CREDO WEALTH

Opportunities in a crisis

Rupert Silver, Head of Fixed Income - 06 April 2020

We are living through extraordinary times and global monetary policy over the past few years has led to a concerted reduction in rates towards their zero bound. The effect of the ongoing coronavirus pandemic on corporates has been even more pressing, with historical analysis and stress tests against even the extreme economic conditions of 2008 not providing answers.

In the leisure sector, for example, we are now contemplating a total absence of customers for an indeterminate amount of time; for energy companies, a very different oil price; financial institutions having to deal with a prospect of increased default rates, and in the insurance sector, the underlying credit portfolio downgrades and write downs, as well as potential claims. All of this has been happening in an environment where corporates have until recently taken on more debt to support share buybacks and to take advantage of historically low-interest rates.

The corporate bond market has seen record outflows in recent weeks and at record speed. With banks having had their capacity to buy bonds dramatically clipped since the financial crisis and dealers trading solo from their homes, it is perhaps no surprise this has resulted in a market which is volatile and opaque and where it is difficult to place a trade.

As a result, fixed income markets currently have seen activity akin to the global financial crisis.

Although pricing and liquidity have all picked up over recent days, anyone unfortunate enough to be a forced seller (especially in a more exposed sector) would have taken a 5 to 10 point discount to screen prices until recently, if there was even a market at all.

In these times of extreme uncertainty, funds have redemptions, ETFs have withdrawals (and start trading below their asset value as a result), and the very sharp moves of the markets have led to wave after wave of margin calls resulting in selling, creating even more selling. Leveraged money has of course been the hardest hit, so it has been no surprise to hear of large hedge funds closing and even long-only funds having to gate sellers to protect their holders.

Anecdotally, it has been recently reported in the press that £2.5bn has been pulled from M&G Optimal Income since mid-February, that equates to almost £100m per day from one fund as at time of writing.

To illustrate some of the moves that we have seen, we have picked out two sterling bonds that we have been watching very closely:

- Intermediate Capital Group is an alternative asset manager which manages and co-invests in predominately closed-end funds with the underlying asset classes of private debt, equity and credit. The company has EUR 43bn under management and is a member of the FTSE 100. Investors have been quick to draw similar conclusion to the financial crisis where Intermediate Capital had two rights issues. However, today the business is more diverse, better managed, with a stronger balance sheet and has a limited exposure to oil or travel. Prior to the market concerns, the company's investment grade bond maturing in 2023 yielded less than 3% at a small premium to par. However, over the past month, the price has plummeted to 62p, then ⏩

back up to 99p before settling at 90p which is still a double-digit yield. This is on no news other than director buying ahead of the fall into the 60's which incidentally would have been a return in excess of 20 pc per annum for anyone lucky enough to buy and hold, or a quick trade for a gain of well over 50%!

- Another illustration of the market volatility is in subordinated long dated financial paper from a range of blue-chip financial institutions, including HSBC and L&G. Prior to COVID-19 gripping the market, the financial crisis was becoming a distant memory and bonds traded at all time high pricing and low credit spreads. During the market volatility, these bonds started trading more like equities, down forty to fifty points at their lows, doubling the yields from 3% to 6%. This is an illustration of one of the ways we will look to invest, namely when we feel we can achieve equity like capital returns on top of an income payment, and do so with considerably less downside risk than the actual equities themselves.

Going into this period of heightened volatility, the fixed income team had actually been relatively quiet over the preceding year or two. As yields became ever skinnier, we took the view not to chase these yields at any price and in fact actively sought to mitigate risk across the portfolios. This left us with a portfolio of stronger credits and more senior paper, although we confess that no amount of stress testing catered for zero revenues for an indefinite period of time, hence we were reasonably quick to cut some particularly exposed positions before things got too late – our historic holding in Royal Caribbean springs to mind.

We remain holders of bonds which we believe represent a good risk versus reward trade-off, and especially so at current pricing levels. We continue to retain a bias towards financials which have been heavily regulated since the financial crisis, giving us excess return for higher quality balance sheets; the sector remains a key area of focus. It is well documented that this is not a banking crisis and it is the banks this time who will be forced to breathe life into the corporates, although we concede if the recession deepens this is likely to erode bank capital as well.

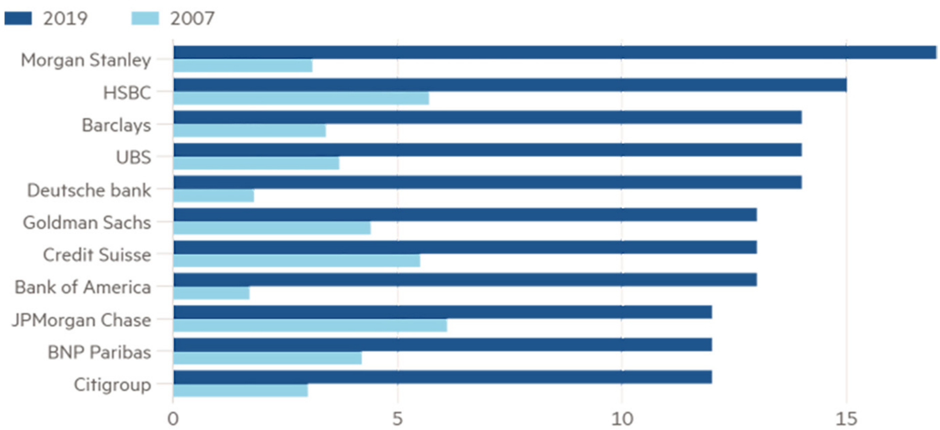
The below recent extract from the FT provides some useful insight.

These are exceptionally testing times from both a humanitarian and a financial perspective. The markets are likely to remain volatile for some time yet and what appears to be an opportunity one day can feel very different the next. We will continue to do our best to keep clients up to speed with these fast-changing circumstances.

Although the fixed income world feels a little uncomfortable now, we believe this will only lead to new opportunities in the future – as it always does. ■

Banks are in a better position now than they were in the financial crisis

Common equity tier one ratio (%)*



*Estimated Basel 3 CET1 ratio 'as-if' for 2007 and reported for 2019 Source: Autonomous © FT