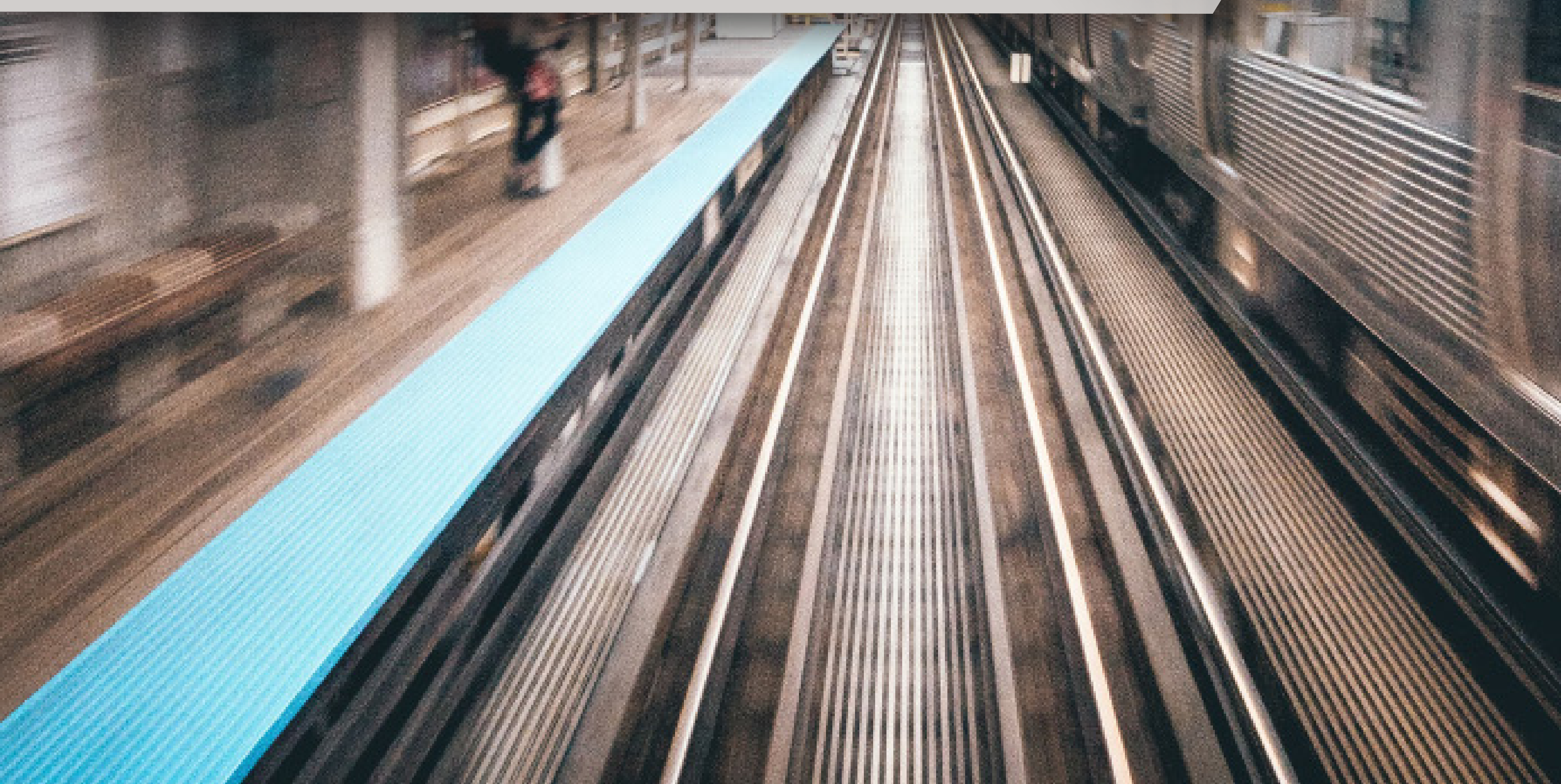
Where we are in credit – A long-term valuation based approach

By Thomas Hansen



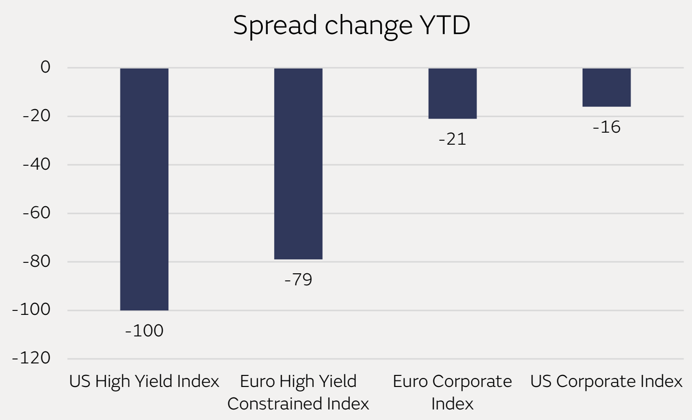
By Thomas Hansen - Portfolio Manager, GIB Asset Management

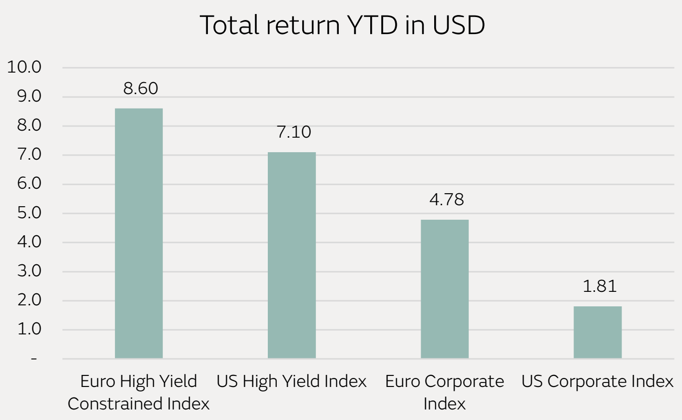
Executive Summary

For most credit investors 2023 has been a year of decent excess returns, yet somewhat disappointing total returns due to steadily rising rates in the US in Q2 and Q3. Despite higher rates and creeping economic pressure, the high yield sector has been the recent outperformer, maybe a surprise to many. In this piece we elaborate on our systematic long-term valuation approach, we look at recent trends in credit metrics and update our scenario analysis for EUR and USD IG fundamentals. We find that long-term valuations suggest that European Real Estate and AT1s still have value but credit as a whole is priced very close to average compared to the last 10 years, and some areas look outright expensive. This, combined with steadily weakening fundamentals, means that we are positioned to protect the portfolio from a potential downturn.

A quick review of 2023 so far

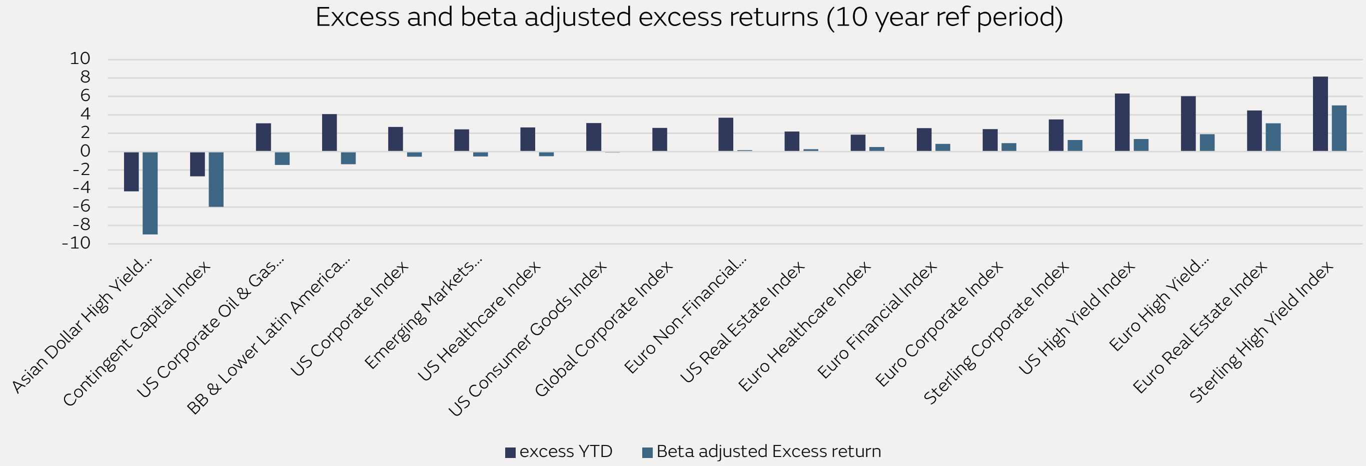
European investment grade has continued its recovery versus the US, albeit at a much slower pace compared to Q4 2022. The spread beta of high yield to investment grade is somewhere between 3 and 3.5 (depending on horizon) thus it is clear that especially in the US, the high yield sector has outperformed meaningfully in spread terms. Covid-cash piles and historically loose US fiscal policy has kept the US consumer spending, undeterred by record high mortgage rates and credit card debt balances. Looking at total returns in USD terms, however, investors in European credit have had a good year so far, thanks to largely stable rates in the EUR area and the hedge pick-up.





Source: ICE Indices, as at 15.09.2023.

Looking at excess returns for a wider set of sectors, we see that a couple of the underperformers from 2022 have been the best performers so far this year, Sterling high yield and Euro Real Estate .



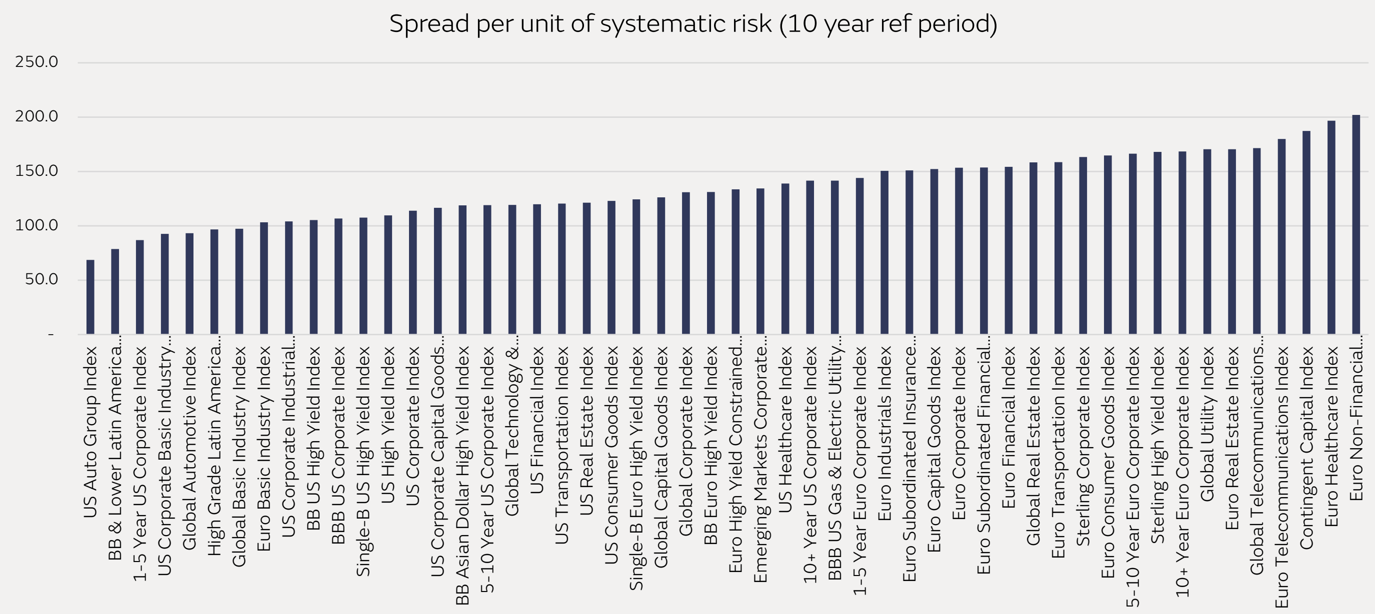
Source: ICE Indices as at 15.09.2023.

Where is the value in global credit at this stage?

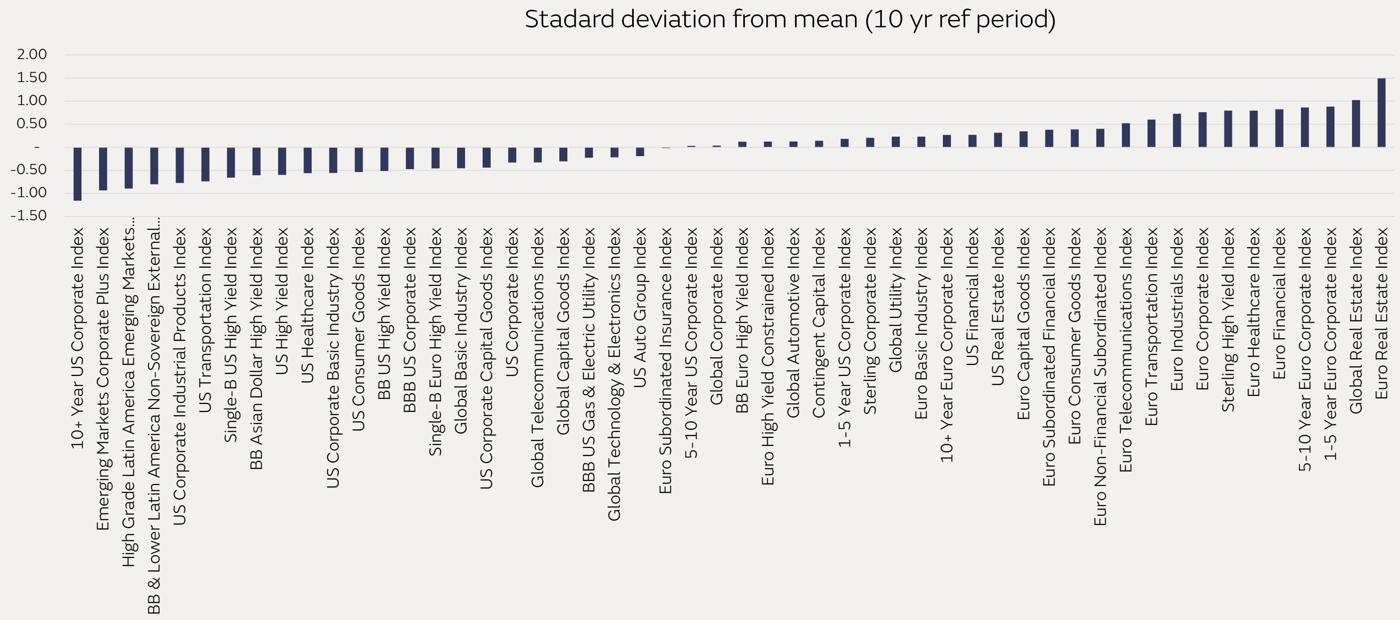
We believe that portfolio construction idea generation starts with long-term valuation analysis. While thorough fundamental and sustainability analysis is needed for inclusion in the portfolio, we initially screen for value across sectors, regions, curves and ratings. As upside in credit is capped, we want to make sure investors get paid for the risk taken. Research has shown that “Value” as a factor in corporate bond markets tends to outperform indices and exhibit relatively high Sharpe ratios compared to other factors (Doctor (2019) and Slimane (2018)). We define “Value” as ‘high compensation for the risks taken’.

Long term valuation analysis

Using the past 10 years as a reference, we look at volatility adjusted valuations and calculate beta adjusted spreads. In other words, we want to make sure investors are relatively well paid, not only for credit and liquidity risk, but also for volatility and systematic risk.

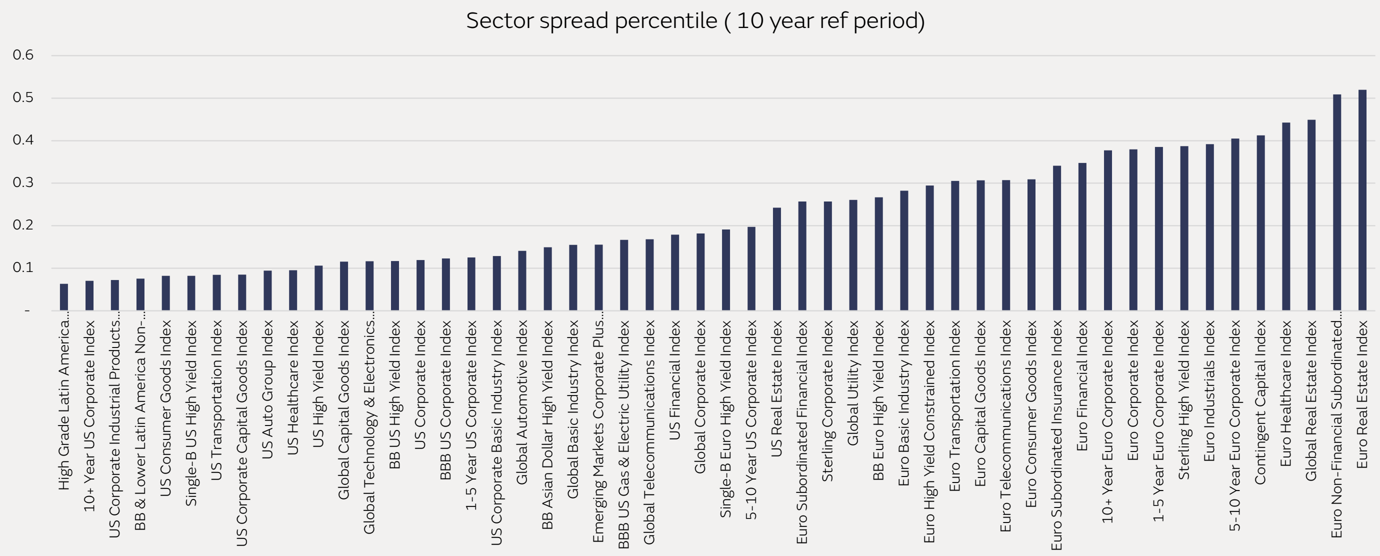


Source: ICE Indices as at 15.09.2023.



Source ICE Indices as at 15.09.2023.

Another measure is simply to look at current spread level percentiles. This does not consider volatility and systematic risk, however, but enables investors to understand upside and downside in terms of extreme tights and extreme wides.

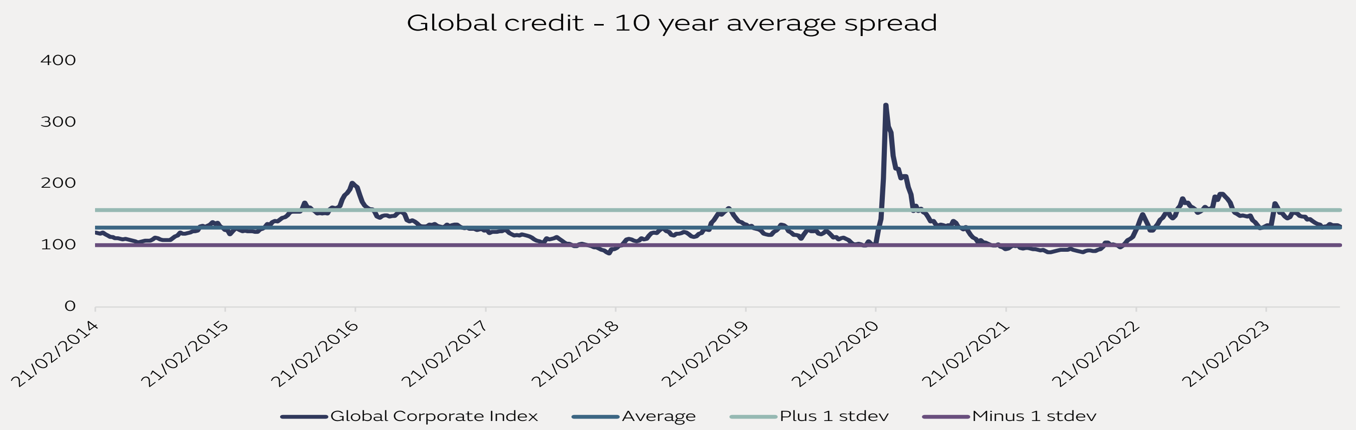


Source: ICE Indices as at 15.09.2023.

An alternative to looking at percentiles is calculating the expected shortfall or Tail Value at Risk (TVaR) as a measure of the expected loss at the left hand-tail of the normal distribution, i.e. the extreme cases.

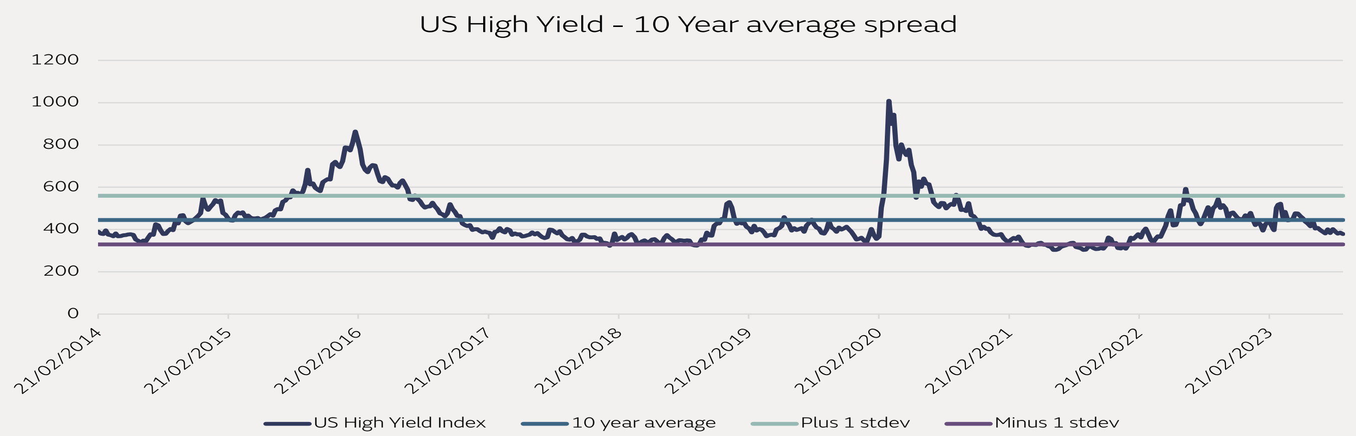
From our long-term valuation analysis, it is clear that European Real Estate , European hybrids and AT1s look relatively wide and potentially offer some value. It also appears that many US sectors such as High Yield, Autos and the long end of investment grade offers less value. It does not look like investors are paid for owning emerging market risk either.

Global credit is at a ten year average spread.



Source: ICE indices, September 2023.

Whereas US High Yield (HY) is trading about 0.5 standard deviation, expensive to 10 year average spreads.



Source: ICE Indices, September 2023.

Fundamental bottom-up relative value analysis

Once we have identified sectors of interest, we carry out comparative quantitative analysis to identify the bonds offering the best value (spread per unit of risk) within a given sector. For large, homogenous sectors this typically involves several multiple regressions where adjusted ratings, distance to default and balance sheet, cash flow and profitability metrics are used as explanatory variables (See appendix 1). The regression output is a theoretical spread level for each bond in each sector which we then compare to the current spread. The bonds with the largest residuals make up the focus of the more quantitative bottom-up sustainability analysis.

Bottom-up sustainability and credit resilience analysis

This last step involves a thorough peer-reviewed write-up, analysing the company's products and operations to ensure these align to one of our sustainability themes and Principal Adverse Impacts (PAIs) are checked to make sure the company adheres to our thresholds for Do No Significant Harm (DNSH). Finally, we incorporate our forward-looking sustainability analysis into the company's credit metrics to evaluate the issuer's credit resilience.

Current sectors of focus

European Real Estate

Towards the end of 2022, most of the fundamental challenges in the global Real Estate sector were meaningfully reflected in spreads. The sector in Europe traded 2.5 standard deviations to the 10-year mean and spread of 240 to its beta.

Access to public capital markets was still a significant challenge for most European companies, and attractive bottom-up stories in commercial and residential were few and far between. Thus, a significant part of the widening can be explained by meaningfully weaker fundamentals.

Within the Real Estate sector, we identified the following sub-sectors as broadly having resilient fundamentals, access to funding and positive demand outlook: logistics, data centres, and student housing.

In October 2022 we started cautiously building a position first via logistics (Prologis), student housing (Unite Group) and later Castellum 29s in April 2023 where a capital raise and a strategic cornerstone investor created the resilience we look for.

We still like the sector and find Prologis and Castellum to be of good value and to have strong sustainability merits. For more adventurous investors, VGP and Logicor offer compelling value.

In the hybrids space, the Unibail nc5 hybrids issued in July offer an attractive yield to call of more than 10% and a yield to maturity of 8%.

European banks

European banks have seen a meaningful divergence between fundamentals and valuations over the past 12-18 months. The sector's relative high beta to the general credit market, positioning, and loss of confidence caused by Credit Suisse and SVB all played a role. Nevertheless, fundamentals are strong with profitability and capital rarely been stronger.

Long-term valuations appear attractive across the capital structure relative to historical averages and comparable sectors such as US high yield. By the end of March, the AT1 index traded at 2.2 standard deviations to the 10 year mean and a spread of 230 to its beta.

As sectors cheapen up, we add risk by scaling in. We use regression analysis to establish cheapness across the universe.

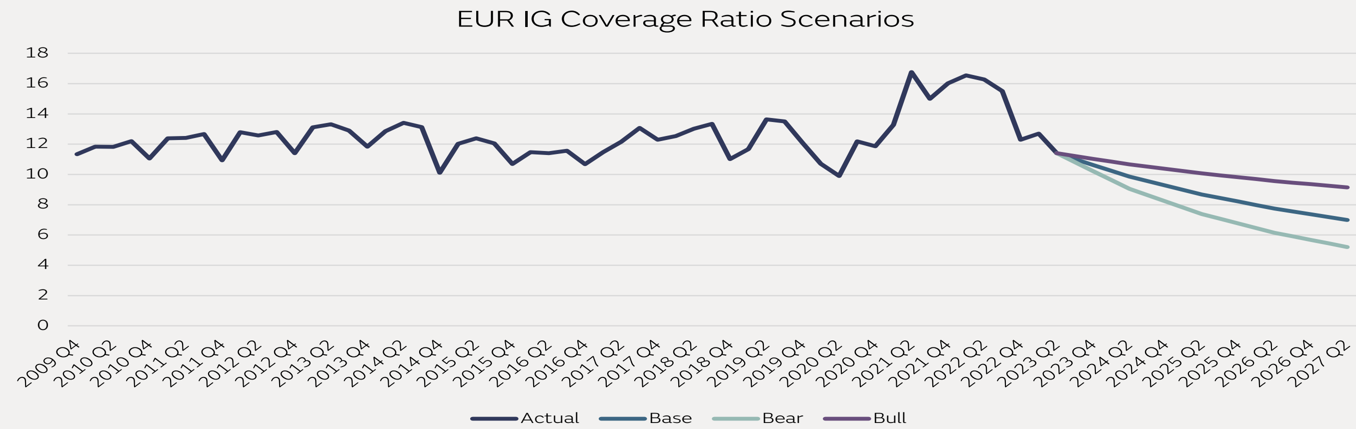
Recent focus includes AT1 issuance of Lloyds, Credit Agricole and BNP.

Recent credit metrics support a cautious stance

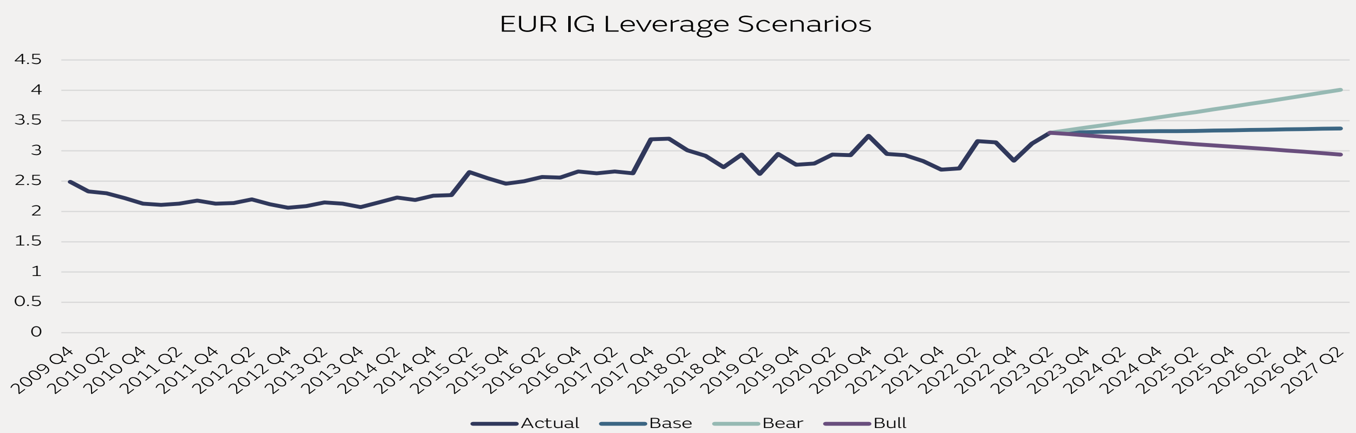
We believe credit is potentially in a sweet spot right now. Investment grade in particular is still benefitting from low average coupons and high interest on cash balances. The consumer is still holding up and PPI has come down somewhat, which is supporting margins.

Most of this is about to change. Over the next couple of years, a lot of debt will have to be refinanced at higher rates, the consumer is likely to fade due to higher mortgage rates/credit card debt and input price falls may soon be behind us. High yield companies will inevitably be hit the hardest as the duration on most high yield debt is very low. Adding a potential non-orderly slowdown in China and US election risk over the next year, we take a somewhat cautious stance to risk at this stage. As highlighted above, there are plenty of good bottom-up stories at attractive spreads, however, we are less convinced about the potential for further spread tightening on an index level.

EUR Investment grade coverage ratios in particular appear to be weakening faster than previously expected. In our bull case scenario, coverage settles close to the low range for the period post GFC. In our bear case, we may see meaningful ratings pressure absent corrective actions from the companies (See Appendix 2).

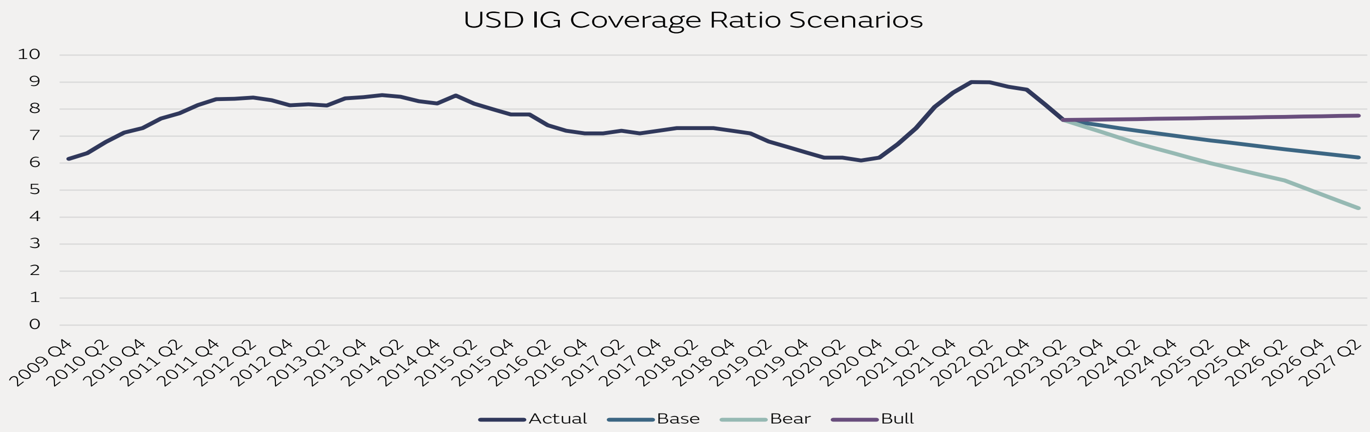


Source: Bloomberg, September 2023.

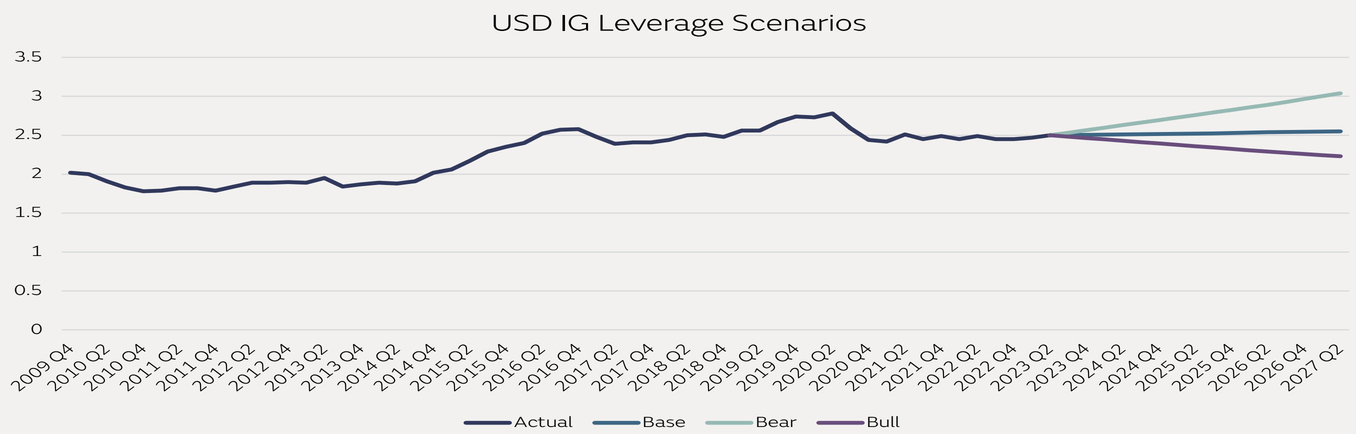


Source: Bloomberg, September 2023.

US IG metrics are relatively stable, partly due to longer duration borrowing, strong earnings on cash balances and stable profitability.

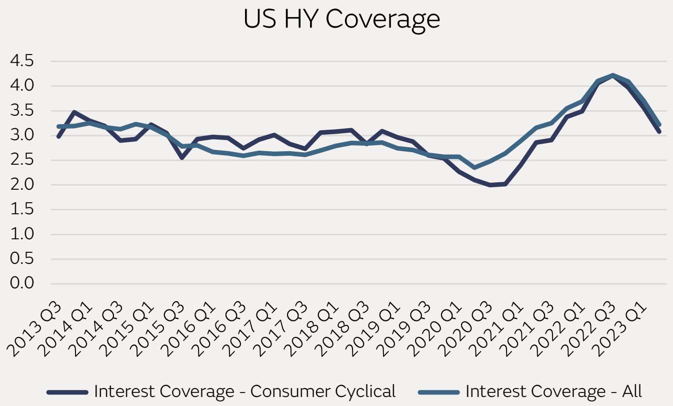


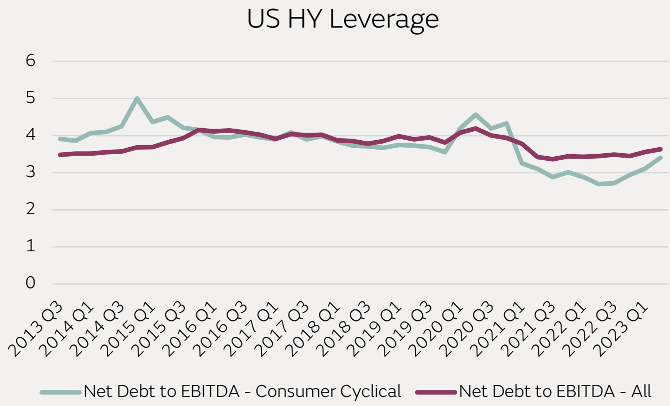
Source: Bloomberg, September 2023.

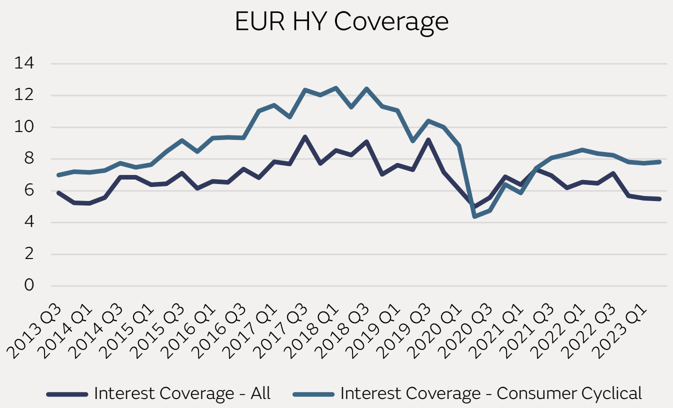


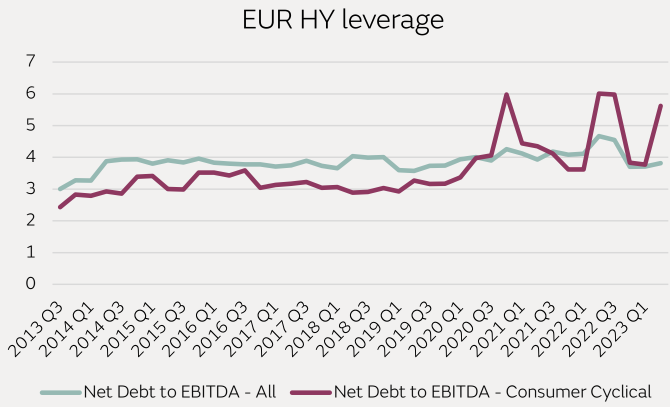
Source: Bloomberg , September 2023.

Recent trends in HY fundamentals suggests a marked deterioration in the US.









Sources: Bloomberg, September 2023.

Conclusion

We believe that, by systematically investing in resilient businesses in attractively priced sectors, we can deliver attractive returns over the long term. Bottom-up credit work is focused on determining the viability of the business and its credit resilience. This is important to avoid falling into the value-trap. We invest primarily in sectors that have attractive secular drivers, or so-called "fast flowing rivers" with strong sustainability credentials. Our holistic, multi-thematic sustainable framework provides a unique approach to bottom-up credit analysis. We focus on forward-looking indicators to make sure we invest in the most resilient and sustainable companies.

Applying this framework has meant recent overweights to European Real Estate and AT1s. While we find no shortage of attractively priced bottom-up stories, however, current fundamental trends make us wary of the recent rally in credit, especially high yield.

Finally, we find that fundamentals are clearly weakening across developed market credit and we expect this to continue as per our base case scenario. This is very much in contrast to the current spread tightening bias and suggests a cautious approach to risk at this stage.

GIB ASSET MANAGEMENT

Appendix 1

Equation 1, regression of spread on maturity and rating with an adjustment for recent spread moves

OAS_i (bps) = c + $\beta_{mat} m_i(years) + \beta_{rating}\, r_i + \beta_s\, \Delta OAS_i + \varepsilon_i$

Equation 2, regression of spread on distance to default (merton) and maturity

$log OAS_i$ (bps) = c + $\beta_{DD} m_i log(naive\ DD) + \beta_m$ log (years to maturity) + ε_i

Equation 3, regression of spread on balance sheet, cashflow and profitability metrics

OAS_i (bps) = c + $\beta_{Leverage} l_i + \beta_{cashflow}\, cf_i + \beta_{profitability} P_i + \varepsilon_i$

Appendix 2

US IG Assumptions	EBITDA growth	Net Debt	Average coupon
Base	2.0%	2.5%	20 bps/year
Bull	5.0%	2.5%	10 bps/year
Bear	0.0%	5.0%	30 bps/year

EUR IG Assumptions	EBITDA growth	Net Debt	Average coupon
Base	2.0%	2.5%	30 bps/year
Bull	5.0%	2.5%	20 bps/year
Bear	0.0%	5.0%	40 bps/year