LOOMIS | SAYLES

THREE QUESTIONS ON CREDIT: OPPORTUNITIES FOR INSURANCE

FEATURING PRAMILA AGRAWAL

HOW HAS COVID-19 IMPACTED CREDIT MARKETS?

The extreme shock caused by COVID-19 came at a time when global central bank policies were coalescing toward a more accommodative stance to keep the late expansion phase of the credit cycle going. Prior to the outbreak, we viewed valuations as tight but not overly rich. A strong consumer rate buoyed by an ultra-low unemployment rate was backing a stable outlook on US GDP growth. As the pandemic took hold and caused unprecedented global shutdowns, credit markets took a swift and severe hit. For instance, US corporate spreads (ICE US Corporate Index) started the year at 101 basis points, widened to 130 basis points as of the end of February, and over the next three weeks tripled to 398 basis points. Fundamentally, all sectors have been affected, some more than others, although our base case is that this downturn, while harsh, will not be as severe as the systemic banking meltdown of the Global Financial Crisis.

Corporations are rushing to boost liquidity by either drawing on bank revolvers (close to $200 billion drawn over the last three weeks) or issuing new debt (we saw record new issuance in March). Liquidity has been a huge casualty of this crisis. Early on, higher-quality bonds saw disproportionate selling, leading to inverted front-end curves for higher-quality issuers. Bid/ask spreads widened to 4 to 5 times the normal amount. While there has been some reprieve in liquidity this week, conditions are still far from normal based on our research.

WHAT DOES THE CREDIT OPPORTUNITY SET LOOK LIKE NOW?

We are seeing potential credit opportunities that haven't been available in some time. Credit spreads and yields are at the highest points we've seen in over a decade. However, there's wide dispersion across credit markets and potential opportunities must be examined carefully as there's increased downgrade and default risk going forward. As global profits have plunged, our long-brewing fear regarding the health and stability of the BBB-rated portion of the corporate index has taken center stage. We have long maintained that BBBs are not created equally; while some issuers have the financial flexibility and balance sheet strength to weather a downturn, several others have stretched balance sheets and limited financial flexibility to manage their credit metrics. These stressed issuers will likely face potential credit migration and even default. Even within the most stressed sectors, such as lodging and leisure, airlines and energy, there will be winners and losers.

Currently, we believe both investment grade and high yield markets are offering attractive risk premiums and we are increasing exposure to well-positioned credits. One example is the global financial sector. US and European banks, which were generally well-positioned going into this crisis with robust balance sheets, ample liquidity and high asset quality, are now strained by new pressure on net interest margins and mounting loan losses. This sector is receiving the much-needed critical support from multiple Fed programs to boost liquidity, ease regulatory pressure and support asset prices.

WHAT CAN INSURANCE COMPANIES DO/ADJUST TO TAKE ADVANTAGE?

For insurance companies, navigating today's volatile markets is a complex task as they are evaluating significant changes in liabilities while simultaneously estimating impairments in their investment portfolios. We believe insurance companies should adjust their portfolios to take advantage of the potential credit opportunities now. We believe ensuring that there is sufficient liquidity for changed liabilities is the foremost concern, followed by considerations for the wave of downgrade and defaults that will increase risk and capital charges within portfolios. Some insurers may need added liquidity for a higher level of claims, especially healthcare insurers and business interruption insurers that will have to make important decisions on how to source liquidity while minimizing realized losses and maximizing higher-income securities.

For companies that had underutilized their risk buckets and were defensively positioned going into the downturn, we believe this is a potential opportunity to dial up risk and gain exposure to lower-quality assets to harvest what we believe is an attractive risk and liquidity premium. For those already holding risk exposure, we view this as an opportunity to start de-risking in stages. Given the uncertainty of the COVID-19 timeline and how long global economies will take to normalize, we believe it would be prudent to assume that the recovery will be slow and prolonged. Rebalancing in volatile markets with severely reduced liquidity presents unique challenges and careful consideration of transaction costs; asset manager skill in transacting in shallow markets becomes even more important. Some important rebalancing questions to consider are:

-What is the true risk premium of attractive asset classes? This should take into account severity and length of downturn and forward-looking credit migration assumptions.

-What is the actual improvement in income after accounting for transaction costs?

-How will rebalancing position liquidity and risk levels across different downturn/recovery scenarios (i.e. V-shaped, U-shaped, L-shaped)?

AUTHOR

PRAMILA AGRAWAL, PHD, CFA
VP, Director of Custom Income Strategies

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