European Loans: A two-way rate hedge

As Governments and Central Banks continue to implement loose monetary policy and expansionary fiscal stimulus in response to the Covid-19 pandemic, inflationary pressure is rising within global markets. Consequently, treasury yield curves have steepened and downward pressure on rates is easing. Fixed income investors are increasingly concerned about duration risk and this has already translated into heaviness in long duration assets. On balance, European base rates could well remain in negative territory for some time. The mechanism of the zero Euribor floor within European Loans is a strong offset to this, providing a unique two-way rate hedge. Overarching all of this is the persistence of low yields; 60% of Global Fixed Income is still yielding less than 1%[1], so the reach for yield remains a key goal. In the hunt for yield, prey is scarce, European Loans are a viable target.

Taper Tantrum 2.0?

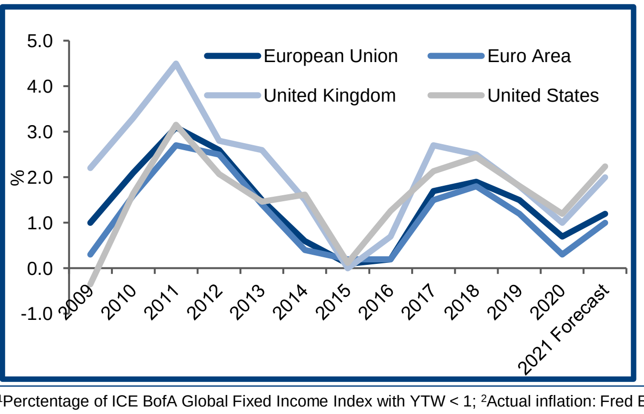
In the wake of the Covid outbreak in 2020 and the macro weakness that ensued, long term government yields were at all time lows and the market was pricing in a yield curve inversion. A year on, investors are focused on quite the opposite, 10 year US & UK Treasury yields and 10 year Bund yields are back to pre-pandemic levels and expected to continue rising. Bunds at -29bps *(March 2021)* may move back into positive territory for the first time since Q1 2019.

The yield curve steepening has been brought on by the market reaction to rising inflationary pressures, triggering concerns over potential taper tantrums. But is it too early? Are these risks really apparent? The macro picture certainly is more positive. Global Covid cases have been falling, particularly in countries with effective vaccination programmes, and global output is on the rise as a number of economies emerge from lockdowns. The scope and size of fiscal policies being implemented certainly has the potential to generate inflationary pressure. Household and private consumption has so far been supported via various employment benefit schemes; in addition to the €750 billion European Union Covid recovery fund to be implemented in the coming year. Corporates have likewise been supported via credit lines, debt guarantees and expense payment deferrals. Germany has pumped over €1 trillion into their economy via bank loans and corporate debt securities, the UK has provided £330 billion in government guaranteed loans; while France has provided similar levels of stimulus, a €300 billion government guaranteed loan scheme.

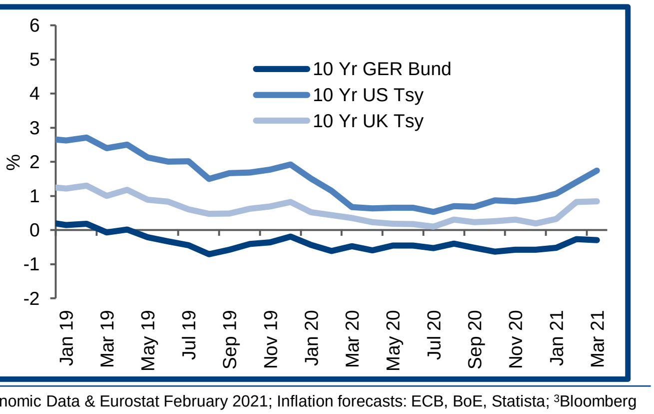
As a result, both the US and the UK are forecast to hit target inflation rates of 2% in 2021. Although the Euro area forecast for 2021 is more modest at 1%, it is still on the rise. The wider global growth and inflation from the US and UK is positive for Europe and an element of trickle down can be assumed from the higher growth economies. For context, European GDP is forecast to increase 0.5% as a consequence of the latest $1.9 trillion US stimulus programme (*OECD March 2021).*

So the stage is set, inflation expectations are rising, are rate hikes imminent? Within the Euro area, we believe the risk of a rate hike is somewhat low; inflation, though trending up, is still a way behind the ECB's target rate of 2%. In fact Euro area inflation has not hit those levels since 2012. All things considered, there is less pressure on the ECB to drive rates lower; this, in combination with strong continued fiscal support, is an attractive environment for European Loans. The trend is similar, albeit more pronounced, in the US. Recent statements from the Fed emphasised their focus on longer term inflation rather than short term spikes for rate change decisions. Base rates are unlikely to rise until inflation has risen to 2% and is on track to moderately exceed 2% for some time.

Inflation (CPI)[2]



Long Term Government Yields[3]



[1]Perctentage of ICE BofA Global Fixed Income Index with YTW < 1; [2]Actual inflation: Fred Economic Data & Eurostat February 2021; Inflation forecasts: ECB, BoE, Statista; [3]Bloomberg

Duration, Duration, Duration

With the steepening yield curve and firmer base rates, long duration assets such as Investment Grade Corporates are under pressure and have been retracing much (if not all) of the positive returns of 2020. Shorter duration assets like European Loans have fared well, benefitting from the potential of increased future income from their floating rate coupon component. We do think this theme will persist through the year; Barclays research forecasts European Loan returns to be 3.5% for 2021 vs 2.6% for European High Yield. YTD 2021 European Loans are outperforming traditional Fixed Income asset classes, but this isn't a one off. European Loans have outperformed comparable fixed income asset classes in several rising rate environments, on average they have returned 4.37% vs 0.07% for European Investment Grade Corporates; -1.50% for European Treasuries and 4.23% for European High Yield. Consequently we see strong value in the asset class given higher inflation expectations.

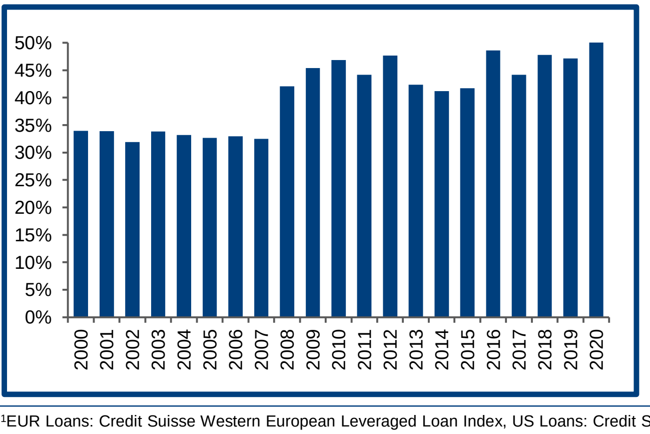
On the flipside if taper tantrum 1.0 in 2013 is anything to go by, the softness in traditional credit yields could be short term and retrace in just over a month. It goes back to the age old saying … *uncertainty is the only certainty there is.* Positioning for both possibilities is key. The Euribor floor of zero in the majority of European Loan assets provides a unique hedge against falling base rates when rates are in negative territory. So if we do return to flatter yield curves, the carry trade of European Loans is largely preserved.

Period		Total Returns (EUR Hedged) During Rising Rate Periods[1]							
Date	**Δ in 10-Year US Tsy Yield**	**EUR Loans**	**US Loans**	**EUR HY**	**US HY**	**EUR IG**	**US IG**	**EUR Tsy**	**US Tsy**
May '13 – Sep '13	+ 137 bps	**2.54%**	0.98%	1.78%	-1.11%	-0.54%	-4.39%	-1.81%	-2.80%
Jan '15 – Jun '15	+ 84 bps	**3.39%**	2.67%	1.81%	2.30%	-1.58%	-0.89%	-1.34%	0.04%
Jul '16 – Dec '16	+ 124 bps	**4.15%**	4.59%	5.35%	6.60%	0.63%	-2.39%	-2.32%	-5.02%
Aug '20 – Mar '21	+123 bps	**7.38%**	7.33%	7.96%	6.57%	1.77%	-4.09%	-0.55%	-6.57%
YTD Mar 2021 (not inc. in average)	*+83 bps*	**1.73%**	1.80%	1.55%	0.69%	-0.68%	-4.93%	-2.35%	-4.52%
	Average	**4.37%**	**3.89%**	**4.23%**	**3.59%**	**0.07%**	**-2.94%**	**-1.50%**	**-3.59%**

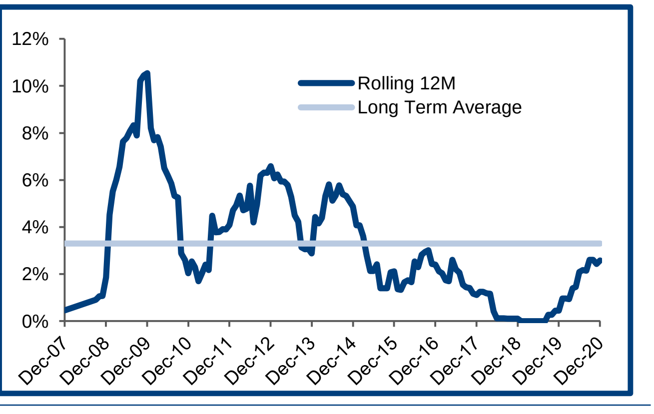
Fundamentals Weren't Locked Down

The economic impact of the virus related lockdowns was clear, a wide range of corporates suffering reduced cash flows and increased leverage. Across the globe, governments and central banks acted quickly, flooding the market with fiscal and monetary stimulus. Within Europe, private equity sponsors sometimes further bolstered this support to corporates, injecting much needed capital. Contributions from sponsors on new transactions are at all time highs averaging 52% in 2020 vs 33% in 2007. This combined boost from a top-down and bottom up perspective was crucial in restoring liquidity and curbing defaults. Interest coverage increased to 4.7x, the highest levels ever seen within European Loans. Though European Loan defaults increased to 2.57% in 2020 from 0.44% in 2019, this is still below long term default levels; and well below the 8% default forecast at the beginning of the pandemic. For 2021 there is consensus that both sponsor and government support will continue, leading to a more benign default rate of 2-4% for European Loans[2], a view we align with given improving fundamentals.

Equity Contribution European Loan Issuers[3]



S&P Rolling 12 Month European Loan Default Rate[4]

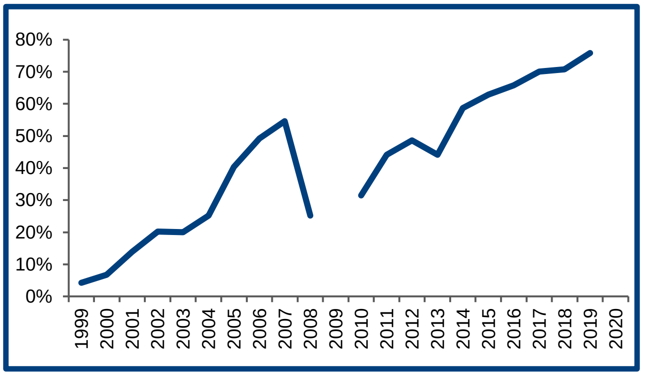


[1]EUR Loans: Credit Suisse Western European Leveraged Loan Index, US Loans: Credit Suisse Leveraged Loan Index, EUR HY: ICE BofA Euro High Yield Index, US HY: ICE BofA US High Yield Index, EUR IG: Barclays Euro-Aggregate Corporates, US IG: Barclays US Aggregate Corporates; EUR Tsy: Barclays Euro-Aggregate Treasuries, US Tsy: Barclays US Aggregate Treasuries; [2]S&P, Barclays, Morgan Stanley & Fitch European Loan Default Forecasts; [3]Standard & Poor's LCD Global Leveraged Lending Review Q4 2020; [4]Standard & Poor's European Leveraged Loans Index; Monthly average from Dec 2007 to Dec 2020. **Past Performance is not indicative of future results.**

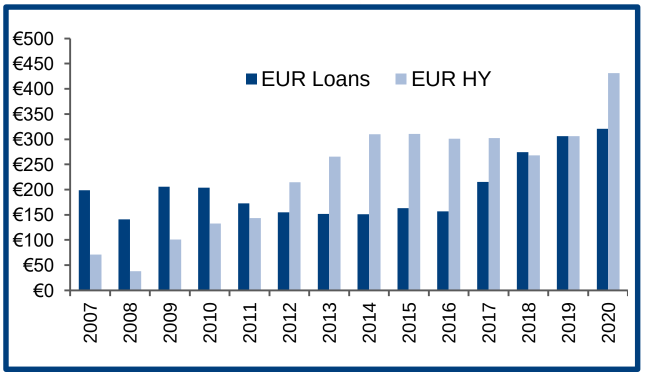
Talking Technicals

Primary issuance of European Loans has been strong YTD, €23.6bn *(10th Mar 2021)* supported by robust levels of M&A activity, marginally lower than the €25.5bn issued over the same period in 2020. Absorbing this supply is a stable, largely institutional, buyer base of CLOs, Asset Managers, Banks & Insurers. Flows and allocations with European Loans are less volatile than High Yield, as the market is less influenced by retail sentiment or short term ETF flows. The asset class has grown steadily since 2007 from €100bn to over €320bn in 2020 given the highly complementary supply and demand dynamics of the asset class. Its depth and liquidity is largely comparable to European High Yield in recent years. It provides the additional benefit of typically sitting senior in the capital structure to High Yield and is secured against assets.

Institutional Investors Primary Market Share[1]



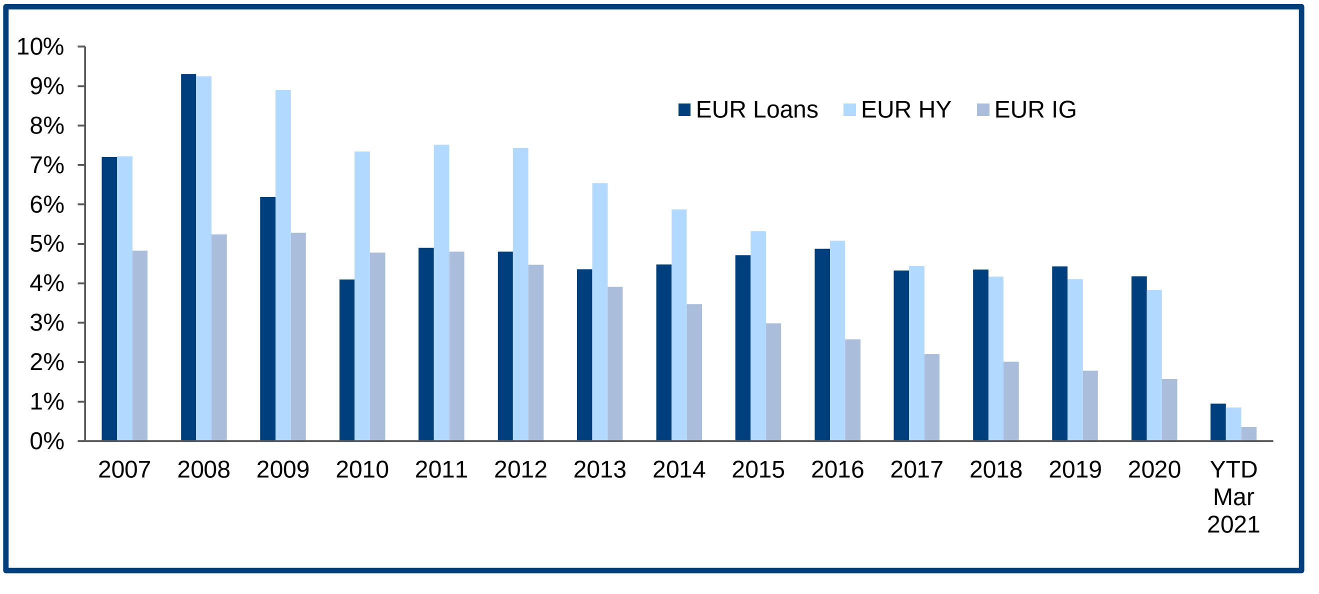
Market Size (€bn)[2]



Income Matters

European Investment Grade Corporates and European High Yield have seen significant compression in the largest driver of total returns, the income stream. Income returns have decreased by almost 70% for European Investment Grade over 2007 to 2020; and roughly halved for European High Yield. European Investment Grade now provides c.1.5% coupon return vs 4.8% in 2007, while European High Yield provides 3.8% coupon return vs 7.2% in 2007. This is largely a direct impact of the ultra loose monetary policy that has occurred since the Global Financial Crisis. Central bank balance sheets have grown exponentially over the period, the ECB balance sheet went from $1.5tn at the start of 2007 to over $8.5tn by the end of 2020 and continues to grow. Similarly the BoE balance sheet grew from <$1tn to $6.8tn over the same period. European Loans have been much less directly affected by central bank policy versus Investment Grade or High Yield, given the asset class was not part of quantitative easing programmes. European Loan income returns did compress over 2007 to 2010 but have been relatively stable since then, averaging in the 4-5% range despite negative base rates, in contrast to the continued year-on-year compression in Investment Grade income.

Income Return[3]



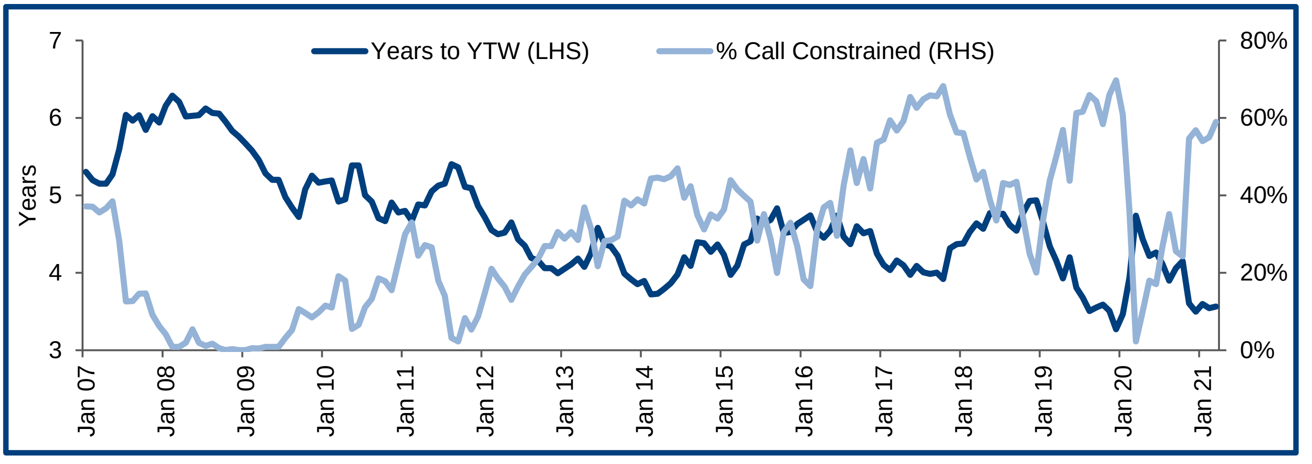
[1]Standard & Poor's LCD Global Leveraged Lending Review Q4 2020. Given lack of primary issuance, S&P did not track enough observations to compile a meaningful sample for 2009 and 2020; [2]Credit Suisse Western European Leveraged Loan Index Market Value & ICE BofA Euro High Yield Index Market Value; [3]As of Mar 2021; EUR Loans: Credit Suisse Western European Leveraged Loan Index, EUR HY: ICE BofA Euro High Yield Index, EUR IG: Barclays Euro-Aggregate Corporates. **Past Performance is not indicative of future results.**

The Price isn't Always Right

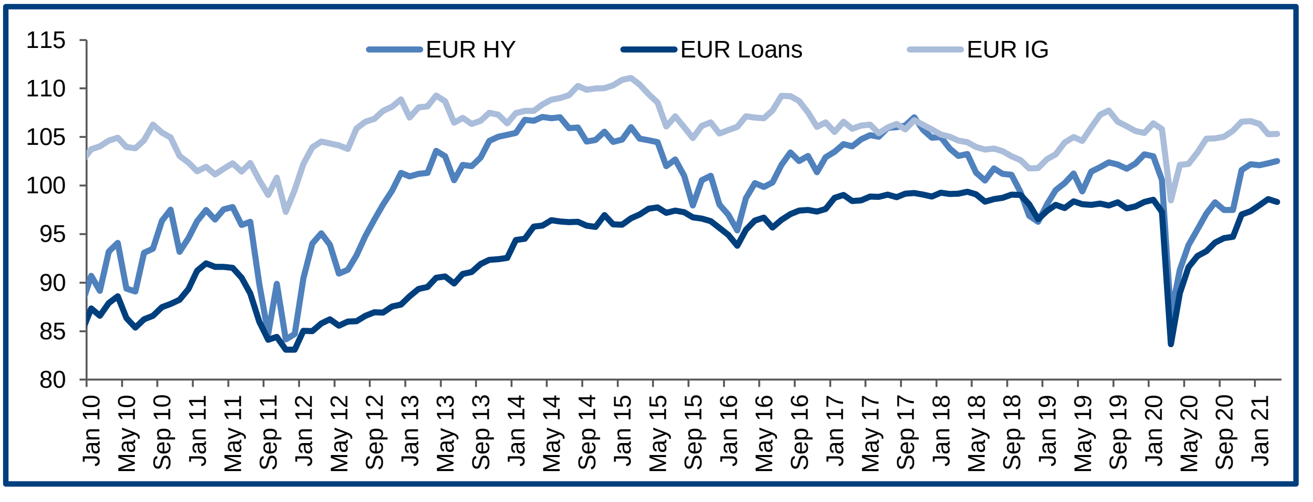
Price returns are an important return driver for a credit portfolio. Over 2007 to 2020, European High Yield generated an average annual principal return of 2.21% vs 0.49% & -0.22% for European Investment Grade and European Loans respectively. European High Yield benefitted from long non-call periods of c.5 years, alongside wide spreads, to compensate investors for the increased volatility and capital risk of sitting junior in the capital structure. This led to less refinancing and repricing activity relative to a similarly rated loan, which has a typical non-call period of 0.5-1 year. Looking forward, we do not see the same supportive dynamics for High Yield. Years to Yield to Worst, a proxy for the non-call periods of bonds has fallen from 5.2 years in 2007 to 3.5 years in 2021; and is likely to continue to fall. In addition, the percentage of call constrained bonds, a measure which tracks the percentage of bonds trading above their next call price, was 59% as of Mar 2021 and likely trending higher. Consequently more bonds are likely to get called and refinanced at tighter yields.

We have also seen an erosion of the pull to par potential of European High Yield, average price is above par at c.104 *(31st Mar 2021)*. Given this juncture, we will likely see mean reversion around those levels for European High Yield rather than the outright price rallies of recent years, similar to European Investment Grade. Within European Loans we have seen significant volatility resulting from Covid, but the asset class has largely recovered, albeit the average price for European Loans is c.98 *(31st Mar 2021)*, so the potential for a pull to par remains.

European High Yield Non-Call Period Dynamics[1,2]



Average Price[3]



Conclusion

Compared to most credit asset classes, European Loans arguably fulfils the fundamental objective of Fixed Income, stable strong income streams with the potential of additional upside via price appreciation, better than most. With c.60% of Global Fixed Income yielding less than 1%, the hunt for yield is rife as ever, but prey is scarce. European Loans are a viable target.

[1]Years to YTW: JP Morgan European Aggregate High Yield as of Mar 2021; [2]% Called Constrained: Barclays Research Mar 2021; [3]As of Mar 2021; EUR Loans: Credit Suisse Western European Leveraged Loan Index, EUR HY: ICE BofA Euro High Yield Index, EUR IG: Barclays Euro-Aggregate Corporates. **Past Performance is not indicative of future results.**

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