Recovery begins, but is it U, V or even W?

Investing in credit is not as easy as ABC. The coronavirus crisis has crushed valuations and although most assets will eventually pull to par, no one is sure how the recovery will pan out

Institutional investors

Several funds were spared Q1 redemptions, which means outflows could soon peak

Oliver Newton

Head of hedge fund portfolios, Aksia

Bullish

High quality, liquid corporate credit and senior rescue finance

Bearish

Legacy credit portfolios comprised of pre-March assets

Greatest challenge

Significant selling pressure likely still to come from ETFs, mutual funds and elsewhere

Funds that have end of quarter redemption dates were spared outflows as the coronavirus pandemic escalated in mid-March. But they will be vulnerable in Q2, particularly if the recovery is not V-shaped, say market participants.

The 2008 crisis was centred on banks, says Aksia's head of hedge fund portfolios Oliver Newton, whereas the covid-19 pandemic is having an immediate impact on the broader economy. Also in contrast to 2008, banks are more defensively positioned. "Yes, some banks have increased haircuts on leverage facilities, but to date, it has not been as chaotic as 2008 when asset price drops led to liquidations," Newton says.

He adds that many institutional investors are adjusting well to the balancing act of managing existing exposures and capitalising on weak market conditions.

Many institutional investors will have to sell assets to be opportunistic

"Many institutional investors are close to fully invested, so they will have to sell assets if they want to be opportunistic. For some, that will mean taking profits and reallocating."

Investment grade

The safe-haven of IG credit is now paying high yields, but you have to be mindful of fallen angel risks

Chris Bowie

Portfolio manager, TwentyFour Asset Management

Bullish

Selected US and UK sub-financials, triple B companies

Bearish

Over-levered corporations, those that paid high dividends to single large shareholders but still want government bailouts

Greatest challenge

Lack of visibility on asset quality for certain European banks; borrowers that are highly levered but do not have access to public equity markets (perhaps private equity owned)

Gilles Frisch

Portfolio manager, Axiom Alternative Investments

Bullish

Bank subordinated bonds, US triple B companies

Bearish

European IG (selectively, until inflows/outflows known)

Greatest challenge

European fund outflows, two-quarter shutdown

Investment grade credit is a changed landscape, with swathes of big names (Boeing, Carnival, Ford, Glencore, Macy's, Valeo) paying high yields. Mispricings also abound in subordinated financial bonds.

"Subordinated financial debt is cheaper than I've ever seen in some sub-sectors, so in the short term offers the best opportunities," says Chris Bowie at TwentyFour. "Some are single A rated borrowers and highly capitalised, but bond prices were hit hard in the downturn. We would expect them to pay AT1 coupons ahead of bonuses and dividends. But you have to be selective and we favour UK and US financials, as we have questions on many parts of Europe — Italian banks for example."

Corporate fallen angel risk is a battle

copyright material

between several competing forces. “There is so much dislocation in the triple B area and this pool of credits is four times bigger than it was 10 years ago,” says Gilles Frisch at Axiom, “so there is no excuse not to diversify. US and European airlines are interesting at current levels, for example, but air leasing companies even more so.”

Bailouts can only go so far. “The difference on default rates between a one-quarter and two-quarters problem could be huge,” says Frisch.

The difference on default rates between a one-quarter and a two-quarters problem could be huge

“Among technical considerations, there have been big outflows from US investment grade funds, which explains why US spreads widened, but there have been no European IG outflows so far. That is a reason to be nervous and keep cash until you have a clearer view, and it is why there are more triple-B opportunities in the US than Europe.”

Heavy new issue premiums are a must. “There are several dollar/sterling/euro issuers coming through each day and you can get very oversubscribed books,” says Bowie. “But some haven’t sold off enough and those still paying shareholder dividends concern me — both from an ESG perspective and because they may not be bailed out. Supposed national champions with large high profile overseas owners may also fall through the cracks.”

Real assets

Commercial real estate is under threat, but governments are likely to throw support behind infrastructure

Jai Jacob

Portfolio manager, Lazard Asset Management

Terence Brennan

Portfolio manager/research analyst, Lazard Asset Management

Bullish

Commodities

Bearish

Real estate, pipelines

Greatest dangers

Monetary and fiscal policy in response to covid-19 favouring other sectors; lenders being risk averse; the human condition

Nicolas Roth

Head of alternative assets, Reyl & Cie

Bullish

Stressed/distressed investors with long-term capital

Bearish

Commercial and residential real estate

Greatest dangers

Uncertainty; a deep recession; a global NPL cycle

Long term, we can expect the fiscal response from many countries to involve building infrastructure

Fiscal policy for many countries is expected to push heavy investment into infrastructure in the long term, according to Jai Jacob, portfolio manager for real assets and pricing opportunities portfolio at Lazard Asset Management.

“In the near term, for example, revenues from many traditional infrastructure projects (toll roads, airports) have been clearly impaired by physical distancing,” he says. “Yet longer term, we can expect the fiscal response from many countries to involve building infrastructure. To many governments, in a crisis infrastructure is like toilet paper: it will eventually be used so stock up when it can be had.”

Terence Brennan, portfolio manager/research analyst in global commodities at Lazard Asset Management sees an opportunity in commodities once normality resumes. “I expect commodities to be in a position of strength, as commodity producers will have been forced to produce less, eventually leading commodities to be scarce assets once economic activity picks up,” he says.

But Brennan and Nicolas Roth, head of alternative assets at Reyl & Cie, think commercial real estate will suffer from the coronavirus pandemic. Roth says: “In the coming recession, corporates could accelerate the shift toward digitalisation and start to rotate workers between home and office in order to rent smaller spaces.”

Roth adds that a wash-up could occur as the search for yield has brought several traditional, liquid investors, into private, less liquid assets. A large portion of these investors could become sellers to generate cash in a downturn.

» more

copyright material

Derivatives

CDS indices gave an early warning that things were getting bad on the back of unprecedented daily widening

Ajit Kumar

Portfolio Manager, LMCG

Bullish

Mezzanine and senior tranches of credit portfolios with sufficient subordination

Bearish

CLOs, especially junior tranches, where the deterioration in fundamentals of many sectors will take some time to play out

Greatest challenge

Liquidity and leverage. Unwinding bespokes and off-the-run products will be difficult for funds

Credit derivatives provided the first signals of a crisis in March as the CDX NA HY index hit 866 basis points and iTraxx Crossover hit 704bp. Investment grade credit also suffered as CDX NA IG reached 151bp and iTraxx Main touched 136bp.

"It was a very challenging environment, but just what credit investors needed to open up higher return opportunities," says LMCG's Ajit Kumar.

"CDX IG and CDX HY at 45bp and 280bp, respectively, were very negatively convex as there was much more downside risk than upside potential. Given the positive convexity of our portfolio going into this volatility, we were able to be on offense and take advantage of market dislocations by rotating portfolio at attractive prices."

Kumar says that the cash/CDS basis widened in March as levered bond holders looked for liquidity, but it has come down since then. "The best bargains to get long risk are in cash products, where forced liquidations due to redemptions and margin calls have created dislocations," he says.

The best bargains to get long risk are in cash products

Still, credit investors were drawn to the liquidity in synthetic credit. $4.1 trillion of credit derivatives traded in the first quarter, according to Isda SwapsInfo, compared to $2.5 trillion in Q1 2019.

Loans

US loans were trading at 76 and despite a mini-recovery, downgrades and weak recoveries pose a big threat

Andrew Chung

Portfolio manager, Birch Grove

Bullish

Low-rated loans in companies that may have material short-term impact from coronavirus but have been recession-resistant historically

Bearish

Companies in industries that are highly cyclical and discretionary

Greatest challenge

Low expected recovery rates

Despite significant spending and cash injections from governments, a consumer-led recession remains likely as consumers remain in bitter financial health, according to Birch Grove portfolio manager Andrew Chung, who predicts that certain companies will struggle even after quarantines are lifted and liquidity needs are met.

"The current cycle may exhibit lower recoveries for the leveraged loan asset class than historically, exacerbated by weaker documentation that allows companies and sponsors to extract assets and value away from lenders," says Chung.

Ratings downgrades are at a faster pace than in 2008, but there is much less leverage in the system today

"While loans are still an attractive asset class over the long-term, wider spreads may have to compensate for higher loss assumptions."

In March, the S&P/LSTA US Leveraged Loan Index dipped as low as 76 points.

The forced closure of businesses and consequent spike in unemployment marks out the covid-19 crisis from the financial crisis of 2008 from a fundamental standpoint, as some companies enter a zero-revenue scenario, Chung says, with multiple implications for loan investors.

"Ratings downgrades and changes to outlook or watch status are at a significantly faster pace than in 2008," says Chung. "However there is much less leverage in the system today, and the majority of the loan holder base, particularly CLOs, are not forced sellers."

There is also substantial investor interest in the loan asset class from non-traditional investors, which is providing a floor on loans. That said, Birch Grove is not anticipating much spread tightening in loans until the impact of the coronavirus has played out, and the firm is forecasting continued volatility.

» more

copyright material

US CLOs

CLOs face downgrades if triple C exposures pile up. But some triple Bs and double Bs will be insulated against this

Laila Kollmorgen
Portfolio manager,
PineBridge Investments

Bullish
Triple A to single A tranches
Bearish
Triple Bs and double Bs with potential for loan downgrades to hit triple-C buckets
Greatest challenge
Not all CLO investors have a high level of expertise and understanding of the underlying credit exposure

We like triple Bs and double Bs, but the swift downgrades to leveraged loans are starting to filter through to CLOs

Investment grade CLO tranches swamped the secondary market in March, with daily trading volumes regularly surpassing $1 billion. Triple A-rated bonds were the most liquid as these notes had shown the most resistance against the market-wide sell-off, with prices dropping from par to 90, before recovering into the high 90s.

Triple B CLO valuations dropped into the 70s, while double Bs slumped below 60 cents for a period, taking the market back to 2009-like levels.

"We like triple Bs and double Bs, but the swift downgrades in the leveraged loan space are starting to filter through to CLOs," says PineBridge's Laila Kollmorgen. "Managers are at risk of failing their triple C limits where the excess will be calculated at market price. If there isn't enough cushion on the OC tests, we could see junior tranches diverting interest as OC tests fail."

The rating agencies began downgrading CLO tranches in March, and the consequences for some investors is severe. Most triple B, double B and single B CLO tranches don't have a flat rating (they're typically BBB-/Baa3, BB-/Ba3, and B-/B3), so a one-notch downgrade will take these bonds into a lower rating band, making them unappealing for insurers.

European CLOs

Better structures and a scarcity of energy credits make European CLOs more attractive versus US deals

Christian Pellegrino
Head of CLOs,
III Capital Management

Bullish
US triple As and European investment grade tranches
Bearish
US equity
Greatest challenge
Loan downgrades

Each debt tranche has higher par subordination levels than its US counterpart

Boca Raton-based III Capital Management has preferred European CLOs over the domestic product for some time, with European transactions structurally better able to handle high default rates.

"Not only does each debt tranche have higher par subordination levels than its US counterpart, but there is also more excess spread to offset losses once overcollateralisation tests are triggered," says III head of CLOs Christian Pellegrino. "We also see sector exposures being better in the European market, with virtually no energy or commodities exposures."

The primary concern facing CLOs globally is loan downgrades, with several transactions already in breach of their triple C baskets. III says these downgrades are a larger problem for equity investors, who may see cash flows shutting off, than for noteholders, who may just undergo a technical mark-to-market event.

"You don't have to get super bearish to expect 15% or more triple Cs, which is typically what it would take to cut off equity cash flows," says Pellegrino, noting that this scenario may not be priced in to equity. He points out that a 20%-plus triple C exposure, which would be required to cut off cash flows to CLO double Bs, may already be priced into these tranches given trading levels in the 50s. This could provide attractive opportunities for notes that have lagged the rally in the high yield market.

≫ more

copyright material

Structured credit

There are divergent views on consumer-related ABS, but it's clear the revived talf programme will improve liquidity

Thomas Sweeney

Co-head of structured finance, DWS Group

Bullish
Consumer ABS

Bearish
Retail commercial real estate, retail, CLO equity and double Bs and unsecured consumer loans

Greatest challenges
An extended recession leading to more margin calls and credit being sold at fire-sale prices

Chris Redmond

Head of manager research, Willis Towers Watson

Bullish
CLO double As and single As; seasoned UK RMBS across triple Bs

Bearish
Low rated and first loss positions in small business loans and consumer unsecured securitisations/risk sharing transactions

Greatest challenges
Covid-19 causing underlying collateral to deteriorate and be downgraded by rating agencies

Consumer ABS is trading at unprecedented multiples

The coronavirus pandemic has hammered most of the structured credit market with retail and hotel commercial real estate feeling most of the pain. But the Fed's Term Asset-Backed Securities Loan Facility (talf) programme has created an opportunity in the new issue consumer ABS market, according to Thomas Sweeney, co-head of structured finance at DWS Group.

"The consumer ABS sector traditionally trades at a slight yield premium to treasuries, but right now is trading at unprecedented multiples. If a two-year treasury yield is at 35 basis points, you would expect high quality consumer ABS to be trading at around 55bp. It currently yields 200bp and you potentially get government support with the talf programme."

Sweeney also points out that talf only includes new issue consumer ABS, while the original talf programme in 2008 was broader and included the secondary market and other asset classes as well. [Since this interview, the Fed has expanded the scope of talf.]

Naturally, there are some sectors that may not thrive in the crisis. Sweeney and Chris Redmond, head of manager research at Willis Towers Watson are concerned about unsecured consumer transactions. Redmond says these are the most vulnerable to the economic slowdown.

He says: "We see limited buffers, which used to enable secondary market activity and provide liquidity, and a lack of a natural buyer base leading to a fragile market structure."

Emerging markets

Triple Bs are in favour in developed markets, but it's a different story in EM credit

John Yonemoto

Chief investment officer, Albright Capital

Bullish
EM distressed corporate debt

Bearish
Triple B EM debt that will likely be downgraded soon; sovereign credit

Greatest challenges
Uneven bankruptcy reform; illiquid secondary market

The distressed cycle in EM is likely to be deeper and longer than in developed markets

The coronavirus pandemic has led to an unprecedented decline in global growth. In the lead up to the present fall-out, the emerging market high-yield bond market doubled in size to roughly $900 billion, according to Albright Capital's co-founder and CIO, John Yonemoto.

"Approximately 14.5% of EM HY bonds are trading less than or equal to 70% of par, and roughly $350 billion of EM corporate bonds are trading at 1,000 basis points over treasury yields," Yonemoto says.

The distressed pool is likely to increase because 37% of EM IG bonds are triple B and a significant portion of those are likely to be downgraded. In addition, the $8.5 trillion EM local corporate debt market should also present a sizable distressed opportunity, he says.

Opportunities may abound, but there are significant challenges beyond simply restarting economic engines once social restrictions relax. Liquidity challenges exist in the secondary market and bankruptcy reforms are asymmetrical throughout the opportunity set.

"The current and upcoming distressed cycle in EM is likely to be deeper and more prolonged than the distressed opportunity in developed markets, creating an attractive investment opportunity that will also reduce the associated human and social costs of the current pandemic. Private investors and development finance institutions alike would be wise to take notice and respond," says Yonemoto.

» more

copyright material

US direct lending

The shift towards lender-friendly terms has brought many benefits — but now there is pricing risk in the market

Art Penn

Founder,
Pennant Park Advisors

Bullish

Resilient segments of the economy: government services, defence contractors, cybersecurity, grocery

Bearish

Near to medium term economic outlook based on repercussions from the global shutdown due to covid-19

Greatest challenges

Pricing risk with limited forward visibility

Many direct lenders have never managed through a crisis, and some may lack resources and expertise

The US direct lending market has been migrating towards more lender friendly terms, which has meant higher yields, lower leverage, better structures and potential equity co-investments. There are also secondary opportunities in this environment, says Art Penn, founder of Pennant Park Advisors.

But there is a pricing risk in the market, with so little forward visibility on the length and depth of initial covid-19 disruption. Further, many direct lenders have never managed through a crisis, and some may therefore lack resources and expertise with respect to distressed credits and restructurings.

"The covid-19 related crisis differs from the financial crisis because of the sudden onset," says Penn. "Additionally, there has been an incredibly broad, immediate impact on many sectors of the economy."

European direct lending

The liquidity crisis means that relationships — between lender, borrower and sponsor — will be vital

Kirsten Bode

Co-head of Pan-European Debt, Muzinich

Bullish

Building relationships with existing portfolio companies and lending to companies with predictable business models in sectors such as tech, e-commerce, healthcare

Bearish

Direct lenders need sizeable and experienced teams to deal at the same time with portfolio companies and new deals

Greatest challenges

The market has not yet gone through a "price finding" phase

The coronavirus crisis is universal so nearly all borrowers will see some impact, but direct lenders are working to build lasting relationships with portfolio companies and sponsors to mitigate challenges as far as possible, says Muzinich's Kirsten Bode. They are also involved with relevant aspects of the loans, guaranties, tax relief and wage assistance offered to borrowers by governments.

Bode is also seeing new deals. "While a number of advanced deals have been put on hold we have seen a good inflow of new opportunities," she says.

These include private equity processes where banks have dropped or reduced quantum as financing providers, companies that have extra liquidity needs, and family businesses where the crisis is opening unique acquisition opportunities. However, she adds that the market has not yet gone through a price-finding phase.

According to Bode, drivers for success throughout this period for direct lenders include a sizeable and experienced team dealing at the same time with portfolio companies and new deals. It's also important, she says, to be defensively positioned with appropriate diversification, and the ability to provide liquidity if needed.

A number of advanced deals have been put on hold but we have seen a good inflow of opportunities

» more

copyright material

High yield

Sectors affected by the lockdown are problematic but high yield spreads are generally at attractive levels

Rob Cignarella

Head of US High Yield, PGIM

Bullish

Recent new issuance across defensive sectors, such as healthcare, consumer packing, and fast food

Bearish

Sectors most vulnerable to the covid-19 shutdown, such as autos, aerospace, and air transportation

Biggest challenge

Uncertainty is fuelled by the potential influx of paper from issuers downgraded to high yield

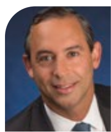
Since hitting their post financial crisis wides of 1,087 basis points in late March, high yield bond spreads have since tightened a little. That said, spreads have reached a level that has historically been an attractive entry point.

"Over the last 25 years, there have been seven periods when high yield spreads traded above 800bp," says Rob Cignarella, head of US high yield at PGIM. "In all cases, the high yield index generated above-average returns in the subsequent 15-month period. Therefore, our two-year outlook is highly constructive."

When high yield spreads have traded above 800bp, the high yield index has later generated above-average returns

Distressed

Sourcing opportunities is no longer an issue. It's all about staying disciplined



Shary Moalemzadeh

Co-head of illiquid credit strategies and of Carlyle Strategic Partners, Carlyle

Bullish

The fact that distressed opportunities have risen to nearly $1 trillion, and could be higher once mid market debt is factored in

Bearish

The market is still volatile with more downgrades and outflows to come

Greatest challenges

With all the volatility, it's important to stay disciplined and price risk appropriately while protecting the downside

Mike Meyer

Partner and head of capital structure advisory, Union Square Advisors

Bullish

Private equity, private credit, and distressed funds that are established and experienced

Bearish

New, sub-scale asset managers

Greatest challenges

Competition among distressed issuers for capital

Some managers have already missed a near-term bottom in leveraged loans

The entrance of new credit and private equity managers into private markets was long thought to compromise underwriting while driving up valuations. Now that the credit cycle is churning, say market participants, large managers of private capital can deploy quickly while less established managers with no edge face the prospect of consolidation.

"There's liquidity in the markets especially in the investment grade and high yield bond markets. Private credit, PE and distressed debt could reach more than $100 billion and will be put to work in the secondary and eventually in the primary markets," says Mike Meyer, partner and head of capital structure advisory at Union Square Advisors.

The challenge is timing and prioritising strategic initiatives. Many general partners are paying attention to damage done to their portfolios while distressed investors are contemplating when to buy.

"Some have already missed a near-term bottom in leveraged loans, which reached 76 cents on the dollar in March but have risen to 83 in April. If this is a W shaped recovery, they will have another shot at buying near the bottom. If the recovery is a V, they missed it," Meyer says.

According to Shary Moalemzadeh, co-head of illiquid credit strategies and co-head of Carlyle strategic partners, the amount of distressed debt in the US has quadrupled to nearly $1 trillion and could be higher once middle market and private credit portfolios are included.

"Companies are going to have strained capital structures and are going to need capital partners to help them with their liquidity needs," says Moalemzadeh.

"Given the sudden and severe price volatility, it's tempting to invest a meaningful amount of capital but it's also important in this market to stay disciplined and sift through the opportunity set to identify the best risk adjusted returns in situations with downside protection and capital preservation for our investors," Moalemzadeh.

copyright material