The Evolution of Credit

January 2021 Commentary

COVID-19 vaccines are being rolled out slowly, with the market looking through the delay. While vaccines are proving effective, they are being deployed unevenly and slower than anticipated in several jurisdictions. However, our view is that the distribution issues will improve materially over the next 6-8 weeks. In the meantime, the market is looking beyond the slower than hoped roll-out and focused on the end state. Deployment of vaccines is clearly critical for ensuring the public health impact of the virus is under control, which is a necessary condition for economic re-opening. Ultimately, we believe that governments likely won't ever vaccinate more than half of the population, although the take up will be much higher for cohorts of advanced age. We believe the end state will likely look a lot like the flu and that herd immunity is likely never achieved (in part because of the mutability of the virus).

Given valuations, a disciplined investment approach is warranted. From a policy perspective, governments and central banks are pursuing supportive monetary and fiscal programs. These policies have succeeded in suppressing market volatility and will continue to do so (setting aside social media driven short squeezes!). While this is encouraging, much of the good news is already reflected in valuations. On average, credit spreads have narrowed back to levels last seen pre-pandemic. This is consistent with an equity market that continues to set new highs despite the economic turmoil caused by a global pandemic. However, looking at an average credit spread does not tell the full story, as this single number masks the high degree of dispersion across companies, geographies, and sectors. Given the valuation backdrop and the market risks, we believe this is an environment where credit selection is paramount, but where attractive opportunities do exist.

As the global credit markets evolve and respond to local developments, the relative value picture will continue to change. We actively manage our portfolios to best capture that value. For example, in recent months we have been selectively moving exposure from defensive sectors to more cyclical areas of the market more exposed to re-opening. We have been doing so on the back of detailed credit analysis from our research team and with a focus on security selection. Another example - on a relative value basis the EUR credit market has been looking more attractive in recent months and so we have increased our allocation to that currency block. Where we have deployed capital there it has generally been in large, strong credits.

Corporations will pursue different approaches to managing the additional leverage they have today. Corporations raised a record-breaking amount of liquidity last year given the uncertainty ahead. It is still somewhat uncertain what we see companies do with this additional liquidity. Some have indeed started to pay down debt while others have "termed-out" their debt by issuing longer-dated securities to replace bank loans. With the cost of debt so low by historical standards, debt reduction is not necessarily the right corporate strategy to pursue. For some businesses, it may be a better long-term strategy to use that cash to grow organically or via M&A. Others may look to boost their stock price and valuation by returning the liquidity directly to shareholders.

We are focusing on companies that are being prudent and are avoiding those focused only on boosting the share price. We are predisposed to companies that are either looking to reduce debt or those that will be able to expand and build market share and profitability through expansion, even if it means manageable debt and leverage increases. Some companies will end up with elevated debt levels - either through choice or because of economic pressure. These companies have a higher risk profile and so we will need to be adequately compensated to take this kind of exposure.

January was the first month of net rating agency *upgrades* since February 2020. Back in April of last year rating agencies were defensive given the uncertainty over the pandemic and forecasts of recession and even depression. Many companies were downgraded into high yield territory quite soon after the crisis started. A number of those corporations have since proven to have access to liquidity and funding, as well as better profitability than expected. Many of them are now starting to get upgraded back to Investment Grade. Clearly central bank policy has played a critical role here. We expect the positive ratings migration trend to continue and are focused on identifying companies where there is upside potential for the remainder of the year.

Environmental, Social and Governance issues continue to be front and center. Over the last two years we have seen a significant focus on climate risks, with companies and capital allocators refining their expectations for decarbonization. We acknowledge the pledge to reach net-zero targets by 2050 from the Ontario Teachers' Pension Plan (Canada's largest single profession pension plan with $204B in assets). In addition, General Motors announced an audacious step in the fight against climate change in January, targeting the sale of electric vehicles alone by 2035. The importance of this commitment cannot be understated as it will require significant transformation within their own manufacturing processes as well as global supply chains. Both announcements likely reflect the aggressive carbon reduction targets now in place amongst the signatories of the Paris Agreement. With the UN Climate Change Conference delayed until November of this year (originally to be held in November 2020) we expect additional announcements in the coming months. In Canada, the OSC recently codified climate-related reporting, requiring companies to report on climate-change related risks. Finally, OSFI announced they are conducting research on including climate-related scenario analysis into their stress testing framework, not unlike what has already been introduced in the UK by the Bank of England.

Important Information

Data as of January 31, 2021. Source: Bloomberg.

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