360°

Volatility, value and variants

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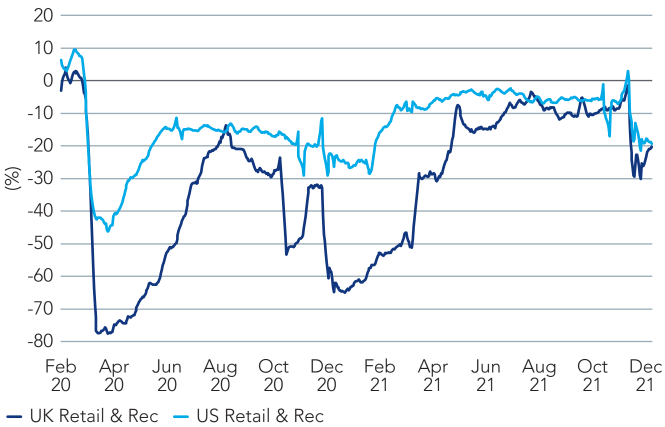
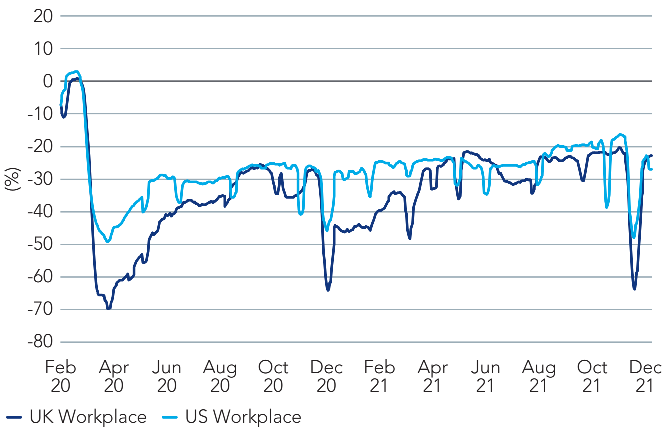
Commentary

It became apparent, quite early on in the pandemic, that time and the perception of time were concepts that were no longer absolute. Indeed, within four months of the first lockdown, a survey found that over 80% of respondents experienced a distortion in the passage of time relative to other periods.[1] After various forms of lockdown, working from home, multiple Covid waves and a lack of travel, I have come to view the last two years as a blurred continuum. Gone are the vignettes of life that segment time into memories, allowing me to separate one moment from another.

Sometime in late 2021 (I can't remember exactly when – for the reason outlined above), I started to feel that life was almost normal enough to consider – and book – Christmas travel. Very quickly I was reminded that life was still a long way away from normal: in fact, before we knew it, holidays were being cancelled again, and the sudden trepidation moved back through the markets as Omicron became headline news.

Figures 1 and 2: Changes in US and UK economic activity





Source: Our World in Data, Google Mobility Report.

Although the newest variant has proven less virulent and led to fewer hospitalisations and deaths, were its effects on the economy equally as mild? Google Mobility trends (Figures 1 and 2) corroborate the view that the impact of Omicron has proved milder on the economy than its predecessors. Indeed, the impact has been sharp but shorter lived than other variants – aided by rapid booster deployment, less-stringent restrictions and a more *laissez-faire* attitude from the public once the lower risk of severe illness was established. In retail and recreation, the 30% pull back in traffic in the UK was dramatically lower than the 80% drop in early 2020 or the 65% drop in early 2021.

In the US, given the multitude of different Covid-19 policies at individual state level, the country avoided experiencing similarly deep troughs at a national level. Even so, the Omicron drop has been more muted (down 20%) than the 45% of 2020 or 30% of mid-2021. Visits to workplaces dropped dramatically, almost to similar levels as the previous crisis points, but rebounded much more quickly this time around. All of this suggests that, in nations with aggressive booster plans and a willingness to 'live with Covid', the impact of Omicron appears to have been short lived.

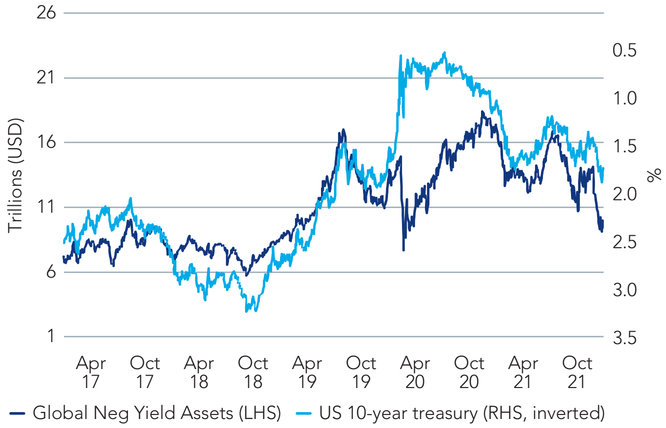
Bloomberg Economics has recently launched a GDP calculator with the ability to extrapolate daily GDP from various real-time factors. It shows that the US economy atrophied by 16% when Omicron first emerged but has already started its bounce back in earnest – so much so that Bloomberg Economics forecasts 3.4% GDP growth by the end of Q1 2022.

However, what this data doesn't tell us, is what will happen to countries that are sticking to zero-Covid policies. Until we can answer this question, supply-chain disruption remains a significant worldwide risk. We have seen that the likes of Japan and Australia, which previously had low case levels, have found it much harder to contain Omicron despite

[1] (Ogden RS (2020) The passage of time during the UK Covid-19 lockdown. PLoS ONE 15(7): e0235871. https://doi.org/10.1371/journal.pone.0235871).

renewed measures. If China sticks to its own zealous policy and favours disruptions to its economy over the spread of virus, the West will continue to experience supply shocks for some months, exacerbating cost inflation from the supply side irrespective of demand. We can assume that inflation, and its impact on rates policy for critical central banks, will remain in the headlines and contribute to volatility. But the markets already assume a lot of this, and my suspicion is that the conversation about inflation will be shorter lived than current noise suggests (as rebasing and other concerns come to the fore).

Figure 3: US 10-year yield versus global negative yielding assets



Source: Bloomberg, Federated Hermes, as of December 2021.

In the meantime we must deal with inflation and, other than favouring floating rate instruments for starters, what other action can we take as investors?

Firstly, the change in the shape of the curve and the widening of the longer end has greatly diminished the amount of negative yielding assets worldwide (Figure 3). The paucity of absolute returns had led to a global hunt for yield, and this thirst for risk was a technical factor supporting our own appetite of higher risk/higher yielding assets. So, it stands to reason that we should be more nervous of this valuation change.

Secondly, it's interesting to look at the fundamental implications of a higher-rate environment. We have yet to see as much margin compression in earnings reports as we expected but we believe continued inflationary pressure will eventually impact demand (bad for high-fixed-cost industries) and/or profitability margins (bad for thin-operating-margin industries or industries that cannot pass on inflation to customers).

Thirdly, higher rates should also lead to a higher cost of funding and cash flows, and interest coverage statistics will likely erode from here. In the short to medium term, we have yet to see enough change to start questioning our views on corporate welfare, but we are more alert to credit quality from here on.

Finally, is there another signal we can glean from rates? We looked at the relationship between spread and rates over time, and no particular pattern jumped out at us. However, when we look at the relationship between the relative contribution of credit spread to overall yields (using the ICE BAML Global High Yield Index incl. Sovereigns) and compare that to the yield generated by the US treasury five-year, we see a more obvious correlation (Figure 4).

What is not clear is whether rates lead spreads or vice versa. We also cannot tell whether this holds true only in this era in which rates and helicopter money have fostered a different relationship to risk. It's possible this is not something that holds true for other asset classes outside of high yield. We will spend more time analysing whether this relationship pattern might develop into a more rigorous signal, but for now it's enough to suggest that there's nothing to fear in a few more basis points on the US treasury five-year from a credit spread perspective.

Figure 4: US treasury yield correlation to contribution of credit spreads to overall yield

Source: ICE BAML Indices, Bloomberg, Federated Hermes, as of December 2021.

That said, all it takes is a few choice words from a certain central bank chairman to reverse the direction of travel and lower the treasury curve quickly. Such a scenario would change the total amount of positive yielding assets globally, renew the hunt for yield and – through the spread-to-yield ratio and correlation to rates – lead to a positive technical for credit. It is, therefore, more important than ever to listen to our economist, Silvia Dall' Angelo, who shares her forecast in the Economic Outlook.

Source: All market data is sourced from Bloomberg, unless otherwise stated.

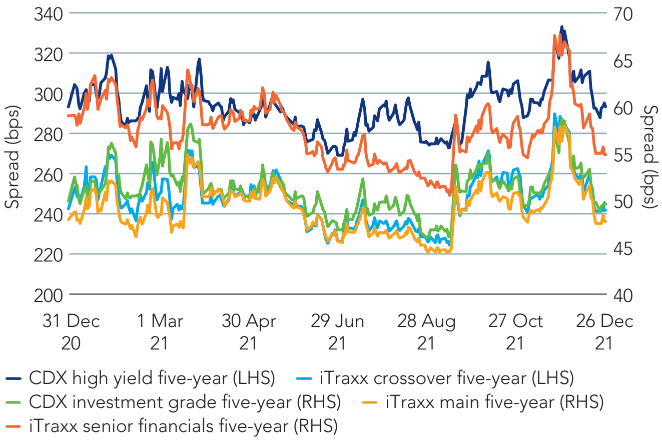
Relative value

Private credit spreads continue to be resilient, having stayed largely immune to the moves seen in public credit markets over the fourth quarter.

Spreads on major credit default swap (CDS) indices finished 2021 at similar levels to where they started the year. The only exception was the iTraxx Senior Financials Index which ended the period 7% tighter. The Credit Default Swap Index (CDX) High Yield spread was 293bps at year end, while the iTraxx Xover was 242bps.

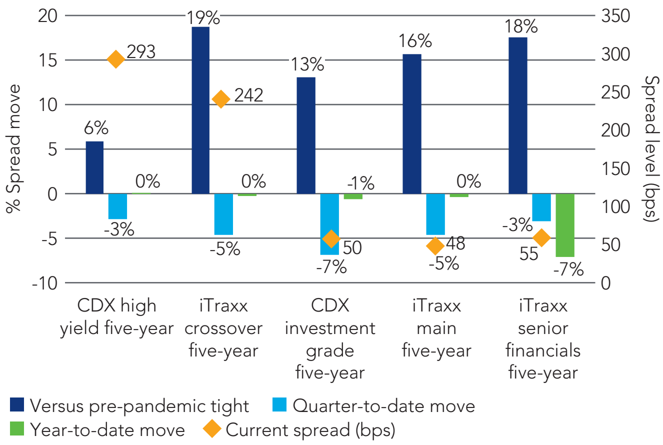
During Q4, spreads did gap wider following the emergence of the Omicron variant of Covid-19 in early December, however, spreads quickly recovered into year end. That said, these levels were wider than the tights seen in September and are 6-19% wider than the pre-pandemic tights of Q1 2020 (Figures 5).

Figures 5: Percentage spread moves for the major liquid CDS indices



Source: ICE indices, Bloomberg as at 31 December 2021.

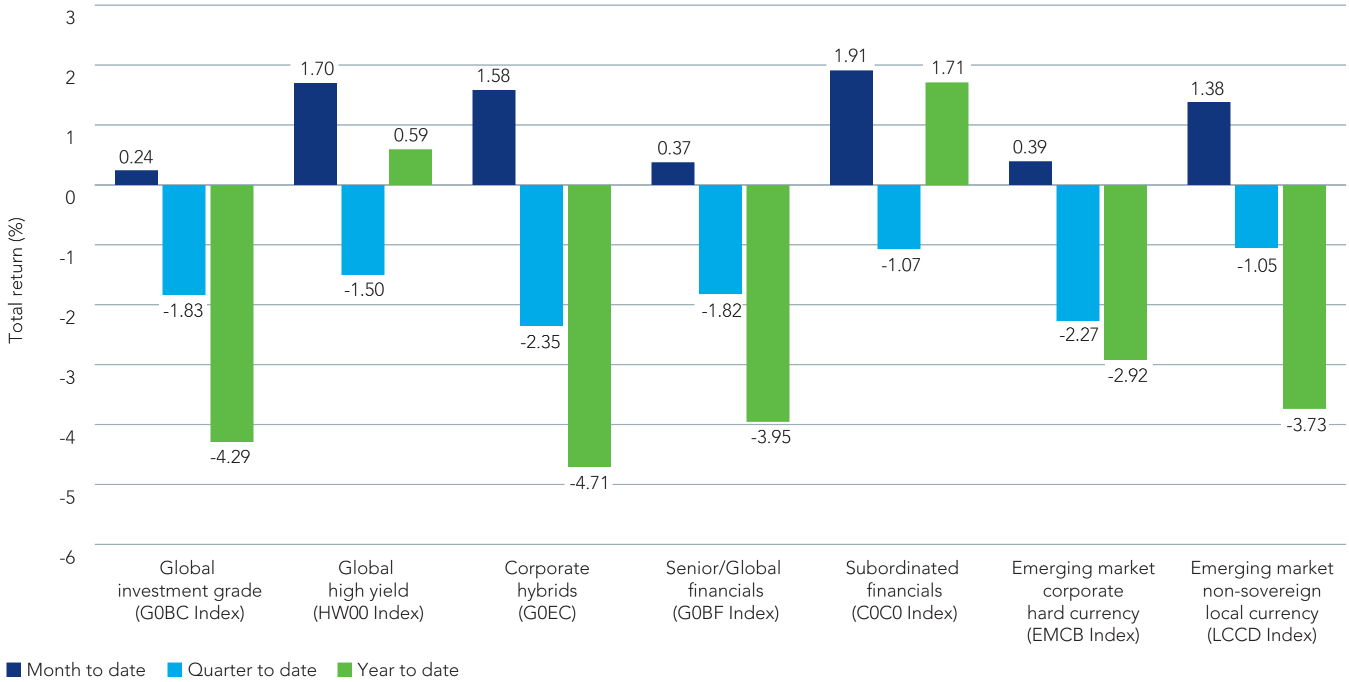
Figure 6: Spread moves during 2021 (%)



Source: ICE indices, Bloomberg as at 31 December 2021.

If we look at total returns on corporate bond indices over the year, despite little movement in credit spreads, the majority of the key indices delivered negative total returns. This was mostly driven by the moves wider in interest rates of which longer duration exposures were most affected. The exception was global high yield and subordinated financials which returned 0.59% and 1.71%, respectively, and were helped by strong December performance across all indices (Figure 7).

Figure 7: Total return on selected major cash credit indices

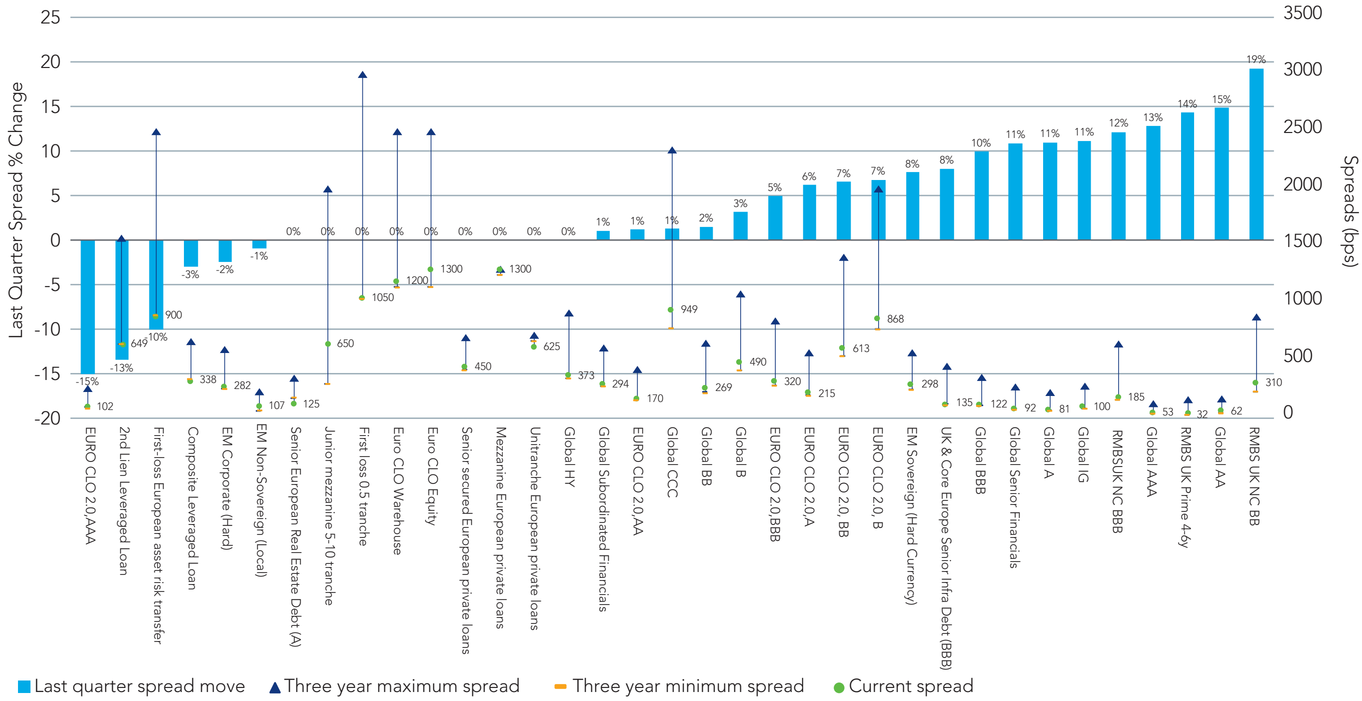


Source: ICE indices, Bloomberg as 31 December 2021.

Looking beyond public corporate credit markets, Figures 8 and 9 show spread changes across the broader multi-asset credit (MAC) universe ranked by Q4 and 2021 moves, respectively. In Q4, there were a narrow set of exposures that moved tighter during the quarter: Euro collateralised loan obligations (CLO) AAAs, leveraged loans, European risk transfer exposures (which are now near their three-year tights levels). Meanwhile, both hard and local currency emerging market (EM) debt moved marginally narrower.

UK residential mortgage-backed securities (RMBS) and investment grade corporates moved wider by more than 10%, mezzanine Euro CLO exposures also widened between 1% and 7% depending on the tranche. As we see regularly, private credit exposures did not change on the quarter with the exception of infrastructure debt that moved 8% wider (Figure 8).

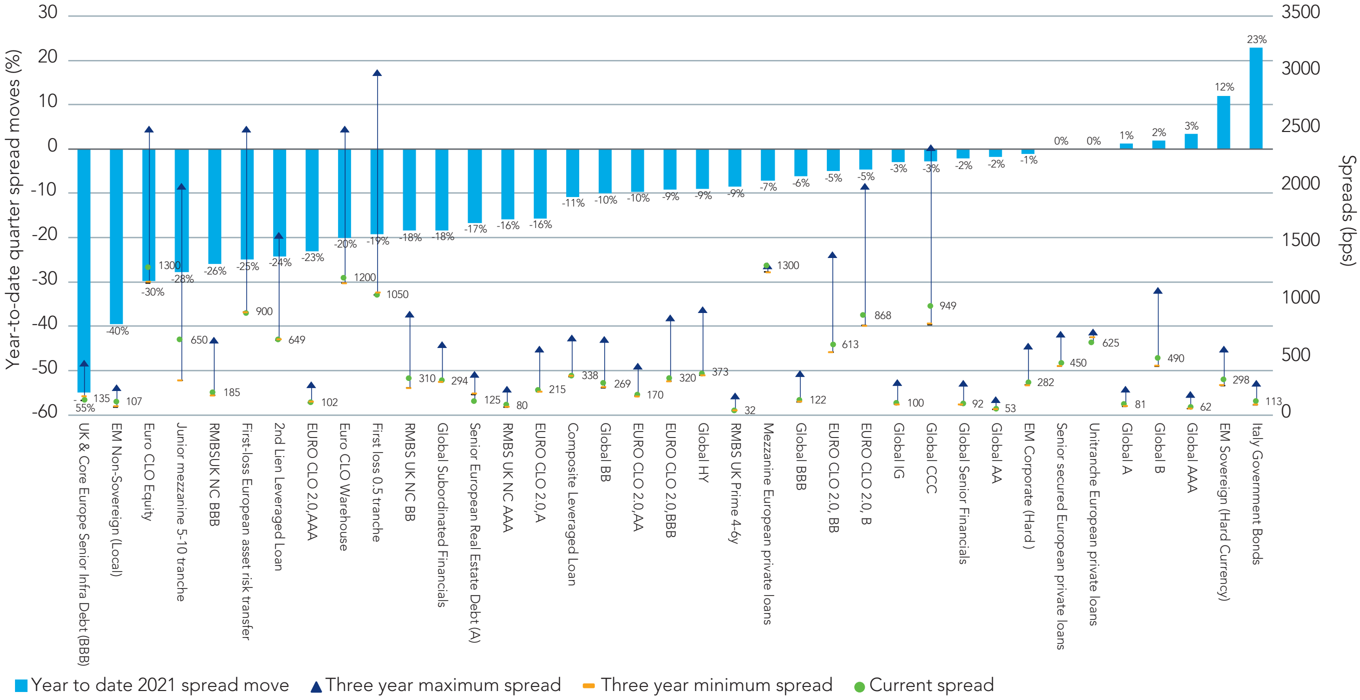
Figure 8: Current spread levels versus three-year minimum and maximum (right-hand y-axis), ranked by Q4 percentage spread moves (left-hand y-axis), for selected multi-asset credit exposures



Source: Federated Hermes, Bloomberg, Citi as of 31 December 2021.

Over the course of the year, spreads on the majority of exposures moved narrower in contrast to the more muted moves in both CDS indices (Figure 6) and corporate bond indices (Figure 7). The largest moves tighter (by greater than 30%), were for BBB-rated infrastructure debt, Euro CLO equity, and local currency EM non-sovereigns. Italian government debt and hard currency EM sovereigns moved the widest in percentage terms. Within European direct lending, both senior secured and unitranche spreads did not move over the year.

Figure 9: Current spread levels versus three-year minimum and maximum (right-hand y-axis), ranked by 2021 percentage spread moves (left-hand y-axis), for selected multi-asset credit exposures



Source: Federated Hermes, Bloomberg, Citi as of 31 December 2021.

When refreshing our MAC relative value framework at the end of the year, there were no significant changes in the rankings. Direct lending retains the number one position, in line with the previous two quarters due to its attractive illiquidity premium coupled with low volatility.

There was a reshuffling of the other exposures within the top five with Euro CLO senior moving from fourth up to second with an increase in the value score. This pushed Euro CLO mezzanine to third after a value score downgrade.

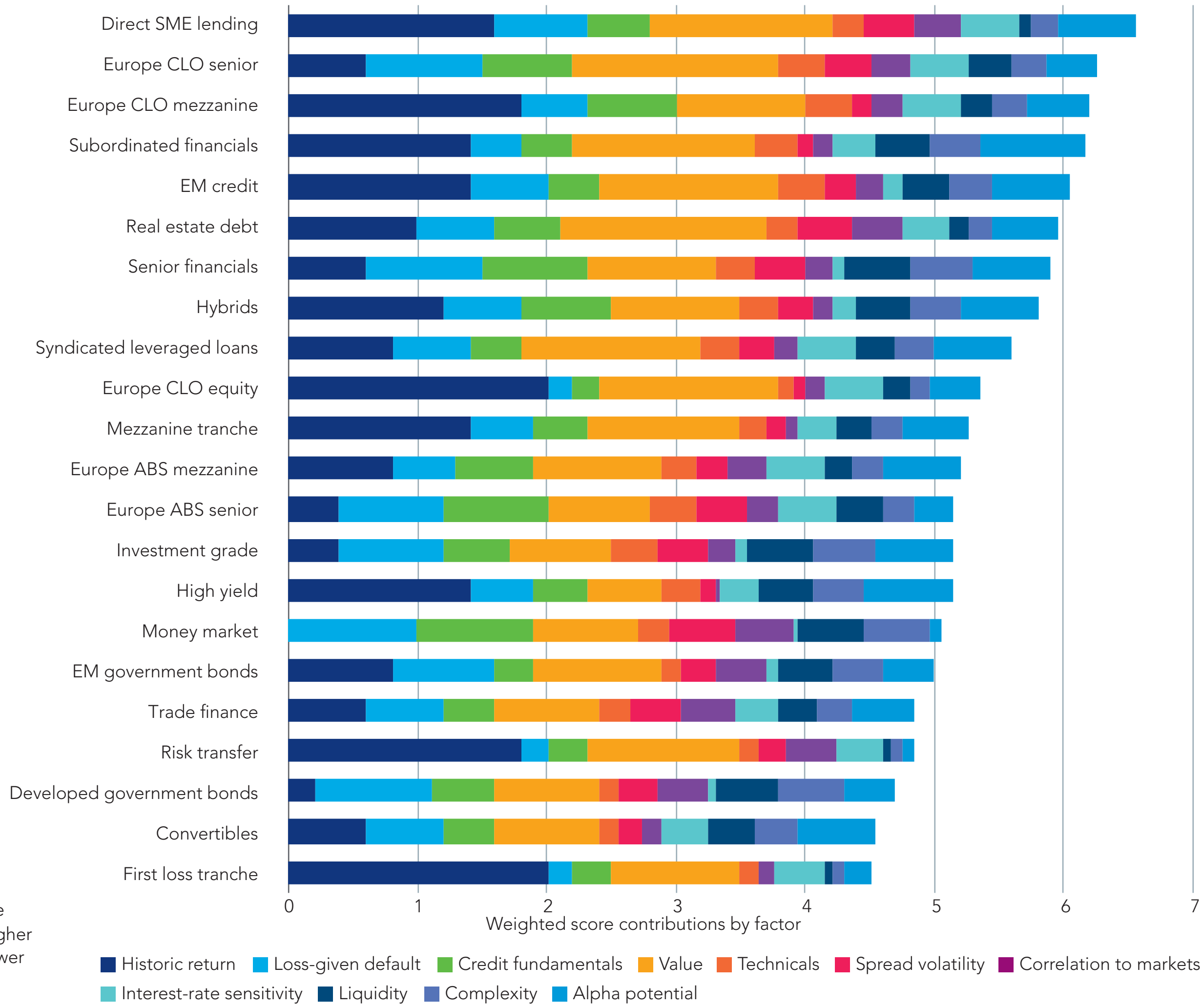
Despite a two-score downgrade in fundamental score for EM credit, the asset class remains in fifth position (down from third) on account of the fact that it remains cheap and so maintains a strong value score. In particular, we see value in some selected areas of Chinese real estate.

Finally, there was no change in score for subordinated financials, which retains its fourth-place ranking.

Figure 10: Our latest MAC relative value framework

Q4	▲	Q3	
1	—	1	Direct SME lending
2	▲	4	Europe CLO senior
3	▼	2	Europe CLO mezzanine
4	—	4	Subordinated financials
5	▼	3	EM credit
6	▲	7	Real estate debt
7	—	7	Senior financials
8	▲	9	Hybrids
9	▼	6	Syndicated leveraged loans
10	▲	11	Europe CLO equity
11	▲	12	Mezzanine tranche
12	▼	10	Europe ABS mezzanine
13	▲	15	Europe ABS senior
13	—	13	Investment grade
13	—	13	High yield
16	▲	17	Money market
17	▲	19	EM government bonds
18	▼	16	Trade finance
19	▼	17	Risk transfer
20	—	20	Developed government bonds
21	—	21	Convertibles
22	—	22	First loss tranche

— No change
▲ Ranked higher
▼ Ranked lower



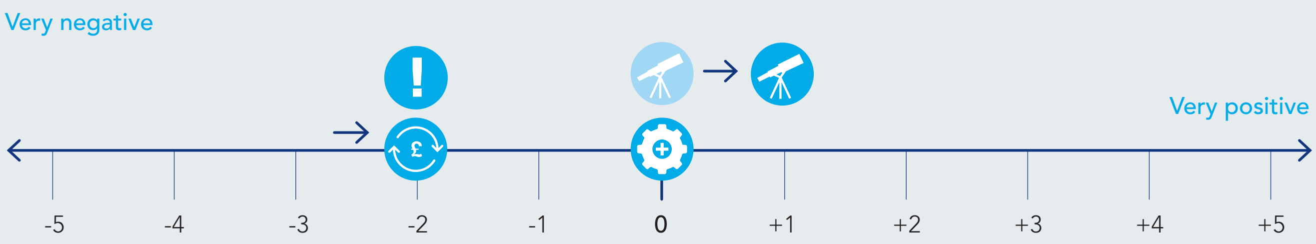
Source Federated Hermes, as of 31 December 2021.

Outside the top-five exposures, syndicated leveraged loans experienced a more significant move down from sixth to ninth as a result of a two-score downgrade in the value score.

A value score increase moved global high yield from 15th to 13th, money markets from 17th to 16th, and EM government bonds from 19th to 17th. A reduction in value score, however, moved European ABS mezzanine tranches from 10th to 12th.

First loss tranches remain at the bottom of the rankings on account of reduced yield despite increasing idiosyncratic risk.

Q4 2021 score card



Economic outlook

- **Move from 0 to +1**

Economic data and earnings seem to have peaked, but the Covid-19 variant and associated restrictions create added uncertainty. Central banks are now moving to tighter monetary policy to curb inflation on growing evidence that price rises may not be transitory.

Credit fundamentals

- **Stay at 0**

Credit fundamentals are still solid with higher EBITDA, lower leverage levels but shareholder-friendly practices are on the increase and event risk from leveraged buyout (LBO) activity is now higher. So far companies have, however, been able to maintain margins through cost management and price rises. Earnings growth is expected to moderate given possible and continued Covid-related disruptions, labour shortages, inflation and supply-chain issues.

Valuations and technicals

- **Stay at -2**

A late-year rally reversed the moves wider following the initial Omicron announcement, which left valuations at rich levels.

Tail risks

Stay at -2

With rich valuations, the risks remain to the downside. The following are the key tail risks that could trigger a correction:

- Omicron or other potential new strains require more severe counter measures, thus having a more negative economic impact than currently anticipated.
- Inflation is higher for longer, potentially triggering stagflation. Labour and energy inflation increases costs, and supply-chain issues cause manufacturing disruption and negatively impact company earnings.
- A policy error from the central banks derails the economic recovery or causes a disorderly market sell-off.
- Rising tensions between world powers impacts global supply chains and global energy supplies. Such a scenario exacerbates the energy crisis in Europe, elevates already high gas prices during the winter, or triggering a spike in oil prices.

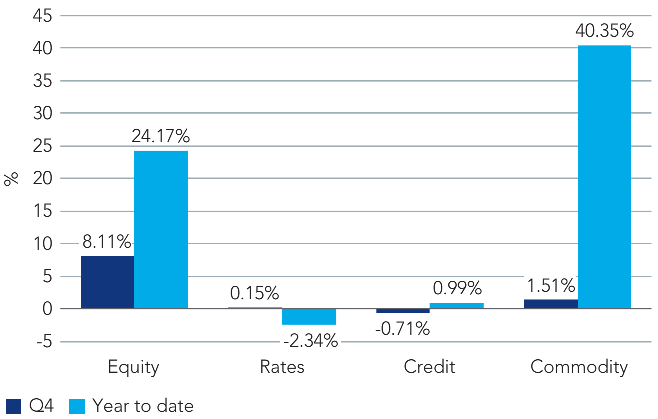
Source: All market data is sourced from Bloomberg, unless otherwise stated.

Multi asset

The fourth quarter delivered a mixed bag of returns from across the asset classes with equities outpacing much of the rest of the market.

Commodities led returns for much of the year, delivering just over 40% as the dynamics of demand outstripped supply. November 2021 proved difficult, however, as fears about the Omicron variant weighed on both the commodity and equity markets. Credit was anaemic for the quarter in what was a fitting close to a lacklustre year for the asset class (Figure 11).

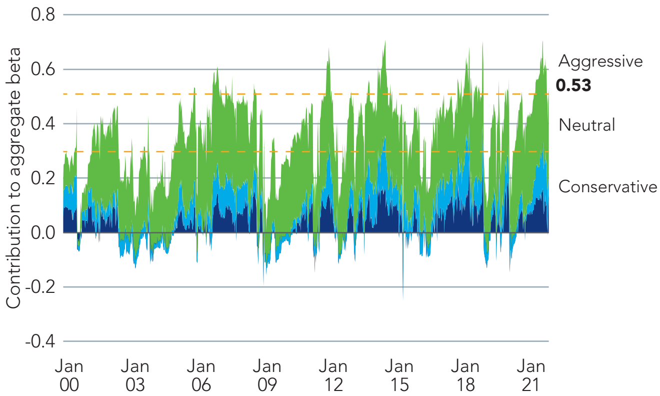
Figure 11: Asset class performance (Q4 and FY2021)



Source: Bloomberg, Federated Hermes, as at December 2021.

In terms of active fund positioning, our aggregate beta to the MSCI World Index (measured across active investors including commodity trading advisors (CTAs), risk parity and mutual funds) is at 0.53 (as at end December 2021). This indicates aggressive positioning, but is off the peaks we saw in Q3 2020. Risk was taken off by the CTAs and risk parity players in the last few weeks of 2021 (Figure 12).

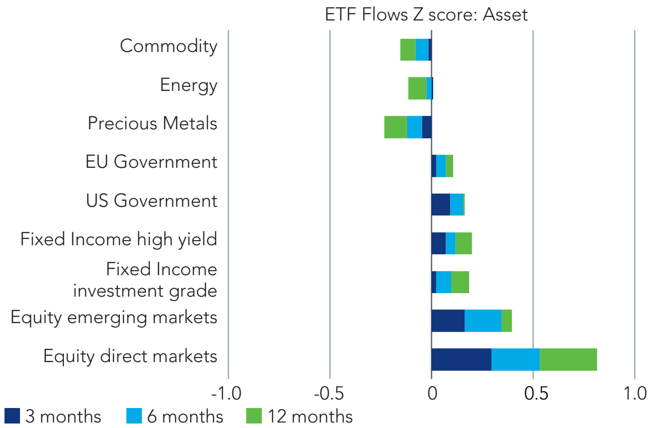
Figure 12: Active investors aggregate beta to equity



Source: Bloomberg, Federated Hermes, as at December 2021.

Our ETF flow Z score (Figure 13) shows us the combined Z scores of ETF flows for each asset for the last three, six, and 12 months. Both fixed income and equity show inflow trends over those timeframes. Commodity, energy and the precious metals sector have experienced outflows.

Figure 13: Exchange-traded fund Z score by asset class

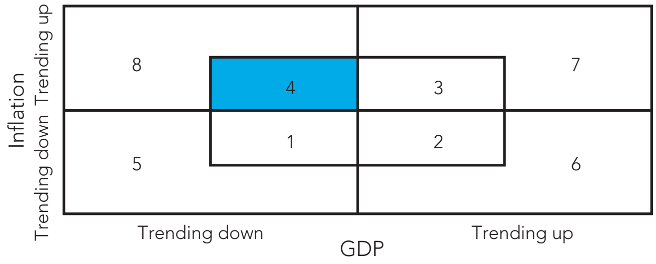


Source: Bloomberg, Federated Hermes, as at December 2021.

For a forward-looking perspective, we use our economic scenario analysis to first determine where the global economy is expected to be, and then we identify the best investments for that scenario historically. At the start of October 2021, the global economy moved to quadrant 4, wherein expected GDP appeared to trend down moderately, while inflation is trending up moderately. This remains the relevant quadrant going into 2022.

The best assets to be invested in for this scenario have historically been commodity carry, treasury inflation-protected securities (TIPS) and government bonds (Figure 14).

Figure 14. Economic scenario quadrant



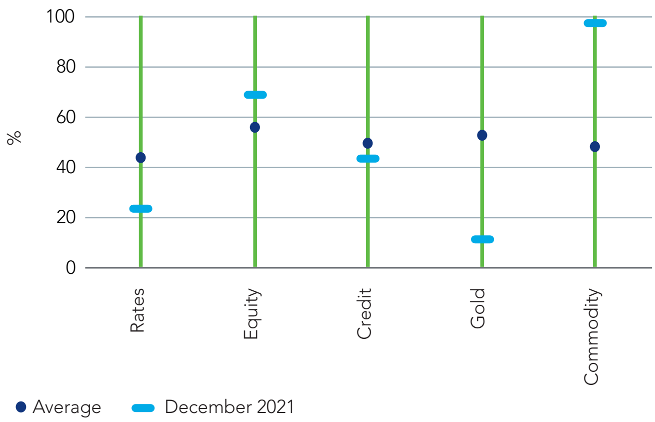
S/N	Q4 top 10	Q4 bottom 10
1	Commodity carry	EU steepener
2	US 7-10 year inflation-protected securities	US credit quality
3	Canada Government 7-10 year	EU credit quality
4	Belgium Government 7-10 year	US small cap
5	UK Government 7-10 year	S&P Financials SPDR
6	US Government 7-10 year	Coffee
7	France Government 7-10 year	National gas
8	Italy Government 7-10 year	US steepener
9	Netherlands Government 7-10 year	Aluminium
10	Germany Government 7-10 year	USD/CHF Cross rate

Source: Bloomberg, Federated Hermes as at 31 December 2021. Based on Bloomberg pooled economists' one-year forward forecasts for both GDP growth and inflation. These forecasts are then compared to their respective six-, nine- and 12-month averages to determine the current trend. These trends are then bucketed into eight quadrants. For example, GDP trend – Current GDP forecast – avg. (avg. 6m GDP forecast), (avg. 9m GDP forecast), (avg. 12m GDP forecast). The split between the inner and outer quadrants is determined by the mid-point between the average and the maximum/minimum on each axis. Data period starts from 1956. The expected asset returns are annualised and are estimated based on a conditional two-factor regression analysis.

To seek out the best investment opportunities, we use our multi asset positioning model to identify which assets are most attractive. This model incorporates three different sub-models, Momentum (which captures short-term price trends), Excess Money Growth (which measures how much excess liquidity is present) and Value (a longer-term model that looks at forward-looking valuations).

Based on our model, coming into 2022, we have a significant overweight to commodities, and a slight overweight to equity. We are significantly underweight rates, as well as credit, which is a shift from what we saw in Q3 2021 (Figure 15).

Figure 15. Multi asset model positioning



Source: Federated Hermes, as at December 2021.

Source: All market data is sourced from Bloomberg, unless otherwise stated.

Economic outlook

In our baseline macro scenario for 2022, the economic recovery from the Covid-related recession will continue, although at a slower pace than in 2021.

While the slowdown will reflect fading re-opening dynamics and waning support from fiscal and monetary stimulus, fundamentals should remain largely supportive. Demand should stabilise as generous cash buffers allow households and corporates to withstand the impact from the looming 'fiscal cliff' represented by the expiry of most emergency fiscal measures. Households, in particular, have managed to build up significant excess savings – amounting to between 5% and 11% of 2019 nominal GDP across advanced economies.

Meanwhile, as the pandemic evolves to endemic equilibrium, supply constraints should gradually ease, supply chains should readjust, and supply-demand imbalances should lessen. Accordingly, inflation should start to gradually ease after the winter months.

A moderating picture for inflation and more clarity of underlying trends in labour markets (likely showing some lingering slack) should allow central banks in advanced economies to gradually withdraw monetary support, leaving financing conditions largely accommodative over the year.

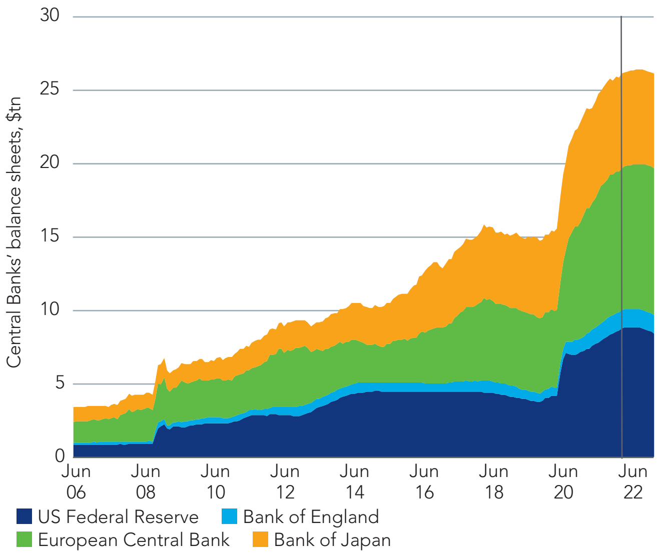
However, central banks will follow markedly different paths. The trade-off between reining-in inflation and supporting the recovery has already shifted towards the former for the US Federal Reserve (Fed) and the Bank of England (BoE).

Following its hawkish pivot in November 2021, the Fed is set to wrap up its quantitative easing programme by March 2022; this would pave the way for lift-off around mid-year (or slightly earlier) and a gradual hiking cycle (at a quarterly rate of 25bps). The BoE started its hiking cycle in December 2021 with a 15bp-rate rise, and is likely to increase its policy rate to 0.75-1% by the end of 2022.

Both the Fed and the BoE are likely to start using their balance sheets to tighten monetary conditions, resorting to quantitative tightening in H2 2022.

In contrast, the European Central Bank (ECB) and the Bank of Japan (BoJ) will likely keep policy rates unchanged this year. The ECB will continue net asset purchases, albeit at a progressively slower pace over 2022.

Figure 16: G4 central banks' balance sheets



Source: Refinitiv Datastream and Federated Hermes, as at January 2022.

On balance, central banks' liquidity will remain elevated this year. In spite of the above, there is a chance that a more challenging economic scenario may emerge given continued uncertainty around inflation.

To point to one such scenario, elevated inflation could affect expectations and wage formation processes and, as result, could become engrained, triggering tighter monetary policies. Crucially, our base line view for inflation relies on the assumption of a return to pre-Covid-19 trends, including consumption patterns shifting back to services from goods; participation rates in the labour market moving back towards pre-Covid levels; and a correction in supply-chain disruptions. However, there is a risk that some of these Covid-induced changes may become more permanent and structural.

In general, risks to our baseline are skewed to the downside due to residual uncertainty about the evolution of the pandemic, an uneven recovery across countries and regions, developments in China, and geopolitical risks.

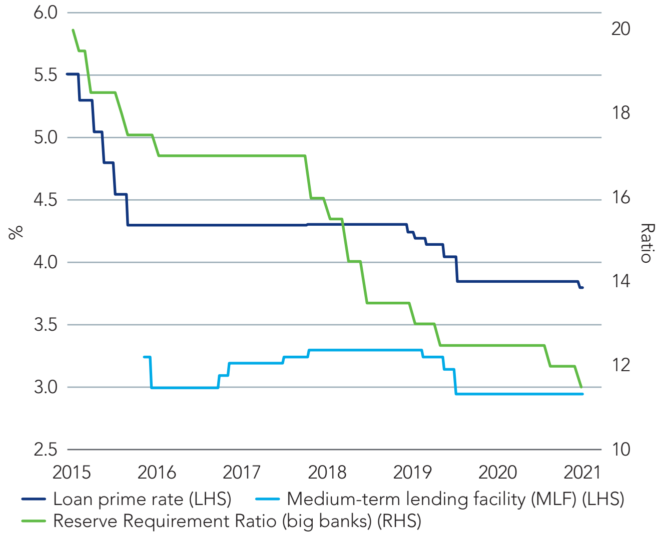
As is often the case, China will continue to be key. The ongoing structural transition of the Chinese economy is rife with risks, but growth is likely to stabilise in the short term as the 20th National Party Congress in autumn 2022 draws near.

While an early withdrawal of fiscal and monetary policy stimulus and a zero-tolerance policy on Covid-19 (intensifying supply constraints) were drags on growth throughout 2021, new regulatory efforts and a crackdown on the property sector (accounting for 25-30% of the economy) played a crucial role mid-year.

These developments need to be read through the lens of the Chinese economy's secular evolution from an export-based and investment-intensive growth model to a more mature model that relies mainly on domestic demand. In the process, policymakers are also trying to tackle imbalances that have built up since c.2000 (i.e. elevated debt, rising inequalities, and environmental damage).

Put simply, the slowdown in growth has been, to some extent, engineered – and the focus is now on the quality and sustainability of growth rather than the quantity. Policymakers will likely try to make the process as smooth as possible, especially during politically sensitive times. More fiscal and monetary stimulus – mainly aimed at supporting domestic consumption and investment – is likely to take place going into autumn's Party Congress (Figure 17).

Figure 17: China signalled a change in its policy stance at the end of 2021



Source: Refinitiv Datastream, as at January 2022.

Source: All market data is sourced from Bloomberg, unless otherwise stated.

Fundamentals

Having held a largely positive view on corporate credit fundamentals throughout 2021, we have become moderately cautious on the asset class into 2022.

Our more conservative stance is driven by our expectation that:

1) As supply-chain disruptions and inflation extend into 2022, earnings growth will moderate, elevating the risk of negative earnings revisions and disappointing guidance

2) After being focused on deleveraging, corporates have begun shifting their attention to returning capital to shareholders. However, issuer behaviour has remained rational so far

3) With significant amounts of unspent cash held in private equity arms, LBO activity will continue, presenting risk (and opportunities) for global credit investors

Offsetting our more cautious view on fundamentals, we note improved relative value and highlight some of the opportunities arising since spreads widened in November 2021.

Corporate earnings: continuing supply-chain issues and inflation

In 2021, corporate earnings were shielded from negative supply-chain effects and inflationary pressures as demand for goods and services remained strong, companies benefitted from pricing power (namely in the autos, healthcare, homebuilding sectors) and inflation was mitigated by cost-saving programmes (particularly among retailers).

Looking further into 2022, extended inflationary pressures and supply-chain issues could result in lower demand and dent the ability of corporates to implement additional cost-saving measures or raise prices. This may result in moderating growth and increase the potential for negative guidance revisions and margin pressure.

Already, in December 2021, US retail sales unexpectedly declined 1.9% versus an expected decline of 0.1% as higher prices reduced spending. With the Omicron variant flaring up in China – 'the world's factory' also known for its zero-tolerance approach to fighting the pandemic – supply-chain disruptions are likely to extend, resulting in additional shortages and inflation.

Toyota Motors has already said that operations at its factory in Tianjin came to a halt in early January 2022 because of mass-testing requirements imposed across the city. Sectors with less pricing power, such as auto parts suppliers, have already begun to issue profit warnings as a consequence of their inability to pass higher costs through to customers.

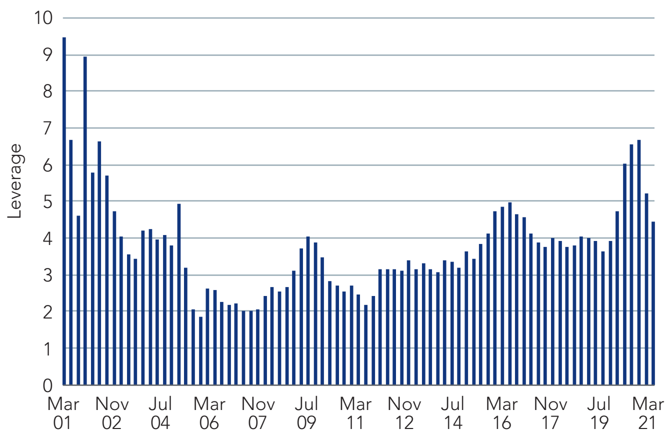
Issuer behaviour remains rational

In 2021, as EBITDA grew from the low base of 2020 and companies focused on paying down debt – some of which was undertaken in 2020 to boost liquidity – leverage metrics, such as interest coverage and leverage continued to improve (Figure 18).

As corporates shift from balance sheet repair mode to a more confident financial position, we are seeing issuers increasing their focus on returning capital to shareholders in the form of dividend increases and announcements of share repurchase programmes.

In some cyclical sectors, such as energy, leverage has declined to levels below managements' long-term targets, providing the opportunity to accommodate more debt to fund M&A or buybacks. However, so far, issuer behaviour appears rational: returning capital to shareholders has been balanced with a focus on preserving current balance-sheet strength. In general, we haven't seen aggressive equity-related initiatives that would be detrimental to bondholders.

Figure 18: High yield net leverage trending down



Source: Bank of America Merrill Lynch.

Event risk on the rise: EU telcos and UK supermarket LBOs in focus

As estimated by S&P Global in January 2021, US private equity dry powder (unspent cash that's available to invest) was at an all-time high of $1.9tn, with as much as $300bn ready to be deployed in Europe[2].

In addition, combined with low borrowing costs and the continued search for yield driving ample liquidity, we saw a comeback in LBOs in 2021, especially across the European telecoms space (along with UK supermarkets). In European telecoms, private equity interest has been sparked by equity underperformance and low valuation multiples as the sector undergoes a major upgrade cycle and is exposed to intense industry competition. Meanwhile, in UK supermarkets, LBO activity has been driven by:

- Predictable cash flows boosted by the pandemic
- The opportunity to make cost savings and drive forward efficiencies under private equity ownership
- The sector's large property portfolios that can be borrowed against to obtain attractive financing terms
- The relative cheapness of UK equities.

Elevated LBO activity presents opportunities for credit investors, including investing in securities that have widened out once the LBO news disseminates. In addition, there is opportunity in entering CDS contracts to capture negative spread movement or, alternatively, moving down the curve ahead of the anticipated announcements.

Credit alpha: eyes on Chinese property

In H2 2021, the fundamentals of the Chinese property sector deteriorated dramatically on account of:

(i) The government's three red line policy (3RL), a supply-side reform aimed at cutting excessive leverage

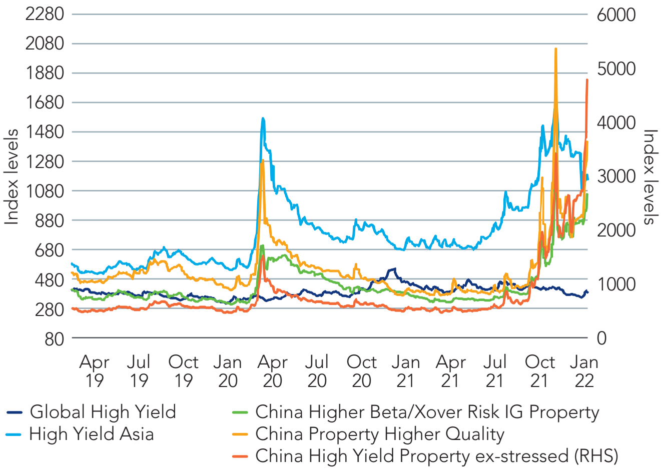
(ii) The two red line policy (2RL), a demand-side reform aimed at cutting systemic risk in real estate by limiting banks' exposure to the sector.

This double whammy precipitated the demise of highly indebted issuers, which needed to accelerate cash collection to cut debt at a time when mortgage approvals were significantly scaled back. As a result, the physical market dropped somewhere between 15-20%, year on year in H2 2021. Local governments have also tightened regulatory scrutiny on presale deposits, triggering a liquidity crisis for the whole sector, including among better-capitalised developers (presales have been a major source of funding for China property developers).

This dynamic creates a conundrum for regulators who must ensure social stability as part of China's Common Prosperity programme while maintaining long-term goals for the sector (3RL and 2RL).

Recent liquidity crises at better-capitalised developers could mark an inflection point for more regulatory loosening. Already, the Ministry of Housing and Urban Rural Development is said to be drafting new escrow rules, which could, in our view, alleviate liquidity conditions onshore. More defaults may ensue, but eventually fundamentals should normalise in H2 2022. Therefore, it is important to keep an eye on highly convex credit opportunities in this space.

Figure 19: Chinese high yield property valuations have become hard to ignore



Source: Bloomberg ICE BofA Bond indices as at January 2022.

Relative value has become more attractive

Despite spreads widening in November 2021, relative value has become more attractive. Through our relative value and security selection lenses, we see opportunities in:

1) Moving down the curve where appropriate

2) Adding exposure in single Bs which have underperformed, via senior to sub, or secured to unsecured switches

3) Emerging markets, especially in Asia.

Source: All market data is sourced from Bloomberg, unless otherwise stated.

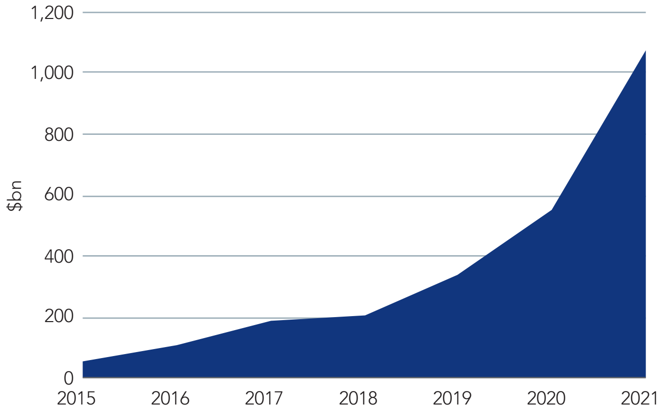
[2] https://www.hermes-investment.com/uki/insight/outcomes/telecoms-buyouts/.

Sustainable finance

The Green, Social, and Sustainability bond market (GSS) has grown to a market capitalisation of some $1.7tn, according to French bank Natixis, on the back of record issuance[3].

As per Figure 20, the $1tn of GSS bonds issued in 2021 amounted to nearly twice the issuance in 2020 – itself a record year.

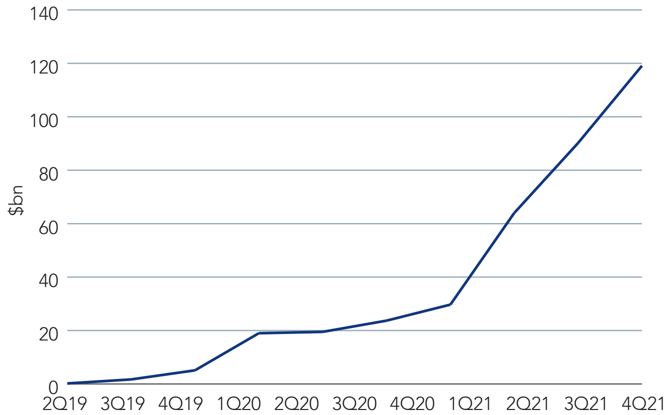
Figure 20: Annual global issuance: GSS-labelled bonds ($bn)



Source: BNEF, as at year-end 2021.

One of the fastest-growing security types in that market is the sustainability-linked bond (SLB). After debuting in 2019, over the second half of that year and in 2020, companies issued some $10bn of SLBs. However, with the surge in issuance of 2021, cumulative issuance crossed the $100bn threshold last year[4].

Figure 21: SLB market: cumulative volume since inception ($bn)



Source: Federated Hermes International, Bloomberg, as at end-2021.

Unlike use-of-proceeds bonds, such as green bonds and social bonds, the proceeds from SLBs can be used for general corporate purposes for companies that do not have specific 'green' projects but want to showcase their sustainability objectives. For the bond to earn the sustainability-linked label, its issuer must attach punitive changes to debt service obligations – generally, either rising interest payments or elevated notional amounts due at maturity – if it misses sustainability targets.

[3] Green Bonds review: Latest Trends (Natixis. October 2021).
[4] Source: All market data is sourced from Bloomberg as at December 2021 unless otherwise stated.

What are SLBs?

Sustainability-linked bonds (SLBs) are any type of bond instrument for which the financial and/or structural characteristics can vary depending on whether the issuer achieves predefined sustainability/ ESG objectives. In that sense, issuers are thereby committing explicitly (including in the bond documentation) to future improvements in sustainability outcome(s) within a predefined timeline. SLBs are a forward-looking performance-based instrument.

Source: International Capital Markets Association[5].

SLBs have become like Marmite to the market: participants either love them or hate them. Some take issue with the fact that the proceeds of these sustainability-labelled securities can be used for any corporate purpose, sustainable or not.

Some point out that, no matter the KPI chosen, issuers set their own level of ambition and accountability via sustainability performance targets (SPTs). In coordination with their relationship banks, they also set amenable changes in financial features if the issuer misses those SPTs.

Others note that issuers' self-imposed, punitive features (e.g. a coupon step-up) can lack financial materiality. (For example, we are currently concerned about the market norm of a 25bp step-up per KPI missed, regardless of base coupon size or credit quality of the issuer.)

On the other hand, it is encouraging that companies in hard-to-abate sectors – or those that have no specific financing needs for a use-of-proceeds bond – have found a path to align their own sustainability objectives with their cost of capital as a demonstration of commitment to the topic.

The International Capital Markets Association (ICMA) has published several framework documents establishing best-in-class principles, structures and key performance indicators (KPIs) for such bonds [6].

Although we are not forced buyers of any security, we maintain a favourable view on the SLB market[7].

As with the financial aspects of any bond, we believe investors must analyse the ambition and accountability of the sustainability agenda of a company issuing SLBs.

As such, whether we chose to buy an SLB or some other security of that same issuer, our own credit and sustainability analysts see value in the structure of an SLB as a means of assessing the sustainability credentials of a company and determining how credible they are in being able to convert potential positive change to realised change.

That there is open debate around the SLB market reflects its nascency and the fact that it has yet to mature into a fully developed market governed by widely accepted norms.

Source: All market data is sourced from Bloomberg, unless otherwise stated.

[5] Sustainability-Linked Bond Principles June 2020 (icmagroup.org).

[6] Ibid.

[7] Enel steps up: the world's first SDG-linked bond – Hermes (hermes-investment.com);
Sustainability-linked bonds get the green light | Federated Hermes (International) (hermes-investment.com).

Valuations and technical

Investor sentiment remained weak in the fourth quarter as volatility returned to markets

Fears surrounding the Omicron variant pushed credit spreads to their 2021 wides in November, improving relative value and easing convexity issues seen earlier in 2021. Fears quickly subsided, however, and we saw the market tighten sharply in December.

During November's widening – and having traded in a tight range at the start of the quarter – we saw implied volatility (the cost of hedging) spike and break away from realised volatility, reflecting investors' nervousness around tail risk.

Figure 22: Implied vs. realised volatility on iTraxx Xover Index

Source: Citi Velocity and Bloomberg.

Flows into European high yield were weak in 2021; and Q4 was no exception. This left cumulative ETF flows largely flat for the year and mutual funds slightly positive.

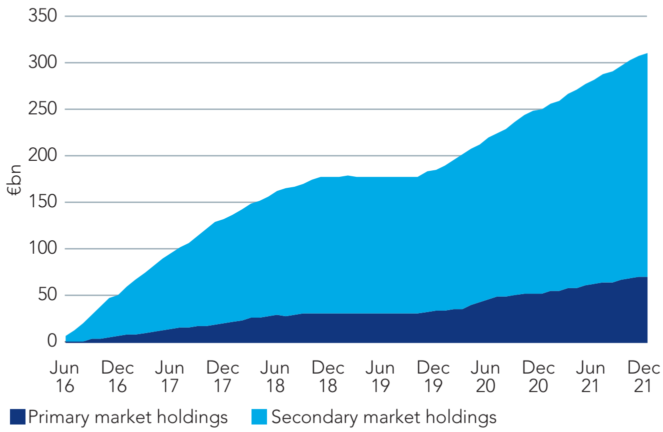
In the US, the picture was similar, despite large inflows into high yield ETFs in December 2021. Cumulative flows into US high yield ETFs were slightly positive for the year overall while mutual funds remained in net outflows, both having seen significant inflows in 2020.

On the issuance side, high yield issuers have spent the past 20 months focussing on strengthening their balance sheets and extending maturities, allowing them more flexibility in their refinancing decisions. This meant that, despite a quiet December, the fourth quarter delivered a solid end to a record year for high yield issuance both in Europe and the US.

In investment grade, the story was different, with gross supply down compared to 2020 and continued support from central bank purchase programmes creating a positive technical for the market. In Europe, for example, the ECB grew the size of its Corporate Sector Purchase Programme (CSPP) portfolio to €310bn in 2021, up from €185bn prior to the pandemic (Figure 23), mopping up a large portion of investment grade corporate supply.

As these schemes begin tapering, we expect this powerful technical for the investment grade market to reverse.

Figure 23: ECB cumulative holdings under CSPP (€bn)



Source: European Central Bank.

In ESG bonds, labelled issuance exploded in 2021 with global corporates issuing $449bn in ESG bonds over the year, nearly 1.5 times the volume issued in 2020. Sustainability-linked bonds (SLBs) are making up a fast-growing share of total supply, but green bonds continue to dominate.

Source: All market data is sourced from Bloomberg, unless otherwise stated.

Public credit

Despite the rollercoaster that was high yield performance in Q4, total returns for the asset class were down by a muted 0.33% in dollar-hedged terms, ending the year up 3.04%.

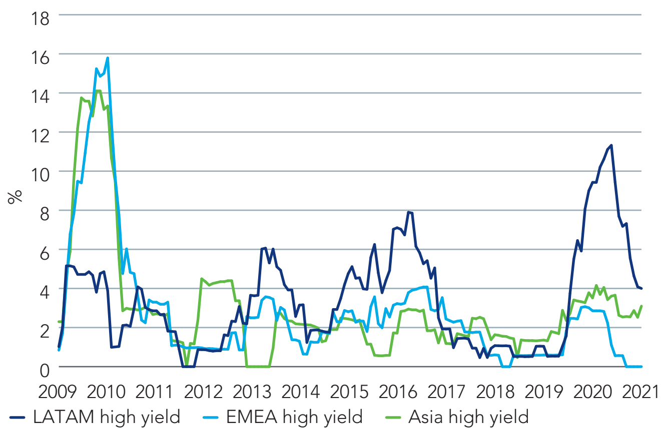
Greater sensitivity to rates left global investment grade with a gain of 0.05% in Q4, while the asset class finished the year with a total return of -0.76%.

From a regional perspective, we see little difference in relative valuations between the European and US markets. However, emerging market high yield continues to materially underperform its developed market counterpart, largely on the back of Chinese high yield where many bonds are still trading at distressed levels.

In 2021, the default rate in EM corporates was 7.1%, the highest level since 2009 when it was 10.5% (Figure 24). Chinese real estate will likely continue to be the biggest component of EM corporate defaults in 2022 as more developers face distress. Given the rise in credit stress and continued market pressures, many market participants expect the default rate for this sector to reach c.20% this year.

Over the coming months the sector will see heavy bond maturities with potentially more maturity extensions/bond exchanges and payment defaults. Our view is that tail risks will remain significant in this sector and, as such, we prefer to stay up in quality and keep a diversified portfolio of exposures in it. We do not expect meaningful contagion across the rest of Asian high yield or to EM corporates more broadly.

Figure 24: EM corporate high yield default rate – last 12 months (%)



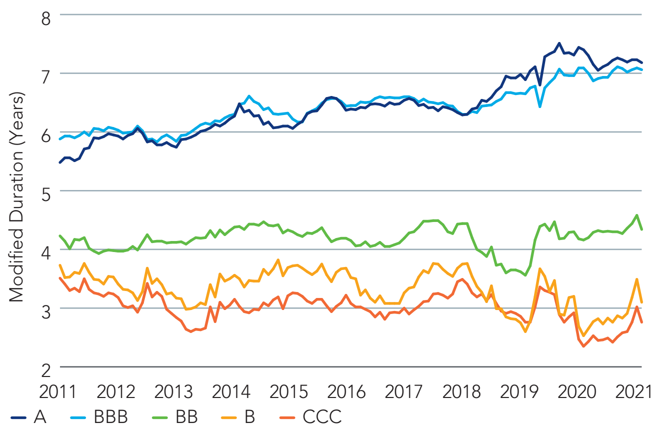
Source: Bloomberg, Federated Hermes International.

From a credit quality perspective, with interest rate volatility rising and many investors concerned about the effects of more hawkish central bank policy on their portfolios, we look at the relative sensitivity of different segments of the global credit market to rising rates.

Among rated bonds, there is a clear divergence between investment grade (those rated BBB and above) and high yield bonds, with the duration of investment grade also having increased steadily over the last 10 years. In high yield on the other hand, sensitivity to interest rates remains low, and has even fallen at the lower-quality end of the market where most of the returns are driven by credit risk.

In our view, a flexible mandate remains the best way to manage the risk dynamics of the current market. This strategy gives investors the ability to select between investment grade and high yield, while also making use of a broad array of instrument types key in delivering alpha and managing risk.

Figure 25: Modified duration by credit quality in global credit



Source: ICE Bond Indices, Federated Hermes International.

Source: All market data is sourced from Bloomberg, unless otherwise stated.

Financials

Follow the rates! Considering where we are in the cycle and the prospect for raising rates, it's apt to start with equities and the US market.

Trying to make sense of 2021 and looking back on the S&P's +27% performance, one would be forgiven for thinking it was easy to make money in today's market. In fact, it didn't feel that way in financials with significant dispersion between subsectors, and multiple swings in bias between value and growth. The US banks did well with the KBW Bank Index returning 38% (Figure 26).

Figure 26: KBW US Bank Index – 2021 performance

Source: Bloomberg, December 2021. The KBW Bank Index is designed to track the performance of the leading banks that are publicly traded in the US. The Index includes 24 banking stocks representing the large US national money centres, regional banks and thrift institutions.

European banks mirrored this performance, delivering +40% on a total return basis[8].

Financials enjoyed a strong start to 2021. After more than a decade of deleveraging, the European banking sector's capital ratios are at multi-decade highs according to H1 2021 data from the European Central Bank:

- Common equity tier 1 ratio (CET1) of 14%
- 5.5% leverage ratio.

This is important for financials on the credit side, but not new news.

The sector was also able to withstand both the real-life stress test of Covid-19 and the European Banking Authority's own very tough simulated stress tests over the course of the year. The sector is also well protected by liquid balance sheets.

Importantly, the rebound from the Covid years of 2020-21 has been faster and stronger than expected. Monetary and fiscal policies have been successful in propping up the real economy in developed markets. In addition, both banks and insurers have taken structural actions to improve earnings using the full range of tools in their kit, including cost cutting, digitalisation, re-sizing their branch footprint, and M&A.

The only lever they did not pull was the one most related to rates: the net interest margin (NIM). This relationship continued to drift lower on both sides of the Atlantic. Just as financials learn to live with low rates, things might start to change, at least in the UK and US.

Looking forward, earnings revision for 2022e and 2023e have been strong. The bulk of this strength is the result of lower credit costs, along with revenue uplifts. In European – unlike the US – we have to go back to H1 2017 to see forecasts as positive as this.

Rates will be the key theme for 2022. Conceptually, financials (banks, in particular) are helped by the prospect of higher rates on account of them being asset sensitive. On average, US financials see a 15% boost to earnings per share following an average +100bp move in rates.

P&L leverage is on the short end (the market expects four to five hikes total between '22-'23) but the long end controls the price-to-earnings ratio (P/E), so as often, the bond market, specifically 10-year treasuries, will be key to bank performance in 2022.

Financials, in Europe too, remain geared to higher interest rates. We would expect a parallel shift of +100bps in all curves to add a quarter to the sector's pre-tax profits. Rates sensitivity is stronger for banks with lower earnings.

Having satisfied bondholders and regulators over the last eventful decade, the next challenge for the sector will be to balance the interest of shareholders (eager for more buybacks and increased dividends) with that of the bondholders that favour a more gradual approach and want to maintain sound capital buffers. Considering the fundamentals, the expected supply and the yield on offer, we still prefer the subordinated part of the capital structure.

For those who are interested in having further details on the thematics pertaining to global financials, please refer to our Fiorino blog.

Source: All market data is sourced from Bloomberg, unless otherwise stated.

[8] Source: Bloomberg 31 December 2021.

Leveraged loans

The S&P European Leveraged Loan Index (S&P ELLI) ended the year at 98.8, marginally behind its end-September 2021 level of 98.9.

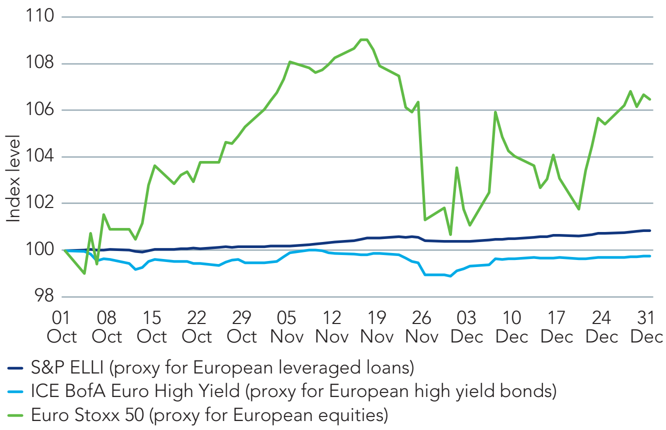
Despite this, 2021 remained a strong year for the leveraged loan market as the index delivered a +4.8% return for the period, its highest performance since 2016. This return was driven by both interest carry and price appreciation as the index started the year at 97.6.

In Q4 2021 and, despite the market volatility caused by emergence of the Omicron variant, the S&P ELLI returned +0.9%, outperforming the ICE BofA Euro High Yield Index, which was down 0.2% (Figure 27).

This performance was driven by:

- The features of the asset class: Leveraged loans are less liquid than high yield bonds. This acts as a technical support in times of moderate volatility (although it becomes a hurdle during periods of severe volatility, as it did in Q1 2020). Likewise, floating rate instruments are also a feature of the asset class – and these are supportive in the current inflationary environment.
- Buying opportunities for new CLOs and warehouse openings: 2021 was extremely busy for the CLO market and the surge of new deals (c.€38.6bn for the year) created a negative net supply (the difference between new loan supply and CLO issuance) of €3.7bn on a three-month rolling basis. This dynamic supported the secondary market which remained strong over the quarter.

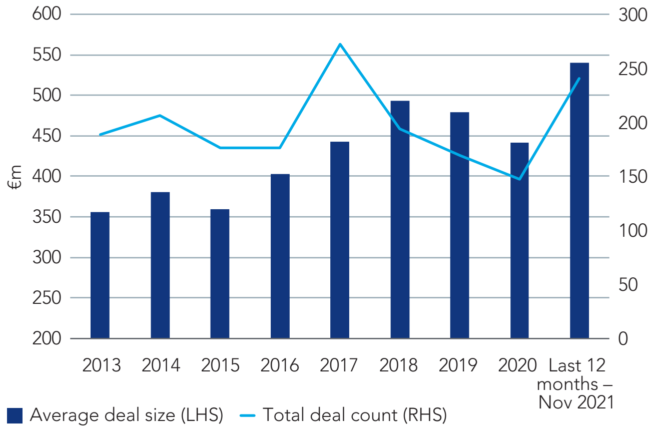
Figure 27: 2021 Performance by asset class (base 100):



Source: Bloomberg, year to end December 2021.

Surprisingly, and despite the net loan shortage, new issue spreads remained stable at between +350 and +400 bps, suggesting the absence of non-CLO investors along with a fresh dynamic around loan new issues. Since 2013, the average size of a primary issue rose from €356.4m to €539.7m for the 12 months to November 2021. Meanwhile, the deal count rose from 189 to 241 (Figure 28).

Figure 28: Evolution of average deal size (in €m) and deal count



Source: S&P ELLI – LCD News.

CLO managers (i) seek diversification (within and between their deals), (ii) need to respect a high number of limits and guidance and (iii) most importantly, need their arbitrage to work. Consequently, the absence of non-CLO investors and the CLO mechanism helped to support yields.

Source: All market data is sourced from Bloomberg, unless otherwise stated.

Structured credit

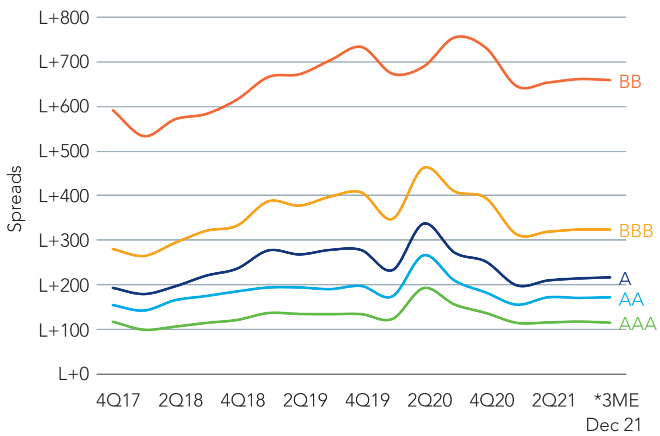
The European collateralised loan obligations (CLO) market witnessed record issuance in 2021 with €38bn of new issues versus a Covid-suppressed €22bn in 2020.

The last year also saw €41bn of resets, and €18bn of refinancings[10]. With Japanese anchor investors (who were prolific in the 2017-2019 period) on hold in 2021, and divesting a large portion of their European CLO investments, significant issuance was absorbed by new accounts or existing accounts with increased appetite.

Buoyed by low default rates and favourable ratings trends, demand for mezzanine CLOs (especially investment grade), remained strong throughout the year, with investors attracted to the types of yields available across the capital stacks in the asset class.

In the absence of any credit fundamental momentum either way, the basic economic theories of supply and demand played out in European CLOs, and spreads remained relatively range-bound as any increase in investor demand was met with increased supply from CLO managers.

Figure 29: Average EU coupon stack



Source: Leveraged Commentary and Data (LCD). *Data is through December 2020.

Our positioning remains focussed on two types of managers:

(1) Those driven by credit fundamentals, and

(2) those who have displayed deft trading styles that build par in times of increased market stress and volatility.

We believe both types of managers will weather any potential deterioration in the credit outlook.

On the asset-backed securities (ABS) side, residential mortgage-backed securities (RMBS) and consumer ABS credit fundamentals have remained generally solid despite the roll-off of government schemes to support borrowers during the worst of the pandemic.

With interest rates remaining low and a number of borrowers increasing their savings during the past two years, there is still plenty of cushion for many borrowers.

However, we have seen some deterioration in +90-day arrears in UK non-conforming RMBS, which we expected as this sector of the market caters to borrowers with more unusual incomes (including the self-employed) and those with a history of credit issues. Despite this, spreads across the ABS market tightened over 2021 and, we believe, remain set to stay tight as investor demand is high for floating-rate asset-backed exposures while supply has increased only moderately.

Source: All market data is sourced from Bloomberg, unless otherwise stated.

[10] Source: Leveraged Commentary and data as at December 2021.

Private credit

Amid the optimism of the vaccination rollout and the reopening of economies in the UK and Europe, the market enjoyed a buoyant fourth quarter.

Transaction flow remained at an all-time high across Europe, particularly in the south of the region where less creditor-friendly laws have made for a more challenging market environment.

This buoyancy is expected to continue in 2022 even if the threat of lockdown from emerging Covid variants continues to hover over economies. With significant dry powder (unspent cash that is available to invest) available, we expect competition for transactions to continue to be intense for the remainder of 2022.

Unitranche lenders are fighting to win back market share and have been successful in some countries, including the UK, France and Germany. As a result, there is expectation in the market that leverage will continue to rise in the unitranche segment – possibly to above 7.5x.

In the senior secured space, we expect yields to remain steady. However, in the unitranche space, we predict a marginal fall in yields over the next year. The senior secured segment is controlled by the banks who are unable or unwilling to reduce yields due to their own return-on-capital constraints while unitranche lenders themselves are not able to undercut senior secured lending yields due to their return targets. In the unitranche space, we do expect to see yields falling marginally as competition to deploy continues; and this already started to happen in the fourth quarter. That said, the declines are likely to be marginal as competition will be primarily focused on loan terms not price.

A rise of defaults in the short to medium term could mean an increase in yields, although defaults have remained low and are not expected to climb significantly in the coming year. Nonetheless, increased pressures on supply chains (which have brought into question the 'just in time' logistics practices of many European companies) remain a risk factor. Higher energy prices, which have started to impact some borrowers, are also hard to ignore. Further rises, coupled with a roll-off of hedges, could have a more material impact going forward.

Labour costs, meanwhile, have started to increase – and, during the fourth quarter, a rising number of borrowers reported challenges in recruitment and retention of staff. Finally, an increase in UK interest rates could impact some borrowers with GBP-denominated loans. This will be especially the case if some unitranche lenders relax the requirement for borrowers to hedge a portion of their loans.

Although the market was buoyant in the fourth quarter and is expected to remain so in 2022, participants are all too aware of the risks and uncertainties that lurk in the background. For the year ahead, we continue to see value in the creditor-friendly northern European jurisdictions, especially Scandinavia which has not witnessed the level of competition seen in other parts of Europe. Similarly, senior secured lending is the key area of focus in a market that requires discipline in lending practices.

Source: All market data is sourced from Bloomberg, unless otherwise stated.

Asset-based lending

As we begin yet another year with lockdowns and school closures across Europe, the nature of new Covid-19 variants and differing political and regional responses continue to make short-term planning and forecasting difficult.

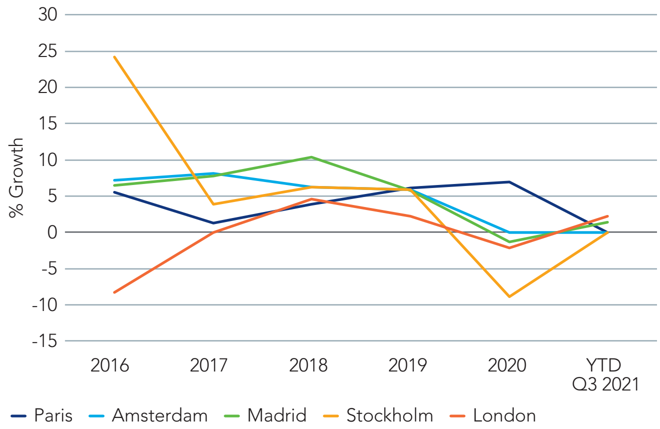
Somewhat unexpectedly, UK rent collections in the fourth quarter were among the lowest seen since the pandemic began[11]. Although our debt portfolio escaped the worst of the effects that such a dynamic might have on real estate equity portfolios in general, we are cautious about ongoing volatility as we progress through the start of the year.

Transaction volumes and valuations have recently trended upwards, indicating that, despite short-term volatilities, investors are largely looking beyond the pandemic towards the medium and long term.

Both the food & beverage sector and the retail sector are seeing valuation recoveries and stronger operating performance (albeit not at pre-pandemic levels). We are satisfied with the performance of our investments in these sectors over the last two years, and we continue to see opportunities in these areas of the market.

Looking further ahead into 2022, we expect total returns in real estate to be driven more by capital value movements than rental growth. Demand for space is dampened by the pandemic in all sectors except logistics. With the total supply of real estate stable in the short term, the reasonable market economist might expect rental levels to fall with these changes in demand. However, the lack of homogeneity in the underlying assets means that rents for the 'right' assets will continue to be strong, and their ability to achieve these rents will see yields hold firm. For the 'wrong' assets, rents will fall dramatically and no amount of yield tightening can compensate for this. The flight to quality, therefore, seems likely to continue while the pandemic remains high on the agenda.

Figure 30: Prime rental growth: office



Source: JLL, Q3 2021.

Source: All market data is sourced from Bloomberg, unless otherwise stated.

The value of investments and income from them may go down as well as up, and you may not get back the original amount invested. Investments overseas may be affected by currency exchange rates. Past performance is not a reliable indicator of future performance.

Investments in emerging markets tend to be more volatile than those in mature markets and the value of an investment can move sharply down or up.

Where the strategy invests in debt instruments (such as bonds) there is a risk that the entity who issues the contract will not be able to repay the debt or to pay the interest on the debt. If this happens then the value of the strategy may vary sharply and may result in loss. The strategy makes extensive use of Financial Derivative Instruments (FDIs), the value of which depends on the performance of an underlying asset. Small changes in the price of that asset may cause larger changes in the value of the FDIs, increasing either potential gain or loss.

[11] Source: JLL, January 2022.

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Federated Hermes
International

Federated Hermes

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