24TH MARCH 2020

THE DEMISE OF FIXED INCOME AFTER A 30-YEAR BULL MARKET?

Not quite yet. Fixed Income has legs left in it, bruised and battered by one week of madness (normally summer madness).

As you would expect after such a bruising episode, we have looked deep inside ourselves to ensure that we have shed all behavioural bias and are looking at each of our major strategies with a fresh lens to ensure we are still committed to them.

As with our Equity team, we are reviewing our themes and our credits and we will soon begin to recommend changes.

However, let us stress a few key points:

1. We have invested in the largest systemically important banks – please refer to the document 'Global Banks Revisited' and our 'Bank Stress Test Note'.
2. We have invested in the largest systemically important insurance companies.
3. We have invested in major utilities that are an essential part of the economic framework – please refer to the 'Overview Investment Grade' Document.
4. We have invested in global corporates that are the major employers and critical to the wellbeing of domestic economies and, as a result, global economies – please refer to the 'Overview Investment Grade' Document.
5. We have not invested randomly in a swathe of high yield companies.
6. We have not invested in leveraged loans.
7. We have not invested in other leveraged products.
8. We have not invested in local currency Emerging Market bonds.

Observations on credit spreads and other valuation factors as an important backstop for all to understand what has been happening:

- The wave of forced selling (primarily through ETF sales) was indiscriminate and has led to some extreme valuations in many sectors along the credit curve.
- Starting at the very short end, as some large US banks on Tuesday experimented with the Federal Reserve to activate the emergency discount window should access to liquidity become a major issue. Some market doomsters read too much into this exercise, in our opinion, using it as a signal that there is a scarcity of liquidity, by widening the LIBOR-OIS spread to 1.00%.

What does this imply? Does it suggest that banks will not lend to each other with any confidence?

No, one of the first acts offered by the authorities was to swamp the system with liquidity, using a wide range of tools. Also, LIBOR's role in effective money management is significantly less important now, as it's being phased out in favour of the Secured Overnight Funding Rate (SOFR).

- Moving to Investment Grade (IG) credit, ETF sales widened out the "basis", which is the difference between the yield spreads on physical bonds minus the CDS rate. Recently, we have seen some stability of the basis. Nevertheless, Euro IG CDS spreads are at 1.24% (off the recent high of 1.41%, a level last seen at the peak of the oil crisis in 2016 and the during the taper tantrum in 2013). Similar levels are seen in US IG credit.
- Equivalent levels on corporate High Yield (HY) have significantly surpassed milestone levels on IG, with Euro Crossover spreads at 6.40%, which are levels last seen in the European banking crisis.
- A few companies have started to draw into previously untapped bank loan facilities, some of which have received negative news coverage. We look upon this as prudent tactical cash flow management, especially as these are money-market linked floating facilities with low interest cost. These companies are most likely to see some EBITDA impairment, which in some cases may be 20% on a year-on-year basis. Government packages across the globe will ensure that these facilities will be made available to corporates, should the lockdown period last more than 2 quarters, with many such loans having high sovereign underwriting.

In summary, the markets have entered into a mind-set that is pricing in a series of coupon skips for financials, and an increased strain on EBITDA that challenge the ability for corporates to honour coupon obligations.

Our internal stress analyses have shocked revenue for banks and earnings for corporates by severe amounts, and our findings are that balance sheets for all the credits we own have ample ability to service obligations. Updated work from Morgan Stanley and Barclays share our conclusions.

Are credit markets returning to normal?

A positive indication from new issues – these companies have announced multi-tranche issues as investor demand is still exceptionally strong:

- INTEL
- COCA COLA
- ENGIE
- UNILEVER
- EOG RESOURCES
- BERHKSHIRE
- CITI
- ECOLAB

Opportunities that London & Capital will soon take advantage of as switches.

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