Opportunities in dislocated credit markets

Options for investors

May 27, 2020

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Overview

As the economic crisis caused by COVID-19 continues to develop, the global economy is entering into a deep recession of an uncertain length. This downturn is already likely to be the worst since the Great Depression of the 1930s. Huge shifts in economic activity and global markets have ushered in the next phase of the corporate credit cycle, characterized by widespread corrections in valuations, significant widening of credit spreads, illiquidity, forced selling and greater risk of downgrades and defaults. Governments and central banks have stepped in by launching a wide array of support programs, which already exceed their efforts during the 2008 global financial crisis. Although these actions have so far kept financial markets liquid, it might take some time until economic activity returns to pre-COVID-19 crisis levels.

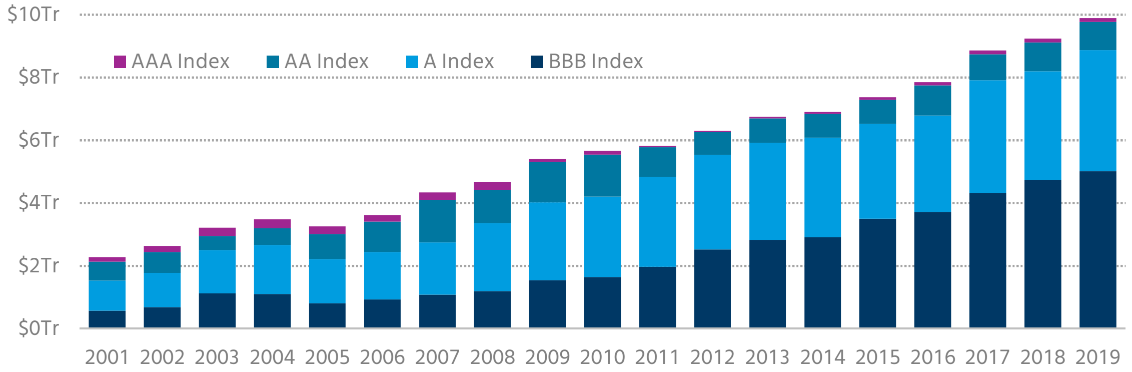
Credit opportunities within long-only fixed income, hedge funds and private markets are broad and likely to expand as the economic impact of the virus is reflected in corporate earnings and balance sheets. This type of environment has historically led to investment opportunities for long-term investors across the credit spectrum. Investors seeking to benefit from credit dislocation should ensure that suitable portfolio allocations are in place.

Below we outline the state of the credit markets coming into this crisis, the impact of COVID-19 and the various options investors have to take advantage of market dislocations in the short and long term.

Market impact

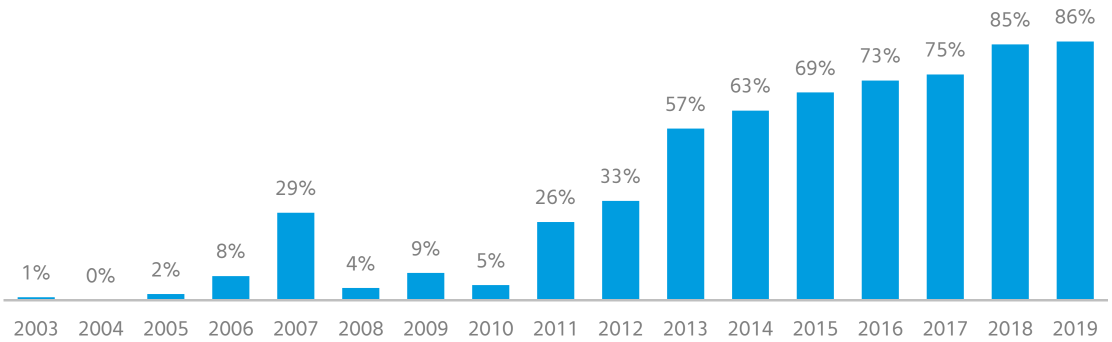
In recent years we have noted increasing risks in corporate credit markets, from both a quality and liquidity perspective. In particular, we have highlighted a considerable rise in lower quality debt issuance across the ratings spectrum (see Figure 1), a decline in creditor protection mechanisms (such as loan “covenants” – see the number of covenant-lite loans in Figure 2) and regulation-forced reduction in market making. Additionally, as investors' search for yield expanded, assets flowed into riskier corporate debt securities, leading to tighter spreads and a lower premium for moving down in quality (see Figure 3).

Figure 1. Global investment grade market outstanding by rating



Source: Bloomberg

Figure 2. Covenant-lite loans as a percentage of all new issuance



Source: S&P LCD, Barclays

Figure 3. Global high yield premium over investment grade

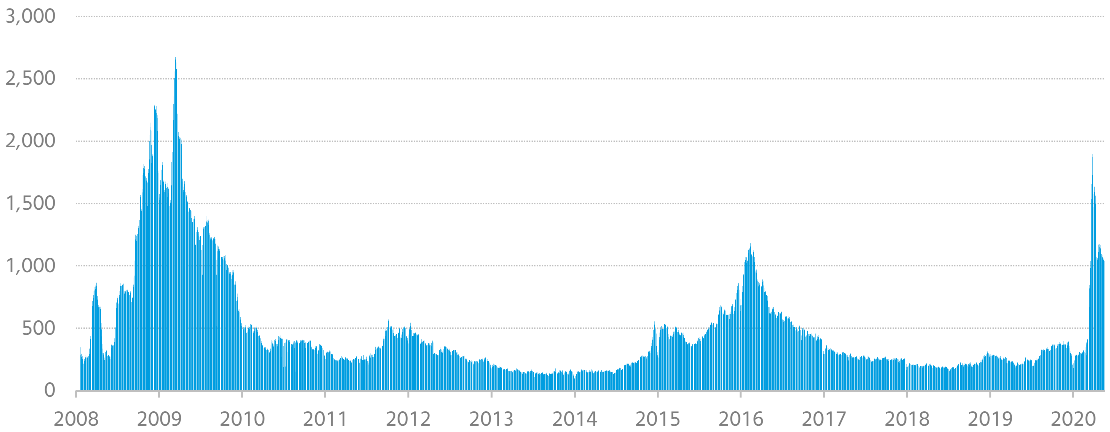
Source: Bloomberg

These risks came to light as fears surrounding the economic impact of COVID-19 began to rattle global markets. Initial selloffs were widespread. The riskiest credits fared worse, with high-yield bonds effectively losing four years of gains in the first three weeks of March (see Figure 4). Many securities were quickly propelled into "distressed" status – defined as trading above a 1,000-basis-point spread over US Treasuries) - surpassing 2015-2016[1] levels in a matter of weeks (see Figure 5).

Figure 4. Global high yield cumulative return

Source: Bloomberg, Barclays global HY index

Figure 5. Number of distressed issues



Source: Bloomberg

[1] The 2015/2016 downturn was comparatively mild and driven by concerns about a slowdown in Chinese economic growth and a collapse in commodity prices, especially energy. Within credit, it was therefore the energy sector, which is predominantly high yield that was the most affected. Other sectors were largely insulated.

Following the initial violent selloff, markets were somewhat pacified by an assortment of central bank measures and the start of government fiscal stimulus packages. The coordinated institutional support buoyed credit markets: the Bloomberg Global High Yield index lost more than 21% in US dollar terms between March 5th and March 23rd, but recovered 13% between March 23rd and mid-April.

Although the initial sell-off was broadly based, sectors like energy, travel, leisure and retail were hit particularly hard. The partial recovery in the general level of bond prices masks some dispersion between sectors. Those borrowers deemed to be more directly impacted by the societal shut-downs related to COVID-19 remain priced as such. The energy sector lost over 35% in the first quarter of 2020, as a result of a new oil price war between Russia and Saudi Arabia, as well as the impact of COVID-19 on energy demand.

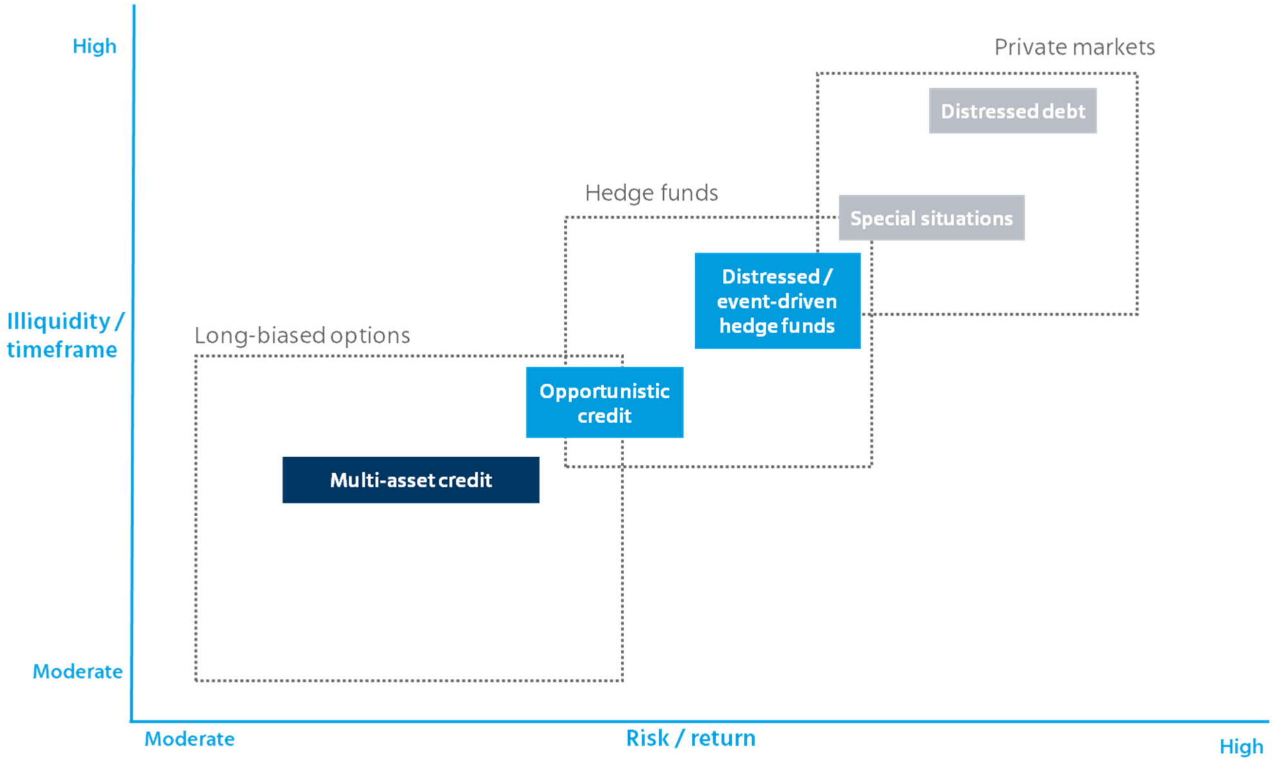
Although the market has begun to further discriminate between those firms that are at greater risk of impact, and price in unprecedented support from governments and central banks, we expect elevated volatility and market dislocations. Continued stress on corporate profits could usher in a sharp increase in downgrades, and we expect default rates to increase as economic conditions worsen. In public credit markets, bouts of volatility and individual borrower distress should provide opportunities for flexible and nimble investors in the months to come.

In private markets, there has been an immediate scarcity of new deal flow in the middle market, where smaller companies are typically not able to access capital markets. The uncertainty surrounding the shape and speed of the economic recovery from the current crisis and its ultimate impact on business models has stalled the underwriting of directly originated transactions. However, there is likely to be a large increase in opportunities to provide directly negotiated rescue financing to “good” companies with short-term balance-sheet problems or other opportunities to enable and benefit from a full turnaround or restructuring of a company.

Options for investors to take advantage of credit market dislocation

Although volatility in credit markets can represent opportunities for asset allocation more generally – high-yield bonds may represent better value and core private-debt transactions are likely to resume with higher spread levels and better deal terms – there are a number of types of strategy that are specifically designed to capture credit market opportunities during periods of dislocation. These will differ according to their risk and return objectives, as well as their liquidity terms and time horizon. At a high level, these are often labelled distinctly as multi-asset credit, hedge funds, or private markets strategies. However, in practice, there can be a lot of flexibility and overlap between them (see Figure 6).

Figure 6. Credit opportunity framework



Source: Mercer, for illustrative purposes only

Long-biased multi-asset credit strategies can allocate opportunistically between different areas of the credit market, including high-yield bonds, leveraged loans, securitized credit (such as asset-backed securities and collateralized loan obligations), emerging market debt, convertibles, and opportunistic/distressed debt. We view multi-asset credit strategies as the best positioned to achieve a favorable outcome within traditional fixed income options, given their flexibility. They are also often able to provide market-like returns, with less downside risk and lower volatility than single-sleeve credit options.

Although multi-asset credit strategies can provide quicker exposure to credit markets, they are long-biased and are likely to underperform when credit markets weaken. Opportunistic credit hedge funds may impose more restrictive liquidity terms on fund vehicles, but can offer flexibility along the credit spectrum. They can also provide access to other drivers of return, such as the selective shorting of credits and a more active approach to distressed debt investing. Distressed/event-driven hedge funds can target stressed credits in a more focused manner, but generally impose more stringent liquidity terms.

Private markets special situations strategies also seek to capitalize on market volatility, pricing dislocations and periods of stress, either on a primary (directly negotiated transactions) or secondary basis. Strategies can range in terms of breadth and flexibility, potentially incorporating shorter-term secondary trades, as well as directly negotiated transactions in situations of complexity or distress, and generally carry the least liquid investment terms. Generally, longer-dated and more complex opportunities carry a commensurate increase in both risk and return. Those strategies focused on generating a higher proportion of returns through equity ownership, such as "distressed-for-control" strategies, will rely more on long-term capital appreciation. The range of outcomes for strategies incorporating a higher degree of equity ownership is likely to be more variable than those with a higher element of contractual margins from spread or up-front arrangement fees.

The range of strategies here is not a perfect continuum, in terms of liquidity profile or risk and return, and there are opportunities that are not represented specifically above. More generally, consistent providers of capital in complex situations – be it non-performing loans ("NPLs") or bank credit risk transfer ("CRT") – are likely to command higher premiums on a forward-looking basis, given the greater demand for liquidity and capital.

It is important for investors to understand the opportunity set, liquidity and likely speed of deployment, and the way in which returns are likely to be generated, when assessing the potential fit for their portfolio (see Figure 7).

Figure 7. Strategy characteristics

Strategy	Multi-asset credit	Credit hedge funds	Private markets special situations/ distressed debt
Income generation	Yes – fund specific	Limited – fund specific	Limited – fund specific
Use of leverage	No	Limited – fund specific	No
Use of shorting	No	Yes – fund specific	No
Distressed/restructuring	Limited – fund specific	Yes – fund specific	Yes – fund specific
Liquidity	Semi-liquid; daily to quarterly	Semi-liquid; quarterly to multi-year	Illiquid; multi-year
Capital call structure	No	No	Yes

Source: Mercer, for illustrative purposes only. Leverage is defined as explicit leverage, not implicit via derivatives such as futures.

Final thoughts

Despite the uncertainty and volatility, we believe the opportunities created by the pandemic for investors able to benefit from credit-market dislocation are considerable. Although there appears to have been a broad-based resetting of valuations at more attractive levels, not all of the apparent opportunities for investment will turn out favorably.

We believe the most effective way to benefit from this unprecedented period is through the use of skilled managers and strategies that are highly selective in the securities or deals in which they invest. Less liquid hedge funds and private markets special situations and distressed debt funds are likely to have the greatest returns, given the timeframe required to harness opportunities and their illiquid nature. Within this space, engaging managers with restructuring expertise could prove beneficial in enhancing process-driven outcomes, such as negotiated settlements. Prospective investors must be comfortable with lower levels of liquidity and, for private markets, the governance burden in respect of capital calls. However, we believe that some of the closed-end vehicles that are launching offer some of the most compelling return opportunities over a multi-year horizon.

Each of the different types of strategies discussed above have risks attached to them, and as always there is no guarantee that any specific strategy will prove successful. With this in mind, Mercer advocates building a diversified portfolio consisting of differentiated strategies to mitigate exposure to the risks attached to any single strategy. Under this approach investors can also gain exposure to different strategies which benefit from different aspects of a dislocated market. For example, a mix of short-term opportunities to benefit from price gains as a result of indiscriminate selling pressure, medium-term opportunities to provide finance to companies with temporary and complex liquidity challenges, and long-term opportunities to benefit from the full restructure of balance sheets and turnaround of companies operationally. Although it can be challenging to understand the nuances between these strategies, the effort in doing so can be particularly rewarding when planning an optimal portfolio allocation.

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This document summarizes Mercer's views on the medium-term outlook for relative returns from the key asset classes; by medium term we mean one to three years. The views expressed in this report are relevant for reflecting medium-term market views in determining appropriate asset allocation and manager benchmarks. We do not expect clients to make frequent tactical changes to their asset allocation based upon these views. The views expressed are provided for discussion purposes and do not provide any assurance or guarantee of future market returns.

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