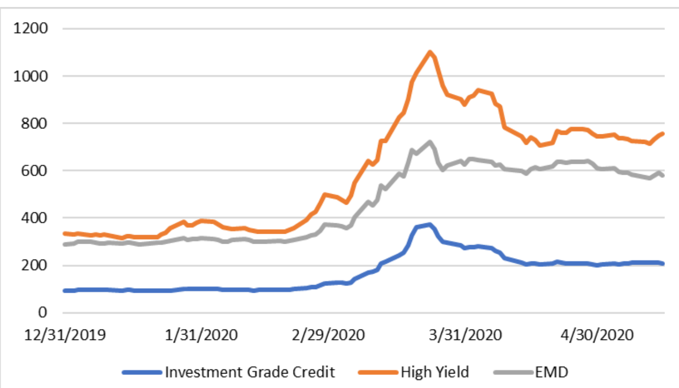
Credit—What Now?

Mark Foust, Senior Portfolio Specialist, Fixed Income

What Happened?

Credit markets were decimated by the economic impact of COVID-19 in February and March. Investment Grade Corporates (IG), High Yield (HY), and Emerging Markets Debt (EMD) all declined significantly despite rapidly falling interest rates across the globe. Spreads quickly widened from levels that were tighter than historical averages early in 2020 to recessionary levels in a matter of weeks. Below is a chart illustrating how much spreads widened this year:



Source: Bloomberg/Barclays, JP Morgan
As of May 15, 2020

The peak in credit spreads was on March 23 as the virus spread across the U.S. and the states progressively moved into a lock-down phase and "non-essential" elements of the economy came to an abrupt halt. Liquidity in all segments of fixed income, including the Treasury market, dried up with few transactions taking place. To make matters worse, oil prices plunged due to a combination of a significant decline in demand due to weaker economic activity, a huge storage problem as there was suddenly too much oil being produced with nowhere to store it, a price war between Saudi Arabia and Russia, and investment vehicles rolling crude oil futures. Oil prices fell from $61 a barrel at the end of 2019 to below $0 on April 20, and finally moved back to a more sane level of $29 on May 15. Although spreads widened for the majority of companies, certain industries were hit much harder as the impact from COVID-19 and the collapse in oil prices were much more devastating. In HY, as of May 15, airlines returned -48% year-to-date, while leisure and energy were down -29% and -23% respectively. It was a similar story in IG, with all three industries posting double-digit losses. The winners were what you might expect and include supermarkets, technology, telecom, and utilities.

Year-to-Date Returns*

Losers	HY	IG
Airlines	-48%	-16%
Leisure	-29%	-33%
Energy	-23%	-10%
Winners	**HY**	**IG**
Supermarkets	2%	6%
Utilities	-1%	4%
Telecom	-2%	3%
Technology	-3%	4%

*As of May 15, 2020

The rebound in credit started later in March when the Federal Reserve quickly and strongly went "all-in" and came to the rescue by cutting the Funds Rate 150 basis points over two weeks back to 0% - 0.25% in March and, more importantly, added a massive amount of liquidity. The Fed re-started Quantitative Easing by purchasing Treasuries and mortgages and, for the first time, they stated that they would also buy investment grade corporates. It was the liquidity moves that ignited the credit rally after March 23. The Federal Government also quickly responded with the largest stimulus package ever of over $2 trillion with potentially more to come. With these measures in place, spreads tightened through the end of April, but in mid-May, still reflect a recessionary environment.

Due to the actions of the Federal Reserve and Federal Government, access to the financial markets resumed in full force for many corporations and countries. March and April set records for the IG corporates new issue market with issuance of $262 and

$285 billion respectively beating the prior record from May 2016 of $168 billion. Despite the wider spreads, many companies still have the opportunity to lock in low yields due to the significant decline in Treasury yields. With the 30-year Treasury at 1.32% as of May 15, some companies can issue 30-year debt with yields at 3.5% or lower. High yield issuance surged in April after being dormant for most of March. In total almost $37 billion in new issuance was priced in April. While this was only slightly more than is typical for April, the net issuance of over $27 billion was the second highest on record. In both IG and HY, some companies that have greatly suffered due to the virus were able to come to the market including Boeing, Delta, Gap, Ford, Avis, Hyatt, and Norwegian Cruise Lines. In EMD, higher quality sovereigns including Saudi Arabia, Panama, Peru, Mexico, and Indonesia were able to access the new issue market as over $150 billion was priced in April. In summary, despite the market turmoil and much wider spreads, many companies and countries were able to access financing to help get them through these very tough times.

Where We Are Now

As mentioned, IG, HY, and EMD rallied strongly in late March and April and recovered some of what they lost in the beginning stages of the virus. The returns for investment grade corporates moved into positive territory for the year by the end of April. However, the returns for high yield and EMD remain firmly in negative territory. Even with the rally, spreads remain near recessionary levels, which is where they should be given the significant economic decline that has occurred globally. To summarize where we are:

1. Spreads are at recessionary levels.
2. New issue market is open for many issuers across IG, HY, and EMD. This will likely be a record year for issuance for IG.
3. Credit fundamentals are poor for many companies and countries with significant uncertainty.
4. Default rates are rapidly increasing in HY, and debt restructurings will be prevalent.
5. Credit rating downgrades are accelerating including numerous companies moving from IG to HY. Recent examples include Ford and Occidental Petroleum.
6. Argentina and Lebanon are restructuring their debt and several more EM countries may restructure including Ecuador, Angola, and Zambia.
7. Industries hardest hit include oil, airlines, hotels, and retail.
8. Policy response from the Federal Reserve and U.S. Government has been unprecedented in both size and speed with more likely to come.

What DuPont Capital is Doing

Except for brief periods in February 2016 and in the fall of 2011, we believe current valuations in all segments of credit are the most attractive they have been since the global financial crisis in 2008/2009. Although the next year will most likely be very uncertain and challenging, we believe there are very compelling opportunities in EMD, IG, and HY credit. We have been selectively buying in all three sectors since early/mid-March.

In investment grade credit, we have been focusing on long corporates where we were underweight and had very little exposure in both Core and Long Duration portfolios. Spreads in long corporates started the year at +136 bps over Treasuries, spiked higher, briefly touched +359, and have recently settled in around +240. Although yields are not very attractive and mostly between 3.5% and 4%, there is good relative value as compared to Treasuries. We have also been adding exposure in intermediate and shorter maturities where appropriate. Security selection will be critical as many industries and companies will experience significant pain and will be downgraded over the next 6-to-12 months. In this market, there are many "Haves" (on-line retail, supermarkets, utilities, etc.) that are doing well and "Have-nots" (airlines, lodging, some retail, energy, etc.) that are getting devastated. Our focus is finding those companies that are in-between these categories that will survive during this short-term economic decline, but currently have very attractive valuations.

In EMD, our strategy has been twofold:

1. Buy higher quality countries where we were underweight that have become undervalued. Most of these countries are in Asia or the Middle East.
2. Buy higher yielding countries/companies that we think will survive the short-term financial economic shocks of the virus and lower oil prices.

Most of our buying in EMD was in mid-to-late March and was funded through cash that was held in our portfolios. We believe cross-over buyers will return to EMD if spreads remain close to current levels. We continue to look for additional opportunities as valuations are still cheap.

In HY, we also have a two-pronged strategy:

1. Buy companies that have attractive valuations that will be able to survive the short-term economic decline.
2. Identify and do extensive research on good companies that are suffering in this unusual environment that may become good buying opportunities as they restructure their debt.

Summary

Due to COVID-19, investment grade corporates, high yield, and emerging markets debt are all trading at recessionary type levels. However, this is not a typical recession and needs to be approached a little differently. We believe valuations are very attractive in IG, HY, and EMD and have been selectively buying since March in our fixed income portfolios relying on our deep fundamental research. Spreads have stabilized recently after narrowing over the prior four weeks from extremely wide levels. Overall, we expect spreads to grind tighter over the next year, but it could be a slow process as we expect economic growth will remain very depressed due to COVID-19. We believe many opportunities still exist and we will continue to add credit to our portfolios as we uncover strong long-term value. Security and country selection are critical as defaults and downgrades will rise significantly over at least the next six-to twelve months until economic activity moves closer to normal. This will cause a great disparity between winners and losers and will have a large impact on relative performance.

Mark Foust, Senior Portfolio Specialist, is responsible for serving as primary point of contact for the Fixed Income investment team to provide our clients with ongoing communication and in-depth portfolio insight regarding our fixed income strategies. Mr. Foust is responsible for understanding and communicating portfolio positioning and buy/sell rationale, attribution analysis, and serving as a representative for senior investment professionals such that they are primarily engaged in investment-related activities. Mr. Foust joined DuPont Capital in 2009 and has been in the financial services industry since 1985. Mr. Foust holds a B.S. in Administration and Management Science from Carnegie-Mellon University and he earned an M.B.A. in Finance from the Pennsylvania State University.