J O Hambro
Capital Management Group

JOHCM Global Income Builder Fund

GLOBAL VALUE AND INCOME DISPATCH

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Stranger things – what's happening in the investment-grade corporate debt market?

"Here we are on top of the world. We have arrived at this peak to stay here forever. There is, of course, this thing called history. But history is something unpleasant that happens to other people. We are comfortably outside all of that I am sure." – Arnold Toynbee, recalling the Diamond Jubilee celebration of Britain's Queen Victoria in 1897.

The scramble for liquidity – is this 2008 all over again?

It feels a lot like 2008 to those of us who experienced the overnight evaporation of liquidity and "tape watching" to assess what the monetary and fiscal policies coming down the pike may mean for your asset class. While there are notable differences to 2008, the search for liquidity and the carnage it leaves behind is the same.

The investment grade corporate bond market has become one of the casualties of investors' search for liquidity. It therefore deserves a second look.

The pressure we have seen in the commercial paper market, along with large redemptions from short-dated corporate bond funds, have created two interesting areas of opportunity, in our view. We believe a so-called barbell strategy of investing in a basket of short-dated (1- to 3-year maturities) and long-dated (20- to 30-year maturities) bonds from companies with higher credit ratings and strong balance sheets is an attractive one.

In this FAQ, we answer some of the questions we have received on this important part of the global bond markets.

Q: Why are my bond funds not providing downside protection in the severe stock market sell-off?

The simple answer is that bond funds don't typically contain just one type of financial asset. Multi-asset funds that may be labelled investment grade can invest across many different asset classes, such as Treasuries, securitised assets (e.g. agency mortgages), and investment grade corporate bonds (often also referred to as credit; in this instance high grade credit as opposed to high yield debt, which is of lower credit quality).

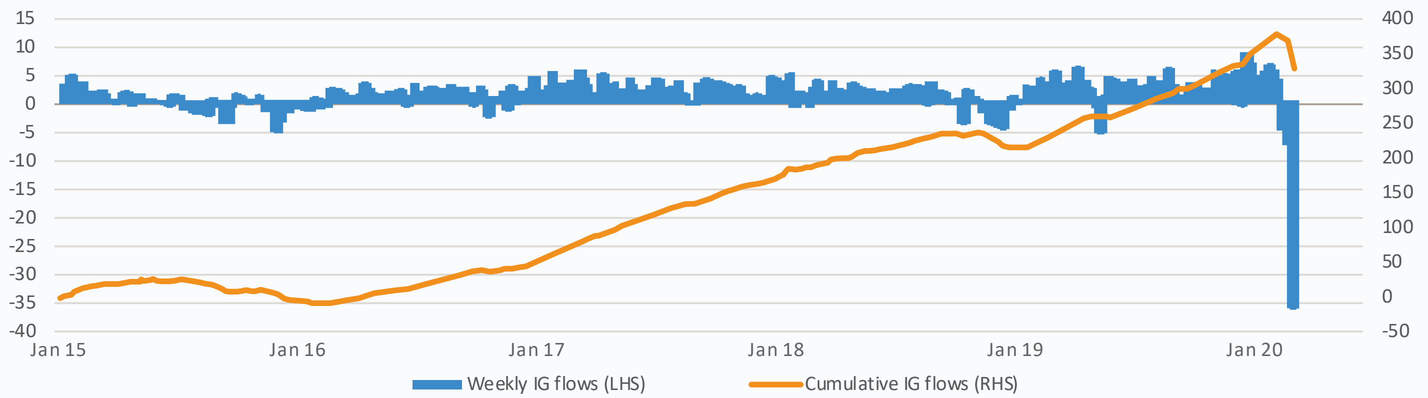
Under normal market conditions some financial assets are negatively correlated with stocks (meaning their prices move in opposite directions), and corporate bonds should provide some degree of downside protection as share prices fall. However, the correlations break down very easily when the search for liquidity (the so-called dash for cash) intensifies.

Q: Why has the value of my investment grade bond fund fallen?

The need for liquidity is showing up as stress across many markets as the funding markets that underpin the financial system – think of them as the plumbing and pipes, dull but really important – struggle. As investors look to raise cash, we have seen effects in the Treasury market, as well as in mortgage-backed securities (MBS), commercial paper, and short-dated investment grade corporate bonds (bonds that will mature in just a few years).

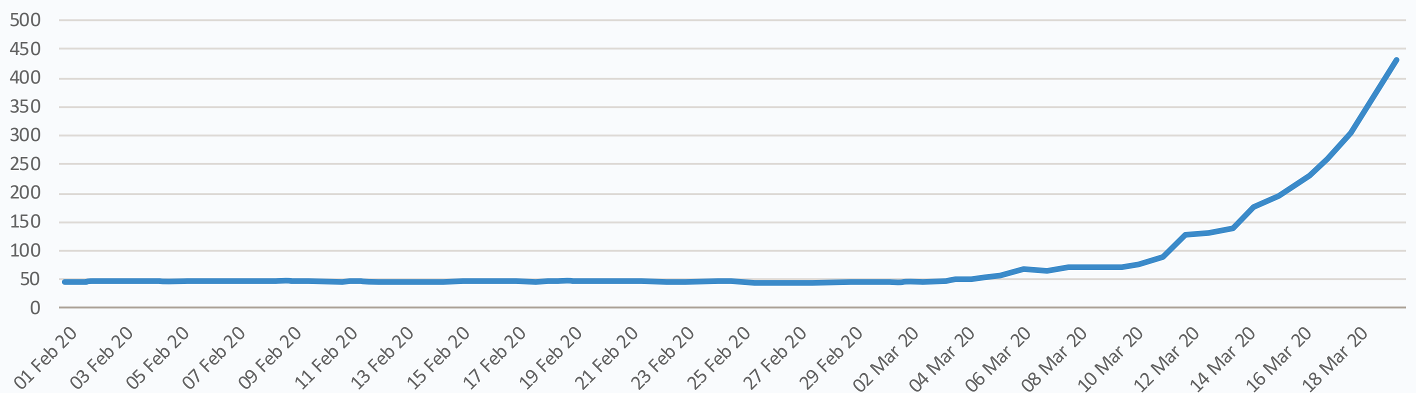
These are all connected by a single thread: funding markets and the fact that various investors, including funds that use leverage, take part in them. Prime money market funds invest in high quality corporate bonds and commercial paper; cash-rich companies buy investment grade bonds; mortgage REITS buy agency MBS; and relative value investors invest across the spectrum.

All these different financial actors rely on the repo/commercial paper markets to function. At a time when investors are trying to sell whatever financial assets they can to raise cash, the ripple effect cascades through various asset classes. This is the main driver behind the Federal Reserve's recent announcements of various facilities to help unblock the financial system's plumbing and pump liquidity into the financial markets.



Source: Goldman Sachs/Lipper as at 18 March 2020.

Short-dated investment grade bonds have notably underperformed as various holders have sold down their holdings to raise cash.



Source: Barclays 1-3 year US IG Corp Index Spread/Bloomberg.

Q: What has the Fed been trying to do with its recent actions?

The Fed has been incredibly proactive in addressing the liquidity issues in the market. All the programmes announced so far tackle the lack of liquidity we have seen in the Treasury, commercial paper, agency mortgages, residential mortgages, municipals, and investment grade corporate bond markets.

The central bank's measures also address the shortage of US dollars in the global financial system, which is crucial as investors globally look to hold dollars in these times of market stress.

The Fed is effectively providing a liquidity backstop (for a fee) for many of the asset classes that provide the underlying collateral for short-term funding markets. This should help to alleviate the liquidity squeeze that is distorting valuations across the asset classes. But because of the economic shutdown credit risk will still need to be incorporated into the risk premium (effectively the additional return you get for investing in financial assets riskier than Treasuries).

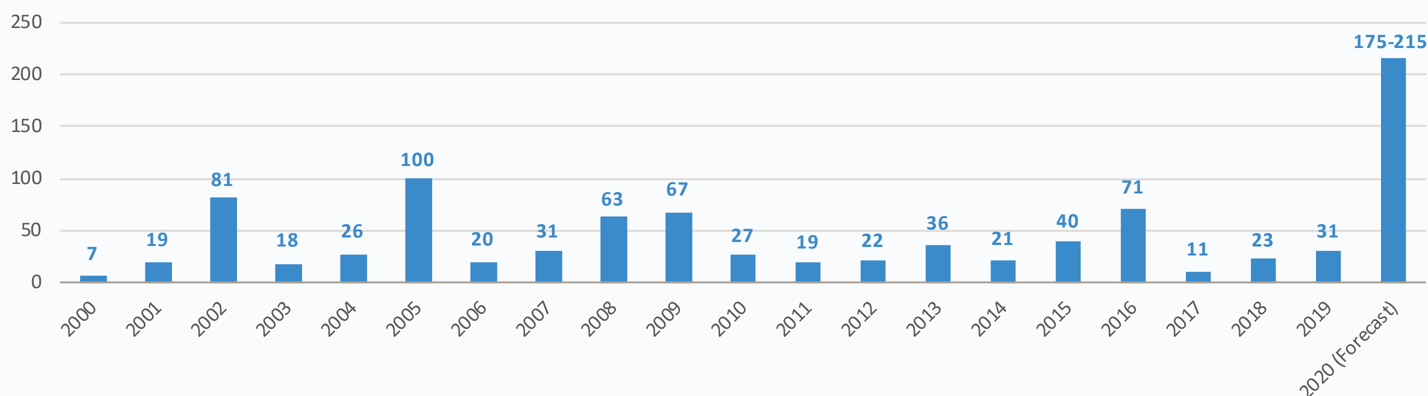
Q: The BBB downgrade risk scares me. Are you worried?

Investors are right to be concerned about downgrade risk of BBB-rated corporate bond issuers that are at the centre of the global economic slowdown and/or carry higher levels of debt. However, there are many companies and industries represented in that BBB bucket, each of which will perform differently under economic stress.

Let's start with the facts:

- The BBB-rated part of the US investment grade corporate bond market is worth $3.35 trillion in total. Of this, the weakest segment represents 24.9%, or $888 billion, in face value (as of 20 March 2020).
- So we are not talking of trillions of dollars of assets being affected, as per some hysterical media reporting, even if every company in the weakest segment were downgraded from investment grade to high yield (and became so-called fallen angels, companies with a credit rating of BBB– or Baa3, or lower). Nonetheless, the weakest segment of the BBB-rated part of the investment grade bond market still bears comparison to the US dollar high yield market (valued at $1.2 trillion).
- Unlike high yield companies, investment grade-rated companies tend to be asset-rich or have access to the stock market in order to raise capital (despite depressed share prices). These are viable options to avoid being downgraded to high yield. This, of course, will depend on the company management's talent to navigate the choppy waters. Some management teams will be proactive and do whatever they can to avoid a downgrade; others will just take their chances. The challenge for an investor is to separate the wheat from the chaff.

- Sell-side estimates range from $175 billion to $215 billion of potential fallen angels this year (including ~$32 billion that have already transitioned, largely consisting of energy companies). This would make it a record year.



Source: JP Morgan.

While a $175 to $215 billion figure is pretty large in the context of the $1.2 trillion US high yield market, the most notable difference today is that the economic impact of Covid-19 is expected to be mostly temporary, whether it lasts three months or a year – some industries will experience structural changes but let's not digress.

While the economy is in deepfreeze these companies should be able to manage their liquidity and cash flow, as well as cut costs to offset the hit to their earnings. Credit rating agencies have historically been more patient with companies that proactively manage their leverage ratios (e.g. dividend and share buyback suspensions, capex cuts) as ratings are meant to be "through the cycle". Industries at the centre of the slowdown, such as travel, leisure, transportation and energy, are likely to be disproportionately affected.

There are, of course, no guarantees, but that is our current assumption. The risk to our view is that economic downturn lasts longer than expected, with a notable impact upon the future profitability of these companies.

Finally, financial markets are forward looking. Energy and autos are trading at stressed levels. As of 20 March, approximately 3% of the overall investment grade bond index was trading at spreads (the difference in yields to Treasury bonds) greater than 1,000 basis points (bp) and 15% trades above 500bp. At these levels, it is a different entry point to the market than a month ago, when overall spreads were in the mid-100s.

Fallen angels by sector

		2020 Fallen Angel estimate range		
Sector	**Par Amt outstanding ($bn)**	**Low ($bn)**	**High ($bn)**	**Central case ($bn)**
Energy	508	$25	$60	$50
Automotive	165	$0	$36	$36
Transportation	179	$2	$45	$24
Healthcare/Pharma	591	$0	$18	$12
Leisure gaming hotels	26	$5	$11	$8
Property/Real estate	158	$5	$11	$8
Capital goods	285	$5	$10	$8
Consumer ex-leisure/gaming	400	$5	$10	$8
Banks	1,362	$0	$12	$6
Basic industries	189	$0	$10	$5
Media/entertainment	198	$0	$5	$5
Finance companies	155	$0	$8	$4
Retail	174	$3	$5	$4
Insurance	220	$1	$4	$3
Technology	440	$0	$10	$0
Telecoms	246	$0	$0	$0
Utilities	438	$0	$3	$0
Estimated Fallen Angels	**5,744**	**$51**	**$258**	**$182**
YTD Fallen Angels	**-**	**$32**	**$32**	**$32**
2020 Fallen Angels	**-**	**$83**	**$290**	**$215**

Source: JP Morgan.

Q: Is there an opportunity now in the corporate bond markets?

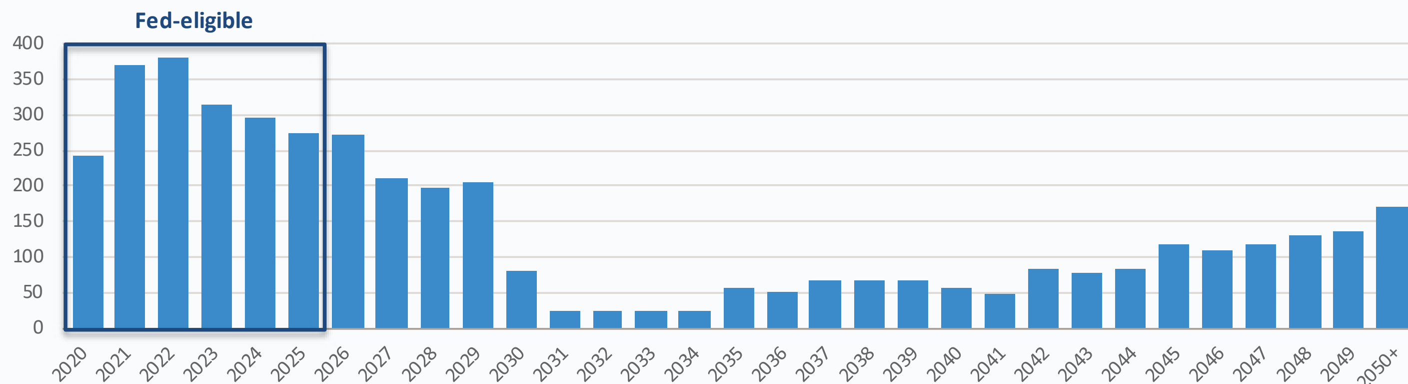
The short answer is yes. We continue to prefer investment grade over high yield, as we have since the second half of 2019. The pressure we have seen in the commercial paper market, along with large redemptions from short-dated corporate bond funds, have created two interesting areas of opportunity, in our view.

We believe a so-called barbell strategy of investing in a basket of short-dated (1- to 3-year maturities) and long-dated (20- to 30-year maturities) bonds from companies with higher credit ratings and strong balance sheets is an attractive one. The shorter-dated bonds should be a direct beneficiary of the Federal Reserve's recently announced liquidity backstop programmes, while the longer-dated bonds should benefit from credit spread normalisation.

1. Values of short maturity investment grade debt have fallen due to selling pressure and now look attractive:

    - An investor can today buy a bond issued by a highly rated investment grade (single A-rated) company and earn ~3.0% to 4.0% for six months to a year, while certain BBB-rated bonds now offer yields up to 5%. In other words, cash is king. Right now, no-one wants to part with their cash. This is where the Fed comes in, and as the Fed's liquidity programmes get up and running, we would expect some normalisation in spreads.
    - High quality investment grade companies should be direct beneficiaries of the Fed's Secondary Market Corporate Credit Facility and Commercial Paper Fund Facility. The former specifically purchases short maturity corporate bonds issued by investment grade-rated US companies and US-listed ETFs in the secondary markets.

Goldman Sachs estimates that ~42% of the US IG index is eligible for the programme ($bn)



Source: Goldman Sachs.

2. Values of short maturity investment grade debt have fallen due to selling pressure and now look attractive:

    - On the other end of the barbell, we favour a diverse basket of corporate bonds issued by companies with strong balance sheets and rated single A to BBB+ that are trading at a 5 - 20% discount to par offer. In our opinion, these should represent an attractive investment opportunity should credit spreads normalise as the Fed unclogs the financial pipes.

Thank you for your interest in the **JOHCM Global Income Builder Fund**. We hope you and your family are safe and healthy in these most challenging of times.

JOHCM Global Income Builder Fund

5 year discrete performance (%)

Discrete 12 month performance (%):

	29.02.20	28.02.19	28.02.18	28.02.17	29.02.16
A GBP Class	7.65	-	-	-	-

Past performance is no guarantee of future performance.

Source: JOHCM/MSCI Barra/Bloomberg Index Services Limited, NAV of Share Class A in GBP, net income reinvested, net of fees. The A GBP Class was launched on 30 April 2018. Performance of other share classes may vary and is available on request. BLOOMBERG® is a trademark and service mark of Bloomberg Finance L.P. and its affiliates (collectively "Bloomberg"). BARCLAYS® is a trademark and service mark of Barclays Bank Plc (collectively with its affiliates, "Barclays"), used under license. Bloomberg or Bloomberg's licensors, including Barclays, own all proprietary rights in the Bloomberg Barclays Indices. Neither Bloomberg nor Barclays approves or endorses this material, or guarantees the accuracy or completeness of any information herein, or makes any warranty, express or implied, as to the results to be obtained therefrom and, to the maximum extent allowed by law, neither shall have any liability or responsibility for injury or damages arising in connection therewith.

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