IS IT TIME TO INVEST IN GLOBAL CREDIT?

Q&A WITH LOOMIS SAYLES GLOBAL FIXED INCOME PORTFOLIO MANAGERS

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GLOBAL CREDIT LANDSCAPE

After years of fair-to-fully valued credit markets, global credit appears relatively cheap again potentially providing an opportunity for investors to consider adding to their global credit allocations. The acute impact of the COVID-19 outbreak on global economic activity, as well as a simultaneous oil price war between Saudi Arabia and Russia, has contributed to significantly higher credit spreads in the sector. In the following Q&A, the Loomis Sayles Global Fixed Income portfolio management team shares its views on the global credit markets, opportunities and risks.

MANAGER INSIGHT

David, what are the current recession risks in the US, European and broader global economies?

We expect the hit to global-GDP growth in the first and second quarters of 2020 to be significant. While we forecast negative GDP in the US (approx. -3.5%) and Europe (approx. -5.0%) for the second quarter, it is less certain whether the impact of the economic slowdown will drive negative growth into the second half of 2020. While there is a possibility the global economy moves towards a technical recession, what is more certain is that a sharp downturn is now underway.

David, will fiscal and monetary responses be enough to carry the economy through the COVID-19 crisis?

Global governments and central banks have not been idle. We believe their fiscal and monetary stimulus measures are offering liquidity to stubbornly tight markets and helping provide much needed financial support to small and large companies and a range of industries.

In our view, valuation of risk assets now requires an evaluation of how much damage has been inflicted on future private-sector and vulnerable government revenues. With this estimated we can compare it to the size of new liquidity and the pace of reinvestment of what may be the largest global cash pile on record.

GFC

We think that one lesson of the recovery from the Global Financial Crisis (GFC) is that cash dominates revenue disappointment. The GFC recovery was only about one half of the expected pace of prior recoveries compared with prior recessions. But this top line disappointment did not prevent credit spreads from falling below 100 basis points (bps) for investment grade bonds, and equity P/E ratios rising above 20. Arguably, the experience of Japan and the Eurozone also suggest that, in the absence of inflation, cash will likely dominate.

As we did in the GFC, the Global team expects to again harness our research expertise and find potential value in discarded high-quality issuers to seek long-term results for our clients. With significant disruption to business conditions, we expect there will be winners and losers for our fundamental credit analysts to uncover. Our team has navigated a variety of stressed markets throughout its nearly three decades of investing in global credit.

Scott, what will be the impact on corporate profits?

While, monetary and fiscal stimulus will help cushion the blow from what is nearly a full national shutdown, revenues and profits will certainly be impacted. In the US, we expect S&P 500 and NIPA 2020 profits to decline by 30% or more, with similar declines in other developed markets.

How will BBB issuers and Fallen Angels fare?

Based on our outlook for the first half of 2020 corporate earnings, we are projecting higher "fallen angel" activity in the BBB tier of the investment grade corporate bond market.

The Loomis Sayles credit research organization regularly and comprehensively tracks BBB downgrade risk activity. For example, prior to the current crisis, it estimated that US dollar (USD) $297 billion (par value), or approx. 9% of US BBB issuers, were at "medium-to-high risk" for downgrade to high yield status. The team now estimates BBB downgrades will likely be nearly twice our projections before the crisis around—$668 billion, or approx. 20% of the BBB market.

Primarily hard hit energy and lodging issuers are driving this surge in potential downgrades. We believe, depending on the duration and depth of the economic slowdown, there remains upside risks to our forecasting for downgrades. While concerning to the overall BBB market, it is worth noting that this recent assessment represents 11% of the overall USD investment grade corporate market.

From an investment standpoint, we think this market can play to our strengths. Information combined with experience has the potential to expose likely opportunities for analysis. We believe judiciously parsing winners and losers can put us in a strong position to be liquidity providers at potentially attractive prices.

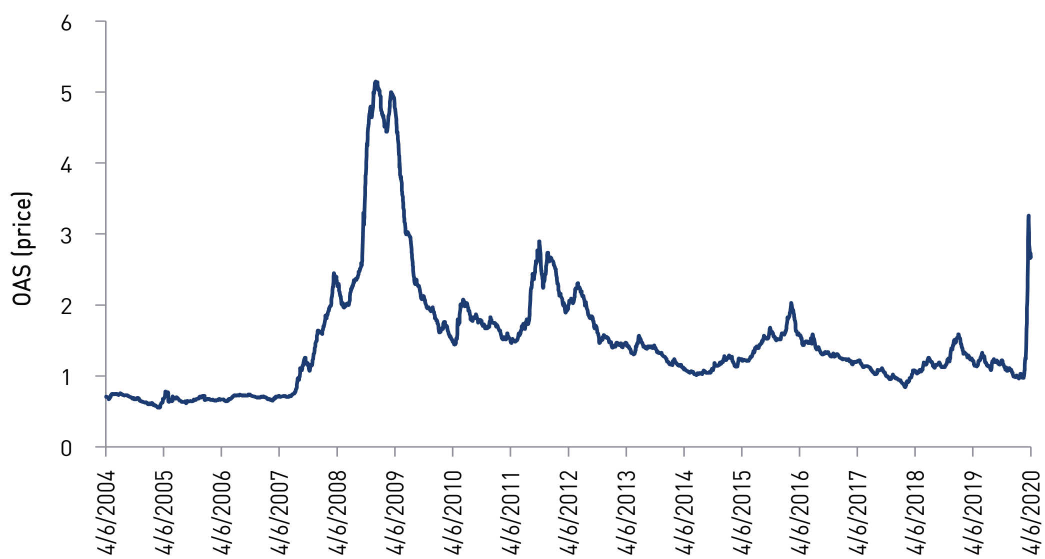
	BBB DOWNGRADE ESTIMATES	
	BBB HIGH-MEDIUM RISK OF DOWNGRADE AS % OF BBB MARKET PAR AMOUNT	BBB HIGH-MEDIUM RISK OF DOWNGRADE AS % OF IG MARKET PAR AMOUNT
1/30/2020	9%	5%
4/4/2020	23%	12%

Source: Loomis Sayles estimate of Bloomberg Barclays US Aggregate Corporate Index,as of April 4, 2020.

Lynda, when will global credit spreads peak in this crisis?

After making a high of 326 bps in late March, credit spreads are trading in the range of 225-250 bps over global Treasuries. Even with the near-term recovery in spreads, these levels are significantly higher. Spreads appear to be pricing in a surge in investment grade credit rating downgrades and a rise in high yield defaults. Global investment grade corporate bond spreads have only seen this level twice in the past four decades—in 2008 and 2009 peaking at 515 bps during the global financial crisis. In contrast, global high yield corporate bond spreads are trading in a range of 900-1100 bps (vs. peak 1845 bps in November 2008).

GLOBAL INVESTMENT GRADE CORPORATE BOND SPREAD



Source: Loomis Sayles as of April 6, 2020.

While predicting the end of this period of reduced global economic activity is difficult, so too is forecasting the peak level in credit spreads. Loomis Sayles has developed proprietary credit models that offer us perspectives on 1) historical spread valuations after considering downgrade losses and 2) estimates of probable positive future excess returns.

TRACKING THE CREDIT RISK PREMIUM

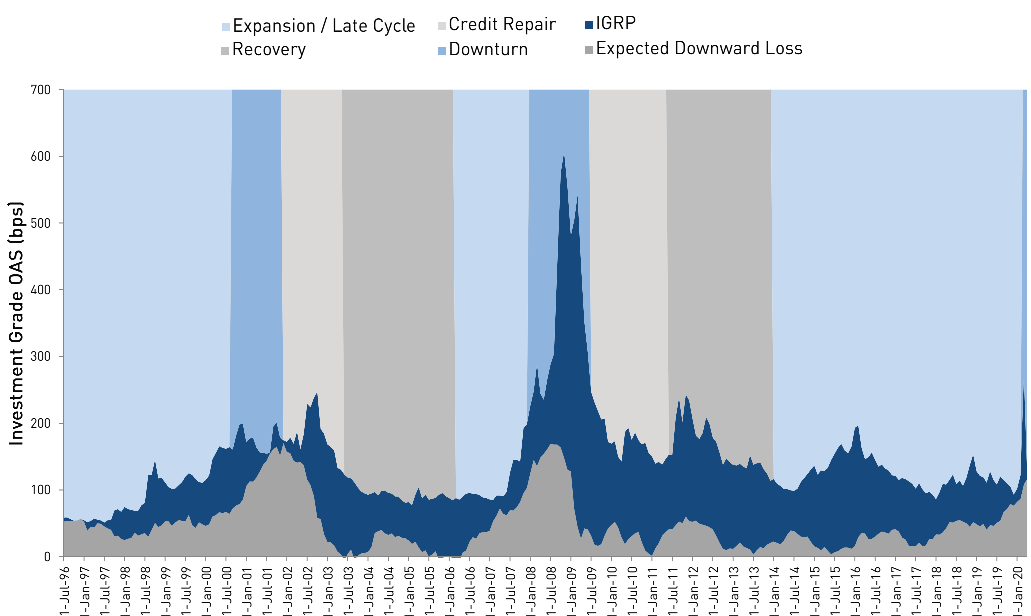
While being one of many different inputs into our investment process, these credit risk premium models visually highlight the pricing dislocations that frequently occur in markets driven by technical factors.

THE INVESTMENT GRADE RISK PREMIUM

Spreads can and do deviate significantly from underlying fundamental fair value frequently, often exacerbated by an inflated liquidity risk premium, as in 2009 and as we are witnessing now. Importantly, we believe our research indicates that the IGRP model can be a far better predictor of forward excess return potential than simply the starting spread level (OAS), as fundamental factors such as forward-looking credit migration and default loss estimates are accounted for in the model. The accuracy of the credit model is supported by its dynamic measurement of macro risk factors (e.g., core PCE inflation, real hourly wages, interest coverage ratios, etc.) that historically respond to, and correlate highly with, credit rating downgrades across the four different regimes (expansion, downturn, credit repair, and recovery) of the credit cycle.

The Investment Grade Risk Premium (IGRP) model (pictured below) tracks the credit risk premium available to be harvested after accounting for expected losses from credit rating downgrades. Spreads can and do deviate significantly from underlying fundamental fair value frequently, often exacerbated by an inflated liquidity risk premium, as in 2009 and as we are witnessing now. Importantly, we believe our research indicates that the IGRP model can be a far better predictor of forward excess return potential than simply the starting spread level (OAS), as fundamental factors such as forward-looking credit migration and default loss estimates are accounted for in the model. The accuracy of the credit model is supported by its dynamic measurement of macro risk factors (e.g., core PCE inflation, real hourly wages, interest coverage ratios, etc.) that historically respond to, and correlate highly with, credit rating downgrades across the four different regimes (expansion, downturn, credit repair, and recovery) of the credit cycle.

SEPARATION OF DOWNGRADE LOSS AND PREMIUM COMPONENTS



Source: Loomis Sayles, as of April 2, 2020.

The current credit risk premium on offer in the investment grade credit market is at potentially attractive levels relative to historical observations.

MACRO ANALYSIS

The Loomis Sayles Macro Strategies team recently published a detailed study of historical investment returns after prior crises that included significant credit spread widening (see Is it Prime Time for Credit?). The team observed that investors can potentially benefit for investing in global credit at times like these.

Scott, what are the key characteristics you are considering when making buy and sell decisions within industries and issuers?

We believe that a consistent focus on fundamental value over a credit cycle in conjunction with dynamic active management can enable us to capitalize on pricing anomalies and capture the investment grade credit risk premium. While market valuations and risks have changed across industries and issuers during this crisis, our investment approach has not. We continue to follow the credit investment process we've implemented for multiple decades and during many different market cycles.

Our investment philosophy is governed by the following key principles:

1. Dynamic active management can help capitalize on inefficiencies in global credit markets.
2. Tactical sector and industry allocation, via effective credit beta management and a concentrated focus on risk-adjusted security-level relative value, are key to potential alpha generation.
3. Market prices reflect fundamentals over time yet may diverge in the interim for a variety of technical factors.

Guided by these principles, we have been adding to industries and issuers that we believe will survive this economic slowdown while avoiding those areas where the outcomes are most uncertain.

These industries include banks, health care, consumer non-cyclicals, communications, energy and emerging markets where we are selectively adding to issuers that entered this crisis with a combination of many or all of the following characteristics:

- well-known franchises
- strong balance sheets
- diverse and stable revenue streams
- low near-term liquidity needs
- bonds trading at a deep discount to par value

POTENTIAL OPPORTUNITIES

In the energy space in particular, we have added to issuers that we feel can temporarily sustain lower revenues, have hedged their near-term oil or gas production and are not burdened by near-term maturity walls which will require financing. Even in the hardest hit industries, such as travel and leisure, we have participated in two new issues of online travel companies (one each in investment grade and high yield) that appear to have sufficient liquidity through 2021 even under extreme stress test scenarios.

GLOBAL DIVERGENCE

We have also noticed a divergence in valuation by region across the global credit opportunity set. We have made purchases in both the primary and secondary markets across USD, euro and British pound investment grade, as well as high yield. These have skewed to the US corporate market given its relative attractiveness.

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In the first quarter of 2020, excess returns in US corporates (-14%) were significantly more negative than in Europe (-7%), even after accounting for duration and index composition differences. Over time, these returns are generally about 80-85% correlated, so the current difference is conspicuous. That said, rather than making a sweeping decision to allocate more to the US market, our increased exposure to USD bonds versus Euro denominated bonds has resulted from individual security selection decisions.

Although the majority of our recent buys have favored the USD market, we have also found a number of potential opportunities across Europe. While the reasons for differences in relative performance between the markets are quite complex, we believe the existence of an abundance of "fast money" in the US credit markets, as well as differences in investor expectations for individual companies, are likely among them.

HIGH YIELD

In high yield, we have selectively added to this sector, but the bulk of our risk addition has been across investment grade. Global central-bank support is firmly centered on investment grade credit, in the US and Europe. While we do not dispute that there will be positive knock-on effects for high yield based on the support for the high grade market, we believe that the higher quality companies are much better situated to weather the economic slowdown. With the unknown duration of the crisis and extent of the negative impact to corporate earnings, we believe there is an elevated risk of losses ending up materially higher in high yield than spread currently suggest.

DISCIPLINE

While we believe an abundance of opportunity exists, and in some cases relative value is most pronounced in specific industries, we still maintain a disciplined approach to risk management and diversification. Where we do add credit beta risk in the portfolio, we limit industry overweights and underweights to only 15% of the total active credit beta risk. At the issuer level, we do not exceed a 3% contribution to relative credit beta from any single issuer. This discipline ensures that no single investment idea or industry can disproportionately dominate the portfolio.

Lynda, we hear liquidity is challenging in the current market environment. What does that mean for bond prices, and what signs of improvement do you see?

We continue to have substantial room to increase risk in our portfolios, but we are dealing with challenging liquidity conditions. However, a couple of developments could improve market access:

- the US Federal Reserve's Primary Market Corporate Credit Facility (PMCCF) and
- Secondary Market Corporate Credit Facility (SMCCF)
- European Central Bank's increased corporate bond buying programs

Lynda, new issuance is also spiking. Is that a concern?

Primary markets in the US and Europe are open for quality issuers that have been coming forward with deals at very attractive levels and concessions, in our view. This has aided our ability to add risk to portfolios. In the US, investment grade corporate issuance was a record USD $262 billion in March, up 129% compared to March 2019. Euro and pound sterling issuance was also highly active in March at approximately USD $50 billion. While this could be viewed as potentially concerning on a headline level, we view this trend as healthy since companies are primarily using these proceeds to build liquidity buffers. Longer term it can also give issuers more flexibility and options to manage their short and long-term liabilities.

QUALITY

We have seen markets become increasingly bifurcated with high-quality paper and securities eligible for central-bank programs being better bid while BBB and cyclicals remain better offered. It is important to add though that it is not generically the same experience across credit as certain issues and industries trade better than others. For example, lower-rated BBB issuers at risk of receiving credit downgrades, trade below BBB issues with a stable or improving outlook.

Lynda, what is driving the difference in liquidity between the short and long end?

There is a liquidity disparity between short-maturity and long-maturity corporate bonds. We have seen many long-term institutional investors holding front end bonds previously viewed as liquidity sources for potentially higher return opportunities. We believe as credit markets have become cheap, few investors want to own short maturity bonds now instead preferring to increase spread duration exposure through longer dated issues. We have also seen the front end dislocated by mutual fund and ETF outflows as well as corporate treasuries selling short-dated corporate bonds to raise capital. Combine this supply-demand mismatch with bank dealers who are not increasing their balance sheets and front-end corporate bond market liquidity is quite challenged. We would note though that the US Federal Reserve's corporate bond buying programs are focused on the front end to help alleviate companies' near-term financing needs. Their active presence in this part of the market should have the added benefit of alleviating some of the supply and demand imbalance.

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