Credit cycle continues to extend

2019 has seen a significant dislocation in sub-investment grade credit markets – most notably in lower-rated global high yield and US loans. In our view, this has created an attractive opportunity for investors prepared to take a medium to longer-term view

While the performance of the US and European sub-investment grade credit indices has been strong for much of the year, there has been a considerable increase in dispersion in high yield corporate credits, approaching the levels seen during energy-related downturn of 2015/2016. Investors are therefore cautious given the late cycle environment of the global economy, but remain on the hunt for yield in a world of record low-to-negative sovereign bond yields. This has led to a 'flight-to-quality', where investors are searching for higher yielding, but albeit "safe", corporate credits. From Chart 1, we observe index spreads at close to record lows, with dispersion sharply increasing. We believe this dislocation has created opportunities in global high yield and US loan markets, but taking advantage will require managers to employ nimble and selective investing, backed by in-depth fundamental research.

Deteriorating macroeconomic data in the second and third quarters, alongside trade war tensions was a major driver of the dispersion in cyclical and lower rated credits. However, we are beginning to see global data trends slowing and even reversing, which is a key signal we are watching. The aforementioned 'flight-to-quality' has seen crowding in sub-investment grade credit, particularly BB rated and in securities with a longer interest rate duration. This has exacerbated the dispersion of credit spreads across ratings, and we have witnessed a reluctance of investors to price idiosyncratic risk; earnings misses in particular have been punished heavily by the market.

We believe that concerns about the stage of the macroeconomic cycle are exaggerated, and that the current cycle should extend – given that both the troughing of macroeconomic data and support from central banks suggest an environment of lower growth for longer. However, we foresee a modest increase in default rates, but primarily in more cyclical sectors.

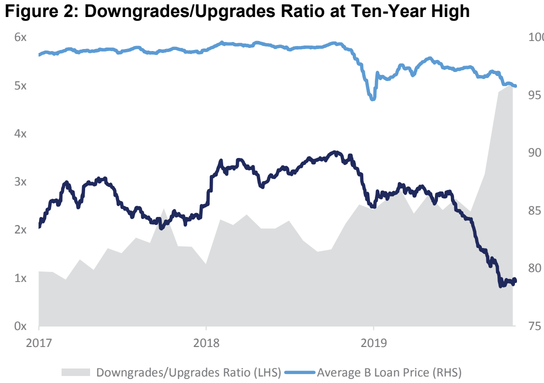
The US loan market is experiencing an unusual technical situation, where the number of downgrades relative to upgrades has increased sharply over a short period, as can be seen in *[Chart 2]*. This has triggered managers of collateralised loan obligation vehicles to sell lower quality B rated securities in advance of potentially breaching their CCC baskets. This technical selling has driven a divergence within lower rated US loan prices, despite businesses often having solid fundamentals.

Bottom-up analysis can help investors identify loans that are misvalued relative to their probability of default and expected loss given default. We are looking to capture this technical-driven dislocation in fundamentally solid companies that are trading cheap relative to their true value. They therefore provide attractive compensation for the present secondary market volatility.

Figure 1: Dispersion in Sub-Investment Grade Credit Markets

Source: CQS, ICE for the period 31 Jan 2010 to 31 Oct 2019. Index shown is the ICE BofAML US High Yield Index (H0A0). Dispersion is measured as the percentage of names that are trading at +/- 100bps relative to the index.

Figure 2: Downgrades/Upgrades Ratio at Ten-Year High



In summary, technical-driven dislocations have created numerous opportunities in sub-investment grade credit markets worldwide. This alongside increased secondary mark-to-market volatility has been a deterrent for some investors. The best way to capture these opportunities while protecting investors from downside is through detailed fundamental research, credit picking and active portfolio management.

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