Ostrum
ASSET MANAGEMENT

2021, the end of the Covid crisis? Anticipating the future on the credit market

Since the beginning of the year, the markets have had to deal with a sharp and rapid rise in interest rates on both sides of the Atlantic. Credit yields, although historically low, remain much higher than sovereign rates, which are still in negative territory, particularly in the Eurozone.

The market is moving in an environment where two conflicting forces are at play:

- Firstly, stimulus, which is huge, with markets hoping for an economic recovery. Central banks are buying heavily (the Fed is buying more than $120 billion per month while the ECB has announced an increase in the PEPP)
- On the other hand, investors' concerns - which are sometimes excessive - about a resurgence of inflation have led to a rise in rates, accompanied by a steepening of the yield curve, with very long-term investments (20 or 30 years) suffering more than very short-term ones.

Since the beginning of the year, the US 10-year rate has risen by 77 bp, while the Bund and the OAT have risen by 26 and 28 bp respectively.

What is the impact on the credit market?

The credit market has remained relatively immune to the rise in sovereign rates in Europe for the time being, while the US Invest Grade segment has suffered *mainly because of interest rates*.

Euro and US Investment Grade have seen their spreads narrow slightly, partially offsetting the rise in sovereign rates.
High Yield, on the other hand, held up better, benefiting from a larger spread cushion and a lower correlation with sovereign rates.

The *negative* correlation between nominal rates and BBB credit spreads goes back to the post-war period: if rates are low, it means that growth is stronger than expected, which is good for companies, and we will tend to see a narrowing of spreads as margins recover. This is a rather logical situation, which is not linear either, since there are peaks, and some exceptions like in 2013, with a withdrawal of liquidity that can be quick. But the correlation is established.

The really important point for *risky asset classes*, including credit, is real interest rates. These have risen sharply in the US since early February. *Fortunately, we are still in negative territory* (the US 10-year real rate is at -0.70%), but we are seeing a sharp rise in real rates, which can be problematic because they are positively correlated with credit spreads.

The real issue this year will therefore be the rise in real interest rates, which, if too fast and too strong, will be a disadvantage for risky asset classes and central banks (given the huge amount

of debt that have accumulated over the years and the resulting overall leverage) and will prove lethal for the economic recovery.

The Fed has recently adopted a more hawkish stance on price pressures and inflation, which is not expected to be persistent and major. We are beginning to see a shift in the central bank's rhetoric, even though the economic recovery will be accompanied by a rise in rates in any case.

What are the opportunities on the market?

Even if we observe a rise in rates on the 10-year rate/Bund/OAT, we still have this "magma" of negative-yielding debt, made up mainly of Japanese and European sovereign debt *but not limited to these*.

The opportunities do not necessarily seem obvious at first glance, especially because of the $11 trillion of negative yielding debt, and Investment Grade credit is no exception, as there is a high proportion of negative yield on European IG credit today. 1/3 of the emissions of an Investment Grade index are dealing with negative yields, and these negative yields still have little appeal to investors, especially long-term investors, who do not have a natural appeal and even find it difficult to invest in these stocks.

Nevertheless, within the 2/3 positive yields, there are sources of value. Before presenting these sources of value in detail, it is important to return to a criteria that has become more important in 2020 and has now become essential for an investment in credit: the consideration of ESG factors.

ESG criteria, an important factor

When we look at the movement of spreads by sector compared to their pre-crisis levels, we see that the spreads of each sector have returned to levels that are tighter than their pre-Covid levels, despite the impact that the crisis may have had on their fundamentals, thanks especially to central banks and governments, which have offset all these impacts.

One notable exception is the oil and gas sector, where spreads have widened despite the rebound in oil prices to pre-Covid levels. This is due to the ESG impact, which clearly became material in 2020 in the credit market. Oil companies have a structural problem with ESG criteria, due to their contribution to global warming.

In 2020, these companies have suffered from the crisis like the others but have not been able to bounce back compared to other sectors, since there has been a lack of interest, or even a disavowal, from investors. Rating agencies are increasingly taking these criteria into account: S&P has downgraded four major players in the sector, pointing out especially the pressure

exerted on these players by the growth of renewable energies and the fact that investors are turning away from this industry.

The boom in SRI-labelled funds in 2020 is further proof of the importance of ESG criteria. Assets under management with the SRI label have increased by 40%, and at the end of 2020 the number of SRI-labelled funds in France reached 500. Ostrum has 23 SRI-labelled funds, including several credit funds. This number will continue to grow (Ostrum's objective is to obtain the SRI label for 98% of its funds by 2022).

As yields are low, spreads are extremely costly, and it is therefore necessary to consider the materiality of these ESG criteria before making any investment in the credit market.

To come back to the market context for the investment grade credit segment, we can see that yields are exceptionally low, with a 0.3% yield on the asset class. This is not the lowest the market has ever seen, as in December 2020, we were at 0.18%. Admittedly, we are in a context of very low interest rates in absolute terms, despite the rise we have seen since the beginning of the year, but over the last 20 years, the average yield on this asset class was barely below 3%.

Today, with 0.3% and a duration of over 5 years, the breakeven is at 6-7 bp. If the spread is higher than that, the performance will be negative, leaving a relatively small cushion. Yields are negative on all maturities below 3 years in this asset class, as well as on ratings above A+, which leaves two options for positive returns: go longer on the credit curve or move down the rating scale.

However, there are different opportunities for investors in the credit market:

- In terms of timing, the yield ratio (which allows us to see how much better they yield) of hybrid corporate issues is historically high (hybrid issues about 3.5x more yield than their senior equivalent), which confirms the attractiveness of this segment.
- US dollar issuance offers a yield of 1.5% for US investment grade compared to European investment grade. This seems attractive, but the correlation with US 10-year yields appears to be a drag. In the current environment, where rates will continue to rise slightly in the short term, the timing is not yet ideal to choose this as a source of diversification.
- We therefore prefer BB, which offers the same excess return with a good yield/risk ratio with high yield, which offers 1.5% more return than BBB. The ratio is comparable to that of hybrids, which is 3 to 4 times higher than the yield of BBB.

Moving down the rating scale seems to us to be a better opportunity than adding duration, especially because of the default rates, which remain very low despite a slight increase in Europe and the US.

Ostrum uses two different methodologies to calculate the default rate:

- A Bottom-Up methodology performed by the analyst team, which consists in analysing all the most fragile issuers to determine which issuers are likely to default. Using this method, the default rate is estimated at 2.6% at the end of 2021.

- A more top-down methodology, carried out by strategists, based on both macro variables (unemployment, growth) and market variables. This method only partially captures the massive government and central bank support (which created an environment for companies that would normally have defaulted and allowed them to re-fund), which explains the difference with the first method, since it is estimated at 4.5%.

According to Ostrum AM, the peak in default rates is behind us. There was a massive wave of *fallen angels* in 2020, but the pace is expected to slow down significantly. There is some inertia in the ratings of the rating agencies. The amount of BBB- rated bonds (with at least a negative outlook), could suggest a large new wave of downgrades in the High Yield category: of the 309bn BBB- bonds in Europe, 109bn have a negative outlook from one of the three agencies Fitch, Moody and S&P. While this may suggest that the level of *fallen angels* will be as high as last year, this is not the scenario anticipated by Ostrum AM. On the contrary, there should be more *rising stars* this year and the beginning of 2021 seems to confirm this view, as there are more *rising stars* than *fallen angels* in the credit market.

Conclusion:

The credit market is experiencing a much more volatile rate environment than expected, with two opposing forces working against each other. Despite this, 2021 will not be a year of bond crashes like 1994, but a year when rates should rise. The US 10-year rate should rise to 2% while the 10-year Bund should not move *much*, the ECB is buying tens of billions of securities every month and we will be in a net negative supply of govies with the ECB buying everything in its path, which means much less to fear in Europe.

In our opinion, investors should be much more aggressive in hedging their credit portfolios and focus on what is less sensitive to rates: shorter securities, funds with shorter durations, medium maturities, variable-rate bonds such as ABS (securitisation has performed extremely well since the beginning of the year, as 95% of this segment is made up of variable-rate bonds). The further down the rating scale investors go, the less sensitive they will be to rates: BB and BBB funds and crossover funds offer a marginal dose of risk with a substantial gain in yield.

As for the most favourable segments, U.S. investment grade credit (even if currency hedged) offers a significant return. As soon as US rates start to fall, this is a credit segment that will be interesting to watch and to which investors can turn.
The ESG approach is unavoidable: we are seeing more and more green bonds and sustainability-linked bonds being issued. *A change* in the financial sphere is underway.

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About Ostrum Asset Management

Ostrum Asset Management draws on its investment expertise to enhance the impact of its clients' commitments as they act together to support European citizens' life plans, health and retirement.
A European institutional investment management leader[1], Ostrum Asset Management supports its clients in their liability-driven investments, offering both asset management solutions on the back of its long-standing fixed-income and insurance-related management expertise (equity and fixed income), and investment services via its innovative technological platform.
Ostrum Asset Management is a well-established responsible investment advocate[2] and manages €448 billion[3] in assets for large institutional clients – insurers, pension funds, health insurers, corporations – as well as €581 billion[3] in assets under administration for professional investors worldwide across all asset classes. Ostrum Asset Management is an affiliate of Natixis Investment Managers.

1. IPE Top 500 Asset Managers 2020 ranked Ostrum AM as the 77th largest asset manager, as at 12/31/2019. Any reference to a ranking, a rating or an award provides no guarantee for future performance.
2. Ostrum AM was one of the first French asset manager signatories to the PRI in 2008. More details; www.unpri.org
3. Source: Ostrum Asset Management, consolidated data at end-December 2020. Administered assets include Ostrum AM's assets. The services provided for a given client may concern certain services only.

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