Q&A with...

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Good Times for Yield

After more than a decade of record low interest rates, central banks have shifted gear and have started increasing interest rates. Combined with surging inflation, geopolitical tensions, a pandemic and a war, this has increased the levels of volatility, risk and opportunity in Credit markets.

CQS' Chief Investment Officer – Credit, Craig Scordellis discusses how a Multi-Asset Credit strategy can help investors find income with low levels of risk in this challenging environment.

Q: Are we going through a regime change, transitioning to a new investment landscape?

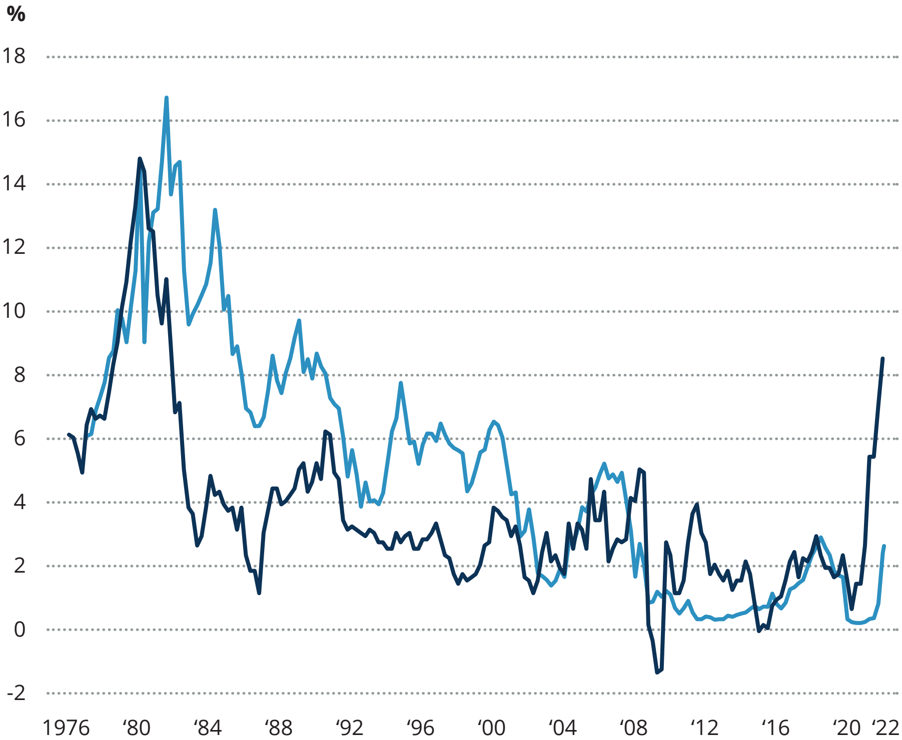
A: Uncertainty is high because the pillars of stability have been removed: mainly, a decade of Quantitative Easing (QE) supporting record low interest rates. This has now finished, as higher inflation is pushing central banks into a Quantitative Tightening (QT) mode. We are going through a drastically-changing environment and we need to think about Credit differently. Passive strategies have benefited from the rate compression of the past 30 years — in some cases, the drop in sovereign, base-rate yields has accounted for about 70-85% of Credit returns, but this has become unsustainable as rates start to rise. As seen in Figure 1, bond yields are just catching up with rising inflation.

"MAC lets us allocate capital to the right sector, right country and right asset at the right time."

Investors therefore need to consider active Credit management in order to achieve returns from now on. As asset managers, we need to generate income while minimising potential losses; this is what Multi-Asset Credit (MAC) allows us to do. Based on fundamental analysis, MAC lets us allocate capital to the right sector, right country and right asset at the right time.

Figure 1

Regime change: Inflation is at generation-highs and bond yields are catching up.



Source: Bloomberg as of 27 April 2022. UST is US Treasury.

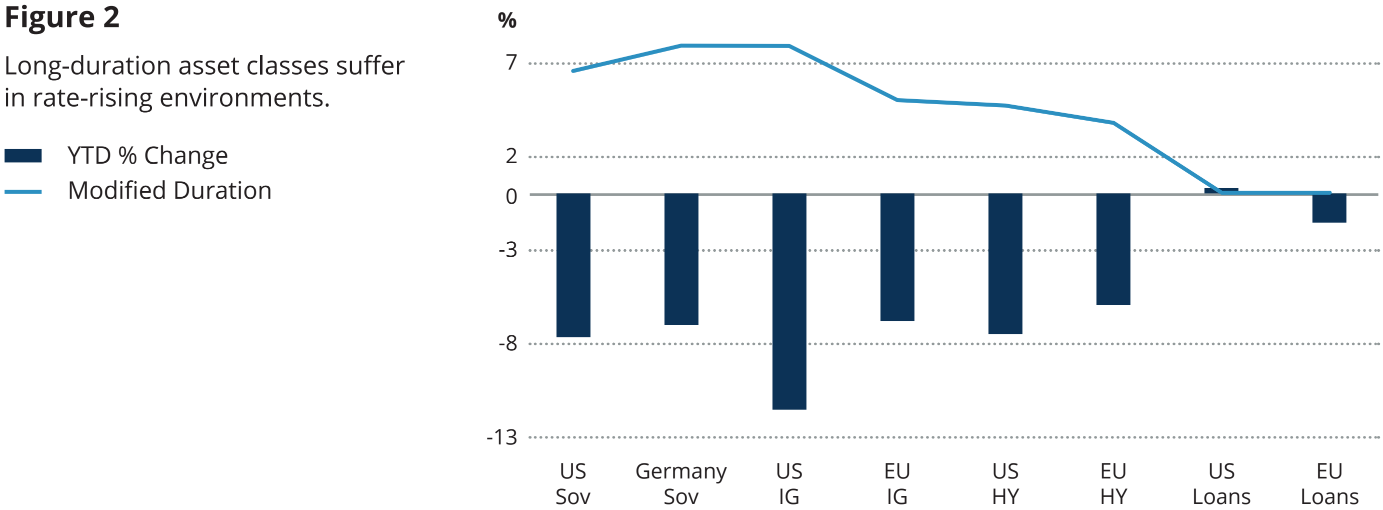
Q: What should investors expect in this new landscape?

A: The traditional low yield of so-called safe-haven asset classes, like Investment Grade (IG) bonds, may not be enough to protect against price swings; at the same time, their usual long(er) duration makes them more interest rate-sensitive, and therefore more volatile in rate-rising environments such as the present one — which is expected to continue for the time being.

As seen in Figure 2, it is the long-duration asset classes that have suffered the most so far this year.

Figure 2

Long-duration asset classes suffer in rate-rising environments.



Source: Bloomberg as of 27 April 2022. IG is Investment Grade, HY is High Yield.

We believe a flexible MAC solution can help investors navigate this environment, capturing opportunities and mitigating risk. We say this from experience: we have been running MAC strategies for 10 years, during which we have maintained robust long-term returns despite facing a Eurozone crisis, a slowdown in China, rising default rates, physical and trade wars, monetary experiments, policy errors, a global pandemic and major geopolitical events.

Q: How have you been able to deliver returns in times of trouble?

"The flexibility offered by MAC has always helped us."

A: The flexibility offered by MAC has always helped us. Based on thorough, bottom-up fundamental analysis, our allocation decisions across asset classes are issuer-centred and complemented with a top-down view on the asset class, country, sector or business cycle phase. We have a potential universe worth trillions of dollars, and the capability and resources to explore it all in order to find and select the best companies to lend to in each market environment.

For example, when the 2015-16 Chinese slowdown led to a slight energy crisis and therefore a US High Yield (HY) default cycle, we were able to avoid allocating to US HY or to the Energy sector. As a result, we were able to deliver higher income while avoiding the more volatile segments of the market. Similarly, during Covid-19 we reduced our exposure to Cyclical sectors, such as Transport, Leisure, Hospitality and Entertainment, pivoting our MAC sub-strategies towards more resilient sectors, such as Healthcare and Technology.

Q: Do prospects of rising defaults keep you awake at night?

A: The most important part of a Credit manager's job is to avoid defaults. While of course I am concerned about the negative impact of rising inflation and interest costs on corporate balance sheets, I am confident in our experience and expertise: our 50+ strong MAC team has delivered a trailing 12-month default rate of 0.4% per annum (as at 31 March 2022), well below broader market default rates (sub Investment Grade (IG) Loans and HY bonds have average default rates of 2% - 4%). In volatile periods, when dispersion increases, we shift the portfolio to sectors where default rates are lower. The key of course is selection; this is why we spend a significant amount of time to select the right businesses and the right timing.

Q: Are markets over-reacting to the probabilities of default?

A: We think default rates will pick up to more traditional levels of about 3% to 5%. However, the European Loan market, for example, is pricing in default rates of about 14%; in the US, it's about 12%; in European HY, the implied default rate is about 10%, and around 8.4% for US HY: this tells us that markets are much more conservative and expecting higher default rates than we think will play out. As a result, we believe there's an opportunity to take advantage of these spreads, which are at attractive levels.

Q: Apart from avoiding defaults and volatility, what is the ultimate goal of a MAC strategy?

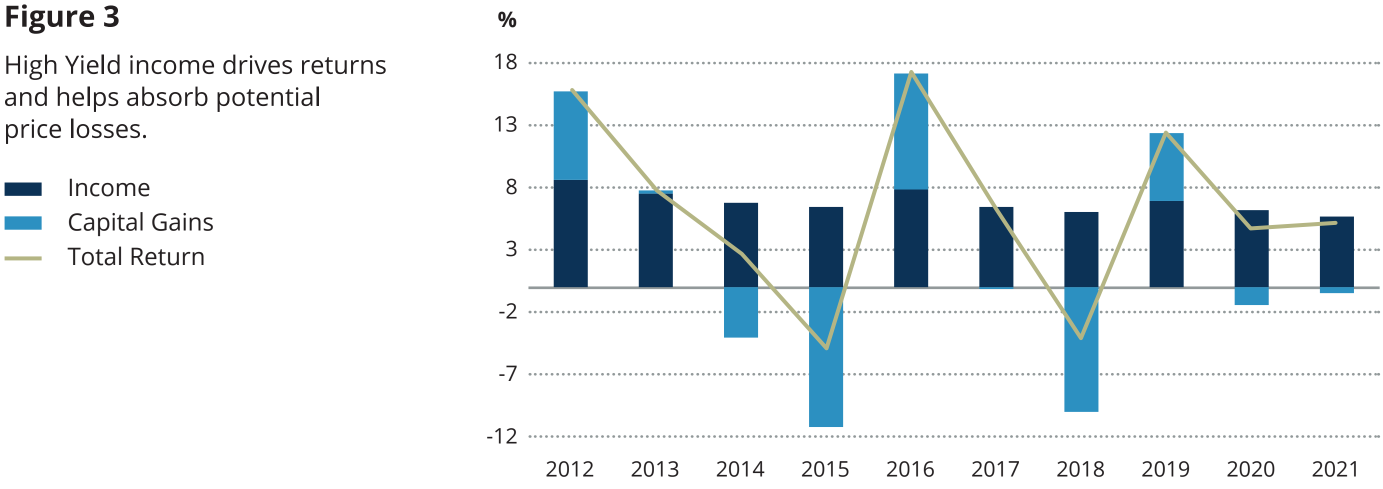
> *"We aim to find HY-income levels with IG-levels of risk."*

A: We aim to find HY-income levels with IG-levels of risk. This, which looks impossible, can be achieved in flexible mandates which can sector-rotate and manage duration. This year, for example, we have favoured low duration (via a combination of floating-rate assets and hedging instruments). This has helped us as yields have significantly increased.

However, the key is always income: coupons have generated about 90% of our MAC strategy's return since we started almost ten years ago. Ultimately, it is income that makes you money in Credit markets. And, of course, income also helps you absorb any potential capital losses in periods of volatility, as seen in Figure 3, and as we have experienced this year.

Figure 3

High Yield income drives returns and helps absorb potential price losses.



Source: BBG, ICE, LCD as of 31 March 2022. Data based on the ICE BofA US High Yield Index.

“Higher rates and wider spreads have yielded attractive levels of income.”

Q: Given the present inflation and rate-rising fears, where do you see opportunity now?

A: Higher rates and wider spreads have yielded attractive levels of income: the average yield of high-quality issuers can be as high as 6.3%, for instance. And High Yield is beginning to yield again: in the US, the yield has reached about 7%.

Q: Do you favour any specific sectors?

A: We are biased towards defensive sectors such as Financials, Information Technology (particularly in security), and Healthcare, given the challenging environment and economic outlook. European banks, specifically, are much better capitalised and regulated than they were a decade ago. They may also benefit from higher rates as this tends to increase their margins.

“Floating-rate debt can help mitigate interest rate risk.”

Q: How could investors reduce inflation and interest rate risk?

A: Floating-rate debt can help mitigate interest rate risk. It can also protect against price losses as its duration is essentially zero. In terms of inflation, our bottom-up research team selects those companies that may deal best in an inflationary environment including companies, for example, that can pass any rising input costs onto customers.

Q: Do you favour any specific region?

A: We have a European bias, but mostly due to idiosyncratic opportunities; from a macro perspective, we are not expecting Europe to outperform the US, but we have found better corporate opportunities in Europe, especially in the more defensive parts of the market. This has partially been caused by the capital retrenched to the US in the midst of the ongoing uncertainty, which has generated attractive entry points in Europe.

Q: Do you invest responsibly?

A: As stewards of investors' capital, we seek endurance and longevity in our investments, business relationships and also within our own firm. Our Responsible Investment approach is categorically not imposed at the expense of performance: for us, responsible investment is perfectly aligned with achieving higher returns and taking less risk in Credit markets. We believe that incorporating ESG criteria into our research and monitoring process helps to reduce risk and enhance investment returns.

“Our responsible investment process is not a box-ticking exercise. Rather, we view it as an opportunity to improve companies.”

Q: In order to foster sustainable investments, do you engage more than exclude?

A: We prefer to engage. Our Responsible Investment process is not a box-ticking exercise. Rather, we view it as an opportunity to improve companies from an environmental, social and governance perspective. We must not be afraid of lending to companies that are beginning the ESG improvement journey and helping them with capital and engagement to improve. For example, we have helped businesses reduce their carbon emissions and negative social impacts, and also to improve their governance. A more sustainable future is in the interest of all.

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