



GLOBAL VALUE AND INCOME DISPATCH

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Multiple acts – What’s next for the credit markets?

“There are these two young fish swimming along and they happen to meet an older fish swimming the other way, who nods at them and says ‘Morning, boys. How’s the water?’ And the two young fish swim on for a bit, and then eventually one of them looks over at the other and goes ‘What the hell is water?’” - ‘This is Water’, by David Foster Wallace – commencement speech to Kenyon College, 2005

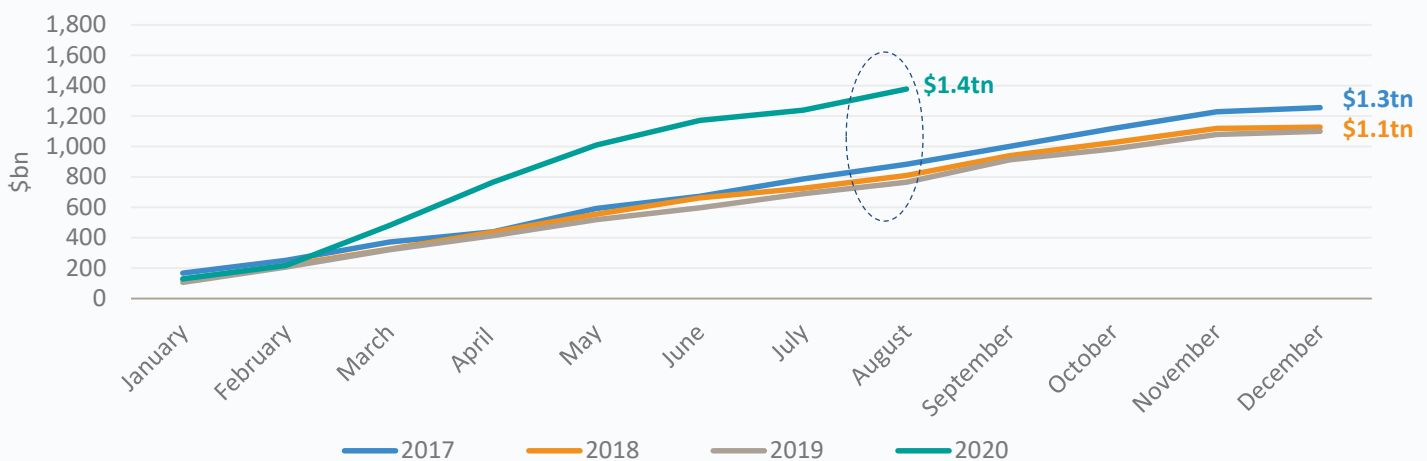
‘This is Water’ is about awareness and paying attention. If one were to apply its message to finance, it would act as a reminder for investors to take a step back and evaluate the markets periodically, being mindful about the driving forces behind the investment landscape. Today the reality of ‘water’ is that central banks around the globe have flooded the market with liquidity, driving asset price inflation.

But don’t write off your fundamental credit analysis training yet. Credit markets are now entering their second act in their Covid-19 performance. This may cap further spread tightening and may even result in losses for investors. Investment grade and high yield markets will each have their own acts in this play. Investors should pay close attention to both.

Investment grade markets enter act two and may soon be entering act three

Unlike their high yield counterparts, investment grade-rated companies generally enjoy easy access to unsecured bank loans, commercial paper and bond markets. When the funding markets abruptly shut in March as the Covid-19 crisis paralyzed financial markets, the first act of the investment grade-rated companies was to ensure liquidity. Act one was all about securing funding, and we saw investment grade debt issuance reach a record \$1.38 trillion (Source: JP Morgan), surpassing 2017’s record \$1.25 trillion.

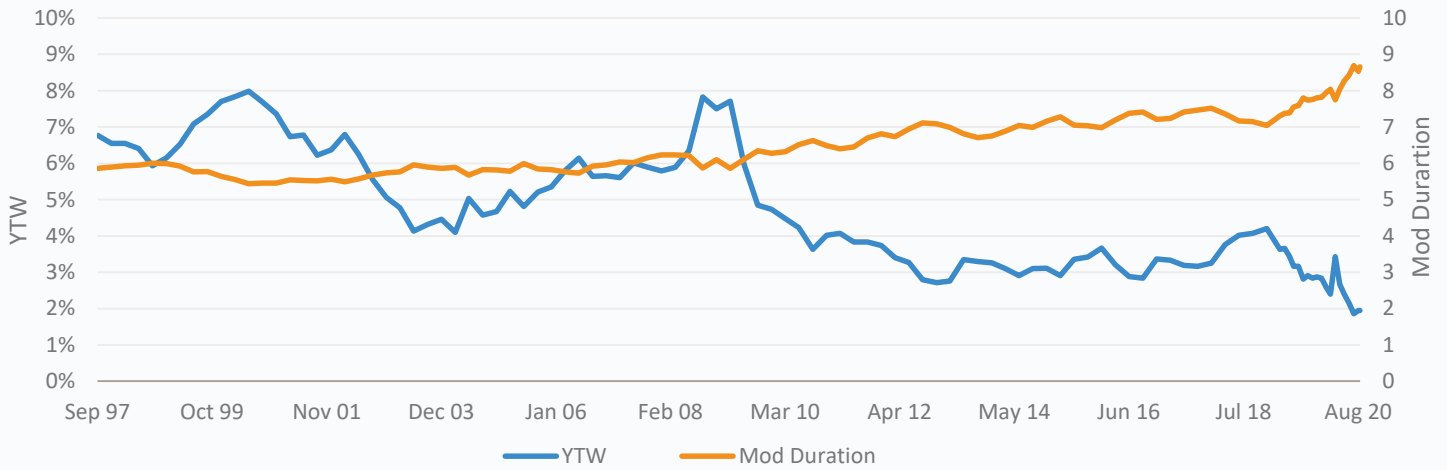
YTD HG gross bond supply is well above the past four year YTD average



Source: Dealogic, JP Morgan as at 31 August 2020.

The second act, which is currently playing in theaters, is about managing the cost of debt and maturity profile via debt tenders or exchanges. With record low borrowing costs, companies are rushing to issue long(er) maturity debt at record low interest rates. Consequently, the overall duration of the investment grade corporate index continues to increase while spreads remain low. This results in very low and unattractive breakevens.

Investment grade index duration continues to increase while yields decline



Source: Bloomberg Barclays US Agg Corporate YTW (LUACYW).

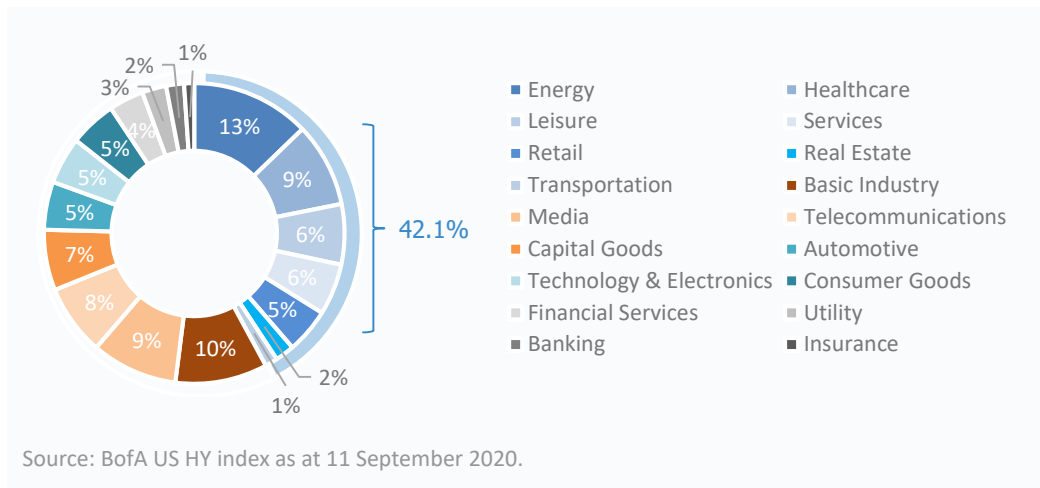
The third and final act to follow will be all about M&A and share buybacks. With limited near-term debt maturity profiles, healthy liquidity buffers and ratings stabilized, investment grade-rated companies may increasingly look towards shareholder-friendly activities. This will obviously be limited to those companies that have seen less demand destruction due to the pandemic. Nonetheless, fixed income investors should remember that management teams work for shareholders, not debt holders.

High yield will be more nuanced between the front row seats and the bleachers

The opportunity in high yield debt is far more nuanced. Defensive sectors such as food, cable & telecoms, staples and/or higher-rated credits (BB) are enjoying strong investor demand, while weaker-rated corporates have had to pay up, via higher coupons, to gain access to the markets. High yield companies learned the lesson of liquidity management and debt maturity the hard way during the Global Financial Crisis. Therefore, coming into 2020, most companies had managed their near-term maturities well.

The challenge for high yield in this crisis was not necessarily maturity profiles but the fact that nearly ~42% of the high yield issuer base is moderately to highly exposed to Covid-19 (e.g. travel, retail, media, lodging, gaming, etc). Nonetheless, ensuring liquidity was the number one act for these companies.

Act two was about refinancing higher coupon debt to further lower borrowing costs. Now with the liquidity coffers full, spreads continuing to tighten and overall borrowing costs remaining low, and covenants essentially non-existent, the higher rated cohort of high yield issuers is now moving to act three: shareholder-friendly activities. We have already seen multiple announcements over the last two weeks on M&A and leveraged or management buy-outs (LBOs/MBOs). Investors who



Source: BofA US HY index as at 11 September 2020.

are hiding out in the safety of BB-rated debt run the risk of being faced with higher leverage due to shareholder friendly activities; while more demand-challenged companies will likely look to existing prime lenders to bridge their liquidity gaps.

Our conclusions:

- The follow the Fed trade has run its course. Investment grade credit, particularly in the 1 to 4-year maturity part of the yield curve, is expensive. Many credits are trading inside their make-whole call premium. We find value in Yankee (non-US) issuers that are not part of the Fed's direct buying program but which are secondary beneficiaries of Fed support. Furthermore, investors should look to move up the yield curve (i.e. extend duration) in credits that they are comfortable with in order to take advantage of the steeper credit curves.
- In high yield, look for what we would call cushion paper – i.e. high quality, short-dated bonds that are likely to redeem

at the call date as companies look to lower their interest costs. Many of the BBs bonds are now trading above their call prices, therefore some caution is needed. Leverage is likely to increase over the next 6 to 12 months and a large position of the high yield market is heavily reliant upon a vaccine-related recovery to be able to grow into the capital structure. In our opinion, risk- reward in such recovery plays may be better found in equities.

- In the lower for longer interest rate environment, we continue to find fixed coupon preferred securities attractive.

In his ‘This is Water’ story David Foster Wallace reminds us that the most obvious and important realities are often the ones that are hardest to see and talk about. In the current credit market environment, this is where we view the water and where investors should be paying attention.

JOHCM Global Income Builder Fund

5 year discrete performance (%)

Discrete 12 month performance (%):

	31.08.20	31.08.19	31.08.18	31.08.17	31.08.16
A GBP Class	-4.39	13.13	-	-	-

Past performance is no guarantee of future performance.

Source: JOHCM/MSCI Barra/Bloomberg Index Services Limited, NAV of Share Class A in GBP, net income reinvested, net of fees. The A GBP Class was launched on 30 April 2018. Performance of other share classes may vary and is available on request. BLOOMBERG® is a trademark and service mark of Bloomberg Finance L.P. and its affiliates (collectively “Bloomberg”). BARCLAYS® is a trademark and service mark of Barclays Bank Plc (collectively with its affiliates, “Barclays”), used under license. Bloomberg or Bloomberg’s licensors, including Barclays, own all proprietary rights in the Bloomberg Barclays Indices. Neither Bloomberg nor Barclays approves or endorses this material, or guarantees the accuracy or completeness of any information herein, or makes any warranty, express or implied, as to the results to be obtained therefrom and, to the maximum extent allowed by law, neither shall have any liability or responsibility for injury or damages arising in connection therewith.

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