Sanlam Investments

Credit where credit's due - a view on the state of the credit markets

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So far, 2022 has been a year to forget for the credit markets – as at the end of May 2022, the US IG/HY have produced a 2022 year to date total return of -11.86%/-7.76% respectively (source CreditSights, end of May). This is one of the worst starts to the year for credit for many years. The weakness in credit markets has been doubly frustrating for investors as it has coincided with a slump in equity markets - for the first five months of the year, the S&P 500 has shed 13.3% in US dollars and the NASDAQ Composite has fared even worse, with a total return of -22.8% (source BBG, end of May). As sometimes happens at periods of severe market stress, the typical diversification benefits offered by bonds have been largely absent at a time when holders of equities and other 'risk assets' would have found them very helpful. Given the slump in public markets, Alternatives have become a larger weight in investors' asset allocations – thus potentially providing a rebalancing headwind for those asset classes in favour of more traditional investments.

Given the poor start credit markets have had this year, we discuss in this note what we have learnt to date the outlook for credit markets for the remainder of this year, and the solutions credit investors can adopt in what is undeniably a difficult environment.

What we've learnt in 2022

1. Interest rate risk remains your key risk

For years and years, 'lower interest rates for longer' - on the back of undisputable and structural changes in the global economy – was the mantra. Credit spread became the bigger and bigger share of yield as a result. Fast-forward through 'short covid' (covid lockdowns) and 'long covid' (reconsideration of the entire supply-chain and its vulnerabilities) with all the consequences in between, and now the central bankers engage in the heavy lifting required to control inflation and demand (as influencing supply is out of their reach).

Consequence for fund managers? Ignore credit analysis for a moment and face the tidal wave (BoE then the Fed… and the ECB next in line). This major uncertainty informs the intrinsic mindset that leads into the following points.

2. The primary market has struggled in 2022

In 'normal' credit markets, when issuers launch a bond, they typically price it so that it is attractive to investors. The spread would typically tighten subsequently. 2022 has, unfortunately, been quite the opposite. Issuers have had to offer significant pricing concessions but, rather than the new issue tightening to the secondary market curve, new issues have in fact tended to pull the entire secondary curve wider, rather than the other way around. In these circumstances, some issuers decided to postpone or cancel issuance or worse not call their debt at the call date [see point 4].

The equation is quite simple from an investor's perspective: why would you add risk in your portfolio when you are on the edge of the most aggressive hiking cycle in recent history? This is a challenge for investors as the primary market is normally a healthy source of alpha opportunities, but for now it can provide a negative technical factor for corporate bonds. Only interest rates and geopolitical stabilisation can put the primary market back on track, as late March has shown.

3. De-risking liquidity

As would be expected in a difficult environment, high yield investors have been reducing risk, partly by selling non-benchmark bonds but also by going up in quality. Given the backdrop, this does make sense, but it also highlights the potential risks for 'yield tourists' who invested in poor quality or non-benchmark bonds which may now be difficult to exit as there are fewer willing or able buyers to be found. Liquidity in credit markets has been sporadic this year and very security-specific, which is a symptom of a 'risk off' environment. While we have seen some decent levels of liquidity at the shorter end of the curve, particularly in the IG names, liquidity at the long end has, at times, been poor. Given the flatness of the curves and rising interest rates duration has also been out of favour, at least during the first four months of the year. With the soft landing of the various economies hoped for, some buyers identified some value in the long end with GDP growth forecasts being continuously revised down.

4. Extension risk…is definitely a risk for investors to consider

Given the rise in risk-free rates and recent spread widening, the 'all in' cost of debt has increased substantially. In the era of very low rates and tight spreads, many bonds launched in recent years were priced at what will prove to be historically low levels. This means that some issuers, rather than calling (buying back) their bonds at the first occasion and refinancing, will be better off allowing their securities to run thereby continuing to lock in to the much lower (better) rates through their back-end coupon. Of course, this is not a risk for bullet securities (i.e. no call structure). It is something that owners of callable bonds should consider, given the environment.

Callable bonds pose a significant conundrum to issuers and are very bond specific; whilst there is clearly the opportunity to lock-in attractive rates depending on market conditions by not calling the issue, there is also the reputational risk (in particular in Europe) that comes with not calling the bond, especially for frequent issuers. The reality is that markets proved to have a short memory of previous cases. If it does make economic sense to the issuer not to call the debt, investors must remain pragmatic and define the actual case for the call: where does the debt sit in the capital structure? Is it detrimental from a rating agency / regulatory perspective? Having said that, while the latter was a relevant point for the German bank Deutsche Pfandbriefbank (pbb), it took the market by surprise in May by not calling its Tier 2. The change from yield to call to yield to maturity often results in a value drop as the bond reprices versus its secondary curve and the new embedded duration. Again, the knowledge that some issuers may decide not to call their bonds provides something of a technical overhang for the market.

What is the outlook for the remainder of the year?

This is the $1 million question and, at the moment, very difficult to answer (inflation-dependent obviously, so likely $1.3 million by the end of this article). If risk-free rates continue to reprice because of high inflation and spreads continue to widen because of the worsening technical picture, then we could see the 'all in' cost of debt continue to rise, which could be problematic for some issuers, particularly those that have a lot of debt to refinance this year. At the sector level, the key thing for investors to consider in an inflationary environment is the inflation sensitivity and demand elasticity for the product/service provided by the issuer and critically the ability of the issuer to pass on rising input costs. In the primary market, new issuance should be possible, but issuers will have to be selective and use the appropriate or available windows when seeking to get deals done (like in late May or early June).

An alternative scenario is that we see a 'stagflation' scenario where the market comes round to the idea of inflation being more or less embedded, but ultimately this crushes economic growth because consumer living standards suffer serious erosion and demand weakens. In this environment, with little or no economic growth, risk free rates would come down, which is supportive of government bond markets. However, if there is a collapse in growth, this would result in a deteriorating picture for corporate fundamentals, which would put upward pressure on spreads. The positive is that all-in yields would remain high, which means that credit should find favour with investors who have shunned the asset class in recent years because yields (particularly in the IG space) have been so low.

What solutions can investors utilise in the current environment?

The inflation shock and subsequent re-pricing of risk-free rates has undeniably been hard for some investors. In a long-only fund, it is difficult to mitigate all of these risks, and more or less impossible to defy gravity, but we certainly found it useful to dial down our duration exposure since 2021 while focusing on our fundamental analysis.

There is another positive to the recent turmoil: the opportunity to reinvest the proceeds of maturing securities at much better (some would say more realistic) yield levels. The period of QE and 'financial repression' is unprecedented in recent history and there was no playbook for central banks on how to exit from it; as such, it was always going to be difficult to move away from such stimulative policy settings. Within our strategy, 20% of our portfolio will mature or come back to us in the next 12 months; the timing to deploy that capital at much better yield levels is excellent in our view. Liquidity Management Exercises remain a feature of the current environment and could mean we see even more of our capital being returned during this period. Either way, there will be plenty of cash to deploy. Investors who can deploy capital now can pick up some decent yields.

The other thing to remember here is that dislocation creates opportunities for active investors, and it is important to take advantage of them when they arise. Our strategy is typically a blend of IG names (around 55% of the portfolio), around a third in BBs (with a focus on bonds that have the potential to be upgraded to IG status) and the remainder of the portfolio split between non-rated bonds and cash. Similarly, non-rated bonds can provide great investment cases, but you have to be prepared to do the work. Of course, not everyone wants to do this, and some investors can't hold names that don't have a credit rating from S&P or Moody's or Fitch, but the fact is there are opportunities out there to pick up yield at attractive risk levels if you are prepared to look.

While investors may reconsider their allocation away from the equity market into fixed income given the uncertainties, the credit market should offer an interesting alternative. While reducing the pure beta of the portfolio, the asset class maintains important upside potential, reinforced by recent repricing. The reset of yields remains a critical element which should help a cautiously constructive view for the asset class, above any risk-free rate exposure. Part of the broader asset allocation decision, the balance between credit risk versus duration risk needs to be fine-tuned for the coming months.

Is there more pain to come in rates?

Possibly, it is near impossible to anticipate, so, we prefer to stick to the shorter end - which has already repriced so aggressively - and focus on our conviction investments to extract the best risk/return outcome. Our expertise lies in the additional reward over the government curve. We see higher rates as a driver of great momentum for banks and insurers to improve their NII and investment portfolio return respectively. We strongly advocate focusing on highly capitalised issuers - that may sound obvious but within our strategy we spend a lot of time focusing on asset quality and particularly on identifying companies that have already done the work to clean up their balance sheets. These are the companies that have given themselves the best chance to perform whatever comes next. For our holdings, we don't see a refinancing wall and the risk of default is very small and we are frequently in touch with management on areas of concern. And remember, debtholders give up growth potential in a company to shareholders; the corollary is that shareholders are the first line of defence if something does go badly wrong with the company (and the economy) while bonds benefit from healthy asset backing.

Lastly, in an uncertain environment, we would always emphasise a focus on the areas of the market which are likely to be the most resilient and which offer low levels of volatility. In our strategy, that means focusing on shorter duration IG names or those that have the potential to achieve IG status, but which offer an attractive yield pick-up in the interim. These shorter duration bonds are the names that are best placed to weather volatility. Moreover, on weak 'risk off' days, investors will look at the short duration IG names before contemplating anything else. Investors may then trade down on risk or quality – but equally they may go no further if markets remain unsettled. As we said earlier, nothing is invincible, but the shorter and IG end of the credit market looks significantly more attractive than it used to, at least in the UK and US. The ability to deploy capital into good quality names at the short end of the curve at attractive yield levels is a development that all investors should welcome as it represents a return to some form of normality in capital markets – even if the journey to get there has been quite painful.

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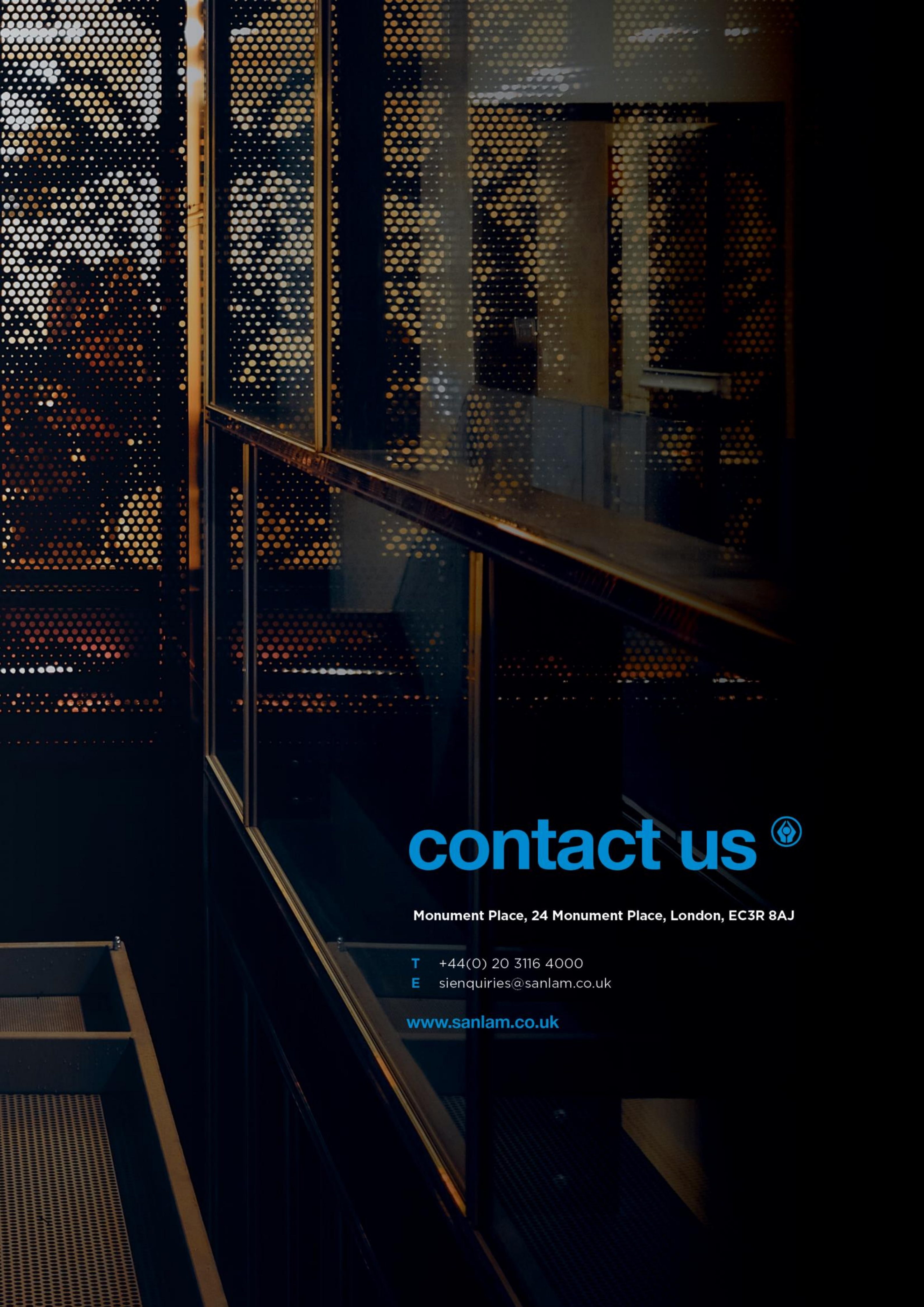

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