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Credit Strategy

22 April 2020

Credit markets had deteriorated significantly during February and March, as noted in the previous March update. The global outbreak of COVID-19 and the restrictive measures imposed by governments, such as lockdowns and social distancing, had a severe impact on economies and business operations across sectors. In turn these developments led to a major deterioration in credit markets – in terms of performance, investor sentiment and even general market functionality. The significant sell off across all spaces of credit drove the increase in borrowing costs and the widening in spreads. Liquidity dried up both in the real economy and in financial markets, as corporates were unable to tap the bond market for their financing needs. During April, the tone in credit improved, with some degree of normality slowly restored in markets. The easing conditions can be primarily attributed to the actions taken by the fiscal and monetary authorities, whereby governments and particularly central banks have stepped in to provide support to financial markets and the general economy.

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Credit Markets – Key Indicators

	21.04.2020	27.03.2020	31.12.2019	bps ∆ YTD
Credit Spreads (OAS)				
EUR IG (LECPTREU)	248.40	242.68	259.02	(10.62)
EUR HY (IBOXX MJA)	182.05	172.17	203.68	(21.63)
US IG (IBOXIG)	324.88	302.92	319.94	4.94
US HY (IBOXHY)	276.25	263.11	303.97	(27.72)
CDS INDICES				
EUR IG (iTraxx)	90.56	92.37	43.69	46.88
EUR HY (xOver)	554.98	570.06	205.02	349.96
US IG (CDX)	98.06	111.89	44.98	53.09
US HY (CDX)	669.15	623.21	278.70	390.45

Central Bank Policies – Support For Credit Markets

U.S. Central Bank Policies

- The US Federal Reserve ("Fed") has been notably very active during recent weeks in implementing several initiatives to support financial markets
- On the 23rd of March, in addition to the 2nd rate cut of the year, whereby the Federal Open Market Committee ("FOMC") cut the federal funds rate by 100bps to 0%-0.25%, the Fed introduced several measures to stimulate the US economy and financial markets
- Whilst certain policies targeted more specifically funding and money markets or the flow of credit to consumers and businesses, in April details were provided on two measures that potentially most directly impacted corporate debt markets:- the Primary Market Corporate Credit Facility ("PMCCF") and the Secondary Market Corporate Credit Facility ("SMCCF"), with a combined size of $750 billion
- The PMCCF was established to provide a funding backstop to qualifying issuers, by purchasing corporate bonds and loans at issuance stage in the primary markets. Eligible issuers will have a credit rating of at least BBB-/Baa3 and the instruments purchased a maturity of less than four years
- The SMCCF was established to purchase corporate debt on the secondary market, including both corporate bonds and corporate bond portfolios in the form of ETFs. Eligible issuers are rated at least BBB-/Baa3 and the bonds have a maturity of five years or less
- Both facilities were extended to include issuers rated BBB-/Baa3 as of March 22nd 2020 but that were subsequently downgraded – subject to having a rating of at least BB-/Ba3 at the time of purchase.
- In mid-April it was further announced that the SMCCF was eligible to purchase high yield bond ETFs

European Central Bank Policies

- The European Central Bank ("ECB") has also been progressively taking steps to enhance liquidity and confidence in Euro financial markets
- Amongst these measures, as concern on contagion and its impact increased, the Asset Purchase Programme (APP), which includes the Corporate Sector Purchase Programme (CSPP), was strengthened with an additional €120 billion in net asset purchases until the end of 2020
- The CSPP is eligible to purchase securities having a credit rating of at least BBB- or equivalent, with eligible securities having a remaining maturity of between 6 months and 30 years, and excluding financial institutions debt
- This program was extended to include also commercial paper issued by non-financial companies, allowing for maturities as short as 28 days
- Most notably, the ECB launched the Pandemic Emergency Purchase Programme ("PEPP") on the 18th March with an overall size of €750 billion; will come to an end once the ECB's Governing Council deems that the COVID-19 phase is over but not before the end of the current year
- In the first two weeks of April, the ECB had purchased more than €35 billion euro within the PEPP. Since the launch of the PEPP, purchases within the context of the CSPP have totalled €9.8 billion and stood at €205.0 billion as at the 10th of April

Credit Markets Performance – An Overview

- During recent weeks, although there was an overall improvement in both US dollar and Euro corporate debt markets as spreads have tightened across both the investment grade and high yield segments, conditions remain elevated compared to period prior to COVID-19 outbreak

- The new monetary policy measures introduced by both the Federal Reserve and the European Central Bank have contributed significantly to the stabilization of credit markets, somewhat providing comfort to investors

- In addition to central banks, the planned fiscal policy measures indicated by governments in different degrees and formats, are also providing hope that substantial efforts will be in place to support economies

- As COVID-19 statistics began to moderate in certain regions, investors are now beginning to assess the impact of the crisis on the financial results of issuers

- In terms of market performance, a major consideration relates to the fact that whilst corporate debt has sold off and yields remain elevated, further major market "dysfunctions" were avoided

- During March, investors had to contend with episodes of severely disorderly markets, whereby liquidity totally dried up, funding spreads surged in money markets, and extreme risk aversion meant it was even near impossible to even execute certain trades

- Recent weeks witnessed somewhat of a return to normality, and whilst losses compared to the start of the year have not yet been recovered, a number of sectors within credit markets have rallied from lows, or at least benefited from stabilisation

- The extraordinary weakness and volatility in oil prices, in addition to certain pressures that have built up in the Euro funding markets, had a dampening effect on investor sentiment

- Capital markets have seen a resurgence in activity as issuers sought to tap the bond markets to improve their liquidity position and strengthen their balance sheet in order to counter the economic impact of COVID-19. The revival of capital markets has been more evident in the US, compared to Euro area

- The cost to insure against credit defaults has declined during April when compared to March across both the investment grade and high yield segments in the US and Europe but remain above pre-Covid-19 levels

Relative Movements in Spreads

U.S. Markets Overview

- Credit market conditions have eased in recent weeks as reflected in movement of spreads, with the introduction of the Fed's measures providing considerable support

- The substantial increase in the size of the facilities, together with the eligibility of previously investment grade issuers ("Fallen Angels") and the potential inclusion of certain high yield bonds, had a positive impact

- Credit spreads within the high-yield segment have contacted by circa 400bps following the introduction of the PMCCF and the SMCCF, with spreads in the investment grade segment tightening by approximately circa 200 bps. However, while spreads within the American corporate bond market have tightened following the launch of the PMCCF and SMCCF, they remain above pre-Covid-19 levels

Euro Markets Overview

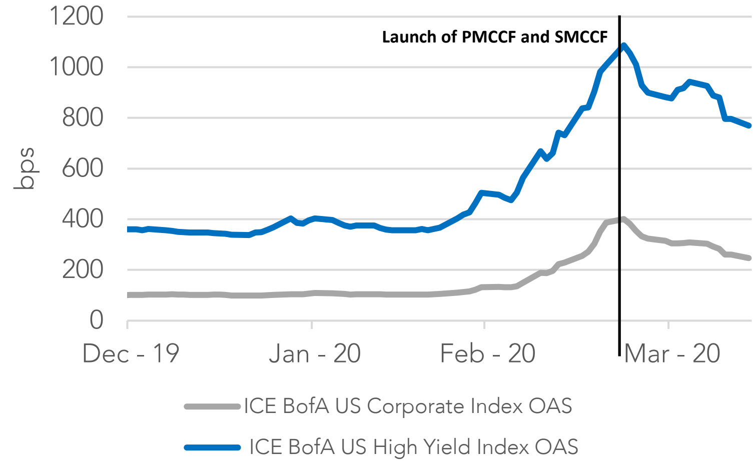
- While credit spreads have tightened within European credit markets, the range and size of support to European credit markets by the ECB does not compare to that of its American counterpart

- Similar to the pattern seen in the U.S. Corporate Bond Market, the movement lower in high yield spreads was more pronounced than that seen in the investment grade space during the month of April; however the high yield is still at decompressed levels vs. pre-crisis levels

- Following the introduction of the PEPP, high-yield spreads have contracted by approximately 150 bps while movement in investment grade spreads was more moderate

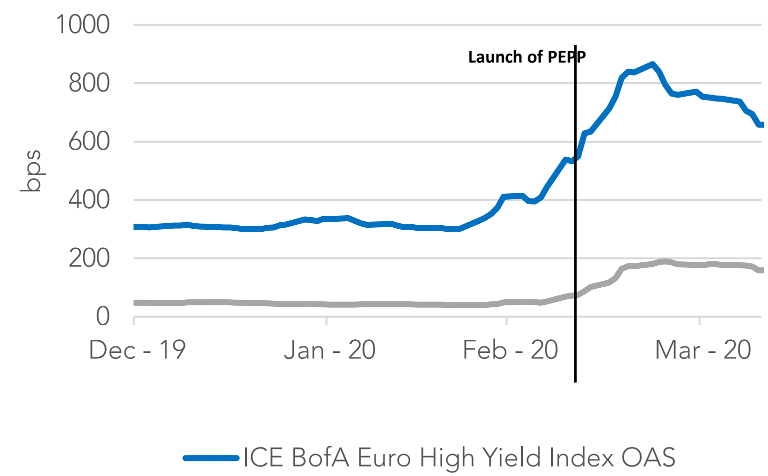
- However, similarly to the US dollar markets, whilst Euro credit spreads have contracted following the introduction of the PEPP, they remain elevated when compared to the levels seen prior to the pandemic

US - relative movements in credit spreads



Source: Federal Reserve Bank of St. Louis;

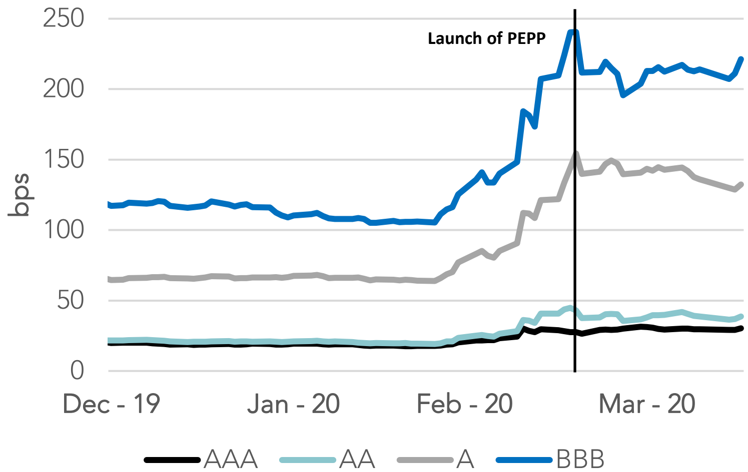
Euro – relative movement in credit spreads



Source: Bloomberg;

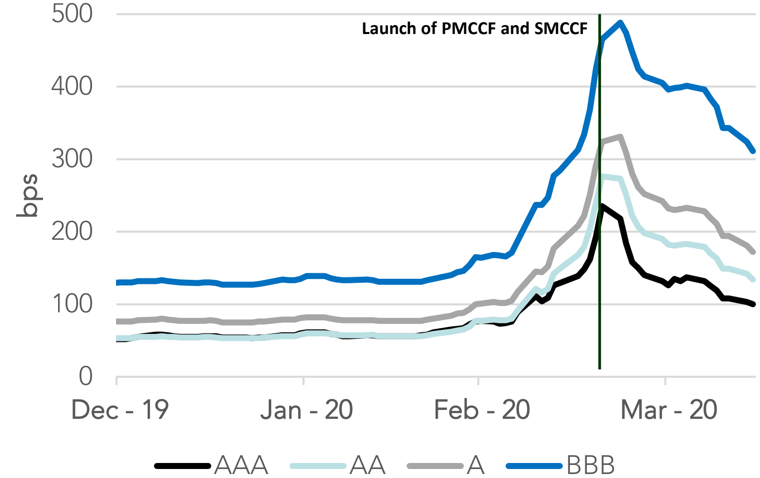
Relative Movements in Spreads (cont'd)

European Investment Grade OAS



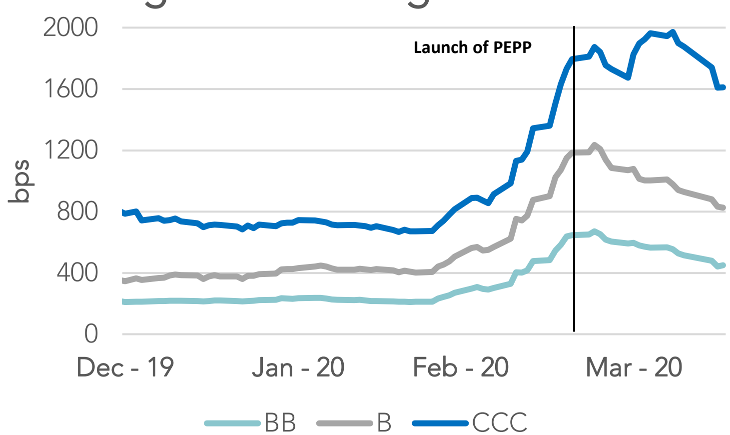
Source: Bloomberg;

U.S. Investment Grade OAS



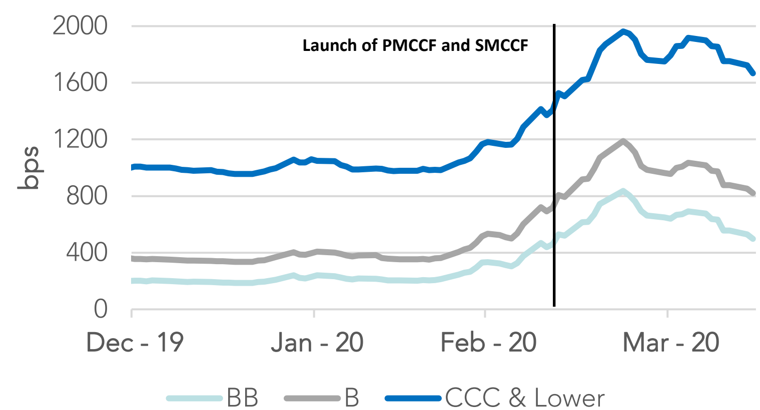
Source: Federal Reserve Bank of St. Louis;

Euro High Yield Rating OAS



Source: Bloomberg;

U.S. High Yield Rating OAS



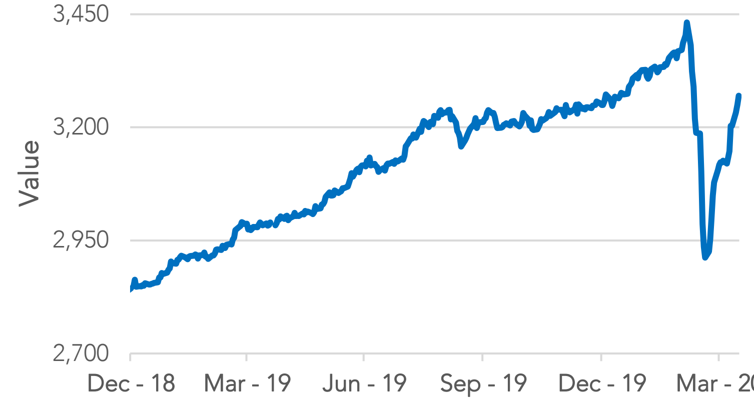
Source: Federal Reserve Bank of St. Louis;

Average Returns – Performance Overview

Euro Investment Grade TRI

Source: Bloomberg;

U.S. Investment Grade TRI



Source: Federal Reserve Bank of St. Louis;

Euro High Yield TRI

Source: Federal Reserve Bank of St. Louis;

U.S. High Yield TRI

Source: Federal Reserve Bank of St. Louis;

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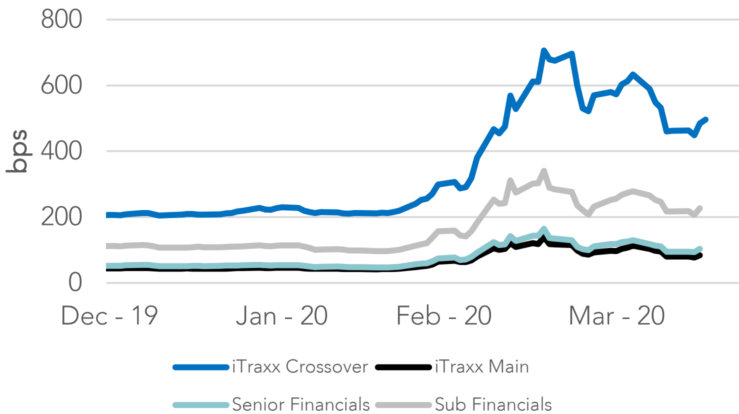
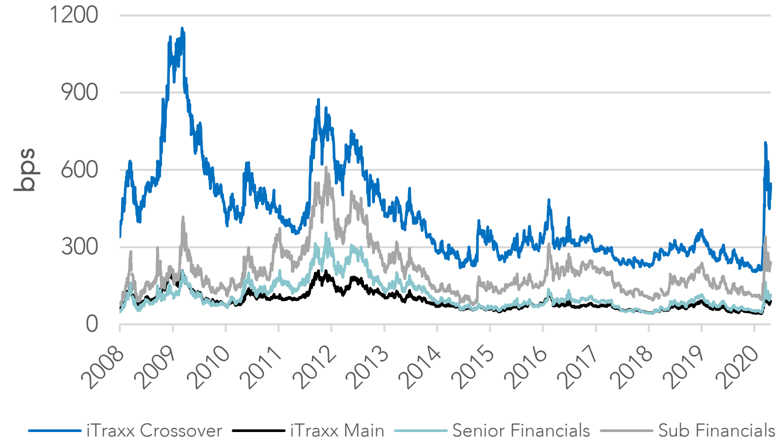
Credit Default Swap ("CDS") Indices and Emerging Markets

CDS Indices - YTD



Source: Bloomberg;

CDS Indices – since 2008



Source: Bloomberg;

EMBI – YTD

Source: Bloomberg;

EMBI – since 2016

Source: Bloomberg;

Capital Markets Update

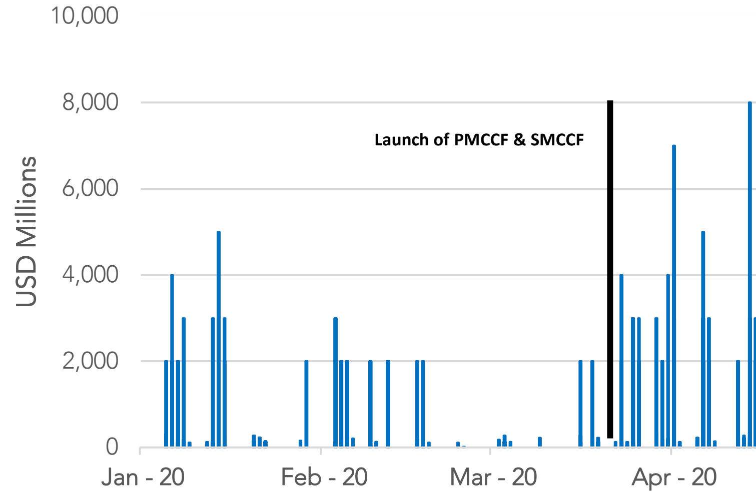
U.S. Capital Markets

- Bond issuance slowed down sharply, almost coming to a halt, between the second half of February and the first half of March given the outbreak of the pandemic in the US
- However, U.S. capital markets witnessed a resurgence following the Federal Reserve's PMCCF and SMCCF as $107 billion worth of bond issues came to market between the second half of March and the first half of April
- Therefore, sentiment within capital markets has improved compared to the negativity seen in early March as new issues came market with companies seeking to strengthen their liquidity position given the impact on their business with COVID-19

European Capital Markets

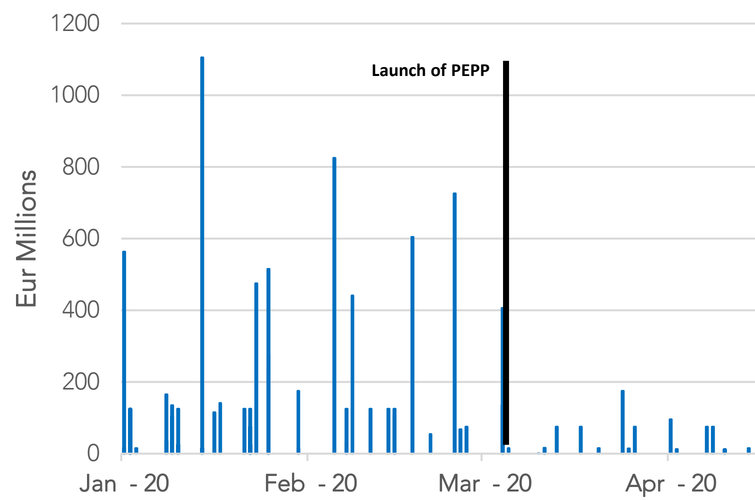
- Compared to the resurgence in capital markets issuance in the US, the recovery in primary markets activity was more muted in Europe
- During the month of March a total of €1.8 billion worth of new corporate bond issues came to market, which is significantly less than the €4.8 billion and €2.7 billion that occurred in January and February respectively
- The slowdown in new bond issuance continued into April as until the 17th of April €370 million worth of corporate bonds were issued in European markets

US Bond Market Issuance



Source: Bloomberg;

Euro Corporate Bond Market Issuance



Source: Bloomberg;

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Outlook for Credit

- It is encouraging to note that the contagion numbers are stabilising in certain regions, whilst there is hope that the ramping up of measures by both governments and central banks will contribute to an improvement in the overall situation going forward
- However, in this respect, it is relevant to note that the reality of the economic fallout from the Covid-19 and from the counter measures being taken, is still unfolding, and the severe challenges could persist well into the longer term
- The corporate sector is facing a combination of unprecedented declines in revenues, compression in margins, and cash flow pressures, which ultimately could lead to severe liquidity challenges
- The deterioration in the ratings scenario is yet to gather pace. The extent of downgrades is expected to become more evident, whilst default rates keep increasing, with expectations of default rates rising above 10%
- In this respect, credit markets investors will be focused on obtaining a better understanding of the impact that recent developments had on the operating and financial performance of companies
- Issuers are expected to increasingly provide some visibility on relevant impacts in coming weeks. Indeed any announcements on liquidity and damage to balance sheets are particularly important on a single name basis, at this stage
- On balance the investment grade sector remains relatively attractive in the current scenario, particularly at the higher quality levels with a particular focus on resilient sectors and issuers, also due to the context of the continued support of central banks
- Even though the high yield market has recovered from its lows, maintaining a risk averse or defensive approach is reasonable, reflecting severe the economic downturn and pressures across corporate sectors. Should the market continue to settle, also in terms of liquidity and pricing, selective opportunities could be attractive
- Emerging markets credit is expected to remain vulnerable to the concerns on global economic growth, trade, and weakness in energy and commodity prices

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