2021 Global Credit Outlook

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Executive Summary

Where Do We Go From Here?

The impact of the Covid-19 pandemic has been far-reaching, especially across developed markets. The swift responses by global central banks and governments was critical in stemming the adverse impact on financial assets, providing an implicit and, in some cases, explicit support. Nonetheless, the impact on economies and our previous way-of-life has been extraordinary, upending small businesses and families and likely to have longer term implications. The introduction of several vaccines holds promise to restore a sense of normality through 2021 and, along with unprecedented fiscal stimulus and monetary support, could unleash robust economic growth in the medium term.

Our outlook for 2021 has become more sanguine despite unsettling headlines on rising Covid-19 cases, continued economic impact from lockdowns and rising political risks. Corporate fundamentals have likely troughed and, with the aid of exceptional monetary accommodation, liquidity and availability remains robust to bridge the gap to wider vaccination inoculation. The resulting effect stemming from these actions is a yield-depressed environment where corporate credit remains one of the few opportunities offering competitive relative yields. Moreover, sub-investment grade assets, highlighted by lower duration and floating securities, offers defensive relative protection for the prospect for rising rates over time. We anticipate pockets of volatility and market dislocations, and believe an emphasis on bottom-up fundamental credit analysis, the foundation of our investment philosophy, will be paramount to delivering value for our clients.

Global Leveraged Loans

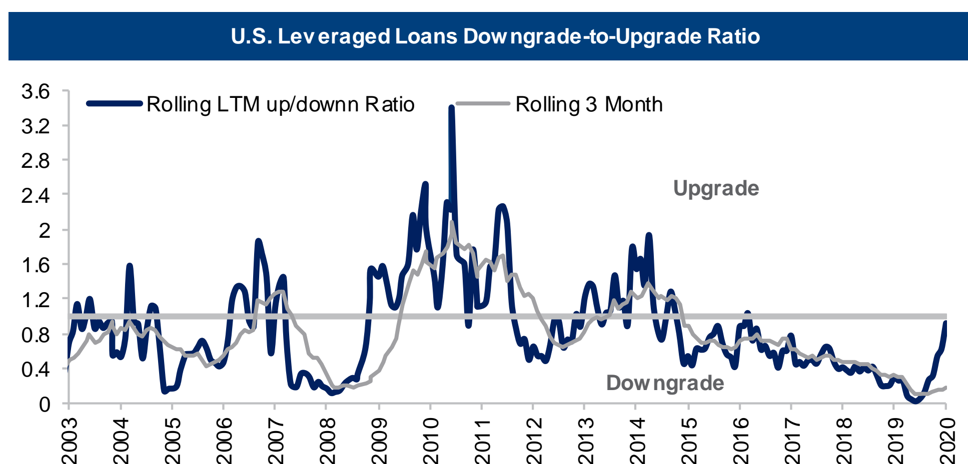
Immediate central bank actions to combat the financial impact of Covid-19 placed significant pressure on short term rates, especially in the US. Global bank loans, with their floating rate mechanism, have little remaining downside from falling rates due to their embedded floors. Meantime, fundamentals have begun to rebound, default activity has slowed and adverse actions from rating agencies have stabilized. Although we do not expect short term rates to rise anytime soon, rising rates are not necessary for global loans to perform well in 2021 and beyond. Global bank loans offer an attractive yield while also providing an insurance against future rate hikes.

US Leveraged Loans

Like other risk assets, U.S. loans witnessed unprecedented volatility in 2020. At the depth of the March sell-off, the average loan was trading below $77 with a (19.8%) year-to-date return. Aggressive fiscal and monetary policy responses and subsequent economic rebound sparked a strong rally with loans generating positive returns each month from April onward. U.S. loans posted a 2.8% return for 2020 despite a 167 basis point decline in the underlying LIBOR base rate.

U.S. loan fundamentals troughed in Q2 with earnings and cash flow contracting and financial leverage surging as lockdowns around the globe shocked demand. Rating agencies were quick to downgrade in March and April and defaults rose to 4.0%, a 2.4% increase from the beginning of the year. Nevertheless, aggressive policy responses, especially by the Federal Reserve, boosted demand for yield and risk unlocking credit markets. The recovery was led by higher quality credits and defensive sectors. Subsequently we have seen a recovery in both the economy and credit fundamentals. Rating agencies have taken more of a "wait and see" approach since April while many companies have taken advantage of open capital markets to bolster liquidity and refinance near term maturities. Q3 earnings demonstrated a modest rebound and financial leverage declined. Defaults declined to 3.8% by the end of November.

For 2021, we expect U.S. loans to generate a total return of around 5.0%. This consists of 4.0% coupon income, assuming no increase in LIBOR, plus 1.0% price appreciation net of default losses. For 2021 we expect the default rate to fall to 3.0%. Upside could come from a stronger than expected economic rebound that improves the default and recovery outlook and raises prospects for higher short term rates. Meanwhile, downside risk could stem from weaker than expected economic growth and a return of rating agency downgrades and ultimately higher defaults.



Source: S&P Market Intelligence, as of December 2020

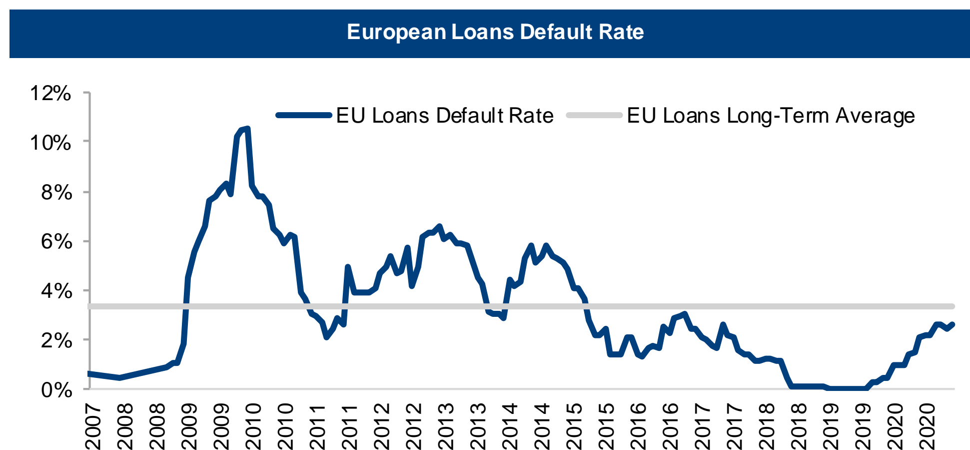
With our constructive outlook, we have reduced portfolio exposure to the highest quality, highest priced, and lowest yielding loans, primarily those rated BB and higher. We have selectively added to Covid-19 impacted sectors (airlines, casinos, etc.) and credits that enjoy strong underlying collateral and have adequate liquidity through 2021. We remain overweight B-rated loans but continue to underweight the lowest quality CCC-rated segment of the market. We believe this environment favors Alcentra's active management which focuses on bottom-up credit selection while maintaining disciplined portfolio construction and strong risk management.

Global Leveraged Loans

European Leveraged Loans

As with other asset classes, European loans saw a material impact on trading levels from Covid-19 driven lockdown measures. At the trough in late March, average index prices fell to 79.06 and returns stood at (18.56%) (hedged to EURs). Market sentiment however rebounded quickly on the back of the extraordinary fiscal stimulus and monetary support measures unveiled by governments and central banks. While the initial market recovery in Q2 was concentrated in the higher rated/defensive segments of the market, as the year progressed and positive vaccine headlines were announced, lower rated and more cyclical credits saw a strong rebound. This recovery left full year 2020 returns for the European loan market at 2.80% (hedged to EURs).

The economic impact of lockdown measures weighed on corporate fundamentals during 2020, reducing earnings and cash flow and increasing leverage. However the benefit from government support measures including wage supporting furlough schemes, rates and tax deferrals helped mitigate some of the downward pressure on corporate earnings. The availability of government backed loans as well as support from lenders and sponsors helped alleviate liquidity triggers, particularly in sectors most impacted by Covid-19 restrictions. While this corporate operational weakness did lead to a downward trend in ratings, the support measures meant default rates undershot initial expectations of high single digits, ending the year at 2.57%.



Source: S&P Global Market Intelligence as of December 2020

For this year, we expect robust new European loan issuance, supported by increased M&A activity, while demand should remain strong given attractive risk adjusted returns on offer (c.4.5% 3 year yield) and a supportive CLO technical from improving arbitrage. Default rates have scope to increase from the current 2.57%, but we would expect them to remain benign overall in the low to mid-single digit area, on the back of continued support and the improving macro-economic environment. We expect European loans to generate returns of 4.0%-4.5% (hedged to EURs), consisting of 3.7% coupon income, zero floor rates and some price appreciation. Downside risk to this forecast could stem from vaccine rollout delays or weaker efficacy as well as weaker economic performance, with upside coming from stronger than expected economic recovery.

We remain focused on deep dive bottom-up credit selection. As economies recover we will look to selectively add within the Covid-19 affected sectors as well as cyclical and lower ratings segments. Despite the tightening in market yields since the trough in March 2020, we still think European loans offer attractive risk adjusted returns, particularly in the current low interest rate environment.

Global High Yield

The global high yield staged a resilient recovery in 2020 while realizing its highest defaults since the global financial crisis and an unparalleled supply of fallen angel supply in such a short time period. Well-known, iconic issuers across U.S. and Europe tapped high yield markets to refinance debt and raise liquidity amidst the economic shock from Covid-19, enhancing the overall credit quality and diversification of the global high yield opportunity set. Moreover, extraordinary inflows, especially from U.S. mutual funds, rushed to capture exceptional absolute returns. While absolute yields have fallen sharply from the 2020 wides, global high yield should continue to benefit from improving fundamentals, declining defaults, and a yield-challenged market.

U.S. High Yield

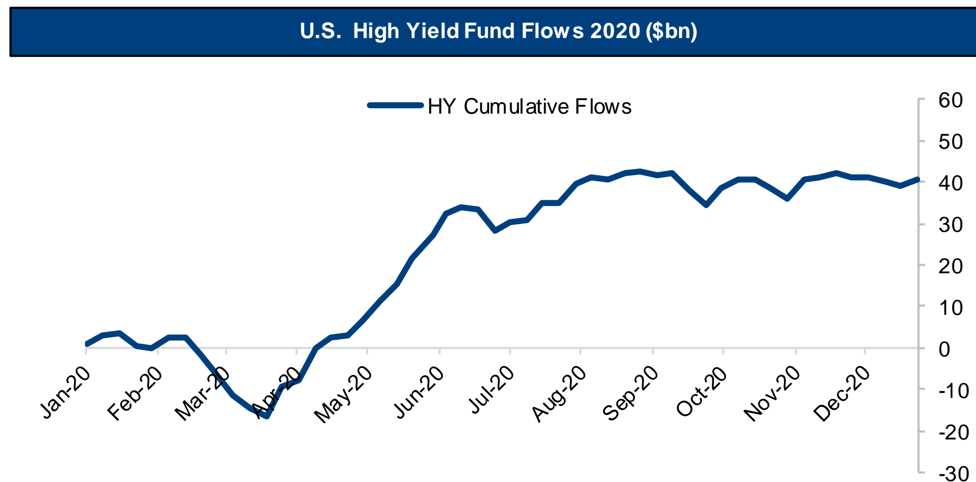
The swings in market valuations were extraordinary in 2020, including U.S. high yield. Spreads widened out to nearly 1,100bps at the depths of the lockdown in March, only to make a strong recovery in subsequent months. For 2020, U.S. high yield generated 6.17% return, which was up over 33% since the March low, while spreads compressed to 386bps.

We do not anticipate this level of volatility in 2021 given the vaccine rollout and ensuing optimism that "normality" returns through the year. As of today, high yield is yielding 4.24%, its lowest YTW on record but a reflection of the yield suppressed environment in which $18T of the global fixed income market, or roughly 26% outstanding, trades with negative yields and 10yr US Treasuries just over 1%%. In terms of spreads, current valuations are well wide of the post global financial crisis tights of 316bps in October 2018.

We are anticipating U.S. high yield total returns in the 3.75%-4.75% range in 2021. Embedded in this forecast, we expect spreads to tighten 25-50bps and defaults declining to the low 4% range, which is almost half of where it peaked in 2020. We expect treasury yields to pick up slightly in 2021, as the economic progress improves and the market readies for potential policy change in 2022.

Within U.S. high yield portfolios, in light of our more sanguine outlook, we have been steadily adding to lower-rated single B paper and select CCC opportunities. We expect improving fundamentals will enable many of these issuers to show improved balance sheet and spread compression. These include issuers in Services, Healthcare, Building Materials and Packaging. We are also assessing opportunities in the Covid-19 sensitive sectors, including transportation, energy and gaming, focusing on the stronger balance sheets and liquidity resources.

U.S. high yield has experienced tremendous inflows in 2020, with U.S. Mutual Funds seeing in excess of $61B since March. While it is difficult to predict flows, we do not anticipate a great unwind either. It is challenging to find yield today with few alternatives in daily liquid vehicles, including asset classes that should see fundamentals improving and defaults declining. We think U.S. high yield will continue to maintain and attract inflows from traditional and core fixed income. Clients will continue to need an income stream with less volatility than equities.



Source: JPMorgan High Yield and Leveraged Loan Monitor as of December 2020

Global High Yield

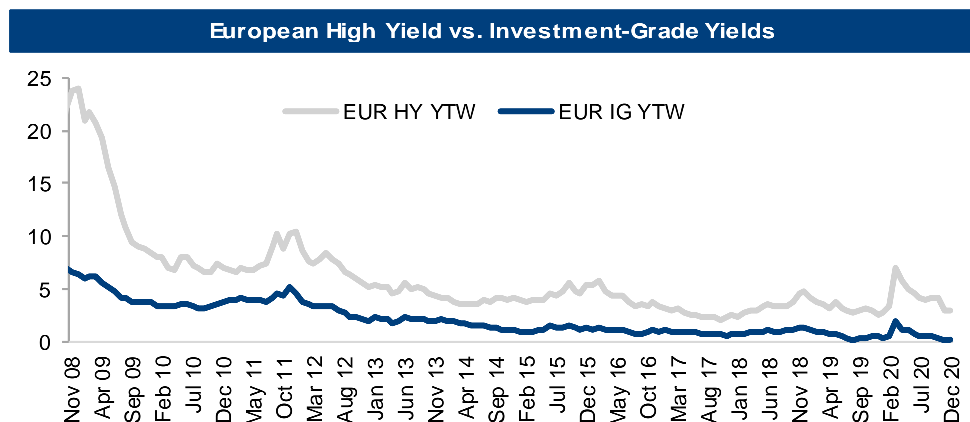
At the same time, we continue to like the fallen angels, where we have been very active since February. We have seen nearly $200B in fallen angels in 2020, or roughly 15% of the total high yield opportunity set, consisting of many iconic, household names. We think this segment of the high yield market continues to offer one of the most attractive risk-adjusted return profiles, especially if some of these names can restore their investment-grade ratings over the next two years. Many of these issuers reside in autos and energy where there are tangible signs of operational improvement.

European High Yield

From the depths of the crisis in late-March when credit spreads approached 900bps, European high yield experienced an unprecedented snap back on the strength of the technical backdrop as global policy reaction resulted in large inflows to high yield funds globally. European high yield ended the year with a total return of c.3%.

European high yield credit fundamentals weakened significantly over the course of 2020. As the pandemic ravaged economies, earnings suffered and leverage spiked. While rising from several years of ultra-low levels, default rates were lower than originally anticipated as issuers focused on preserving cash and, crucially, capital markets remained open, funding cash needs of even the most impact sectors. Government and central bank intervention played a significant role in this. Looking ahead to 2021, we expect fundamentals to improve, albeit slowly, given the most recent restrictions on movement. As a result, we expect the default cycle to peak in Q1 and decline through the remainder of the year, with full year default rate of 2%-3%.

As highlighted above, the solid technical backdrop should continue through much of 2021. We expect demand to remain robust, driven by a number of factors. In addition to the improving macro backdrop leading to lower defaults, we believe the ultra-low interest rate environment will continue to force investors along the credit rating spectrum in search of income, benefitting the European high yield market. For example, at December 31st, the average yield on European investment grade bonds was 0.2%. According to JPMorgan, European investment-grade funds have an allocation of 6.5% to European high yield and we expect this to rise further as ECB and QE continues in 2021. On the supply side, Q1 should offer a healthy pipeline of new deals, including a number of large M&A transactions. However, visibility beyond March is limited, which should benefit market technicals. Refinancing will be a common theme again in 2021, with ~€40B potentially callable assets.



Source: ICE BofA Euro High Yield Index and ICE BofA Euro Financial Index

Overall, we see a supportive market for high yield bonds. We see the spread compression trend continuing into 2021, with BBs outperforming BBBs, as investment-grade investors move down the quality spectrum, and single-Bs outperforming BBs as lower rated companies benefit from the improving macro backdrop. We are positive on CCCs, however, due to renewed Covid-19 driven restrictions, discipline in this space is required. As economies recover, we will add selectively to issuers in more cyclical sectors, including certain Covid-19 impacted issuers.

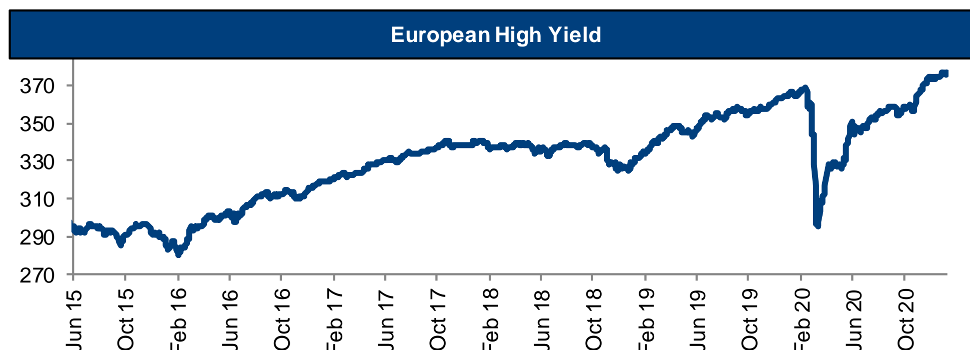
We expect returns for the European high yield market to come in a little above coupon at 3.5%-4.0%, as we expect spread compression offsets default losses.

Special Situations

2020 was an extremely active year on the special situations side. At the end of Q1, investors were furnished with an abundance of opportunities across multiple performing credits as incumbent lenders rushed to raise liquidity, sending the prices of many leveraged loans and high yield bonds down by 15-20 points or more. Even high quality issuers in sectors unaffected by the virus were severely impacted. However, as it became clear that central banks and governments would deploy all resources available to avoid a sustained economic crisis, the initial flight to cash was reversed. It was soon followed by increasing investor appetite for credits not unduly affected by the pandemic, and thereafter by a strengthening bid for more cyclical, lower quality assets. Indeed, by the end of 2020, it was CCC-rated assets which had performed the best of all. By contrast, distressed assets, and especially post-reorg equity, never really recovered from the initial downdraft, even in cases where balance sheets are healthy and operating performance has already begun to recover.

The key determinant of price recovery was investor sentiment surrounding the near-term sustainability of capital structures, with those considered unviable the source of considerable trading activity, as existing lenders unable or unwilling to participate in balance sheet recapitalizations sought to exit. By contrast, and particularly in cases where ratings had not been downgraded to B- or lower, incumbent lenders were more willing to remain invested, and indeed in a number of cases extend additional debt finance, often on very company-friendly terms, to borrowers that were facing a short-term liquidity squeeze. As we begin 2021 still in the grip of the pandemic, it will be interesting to see whether those issuers that attempted to borrow their way out of trouble manage to make it through unscathed – we suspect that a number unfortunately will not.

Alongside unprecedented levels of monetary stimulus, 2020 also saw governments make dramatic interventions in the running of the private sector. Across Europe, fiscal policy tools were used extensively, and in many cases saved companies from needing to seek assistance and/or protection from their creditors. In addition, in several countries, extensive changes were made to domestic bankruptcy regimes, often with a view to limiting the rights of financial stakeholders to seek recourse to companies that would otherwise be in default. In the main, such interventions were successful, as evidenced by the European high yield default rate which remained miraculously low all year, landing at 3.3% for the year which compares to 7.2% in 2009 per JPMorgan. Looking ahead however, there is a question mark over whether this can be sustained. Governments have had to shoulder the cost of the virus while, in general, households and companies, apart from those in the most exposed sectors, have been able to reduce expenses and build capital buffers. Over time governments will strive to return towards fiscal balance and bring down their borrowing levels which will impact consumers' ability to spend and companies' cash flow generation.



Source: ICE BofA European Currency High Yield Index (Hedged to EUR), as of 19 January 2021. Reflects the % change in price as of 19 January 2021.

At the end of 2020, the overall size of the stressed and distressed opportunity set was relatively unchanged compared with 2019, an extraordinary outcome given the challenges encountered during the year. What has changed however is the diversity by sector which is reflective of the broader macroeconomic impact of the pandemic, something which we welcome after several years of dominance by the retail and energy industries. With extremely tight market pricing reflective of a relatively benign outlook, we expect there to be numerous instances of companies underperforming elevated market expectations in 2021, the advent of which will give rise to market volatility. We also see the need for private lenders to step in as government supported bank lending schemes are gradually phased out. As was the case in 2020, those investors with a broad coverage of the investable universe and access to company management teams and financial information will be the best placed to take advantage of any temporary dislocations in secondary pricing.

Structured Credit

As with other credit assets, 2020 was a rollercoaster ride for CLO tranche investors, with extreme volatility and swings in liquidity – particularly for the lower-rated and equity tranches. Prices of BB tranches were down almost 50% at the lows, and even AAA tranches were down up to 20% in March as investors scrambled to raise liquidity from anything they could sell at the highest possible $ price. Senior tranches rallied on the back of stimulus measures in April – in step with loans and high yield – but lower-rated CLO tranches lagged, with significant upwards price action coming at the end of May and early June.

CLO trading volumes hit a new record in 2020 and new issuance was c.80% of last year's figure (our market has grown by c.61% over the past 3 years) showing the resilience and continued broadening of the CLO investor base. Our secondary trading volumes were almost 90% higher in 2020 vs 2019 as we sought to take advantage of market opportunities through the year.

At the end of 2020 we continue to see dispersion in the performance of lower-rated CLO tranches depending on the quality of the underlying loan portfolio, with clean BBs trading tighter than where they started the year and weaker ones trading wider. This disparity is greater in the U.S. than Europe with some U.S. CLO portfolios having significantly underperformed, mostly due to higher energy / commodity exposure.

	USD			EUR		
	75th Percentile	Average	25th Percentile	75th Percentile	Average	25th Percentile
BB Par Subordination	6.02	7.27	7.95	9.29	9.86	10.28
BB MV Subordination	3.12	4.44	5.56	6.92	7.72	8.45

Source: Alcentra, as of December 2020. Average of metrics across the 2.0 European and US CLO universe reporting into Intex. Excludes deals issued in the last 9 months. Excludes deals where the AAA has amortized to less than 70%. Excludes deals where <75% of the assets are mapped.

The 'below average' or 3rd quartile BB and B tranches were a focus of our incremental investment activity in our hedge fund and closed ended funds, and it was these tranches that rallied most strongly on the back of the news of high vaccine efficacy rates and imminent rollout. Although Q1 2021 will be challenged with rising Covid-19 infection rates across the U.S. and Europe, we expect this tightening trend to continue through 2021 as central banks remain accommodative, vaccines are rolled out, and investors gain confidence that these tranches will most likely not be impaired.

	End 2019		Dec-20	
	USD	EUR	USD	EUR
AAA	115	105	115	135
AA	170	170	170	202.5
A	220	225	230	267.5
BBB	330	337.5	345	375
BB	675	600	675	650
B	1000	850	1100	850

Source: JPMorgan secondary spread data as of December 2020.

Most tranches ended up roughly where they started 2020 "on average". European AAAs being the main exception. It's important to note there has been a large disparity in performance in BB and B tranches

We expect senior tranches to tighten in Europe in the first part of 2021 – lack of year-end purchasing budget for some of the larger European buyers meant they didn't rally as much as other tranches at the end of 2020. Overall CLO debt tranches look cheap vs vanilla corporate credit and we therefore expect the strong momentum seen at the end of 2020 to continue into 2021. CLO equity lagged for most of the 2020 rally but we saw real positive momentum in CLO equity prices leading up to and post the vaccine announcements and we expect demand for CLO equity – in both primary and secondary – to continue to grow into 2021 as investors hunt for yield in a tightening market.

If senior tranches tighten we will see a strong wave of CLO issuance and also resets and refinancings of older CLOs which, as usual, will increase supply and no doubt temper some of this rally. We expect some of the larger U.S. and Japanese bank buyers of AAAs, who were mostly inactive during 2020, to come back to the CLO market again as they get reset or refinanced out of some of their older positions. Periods of particularly heavy new-issue supply could provide opportunities for investing in primary, particularly for IG tranche investors. In our view, barring negative news about vaccine rollout of efficacy, we expect demand for junior tranches to remain strong as investors hunt for yield and reallocate towards CLOs from more liquid / vanilla credit assets.

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