Credit Fund Management

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November 2021

Divergence & Dispersion
Global Sub-IG in September & October

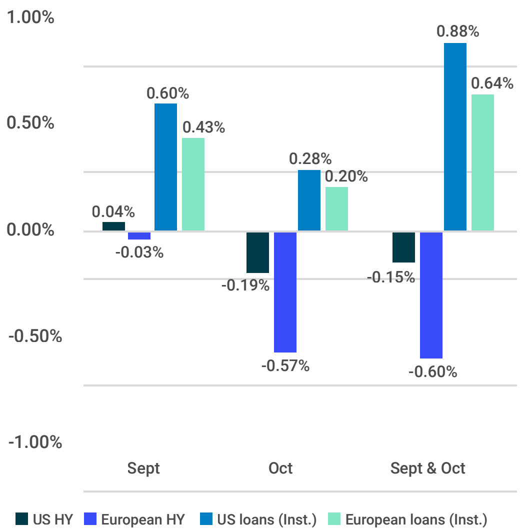
Key Points

- September and October saw global sub-investment grade asset class total return performance diverge, with US and European high yield bond indices underperforming senior secured loan indices. While rising risk-free rates are the dominant explanation, index-level credit spreads also diverged: European high yield bonds experienced credit spread widening and high yield bonds globally moved within a much wider range than senior secured loans.
- **The key question is why?** We attribute the majority of this divergence to technical supply-demand factors specific to individual asset classes: While heavy new issuance is a common supply-side factor across global sub-IG asset classes this year, robust CLO formation has provided a vital source of demand for loans specifically, allowing the asset class to continue performing well in this environment.
- Recent divergence also highlights long-term structural features that reduce the relative volatility profile of loans versus high yield bonds:
  - **Loans are floating-rate, high yield bonds are fixed-rate.** It is natural to expect high yield to underperform in an environment of rising risk-free rates and higher risk-free rate volatility, for example, in today's uncertainty around the path of monetary policy.
  - **The dominant investor category in sub-IG loans is the CLO vehicle.** CLOs are long-term investment vehicles that, once created, have no exposure to short-term capital flows or investor sentiment. This provides a stable, consistent demand base for the asset class. High yield, in contrast, is more heavily exposed to volatile mutual fund flows and, increasingly, ETF flows. In addition, European loans are not eligible for UCITS, ruling out retail investor participation and dampening volatility arising from investor flows. This all manifests in high yield exhibiting higher total return volatility.
- The recent underperformance in European high yield was accompanied by rising name-level dispersion within the asset class. This created a richer environment for bottom-up credit selection, in our view.
- **Multi-credit strategies are designed to exploit these episodes**, both through **reallocation across asset classes** (as valuations diverge for technical reasons) and **reallocation within asset classes** (as greater name-level dispersion creates opportunities to add value through credit selection).
- Our multi-credit funds have been underweight high yield versus loans and CLO debt. We remain so. **This preference reflects higher spreads, better downside protection via seniority and security, a more defensive sector profile, and higher private equity participation at a time when private equity has record amounts of dry powder.** However, we took advantage of this recent divergence to selectively increase exposure to European high yield bonds, exploiting the shift in relative value.

Global Sub-IG in September & October

September and October saw divergent total return performance across global sub-IG credit markets, with high yield bond indices underperforming loan indices. European high yield bonds performed worst of all. While the recent increase in risk-free rate curves explains much of the loan-bond divergence, credit spread widening has been a specific factor seen in European high yield. In addition, credit spreads in both European and US high yield indices moved within a relatively wide range over this period.
Loan indices, in contrast, show little movement overall within a relatively narrow range.

Sub-IG index total return



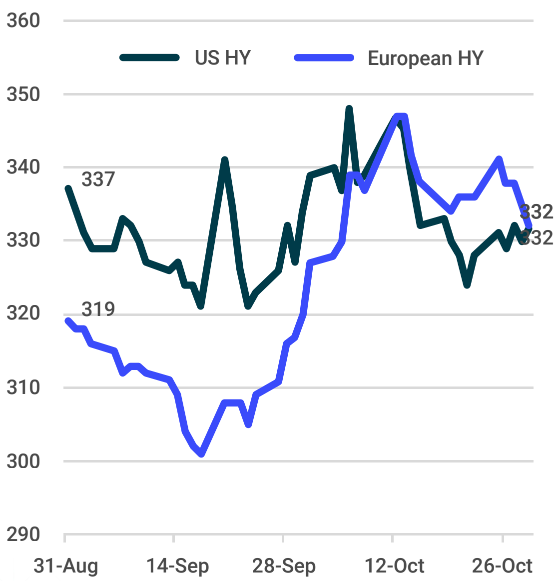
Source: ICE BAML (US HY: HCNF, European HY: HPID), Credit Suisse (CS LLI Inst., CS WELLI Inst.), USD hedged, October 2021

Sub-IG credit spread data points

	US HY	European HY	US loans	European loans
31-Aug	337	319	447	405
30-Sep	334	320	438	403
31-Oct	332	332	440	407
Δ 31-Aug to 31-Oct	**-5**	**13**	**-7**	**2**
Min	321	301	437	402
Max	348	347	449	408
Range	**27**	**46**	**12**	**6**

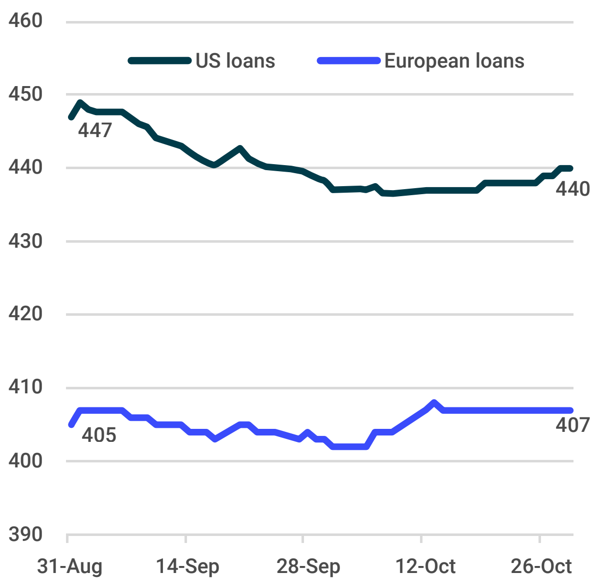
Source: ICE BAML (US HY: HCNF, European HY: HPID), spread-to-worst basis points; Credit Suisse (CS LLI, CS WELLI), 3 year discount margin basis points, October 2021

HY bond credit spread development



Source: ICE BAML (US HY: HCNF, European HY: HPID), spread-to-worst, October 2021

Loan credit spread development



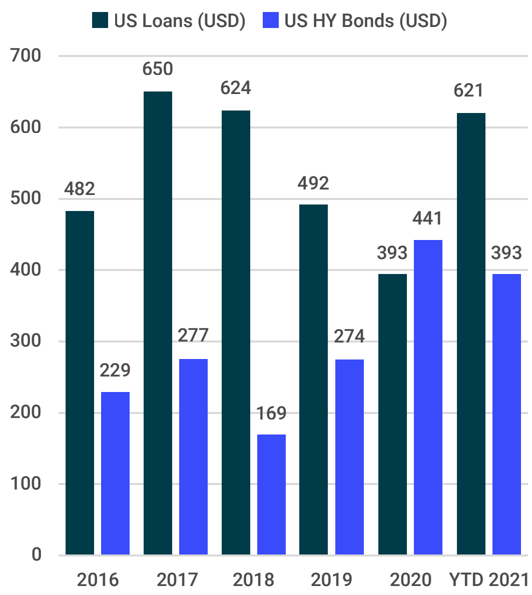
Source: Credit Suisse (CS LLI, CS WELLI), 3 year discount margin, October 2021

The key question is why?

We attribute loan stability to better technical supply-demand dynamics. As discussed in our previous papers, we continue to view the fundamental default outlook across sub-IG as benign.

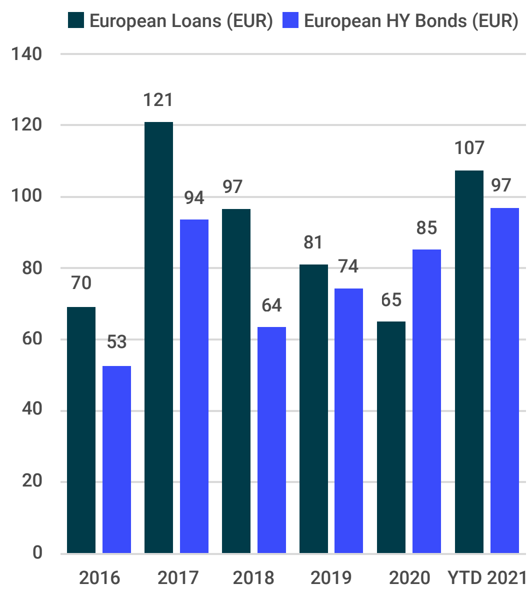
From the supply-side, new loan and bond issuance has been strong this year: The charts below show historical issuance by calendar year and year-to-date period through September. 2021 will likely surpass historical records for issuance. Favourable conditions for corporate M&A, including the deployment of private equity dry powder through buyout activity, low interest rates, and tight credit spreads, have contributed to this year's increase.

US sub-IG primary issuance



Source: S&P LCD, YTD to Sept 2021

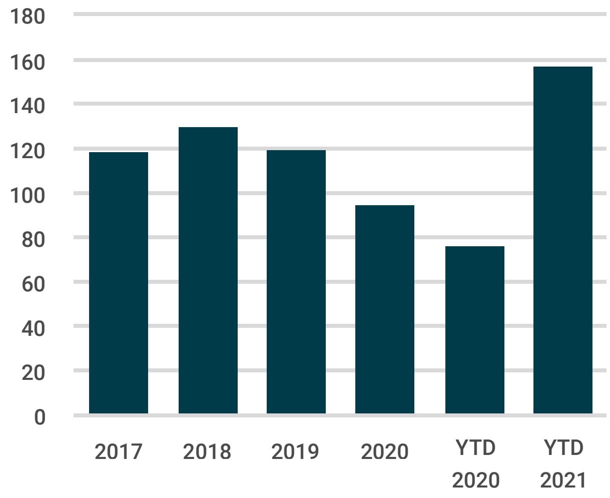
European sub-IG primary issuance



Source: S&P LCD, YTD to Sept 2021

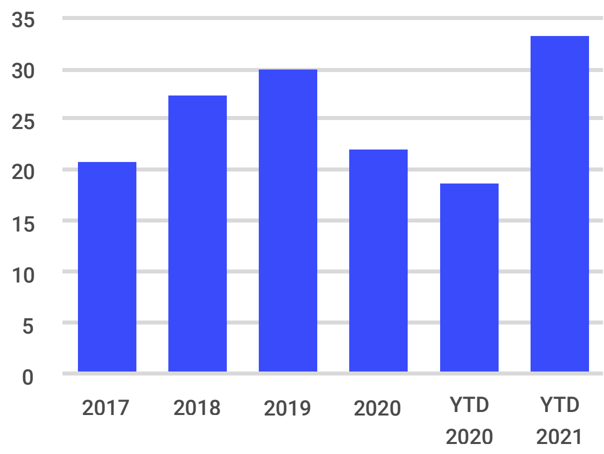
Heavy primary market issuance can represent a headwind to performance, particularly in periods of elevated market volatility. We attribute some of high yield's relative underperformance in September and October to these factors. The fundamental difference driving the loan market's relative stability is a robust demand-side dynamic: Heavy new loan issuance has been offset by record CLO issuance volumes. CLO vehicles are the dominant investor category in loans and therefore represent the primary source of demand for loans. The charts overleaf show historical new CLO issuance volumes in both Europe and US, with the 10 month 2021 year-to-date total already surpassing recent annual totals.

US new issue CLO volume, USD bn



Source: S&P LCD, October 2021

European new issue CLO volume, EUR bn



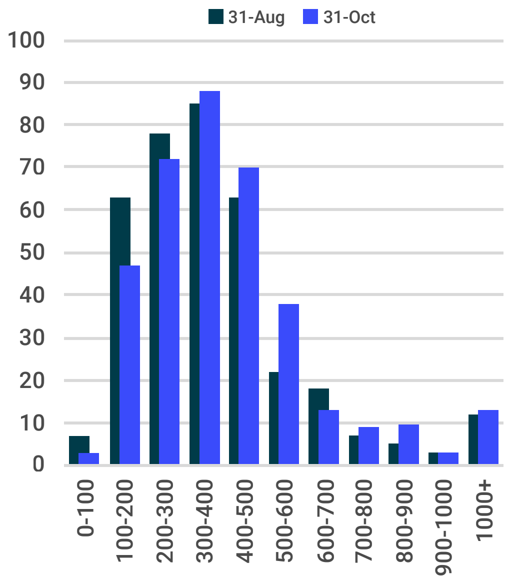
Source: S&P LCD, October 2021

Recent divergence also highlights structural features that reduce the relative volatility profile of loans to high yield bonds and creating a superior volatility-adjusted return profile:

- Loans are floating-rate, high yield bonds are fixed-rate. It is natural to expect high yield to underperform in an environment of rising risk-free rates and also higher risk-free rate volatility, for example, in today's uncertainty around the path of monetary policy. If investors decompose risk in these asset classes into interest rate risk and credit risk components, high yield carries both, and loans only carry the latter.
- CLOs are long-term investment vehicles that have no exposure to short-term investor capital flows or sentiment, and therefore provide a stable, consistent demand base for the asset class. High yield, in contrast, is more heavily exposed to volatile mutual fund flows and, increasingly, ETF flows, which manifests in higher volatility.

We also observed a slight increase in dispersion within European high yield throughout this episode of spread volatility. The following chart shows the change in the distribution of issuers by average credit within the European high yield index in August and October. A slightly bigger tail of credits trading at 500bp or more in October is evident. We attribute some of this dispersion to lower secondary market liquidity allowing single-name dislocation to open up, as investors focussed on new bond issuance.

European HY index: name distribution



Source: ICE BAML (HPID), October 2021. Average spread-to-worst by ticker

How have we invested?

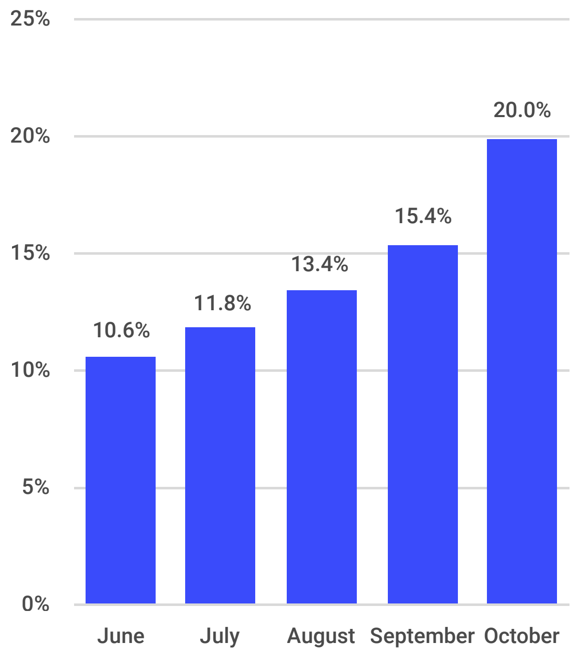
Multi-credit strategies are designed to exploit these episodes through two channels:

- **Reallocation across asset classes**, as valuations diverge for technical reasons, and
- **Reallocation within asset classes**, as name-level dispersion generates opportunities to add value through credit selection.

Our multi-credit funds have been underweight high yield versus loans and CLO debt and remain so. This preference reflects higher spreads, better downside protection via seniority and security, a more defensive sector profile, and higher private equity participation at a time when private equity has record amounts of dry powder.

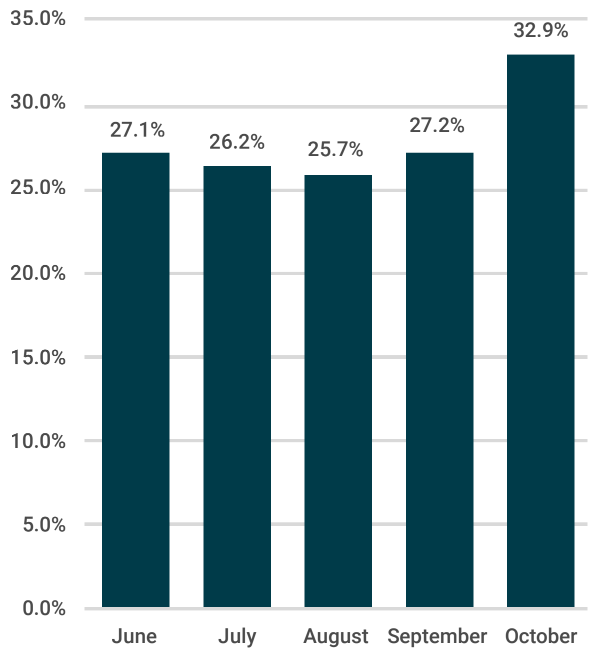
However, rising volatility in September and October created a richer opportunity set within European high yield, allowing our research team to identify several attractive single-name opportunities manifesting in a moderate reallocation towards the asset class. The charts below show our exposure to European high yield within our Global Total Credit and Total Credit (Europe focussed) multi-credit funds.

ICG Global Total Credit: European HY exposure



Source: ICG, October 2021

ICG Total Credit: European HY exposure



Source: ICG, October 2021

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