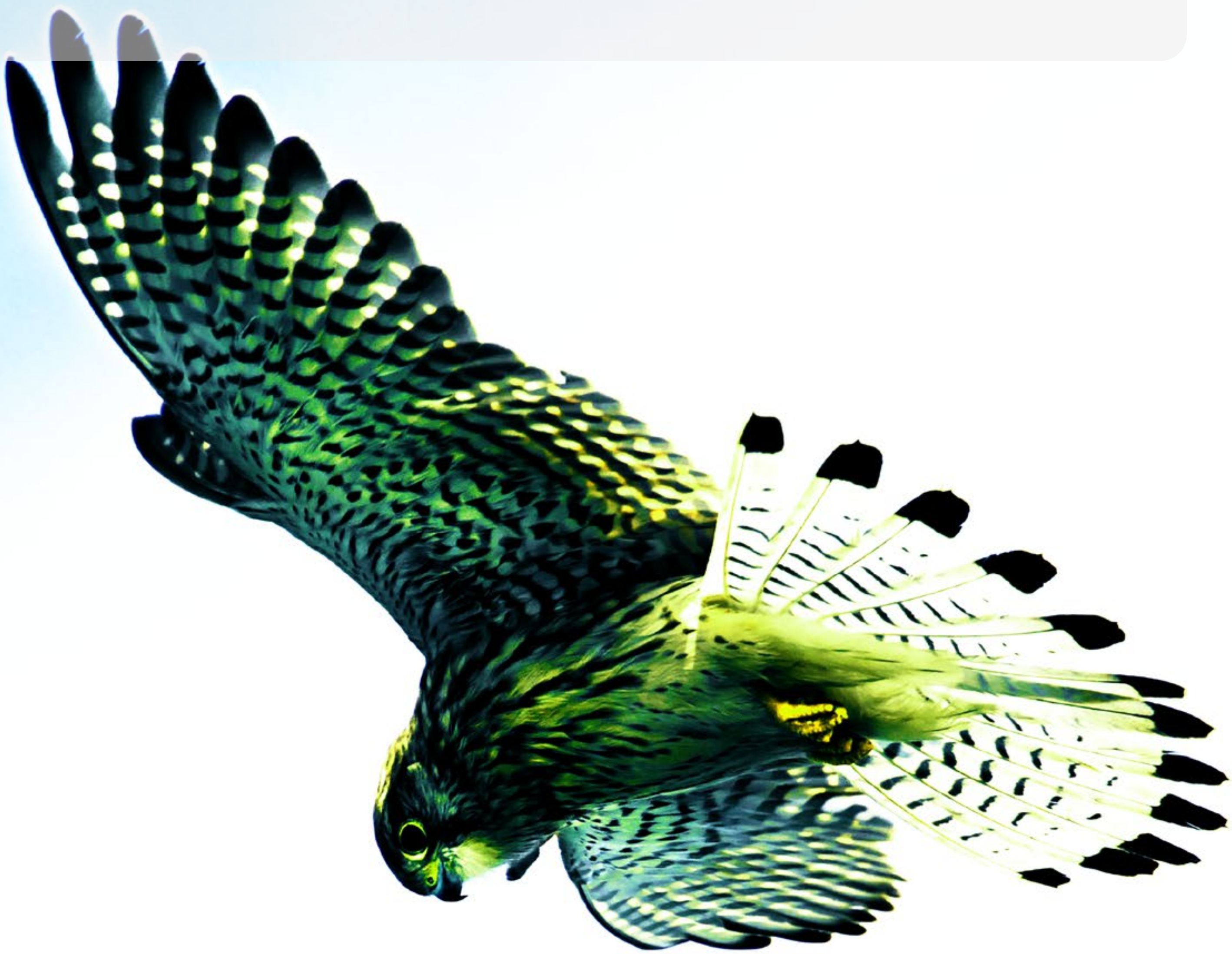
Creditflux

Q2 2021

Credit Rendezvous



Ready & waiting

Among bouts of volatility, inflation and rising dispersion, managers are predicting opportunities as economies recover

Institutional investors

Investors look to complement direct lending with CLOs, specialty finance and sports lending

Jess Larsen

Chief executive officer, Briarcliffe Credit Partners

Bullish

Specialty finance, CLOs, real assets, growth debt, private credit secondaries, special situations

Bearish

No areas of private credit — but maybe crowded public markets and inflexible solutions

Greatest challenge

Face-to-face meetings

Since tech and pharma firms are staying private for longer, growth debt is on the rise

The covid pandemic has shifted investor demand through several stages, says Larsen, but has generally favoured private credit strategies versus more public markets (a factor noted by our respondents in direct lending: see page 7-8).

While many managers turned first to defensive areas, they have since looked to pivot to more aggressive investments to take advantage of volatility. "A huge amount of capital came into distressed and we are finally in an environment where we could see more distressed situations," says Larsen. "Government injections have mitigated this somewhat, while a lot of mid-market names have had material documentation changes and liquidity injections allowing flexibility. These have been helpful factors in the short term, but depending on the duration of the pandemic, these short-term solutions could potentially act as a delay for the increase in defaults."

Though direct lending will always be central to many LP credit portfolios, covid has brought challenges to the health of corporate profits.

"As a consequence, there is a heightened demand for strategies to complement direct lending. We are seeing an increased need for 'niche' strategies such as CLOs and real asset lending," says Larsen. "Specialty finance is growing fast, as are music and media, non-life insurance and sports lending, among others. We are expecting demand for these strategies to be long term."

Larsen also foresees a spike in secondary trading of corporate private credit, an area some managers have begun to explore. Growth debt is also on the rise, since firms in areas such as tech and pharma are staying private for longer.

"They need private capital and debt, as they have high valuations but low ebitda so can't go the normal routes," says Larsen. "This requires innovative solutions in the space between private equity and private credit so they can retain more equity and wealth as they grow. Debt provides downside risk protection and the burning hot spac [special purpose acquisition company] market means equity instruments will kick into value as companies IPO."

To access niche strategies, some investors are looking beyond brand-name managers.

"Flows into special situations and direct lending should grow in Q2 and Q3 as more people allocate to private credit," says Larsen. "But in six months we will really see flows increase. It's hard to be bearish on any areas, given most people were under-allocated to private credit. Yield is still attractive compared to other credit assets and there aren't as yet any really crowded trades."

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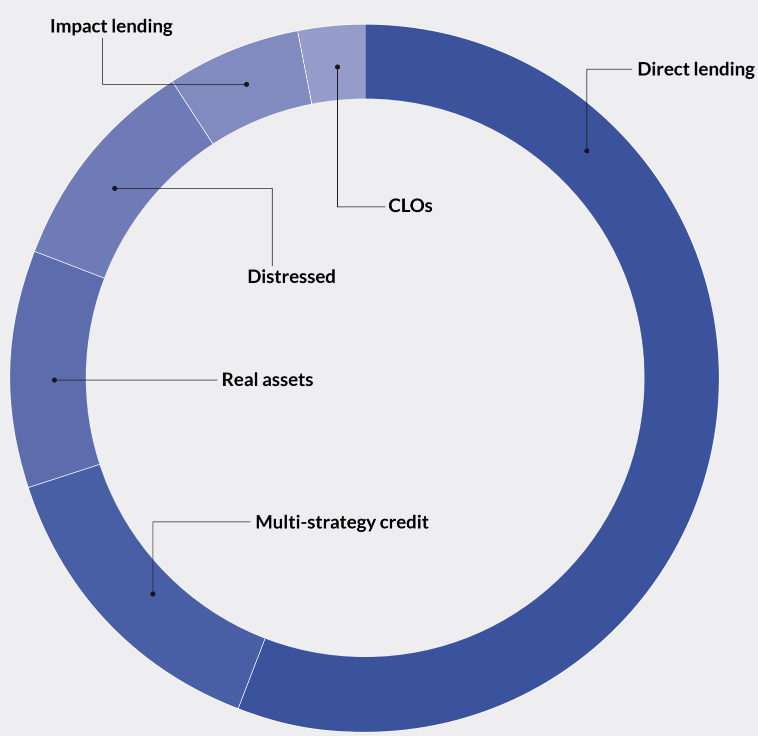
Direct lending dominates Q1 fundraising*



* Number of funds globally raising funds in Q1
Source: Creditflux

Direct lending is again the most popular strategy with 56 funds raised, the largest among them Goldman Sachs's Broad Street Loan Partners at $7.1 billion. Impact lending is an emerging category, with Tikehau and GAM launching strategies.

Investment grade

There is little room for error — but watch those rising stars as they start to rise again

Brian Kennedy
Portfolio manager, Loomis Sayles

Bullish

Rising stars; covid-recovery sectors such as consumer services which will be on the end of 'revenge spending'; banks; housing market

Bearish

High quality, long duration bonds

Greatest challenge

Recovery is stronger than anticipated and leads to a temporary higher inflation than modelled

Edward Farley
Head of European Investment Grade Corporate Bonds, PGIM

Bullish

Triple Bs should benefit from spread compression; many pandemic affected names such as airports and hotels have the most spread upside

Bearish

Paper eligible for corporate sector purchase programme

Greatest challenge

Inflation and interest rate volatility

The US market is factoring in inflation that hits 2.25-2.5%

Investment grade credit spreads have priced in a full recovery from the coronavirus pandemic-induced volatility, leaving little wiggle room for investors, but there are still pockets of opportunity in European and US markets.

Kennedy points to banks and upgrades of fallen angels back to investment grade as attractive investments. These rising stars were downgraded to high yield during the initial phase of the covid-19 outbreak, but he expects many to be upgraded again after companies begin to deleverage and improve their balance sheets.

This is less of a phenomenon in Europe but Farley also sees value in banks and particularly "in the belly of the curve". He says: "The five-to-seven-year range in the curve is very cheap as investors are more sensitive to buying banks at negative rates compared to corporates."

Kennedy and Farley both see a short-term inflation spike on the horizon as economies open up following the pandemic — and that raises the prospects of an interest rate rise.

Kennedy states that the US market is factoring in an inflation rise to 2.25-2.5% but a stronger economic recovery than expected could mean that figure goes higher and the US Federal Reserve may need to step in with higher interest rates sooner than anticipated.

This means, he says, that high quality-long duration bonds are not attractive. They do not have the protection of a significant yield advantage over treasuries to offset higher interest rate risk.

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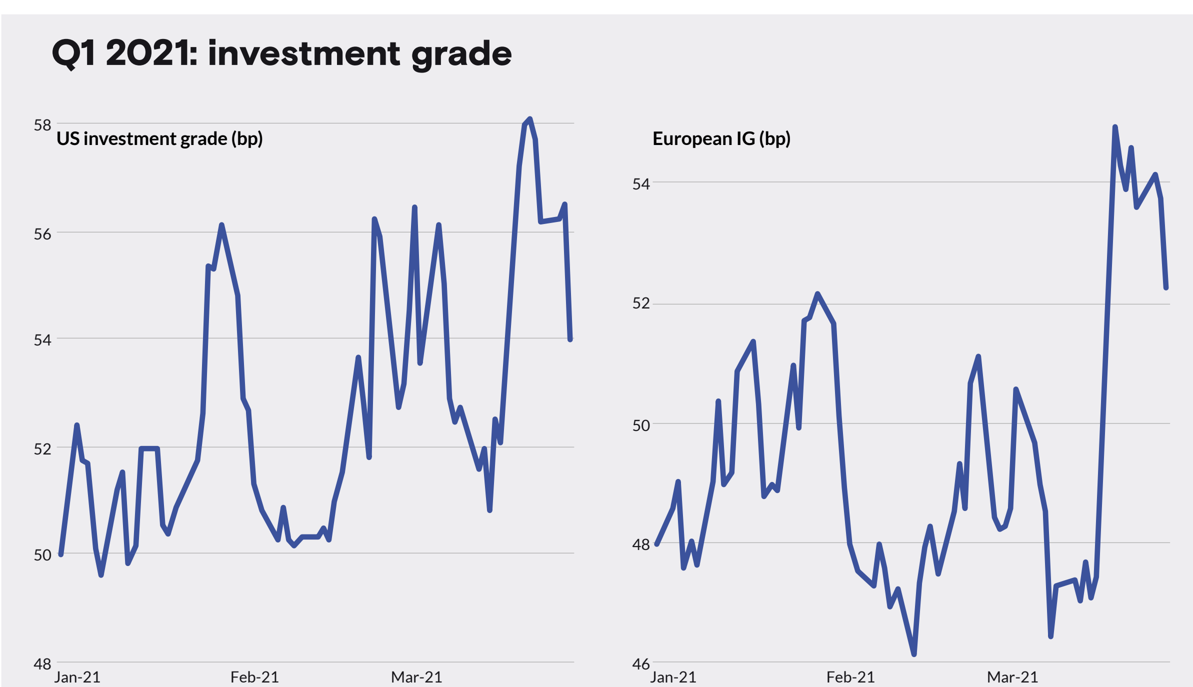

Source: Creditflux

Investment grade was range-bound early in the year but whipsawed from mid-February after treasury yields rose and investors began positioning for a spike in inflation.

Real estate debt

Savings and low rates mean it's a buyer's market in residential real estate

David Walch

Partner,
King Street Capital Management

Bullish

Opportunity to be a capital solutions provider; residential sector

Bearish

Mall-based retail

Greatest challenges

Offices and hotels

In the US and Europe, there is an oversupply in the retail market

Although pockets of the real estate debt market were earmarked as some of the best investments in the last edition of the Credit Rendezvous, there are questions as to how the industry will change over the longer term.

Like CLOs, the CMBS market has seen a sharp recovery of spreads, though less complete than corporate IG. Some lenders also pulled back and loan-to-value ratios on offer are lower than before the pandemic.

But Walch says the opportunities are abundant and driven by disruptions and uncertainties caused by the coronavirus. This includes providing capital for cashflow issues for properties that were shut down or had slow re-openings, projects that were delayed, or even stepping in to provide solutions to borrowers facing maturity issues, all of which King Street has been focused on this past year.

One area that Walch is bullish about is the residential sector. "People are spending money on places to live, have savings built up and there are relatively low interest rates," he says. "It's a large market and we can provide meaningful solutions."

Retail, however, is a sector the firm is avoiding, particularly mall-based retail owing to that famous phrase 'location, location, location'.

"In the US and Europe, there is an oversupply in the retail market and high starting costs for retailers in terms of rent," Walch says. "Tenants had a space expansion over the past couple of decades and now it's less important to be everywhere versus the best locations only." He says that better malls tend to be in the hands of large companies that don't look for capital solutions.

Offices and hotels are the two sectors facing the greatest uncertainty, he says, but the situation varies across regions.

In Paris, for example, office shutdowns have had less of an impact than elsewhere because of the cultural importance of social gathering and because people live closer to their offices than in many US cities.

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High yield

Fixed rate paper could have a stellar year, despite the risk of inflation

Tim Leary

Senior portfolio manager, BlueBay

Bullish

Underlying fundamentals are improving, spreads are attractive and benchmark constituents are of higher quality

Bearish

Bond math — rising interest rates mean bond prices may go lower and duration risk increases

Greatest challenge

Not getting carried away in a buoyant market

High yield took a hammering last year but is coming back strong with a range of factors stacking in its favour, says Leary. Fundamentals are improving and default rates are projected to be low. Investment grade portfolio managers believe the best opportunities are in double B names as they try and identify rising stars.

"High yield has historically been viewed as the ugly duckling of credit, but that has changed," says Leary. He points out the composition of high yield benchmarks have changed markedly from a year ago owing to the slew of corporate credit downgrades last year. This has pushed former-IG names into high yield buckets with a roughly 7% increase in double Bs, which means that high yield portfolio constituents are cleaner than they have been in a long time.

One of the big themes this year has been rotation into floating rate products and this was thrust further into the spotlight when treasury rates escalated in February.

Leary concedes that duration risk has increased, particularly as some of the IG downgrades in 2020 were longer tenor bonds. But he says portfolio managers can navigate this by rotating portfolios and identifying bonds with enough spread to offset duration risk. That opportunity is much more limited in investment grade credit.

"This year will be more about hitting singles; slow and steady, avoiding defaults and blind-side risks," says Stamford-based Leary.

According to research by Wells Fargo, gross high-yield supply was $148 billion in the first quarter with $35 billion of net new supply.

US high yield spreads (option-adjusted) have tightened from 386bp on 1 January to 336bp by the end of Q1, according to the Ice BofA HY Index.

> **This year will be more about hitting singles and avoiding defaults**

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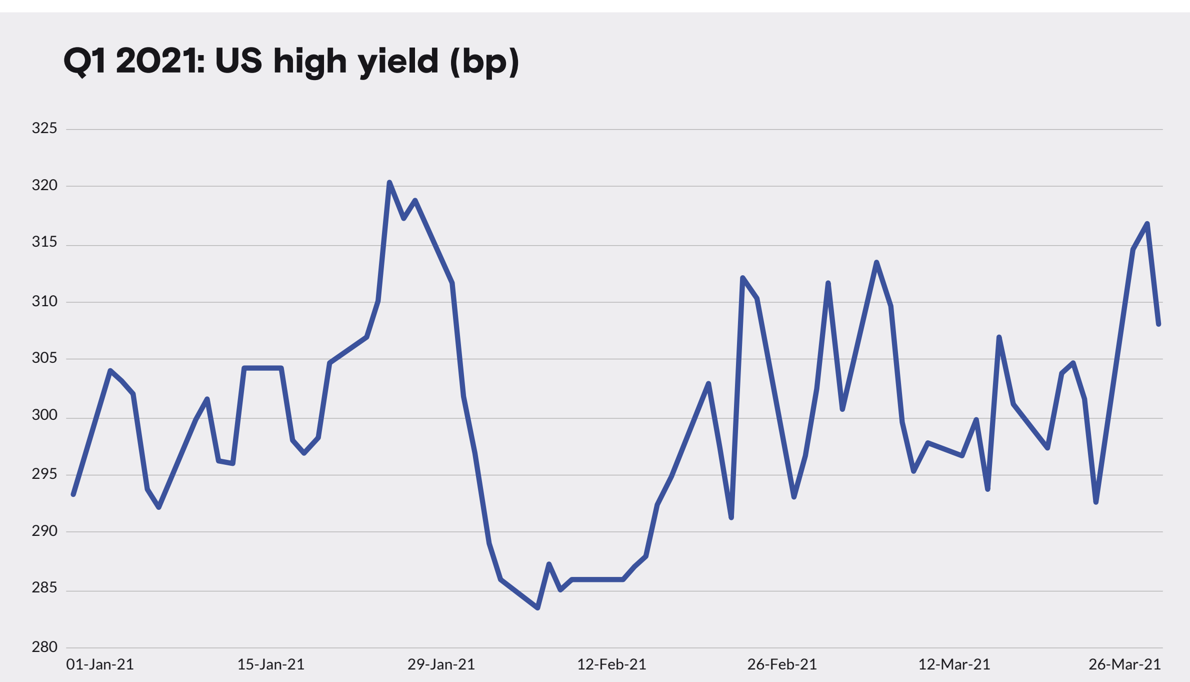

Source: CDX NA HY from IHS Markit

Inflation fears in February spooked markets, but high yield spreads have bounced around most of this year. There were sharp moves wider in late March though as CDX HY added 24bp to reach 316bp.

US loans

Covid-affected businesses offer opportunities as economic outlook improves

Gretchen Lam
Portfolio manager, Octagon Credit Investors

Bullish
Discounted, covid-impacted names where business model remains intact

Bearish
Higher-rated, high-priced, low-coupon loans

Greatest challenges
Supply/demand imbalance

US loan managers have a constructive view on the US economy in 2021. GDP expectations look robust and there is pent-up demand as people become vaccinated, which bodes well for corporate borrowers in the loan market.

Lam says this is evident from the loan level statistics. "Triple Cs as a percentage of the market have come down, the percentage of loans trading under the price of 80 is 1.1% — the lowest level since 2018 — and the run-rate default volume over the past eight months is under 1% annually, which is low historically," she says.

Lam says she is most bullish on discounted, negatively impacted covid names where the long-term business model is intact, for example airlines and healthcare providers.

"Many of those names still trade at discounts relative to their non-covid-impacted peers and many have ratings that we think are low in light of future prospects," she says. "Rating agencies will likely be slow to initiate upgrades, so we expect there will be a lag in upgrades relative to performance."

She points to the S&P/LSTA Index which today is at 97.9, while the average triple-C rated loan is at 91.7. If managers pick the right triple-C rated loans, that don't have triple-C rated risk, there is potential for upside, she says.

On the flip side, double B and higher-rated loans with skinny coupons are less attractive, Lam believes. But it's not the performance of the companies she is bearish about, rather where they are trading.

"It's hard for these loans to outperform the broader market because they are generally trading at relatively high prices — around 99.4 — and their coupons are sub 2% in some cases," she says.

The biggest challenge for US loan issuance is technical, not fundamental, Lam adds. There has been large issuance that has ramped up from a slow start to the year, and while demand will be robust over the long term and the market needs that issuance, supply and demand may be out of sync day to day, she says.

"We saw that into quarter-end where there was a push to price and allocate loans; banks have a strong preference to get them off their books before quarter end."

"That tends to cause some pockets of weakness in the loan market. We saw some of the most liquid, easy-to-sell loans trade off as managers looked to raise cash for primary purchases."

It's hard for these loans to outperform because they are trading at high prices

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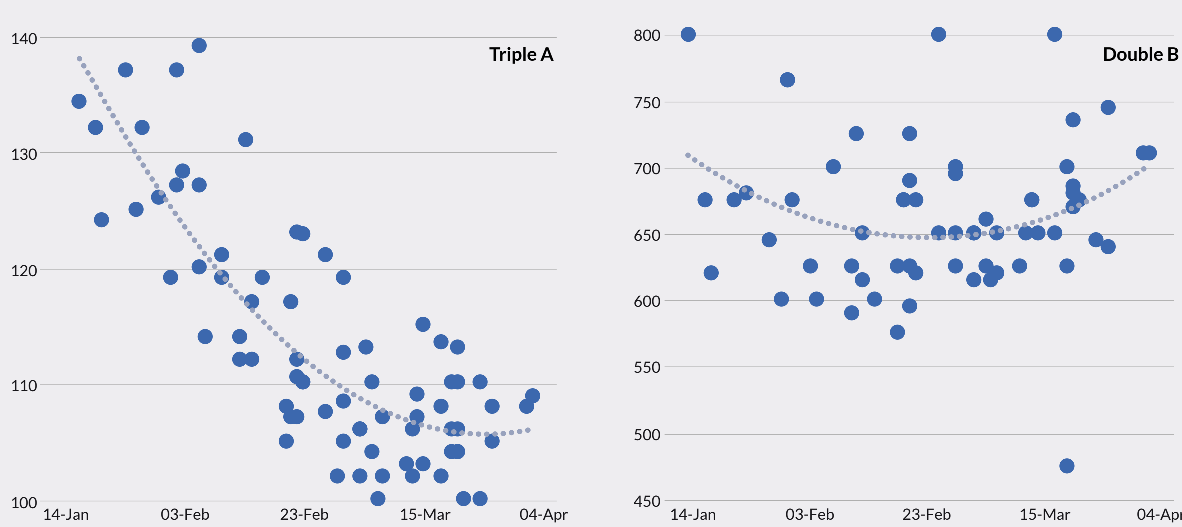
Q1 2020: five-year US CLO tranches



Source: Creditflux

CLO triple As have shot from the high 130s in January to just 100bp despite a slowdown in March. Double B tranches took a different path, with a rally and subsequent slump taking these notes back to where they started 2021.

European loans

Some loans are trading on expected recovery this year, a metric which is difficult to predict

Alex Leonard

Senior portfolio manager, Blackstone

Bullish

Loans as an asset class amid rate volatility, liquid large cap names trading at a discount

Bearish

Bricks and mortar retail

Greatest challenge

Idiosyncratic risk now trading on forward-looking expectations

European loan managers seem broadly optimistic about 2021 amid vaccine rollouts and continuation of fiscal stimulus. Corporate leverage is elevated, particularly in leisure and entertainment, but is expected to improve.

However, Leonard says managers must be cautious. “A lot of risk today is trading on a forward-looking basis of expected recovery in the second half of this year/beginning of next year, so we need to be focused on the actual rate of that covid recovery and the expected manager shift to a focus on fundamentals,” he says.

There is also a bear downside case, albeit viewed as lower probability, where there are delays in vaccine rollouts, varied rollouts in different regions, increased concerns around specific vaccines or concerns about a new wave of covid infections.

Leonard feels managers should ensure portfolios are positioned in businesses that can sustain high-leverage capital structures if recovery expectations shift from Q3 2021 to the first half of 2022.

The good news is that loans are an attractive asset class in a rise environment. “Liquid large cap names that have robust business models are also still trading at a discount and look cheap relative to historical terms and credit products including high yield,” he says.

Leonard says he is not avoiding all covid-affected sectors, but is more comfortable with names linked to domestic travel, which is expected to recover before international travel.

Primary issuance hit a lull as the Easter break approached, Leonard says, but he adds that guidance from capital markets suggests there will be a pickup of issuance going into May.

> **We need to focus on the actual rate of covid recovery**

There has also been a pickup in M&A activity, which may take time to flow into leveraged loans, but is constructive. The refinancing pressure in the first quarter also appears to have dissipated, although this was a bigger issue for the high yield market.

Leonard says that one theme to look out for over the next 6-12 months is rating agency volatility. Rating agencies took a swathe of actions in April/May last year, identifying businesses with weaker balance sheets and those most impacted by covid. “These names need to de-lever before they are re-rated, or demonstrate a real improvement of performance,” he says.

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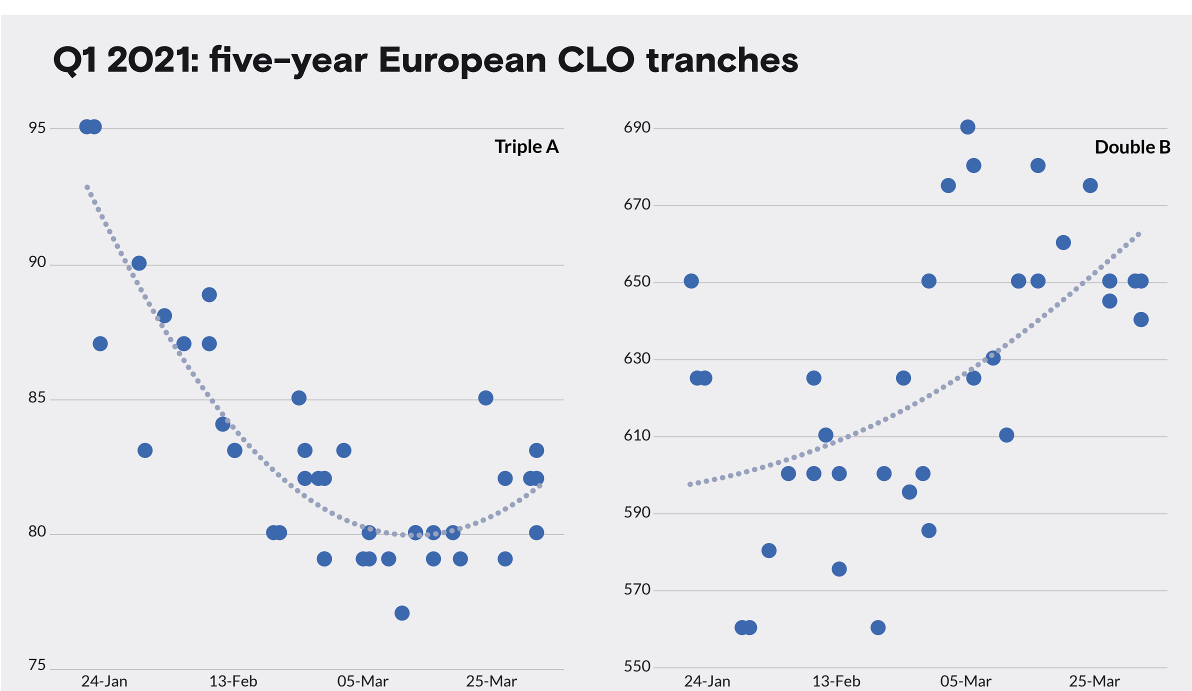

Source: Creditflux

European CLO double Bs have suffered this year, going from as tight as 560bp to 690bp in March. It has been a different story in top-rated tranches, with first pays rallying sharply from 95bp to just 77bp (the tightest levels since early 2018).

US direct lending

The pick up in spread of secured credit in the middle market over high yield is up to 300bp

Ted Goldthorpe,

Partner and head of BC Partners Credit, BC Partners

Bullish

Resilience of direct lending; technology

Bearish

Covid-affected sectors including cruise lines, cinemas, gyms and restaurants

Greatest challenges

Finding great deals

There is less capital for companies with less than $15 million ebitda

US direct lending has navigated the covid crisis reasonably well and Goldthorpe says there is good relative value in the sector.

"The pick-up in spread between private lending and liquid credit is still at historic wide levels," he says. "First lien secured credit in the middle market, which has covenants and is senior, is still being priced 200-300 basis points wider than high yield bonds, which is rare."

The US direct lending opportunity set is in defensive resilient businesses and there has been a big pick up in the private equity pipeline, according to Goldthorpe.

Technology is a big focus for several US direct lenders but Goldthorpe says that while the market is competitive, investors have been sensible. He says healthcare is a sector the firm focuses on, but there have not been a lot of healthcare deals recently.

One area that hasn't fully recovered is the lower middle market, says Goldthorpe, adding that there is less capital for companies with less than $15 million ebitda, with some lenders pulling back from that space.

Goldthorpe also says he expects to see a pick-up in fundraising over the next 12 months. "Last year, investors who were allocating to direct lending took a pause because they wanted to deploy capital into opportunistic/distressed funds but now we may see a shift back," he argues.

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European direct lending

UK lenders expect to snap up bigger share of market from banks

John Clifford and Grant Davidson*

Co-heads of UK private debt, Muzinich

Bullish

UK mid-market direct lending

Bearish

Potential wave of loans coming to maturity that will struggle to be re-financed

Greatest challenge

Understanding the covid-19 impact on new borrowers

Stuart Hawkins

Managing director, Ardian Private Debt

Bullish

Defensive sectors such as healthcare, IT services and B2B software

Bearish

Over-levered businesses in limited recovery industries, amid low growth, tax increases and rising inflation

Biggest challenge

Unpicking temporary versus permanent reductions or improvements in businesses' performance through the pandemic

According to Hawkins, the year of covid-19 has been a differentiator between managers but also proved the resilience of the private debt asset class in Europe, with strong returns and low loss rates.

Government support schemes have delayed covid's impact and markets are not yet pricing in inflation risk. Even so, businesses looking for finance may have been greatly impacted either positively or negatively by the crisis and direct lender due diligence is focused on trying to understand true underlying earnings.

Most businesses going through a sale have some form of covid-19 impact adjustment to normalise earnings, say Clifford and Davidson. This, they add, has led some advisers to propose very creative adjustments.

"With the clearing banks' increasing regulatory burdens, and the amount of portfolio issues they still have to deal with, we have a strong belief that the market share of UK mid-market direct lenders is only going to increase," says Clifford.

Throughout 2020 and into 2021, direct lenders have focused on deals in resilient sectors, such as IT services, software and healthcare. They are looking for strong private equity sponsors and experienced management teams. Deals coming to market where a loan was coming to maturity and would normally expect to be refinanced have been few and far between.

"Anecdotally, we know of businesses in more cyclical end sectors, or sectors that were negatively impacted by covid-19, where loans were extended for a 12-month period to give businesses breathing space as they navigated the effects of covid-19," says Davidson.

"Those lenders will still need the loan to be repaid in the short-to-medium-term and clearly, as time moves on, even more loans will be coming to maturity."

Ardian has also backed businesses in defensive sectors. "In terms of sectors such as healthcare, logistics, commercial real estate/property management, and food and drink, unpicking which businesses have seen temporary versus permanent reductions or improvements in performance through the pandemic is challenging," says Hawkins.

"Arguably, with capped upside and all risk on the downside, credit investors should be wary about making judgement calls on such dynamics so early post pandemic. It may therefore be a while before we see lenders venture back into some sectors."

But sectors such as retail and travel have suffered and are likely to undergo structural changes for the worse for years to come, adds Hawkins. "Changes to working habits and increased flexible working could have far-reaching consequences for many industries, both positive and negative." In particular, he believes IT and B2B software businesses, which were already benefiting from tailwinds prior to covid, are likely to see a step change in terms of demand.

* Pictured

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> **IT businesses which were already benefiting from tailwinds prior to covid are likely to see a step change in terms of demand**

Distressed

Investors are looking beyond traditional distressed-for-control strategies

Ivelina Green

Co-founder, Broadstone

Bullish

The pipeline of middle market rescue and new money opportunities

Bearish

Overvalued public credit markets and large cap opportunities

Greatest challenge

The misperception that the credit cycle has somehow been reset when in fact bailouts simply resolved a liquidity problem

Marianna Fassinotti

Managing director, asset-backed strategies team, DE Shaw

Bullish

Special situations in single-name corporates; European significant risk transfers (SRTs); and US structured credit

Bearish

Central bank intervention in large syndicated markets (corporates and structured credit) has reduced return opportunities

Greatest challenge

The market for distressed investing has entered a phase in which opportunities are likely to be episodic and/or fleeting.

The stressed middle-market might slip through the cracks

The distressed window has not closed following the 12-month recovery and subsequent rally in credit. Instead, credit portfolio managers anticipate bouts of volatility, and the same applies in distressed debt investing.

Green says that the large amount of stimulus thrown into the economy has not reset the credit cycle, rather it has resolved a liquidity problem and simultaneously added to high corporate leverage.

"Distressed cycles are often characterised by cycles within cycles globally and often lag economic slowdowns," she says.

London-based Green says that special situation investing has evolved over the past decade to the point it is not just about dislocation and distressed-for-control strategies.

"Lending on a super-senior basis, often in bankruptcy-remote fashion, to struggling private businesses, is a big growth area for distressed investors in my view," she says. "In order to produce consistent risk-adjusted returns regardless of where we are in the cycle, you need to have more tools at your disposal and be able to pivot among them as far as portfolio construction is concerned."

Fassinotti agrees and says that opportunities "may benefit market participants with a broad mandate and the ability to pivot to attractive opportunities across the credit market, as opposed to those that are focused on a particular segment or geography."

In Q1, Green says investors were focused on cyclical sectors which had lagged last year, such as travel, leisure, airlines, retail and commodities. This came about as investors anticipated a return to normal day-to-day life amid vaccine rollouts, and they rotated out of 'covid themes' which were popular in 2020.

Looking ahead Fassinotti expects "episodes of idiosyncratic mis-pricing". She says: "We tend to gravitate toward areas of the credit market with exposure to issues such as regulatory change, liquidity or asset/liability mismatches, and/or fundamental distress."

Green envisages opportunities in Europe as economies reopen, but warns that dispersion will rise amid uneven recoveries.

"Systemically important companies and performing companies will continue to get bailed out," she says. "The stressed middle-market might slip through the cracks. You also need to be excited about writing smaller tickets because Europe has always been and remains ripe with predominantly middle market investments."

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Credit derivatives

Dispersion will pick up which means index tranches are back on the radar

Michael Hattab

Senior portfolio manager, LFIS Capital

Bullish

Default risk on investment grade looks like a safe haven

Bearish

Negative basis trade, or going long cash bonds

Greatest challenge

To build trust again, not only in credit but across all asset classes

LFIS's Hattab says the economic environment is almost perfect for credit. After a race for convexity in 2020, carry trades will attract more and more investors, while at the same time confidence in the economy is set to improve.

"As the year goes on, the market should pursue consolidation across asset classes," Hattab says. "As in past crises, we expect episodes of strong volatility along the way, but overall the default risk is currently managed by states or central banks, and the amount of cash available in the market should prevent a liquidity crisis."

There have been bouts of volatility in the first quarter. CDS index spreads, although range-bound, have fluctuated one way and then the other, almost weekly.

As economic normalisation progresses through 2021, says Hattab, a market dynamic should emerge that is more driven by fundamentals and where dispersion in credit is likely to increase.

"In the derivatives world we have many products, like tranches, that are able to benefit from a move in dispersion, and we expect most of the activity to focus on that theme for the rest of the year," he says.

"Between implied dispersion/correlation versus realised, we should see some convergence both in Europe and the US in investment grade and high yield."

The amount of liquidity in the market should mean investment grade risk is well remunerated, especially in the synthetic market, he believes.

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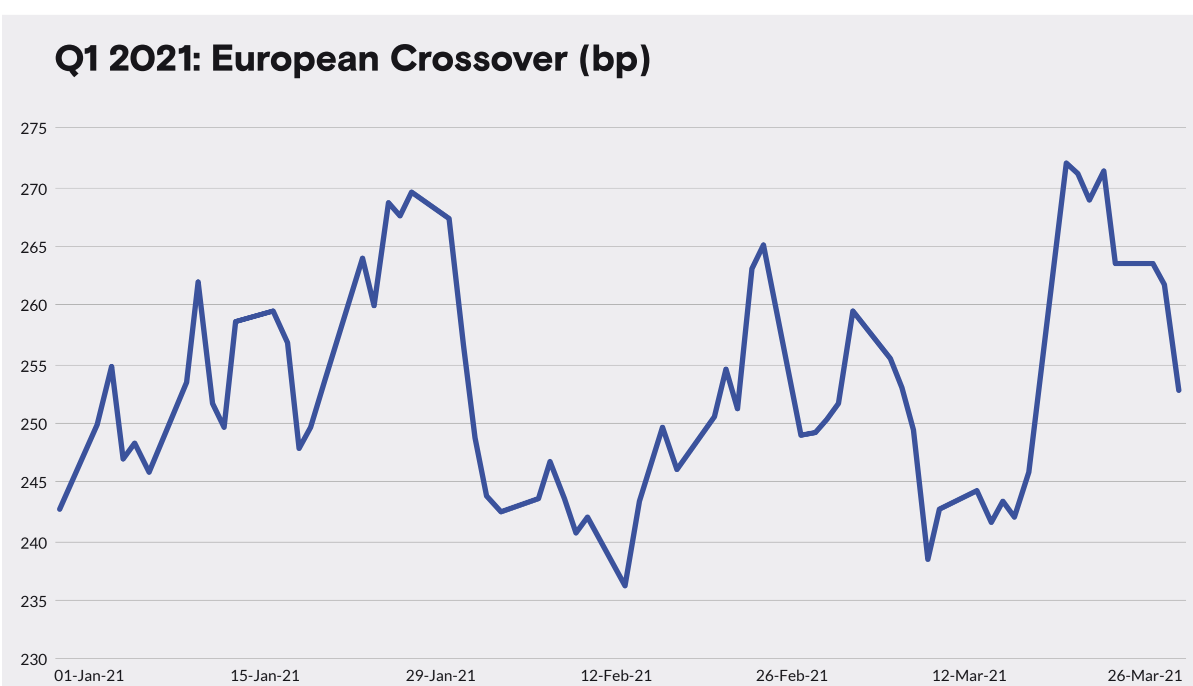
We expect episodes of strong volatility along the way



Source: iTraxx Xover from IHS Markit

A rise in coronavirus cases across France and Germany late in the quarter was reflected in credit as iTraxx Main jumped wide of 50bp. Crossover was just as volatile but ended the quarter close to where it started.

US CLOs

Glut of issuance causes CLO mezz to soften

Chandrajit Chakraborty
CIO and managing partner, Pearl Diver

Bullish

CLO mezzanine tranches, particularly in the primary market

Bearish

CLO triple A spreads

Greatest challenge

Getting Libor floors back into loans; arbitrage levels; alignment between managers and equity investors

At the moment, the secondary market is more flexible and provides better risk-adjusted returns

There has been a massive amount of supply in US CLOs this year, with volumes reaching $99.53 billion in the first quarter, versus $40.93 billion in Q1 2020.

However, Chakraborty says the secondary market offers value when it comes to CLO debt. “At the moment, the secondary market provides better risk-adjusted returns, along with the flexibility to choose an appropriate price point and return target,” he says. “In the CLO equity market, the absence of bids — or sometimes non-economic bids from affiliated capital — makes the risk-return dynamic in the secondary market far more evenly balanced.”

For relative value between tranches, Chakraborty says triple As have probably run their course, with any further increase more likely to be in issuance volume rather than price. But there are opportunities in junior mezz. “We are bullish on CLO mezzanine tranches where there has been somewhat of a step back in March and there is still scope to tighten from here on,” he says.

Despite an influx of investors and CLO paper, it is unlikely there will be significant changes in the structure of CLOs given how well their structures have worked in the past, but Chakraborty sees scope for change around the fringes. That could be through allowing equity investors to buy restructured paper, taking into account any rating agency changes, or accommodating new Libor language. All of these are likely to become part of every CLO.

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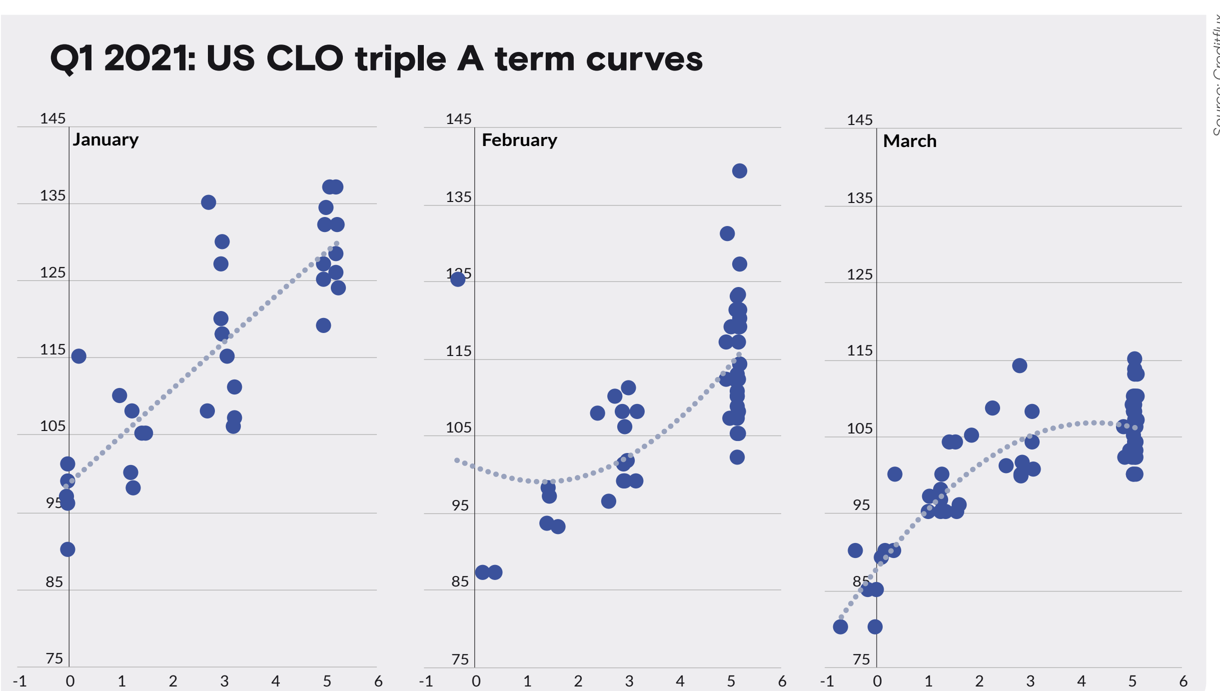

The wide range of CLO prints can make it difficult to draw curves — CLO triple As priced at 102-139bp in February. But there was evidence of the term curve flattening in March, with little distinction between three-year resets and five-year new issues.

European CLOs

Tight spreads are increasing demand for CLO equity, so deals are oversubscribed

Inès Bartsch

Chief executive officer, CIS

Bullish

CLO equity

Bearish

Senior CLO primary notes

Greatest challenge

Handling the refinancing of underlying loans; regulatory issues in the US healthcare sector and tax-related uncertainties

Bartsch says that, historically, CLOs that priced in tight-spread environments produced attractive equity returns during the life-cycle of the deal. Current market conditions offer low funding costs and therefore attractive arbitrage opportunities, along with cleaner (less covid-affected) portfolios and relatively long reinvestment periods. So as CLO liability spreads tighten despite growing volumes, the market looks attractive for equity investors.

"This, coupled with more flexibility for CLO managers in the underlying legal documents to achieve higher recovery rates, for instance through default swaps and the ability to participate in work-our loans, has made primary CLO equity good value," she says. Conversely, senior CLO notes are less attractive as spreads grind tighter.

One challenge CLO investors face is sourcing attractive CLO equity pieces from top tier managers as these are generally oversubscribed.

"It requires patience as well as a good network to be able to participate in those deals," says Bartsch. She also believes that dispersion in CLO manager performance requires that managers are able to delve deep to identify the best performers.

There is growing focus on ESG compliance in CLO portfolios, particularly from European investors, although evidence of US CLOs adopting ESG language in their deals is increasing.

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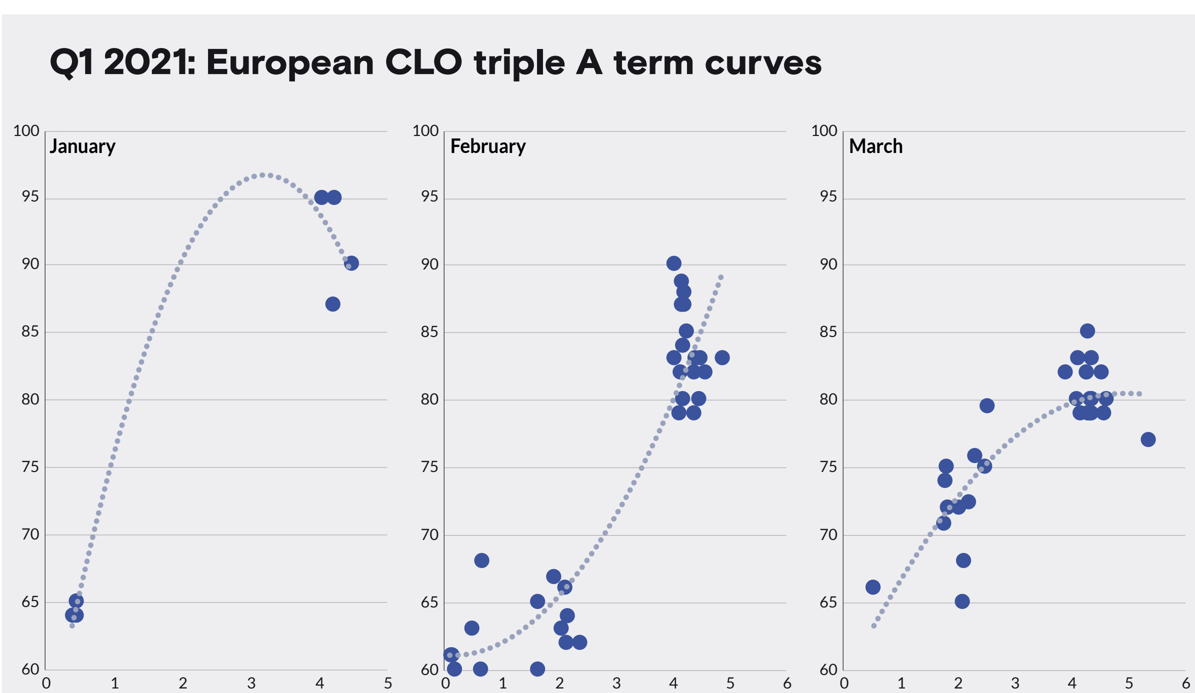
CLOs that priced in tight-spread environments have produced attractive equity returns



Source: Creditflux

There is clear evidence of curve flattening in Europe: two year CLO triple As priced in the mid 60s in February, softening to the mid 70s a month later. But, five year triple As remained in the low 80s in that time.

Emerging markets

Emerging economies are receiving IMF support but face many challenges

Mary-Therese Barton
Head of emerging market debt, Pictet

Bullish

Egypt, Ukraine, Angola, Uruguay and Jamaica all have positive fundamentals

Bearish

Colombia, Brazil, Turkey and Sri Lanka are among the countries with more challenging fundamentals. Turkey has high sensitivity to higher core yields

Greatest challenge

Healthcare in EM countries emerging from covid; relative performance of emerging markets in a desynchronised recovery

Commodity exporters should do well as developed countries spend on infrastructure

The world is inching closer to emerging from the coronavirus pandemic and this is leading to desynchronised growth between countries. Developed markets are opening up economically and socially as the vaccine rollout continues, but emerging market countries are being left behind.

This has led to the inverse of the usual developing/emerging market growth gap, with developed market economies expected to boom this year and emerging markets lagging. Barton points out that developed countries tend to have greater service sectors in their economies, meaning that emerging market countries that are reliant on exports could be left further behind.

But an increased focus on infrastructure and the concept of 'building back better' are commodity-intensive, which could help emerging markets that are large commodity exporters, says Barton.

The new $650 billion allocation of the International Monetary Fund's Special Drawing Rights currency (SDR) is also to be rolled out. The SDRs can be exchanged for hard currency such as US dollars to increase low-income countries' foreign reserves. The 100 countries with the lowest GDP per capita are expected to receive $90 billion to help them recover from covid-19.

With help for emerging countries increasing, spreads have remained stable, as the market takes into account the gap in growth rates and the slow emergence from the pandemic. The JP Morgan Emerging Market Bond Index (EMBI) has been unmoved for much of the year at around 350bp over US treasury yields.

The index fell by 4% in Q1 2021, but almost all the negative return was driven by a rise in core yields and negative duration, according to Barton. Now, with spreads holding steady, the relative value of emerging markets to developed markets is still attractive and the market is looking through to better growth, a pickup in trade and a return to normal economic activity; all of which will be positive for emerging markets.

≫ more

Structured credit

Floating rate paper creates inflation-proof opportunities

Ben Hayward

Portfolio manager at TwentyFour Asset Management

Bullish

UK non-prime RMBS

Bearish

CMBS

Greatest challenge

Working with issuers on ESG data provision

European ABS is a natural home for ESG thanks to its data transparency and lending standards

As a floating rate product, the ABS market is well protected should fears of inflation materialise as government economic support keeps markets liquid.

"Our outlook for European ABS in general is positive given we believe there are strong relative value opportunities in the market when compared with other parts of global credit, in particular US ABS and investment grade corporate bonds," says Hayward.

"As a mainly floating rate market, European ABS should be well insulated from rising inflation, and as such is often used as a diversifier for global bond portfolios, as well as having the ability to address an investor's hunt for yield helped by the range of opportunities in different rating bands."

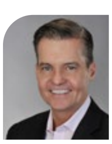
The outlook for CMBS is more uncertain, largely due to post-covid uncertainty around the use of office buildings leading to valuation unknowns on underlying property. Leading managers are increasingly unwilling to commit to providing liquidity for transactions.

ESG is becoming an increasingly important factor in ABS transactions, which TwentyFour's Hayward identifies as a positive trend.

"We believe European ABS is a natural home for such strategies thanks to well-established data transparency and lending standards — this analysis almost certainly makes a manager's investment process take longer, but should be mutually beneficial for issuers and investors in the long term."

Equities

Spacs are increasing the overall volume of M&A business and driving valuations



Mike Meyer

Head of capital structure advisory, Union Square Advisors

Bullish

The economy: globally it has been given liquidity and there's pent-up demand

Bearish

Inflation

Greatest challenge

Finding quality product at a decent yield

The popularity of special purpose acquisition companies (spacs), combined with vast amounts of liquidity in financial markets, means the pipeline for mergers and acquisitions is running red hot — and Meyer says his firm is incredibly busy with this work.

"The boom in spacs opens up a whole new capital market as a buyer for our product," Meyer says. "When we have a sell-side M&A mandate we can sell to a private equity firm, we can sell to a strategic buyer, or now we can sell to a spac.

"This has created an explosion in the M&A market, so companies that would traditionally not be ready to do an IPO can suddenly go and do a spac," he adds. "That produces a new form of liquidity for the shareholders of a company, and it's increasing the overall volume of M&A business."

This has created an explosion in the M&A market

The advent of spacs is also pushing valuations and enabling issuers to add leverage. At the same time, intense competition means covenant-lite — which was confined to syndicated loans and large private transactions — is seeping into smaller middle market companies' documentation in private credit.

Elsewhere, stocks have rallied in 2021, despite a couple of blips in late January and February. The S&P 500 started the year at 3,700.65 and reached 3,972.89 by 31 March.

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