ANALYSIS

Credit Continuum

15 January 2021

Stay Focused (II)

So far 2021 has seen a continuation of the optimism in credit markets from the second half of last year. However, we continue to be focused for any potential warning signs.

December saw continued optimism with all asset classes ending the year in the green. One would almost think, looking between December 2019 and December 2020 that it had been an uneventful year in financial markets. Positive news supporting the year-end rally included the start of the vaccine global inoculation effort in the fight against COVID-19, the approval of the fiscal stimulus in the US late in 2020, President-elect Biden's new fiscal plan for further stimulus, now made possible after the resolution of the Georgia senate vote in favor of the Democrats, and the last-minute Brexit agreement, which removed immediate risk of heavy trade distortion.

As the economic cycle is expected to recover in 2021, we believe investors are starting to focus on inflation. Whilst it has been low for a long time, inflation expectations are now starting to go up and push nominal yields up. The Federal Reserve will search to avoid a "taper tantrum" as in 2013, probably translating into a progressive and late-in-the-cycle reduction of bonds purchases. Something we do not see happening in 2021 and possibly not before the second half of 2022. The adoption of flexible average inflation targeting framework precisely leaves more room to wait for the Federal Open Market Committee (FOMC) before adopting more restrictions in monetary policy.

The European Central Bank (ECB), in their last announcement in December, increased again the Pandemic Emergency Purchase Programme and indicated a shift going forward, from increasing the stimulus packages to extending the duration of the various measures overtime. We believe it is reasonable to say that we have seen the peak in monetary stimulus at the end of 2020.

Michael McEachern, MBA

Portfolio Manager & Co-Head of Public Markets

Michael manages the Muzinich Global Tactical Credit strategy. Prior to joining Muzinich in 2012, Michael was president and Head of the High Yield Division at Seix Advisors, Inc. At Seix Advisors, he was the founding partner of the high yield strategy that grew to over $13 billion under his leadership. Previously, Michael served in various research and portfolio management capacities at American General Corp. and at Capital Holding Corporation. He earned a BA in Management Science from the University of California, San Diego and an MBA from Rice University.

In our opinion a key differentiator for investors, particularly when looking at multi-asset credit portfolios, should be a shift to an allocation that targets more carry and less duration risk, more income related investments than pure capital appreciation.

With tight valuations at the end of last year, the question is often where is a reasonable entry point? This is something investors are right to ask. First, we believe 2021 is not a year to remain uninvested. The pandemic led investors to maintain high levels of cash or very low risk exposure in their portfolios. This creates an immense reservoir of risk capacity. At the end of last year, we already started to see some of that cash coming back into the markets.

Second, we think further spread compression is possible, especially in relative value across credit quality. The recent year-end rally has seen US High Yield (HY) outpacing US Investment Grade (IG). A similar observation can be made with Euro HY and IG, with the additional motivation that almost half of Euro IG has yields below zero as at mid-December 2020.[1]

In a similar way, Emerging Market (EM) debt also presents a potentially good opportunity for carry. Emerging economies have recovered at a much faster pace than developed ones. The current premium in EM spreads, IG as HY, has further compression potential, and episodes such as 2010 or 2016/2017 demonstrate the capacity of credit markets to outperform in global economic normalisation phases, with little to no external financing risk.[2]

Leveraged Loans have started to catch-up in performance versus bonds and we see this appetite for carry without duration continuing in the near term.

Third, we believe beta trades (more directional market trades) still have some room to perform but we believe that 2021 may be a year where income generation will be critical and that alpha opportunities will be a necessary complement to available carry. Flexible, liquid and conviction-led multi asset credit strategies should be very appropriate to such an environment.

1. HY Yield Credit Chartbook, BofA, as of December 2nd, 2020. US HY performance is based on the ICE BofA ML US High Yield Index, US IG is based on the ICE BofA ML US Corporate Index, Euro HY is based on the ICE BofA ML Euro high Yield Index and Euro IG is based on the ICE BofA ML Euro Corporate Index. 2. Bank of America EM Corporate Chartbook as at the end of November 2020.

Important Information