Corporate Hybrids

Corporate Hybrids were a strategic component of our medium-term Fixed Income allocation made up of

- **Defensive Utilities**
- **Major Global Corporates**

In the recent market maelstrom, even defensive names such as major utilities have got hit by a mark-down in bond prices.

Given the material short-term shift in underlying global economic fundamentals, we are reviewing all our investment themes with the specific purpose of making tactical changes to optimise the returns when the bounce comes.

Our quick macro framework which is vital for fixed income

INTEREST RATES
The average global monetary rate has been slashed to new lows (even lower than post-financial crash period).

ASSET PURCHASES
Asset Purchases are back with a vengeance with The Fed ($1 trn), ECB (c$1 trn) and BoJ similar in the vanguard. All of them stand to increase purchases further.

LIQUIDITY PROGRAMMES

– Global provision for banks and companies
– Credit guarantees for banks to keep money flowing to companies
– Direct government credit assistance for SMEs

FISCAL POLICY
G4 stimulus already stands at $1.7 trn

FISCAL POLICY

– Loans and grants for companies
– Tax reliefs for all companies
– Direct fiscal transfers to individuals
– To come: tax cuts for companies
– To come: tax cuts for individuals

Utilities

The prices of Utilities were buffeted by a confluence of events

CAUSE	RESULT
Need for liquidity from retail investors	ETF liquidation led to sales of high grade and defensive names
Significant equity market weakness	Equity market weakness will take time to bottom following the significant falls in recent days
Damaging rise in credit spreads	QE action is beginning to have a positive impact but will take time to have a sustained impact
Sudden four day jump in government yields	This hit all risk markets and will remain an intermittent threat

Therefore we must revisit why we favoured debt issued by major utilities and whether anything has materially changed, either tactically or strategically

FEATURE OF MAJOR UTILITIES	CHANGE?
Highly regulated industries	No change
Oligopolies – high barriers to entry	No change
Certainty of earnings and cash flow	No change
Part of the economic infrastructure	No change

Considering this, we see no reason to alter our Utilities strategy.

Recovery will be patchy but will be helped by the significant corporate bond purchases that will take out outstanding bonds and squeeze the market in time.

Major Global Corporates (MGC)

This category includes a wide range of industries and sectors and are generally mega-caps and of high grade credit quality. The business interests of members of this group generally span continents and countries, benefitting from their huge economies of scale by effectively raising barriers to entry.

The latest market turmoil has extended to this group of Investment Grade Major Global Corporates

CAUSE	RESULT
Need for liquidity from retail investors	ETF liquidation led to sales of high grade MGCs, which provide this liquidity facility. Adverse price action reflects reluctance of banks to run positions on their balance sheets
Need for from professional investors	Market stress has led to the need to raise cash. Investors have sold sectors where prices have held up relatively well, including MGCs
Significant equity market weakness	Discretionary distributions will be hit hard, with many dividends zeroed and share buy-backs cancelled. Bond coupon payments will be prioritised
Damaging rise in credit spreads	The sheer scale of the Fed, ECB & BoE credit purchase programmes will stablise/squeeze spreads, which have jumped to their widest levels in years
Sudden four day jump in government yields	While this was an immediate negative this week, central bank buying, will soak up a good part of the planned new issue in government bonds, in turn helping MGCs

Given the Covid-19 changed macro/policy/market environment, we revisit why we favoured debt issued by the Major Global Corporates and whether anything has materially changed, either tactically or strategically

MAJOR GLOBAL CORPORATE SECTOR	CHANGE?
Information Technology	No change - Low leverage & high cash piles insulate against the downturn
Consumer non-cyclicals	No change - Revenue, Op cash flow to be pressured, but ultimately pull-through. Geographic diversification an aid
Consumer cyclical	Be selective - little exposure here
Pharmaceuticals	No change - Resilient demand
Media/Entertainment	No change - Fall in high-street footfall, but greater demand for home entertainment
Autos	No change - cash rich, but these will be run down on prolonged economic disruption
Manufacturing	Be selective - Pressure on production process, scale key and strategic considerations will play role
Resource & Oil Majors	No change - very little debt to service

There is little change to strategy for most sectors. The strategy was always geared to the most resilient industries and credits. IT, consumer non-cyclicals, pharmaceuticals and media These are sectors which will remain favoured at the expense of cyclicals, manufacturing, and potentially autos, where individual credits will be assessed upon their own merits.

Mark-to-market price volatility is likely to remain high, but strategy continues to be driven by macro/ policy considerations and credit balance sheet fundamentals. As the price adjustment has been abrupt, expect the reverse once signs that the worsts of Covid-19 has passed.

By design, London & Capital Fixed Income strategies have no exposure to major global airlines, restaurants, high-street retail, and very little in transport, resource or small/mid-sized energy. Real fundamental cash flow are expected problems here.

We shall be monitoring revenues, and their impact on operating cash flows. Fixed and variable costs will be examined, together with the scope for savings and relief offered by government aid programmes. The rate of cash burn will be important.

Discrimination will be made between credits on the grounds of the duration that they can withstand adverse trading conditions, whether it be 3 or 6 months.