partners	USD	-	
CIFC CLO Opportunity Fund	CIFC	USD	-	
Edition CLO Opportunity Fund	CSAM	USD	265	
Vibrant CLO Opportunities Fund	Vibrant	USD	90	
EP CLO Opportunities Fund II	Eagle Point	USD	25	100
Eagle Point Defensive Income Fund	Eagle Point	USD		
GSO CLO Opportunity Fund	Blackstone	USD	-	
Hildene Credit Fund	Hildene	USD		300
Janus Henderson AAA CLO ETF	Janus Henderson	USD	-	
Kayne CLO Partners Fund II	Kayne Anderson	USD	600	-
NP Strategic CLO Fund Credit	Napier Park	USD	-	-
Nassau Private Credit Fund	Nassau	USD	-	
NB CLO Opportunity Fund	Neuberger	USD	43.6	500
Oak Hill Advisors Structured Products Fund II	Oak Hill	USD		
Octagon Partners CLO Opportunity Fund	Octagon	USD	-	
Onex Structured Credit Opportunities Fund I	Onex	USD	-	
PDC Opportunities VIII	Pearl Diver	USD	400	300
Pearl Diver Empire Fund	Pearl Diver	USD		
Preserver CLO Fund	Preserver Partners	USD		
Sound Point Harbor Fund	Sound Point	USD	650	1,000
Nuveen CLO Issuance Fund	Symphony	USD	77	200
Tetragon Credit Partners CLO Opportunity Fund	Tetragon	USD	-	

Source: Creditflux

US CLOs

Everyone expects resets, but that could make them difficult to execute

Serhan Secmen

Head of US CLO Investments, Napier Park Global Capital

Bullish

High loan issuance should contribute to lower default rates

Bearish

Loans again — high issuance will mean spread compression and some low quality deals

Greatest challenge

Resets and refis may not be as easy to execute as many expect. There will be long queues when spreads tighten and some 2018-19 CLOs may need an equity injection due to par burn

We could see increased liquidity helping issuers to push the can down the road

Almost all CLO market participants are expecting a barrage of CLO refinancings and resets in 2021 with spreads tightening sharply in the early weeks of January.

There will be times when spreads tighten to such an extent versus 2020 that reworking a CLO's capital structure will be a no-brainer, but if all CLO equity investors think the same way then the resultant crowds will be forced to join an orderly queue, causing those at the back to miss out.

The November rally caused triple A spreads in three-year CLOs to tighten to 120bp by the end of 2020 having started the quarter at 132-165bp.

There are strong growth prospects off the back of a year in which CLO structures drew acclaim for withstanding the effects of the coronavirus pandemic. But Secmen cites the loan market as the thing he is most bullish and bearish about.

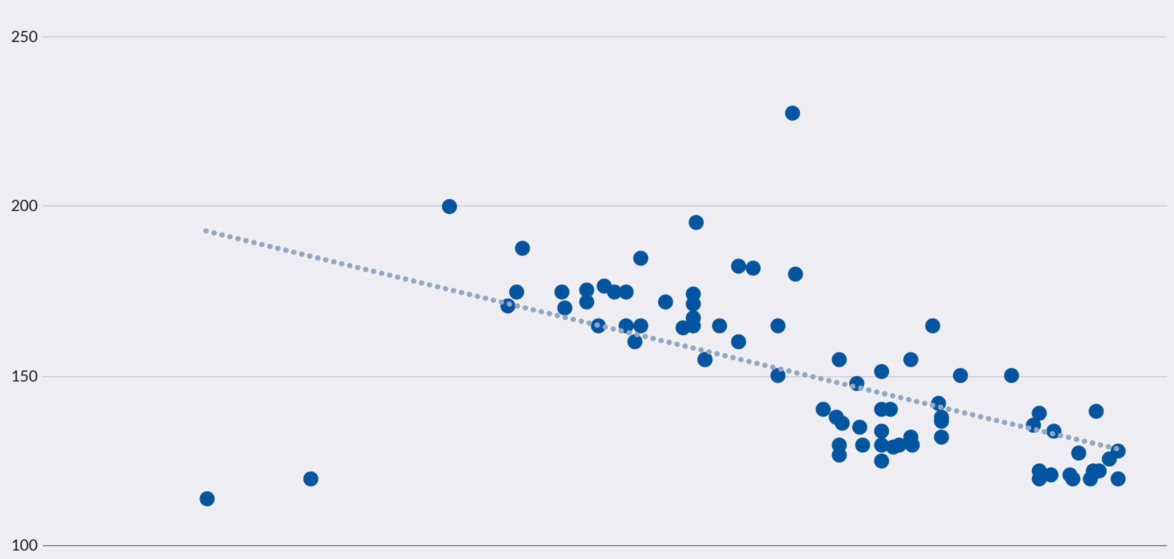
He says that high expected loan issuance should result in lower default rates as issuers gain access to the primary market. There will likely be more upgrades than downgrades in 2021, too.

But on the flip side, Secmen sees spread compression, which could make it more difficult to assemble CLO portfolios unless CLO spreads keep pace. And loan prices could start to become ever more binary with the dividing line moving closer to poorer credits.

"We could see increased liquidity help some issuers to push the can down the road for some of the problems they are facing," he says.

≫ *more*

Three-year US CLO triple As



Source: Creditflux

Five-year CLOs were discarded from March to September, replaced by three-year reinvestment deals. Triple A spreads went as tight as 120bp in November — 6bp away from January levels

US loans

Huge demand could squeeze returns when there is already little leeway to tighten

Steve Columbaro

Deputy head of US loans, Columbia Threadneedle

Bullish

Discounted performing loans

Bearish

Vaccine-related concerns, defaults

Greatest challenge

Excess demand

> **We expect total US volumes to be down approximately 10% compared to 2020**

US loan repricing has been a popular ploy among issuers to start 2021, but 'net new money' has not been as busy as market participants had hoped, according to Columbaro.

"Not enough new money supply and robust demand from CLOs has pushed the market higher," he says.

This could continue to be a theme throughout 2021. Demand from CLO managers shows no signs of slowing and the relative value to high yield that leveraged loans currently offers could lead to an influx of players into the asset class causing spreads to be driven down, Columbaro adds.

But there may not be much leeway to tighten. The JP Morgan Leveraged Loan Index has rallied to the high 97s and Columbaro points out that "the entire market trades above 99 less than 10% of the time, so realistically from a price perspective there is not a lot of room to run".

Issuance of loans in 2021 is not expected to be higher than last year. Columbaro expects total volumes to be down approximately 10% compared to 2020.

European loans

Default expectations are lower, but further waves of infection could wreak havoc

Laust Johnsen

Portfolio manager, Capital Four

Bullish

Being senior secured and earning 400-500bps in broad portfolio with low expected default loss

Bearish

Unsustainable capital structures for covid hit sectors

Greatest challenge

Market timing difficult after the latest rally with a number of uncertainties ahead

> **There is positive sentiment after strategists halved the expected default rate**

The European loan market appears in good shape both on the financing and M&A sides. Spreads, however, are still at wider levels than January 2020, although expected excess loan demand this year will likely drive spreads tighter, says Johnsen.

The biggest challenge for European CLOs in early 2021 will be gauging asset spreads and getting a sense of what default rates and recoveries might look like.

Defaults were subdued relative to expectations in the immediate aftermath of the March sell off and the direction defaults take now depends on whether they were low for the right reasons, or whether there was simply a delay.

Government intervention, such as furlough schemes, remains prominent, and the question will be what will happen when these supports are taken away, especially in industries that are likely to see a negative mid- to long-term impact from the coronavirus and changed consumer behaviour.

There is an overriding positive sentiment after strategists halved the expected default rate to around 2% following positive vaccine news, Johnsen says. However, he cautions that second and third waves of covid-19 infections, plus further lockdown measures, have the potential to wreak havoc in portfolios.

Depending on this, European CLOs may have higher stress levels in their portfolios, and managers who do not have a dedicated workout team and analysts to deal with that may struggle.

≫ *more*

Credit derivatives

After a strong 2020, CDS valuations seem very tight and positioning is long risk

Alberto Gallo

Head of macro strategies, Algebris Investments

Bullish

Sectors and situations attached to reopening economies, convertibles

Bearish

Beta credit, low yielding investment grade, CDS convexity

Greatest challenges

Market complacency, divergence in market/real economy valuations and V/K recovery shape expectations

The CDS market finds itself in a difficult place at the start of 2021. Having enjoyed a strong run into the end of last year, it has demonstrated little impetus to improve further in January. There has been frequent decoupling in day-to-day performance from more growth-linked assets, such as stocks and oil, but cash bonds have also looked more likely to make gains despite a busy pipeline.

"CDS market valuations seem very tight and positioning is long risk, which we can see from DTCC data," says Gallo. "Beta has hardly any value this year compared to last year when dislocations were much stronger."

Portfolio managers at other funds caution that opportunities for market-neutral relative value bets using CDS have also diminished in size and return profile. One PM told *Creditflux* his firm had stopped taking in new money for this reason.

"There is some nervousness in the market with CDS widening more than single names," says Gallo. "This is due to crowded positioning from investors that were underweight last year and stayed a bit behind the rally."

Algebris does not find beta in credit attractive and so has tried to stay very lean with a third of its Global Credit Opportunities fund, which Gallo oversees, in cash.

"We don't like the convexity in CDS," he says. "Having said that, we do like some credits in special opportunities and certain sectors linked to the reopening of the economy. And we do like the convexity in convertibles, which can give more upside than downside, especially in solid credits — and that's where most of our portfolio is at the moment."

We like the convexity in convertibles, which can give upside

A push in Italy to oust prime minister Giuseppe Conte has prompted volatility in Italy's sovereign and financial CDS. But Conte survived votes of confidence in the Senate and Chamber of Deputies.

"We don't think Italy goes to new elections or a protracted crisis," says Gallo. "The German CDU leader choice is probably more of a long term macro mover given elections later in the second half. But the big theme is market complacency and divergence between valuations in markets versus the real economy, as well as V-shaped versus K-shaped recoveries."

≫ *more*

European crossover credit (iTraxx Xover)

Source: IHS Markit

The emergence of coronavirus vaccines caused spreads to narrow from 367.0bp on 30 October to 242.8bp by year end. This is tighter than early 2019 when crossover spreads had blown out wide of 300bp.

Real assets

Real estate is the place to be, but recovery could take a while

David Rosenblum

Partner,
Prophet Capital

Bullish

Premium coupon MBS versus treasuries

Bearish

CMBX triple Bs across the board

Greatest challenge

Too much money in the system chasing too few assets — much lower than normal expected yields — with inflation risk potentially around the corner

Rob Promisel

Portfolio manager,
Resolution Capital

Bullish

Student housing, with returns to universities to normalise over the next one-to-two years; and single family rentals where families relocate to larger properties from smaller urban apartments

Bearish

Central business district offices — the leasing environment will be weak for an extended period

Greatest challenge

The pace of recovery from covid-19 clouds the trajectory of future demand

When times are bad, investors like the security of investing in instruments linked to tangible assets. That's one of the reasons that real estate — whether through direct loans or via securitisations — is being cited as one of the big credit picks over the next couple of years.

> **You have the potential to make money on your longs and shorts**

Promisel, who invests in listed real estate companies and reits through the Nedgroup Investments Global Property Fund, sees strong prospects for student housing, single family rentals and select multi-family apartments, such as those in Germany and Canada. However, he thinks rents are more likely to rise in 2022 rather than 2021.

He is also cautious that some parts of the market will not recover as fast as others — particularly offices in central business districts. "Market conditions are softening as space availabilities rise and effective rents fall. It has switched from a landlords' market to a tenant's market in only a few quarters," says Promisel.

Austin-based Prophet Capital has long been an investor in structured credit and partner David Rosenblum says the firm has grown AUM in the RMBS space, where it has participated in early buy-outs originating from Ginnie Mae MBS pools.

He likes premium coupon MBS versus US treasuries because, "if and as rates rise, prepayment speeds will likely fall, coupon spreads will likely steepen, and you have the potential to make money on both your longs and your shorts".

But Rosenblum is steering clear of CMBX triple Bs because he thinks it will take commercial real estate longer to recover than people think, and loan severities will likely be worse than expected on loans that default in the underlying CMBS.

≫ more

Equities

Tight credit spreads mean equities are likely to outperform in near term

Christos Charalambous
Lead analyst,
CSQR Capital

Bullish

Elevated asset valuations favour active over passive investments

Bearish

Stocks in vulnerable sectors if and when reflationary window ends

Greatest challenge

Investor transition from reflationary positioning as inflation expectations peak by mid-year and the Fed attempts to keep a lid on asset prices and excess risk taking

Stock indices have started stronger than credit in 2021, with the S&P 500 up over 4% against flattish bonds and a slight widening of CDS index spreads. Credit has struggled to improve after hitting super tight levels in December, but US growth assets especially look as though they have room to run with a new administration eager to pass a round of fiscal stimulus.

But 2021 looks set to be a game of two halves, warns Charalambous.

"Cyclical assets like global equities could outperform credit in the near term as spreads are tight across the board," he says. "But defensive areas and assets will do better over the longer term as fiscal and monetary policies produce diminishing returns and real interest rates start to creep back up. The latter will likely increase correlations across asset classes and sectors."

High price/earning multiple sectors such as technology, slim margin companies such as small caps, and cyclical sectors such as materials financials, industrials, materials, consumer discretionary and energy could be vulnerable in H2 as growth expectations temper and the US dollar rebounds, Charalambous adds. Healthcare, utilities and consumer staples will likely outperform in this scenario, but are not immune in absolute terms due to current valuations.

"It is important to separate the underlying economic recovery from risk asset performance," he says. "We are in a reflationary window in which monetary and fiscal authorities are supporting the cyclical recovery in asset prices and earnings expectations. The question becomes how we transition from this window once inflation and stimulus expectations peak, and as the Fed falls behind the curve in terms of curbing financial instability concerns due to excessive asset valuations."

US equities are underpricing risks to long-term economic growth, which is likely to be constrained by factors such as unsustainable global debt and fiscal deficit dynamics. Companies have been levering up over the past few years, with median US company net debt-to-equity ratios near record highs. US equities also face crowding risk given elevated investor optimism, above 2% break-even inflation expectations and consensus reflationary sector positioning in equities.

"Stretched US asset valuations and financial instability concerns could be the catalyst for Fed hawkishness by mid-2021," says Charalambous. "Therefore, peak inflation expectations and rising real rates will likely undermine market P/E multiples as the equity risk premium is currently low. On the fiscal side, the Biden administration may feel beholden to address wealth inequality with higher corporate and wealth taxes for higher income groups. Lastly, a more global headwind for global risk assets is the beginning of a gradual deleveraging cycle in China."

Peak inflation expectations and rising real rates will likely undermine market P/E multiples

***Creditflux* is published in London & New York**

10 Queen Street Place, London
1501 Broadway, New York
creditflux.com
Creditflux ***is an Acuris company***