

## FINDING THE SWEET SPOT IN CREDIT IN 2021

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The 2020 global pandemic resulted in an unprecedented international policy response from monetary and fiscal authorities. And as interest rates fell sharply to zero, or more negative in some instances, investors are now left with a conundrum of where and how to source yield as interest. This has inevitably led many investors reaching for higher income/yield by increasing risk exposure to nominal interest rates, the economic cycle or illiquidity.

Our 2021 outlook has a base case of further tightening in credit spreads, targeting AUD credit spreads reaching a new post-GFC low of around 75 basis points (bps) in 2021 vs 94bps currently.

Considering the insatiable demand for yield, we feel the following will become increasingly important in 2021 for investors:

- global expertise to identify pockets of value with an Australian viewpoint;
- flexibility to extract value across all fixed income instruments; and
- fundamental credit analysis to identify bottom up credit risk and resilience and whether this is in the price for an issuer's corporate bonds.

In this short paper, we will outline why credit remains an attractive option for investors in the coming year, especially with increased competitiveness, and where the "sweet spots" will be.

The 2021 outlook is the tale of two events: the roll out of COVID-19 vaccines, which has the potential to offer huge upside to economic growth, and which will culminate in increasing discussion of future tapering of fiscal/monetary stimulus. These two factors will continue to be rambunctiously debated throughout investment committees in the coming months ahead.

In terms of nominal yields being forced higher due to an improved economic outlook in 2021, a note of caution should be heeded. Even if vaccines become as successful as hoped, we remain at the very early stages of a new economic cycle. Bear in mind, that the last time the U.S. Federal Reserve cut interest rates to near zero was 2008, and it then took seven years to increase interest rates with an additional three years to reach a high of 2.5 per cent.

As we look at reactions from multiple vaccine news reports in November, credit and equities have had a strong positive response, whereas government bond yields remained muted. Central banks yield curve control (YCC) measures globally will see the short-end of nominal yields remain well anchored. However, the above tussle of Quantitative Easing (QE) removal will see it fought in the long-end trenches of nominal bonds.

**Therefore, with buying programs expected to be maintained for at least 2021 and potentially longer (e.g. Australia's Term Funding Facility can be drawn up until 30 June 2021, providing 3-year funding) we will continue to see the need and demand for yield to outstrip supply – and to only intensify into 2021.**

## NAVIGATING A CROWDED MINEFIELD

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As discussed, rates and cash offer very little in way of yields for investors, therefore credit remains the attractive option. However, as demand has become ferocious, finding value and discerning selection will remain key for investors.

We feel that assessing a global opportunity set will be necessary in enhancing credit investors' search for value. As we see an ebb and flow of sentiment surrounding the new economic cycle, there will inevitably be winners and laggards. As government support wanes in 2021, fundamental credit selection to avoid the laggards will prove that being discerning in credit selection will be key to success.

Fundamental credit research remains as imperative as it always has been. One must focus on generating yield and allocating between fixed income asset classes and extracting value from selective bottom-up credit selection. Active selection will look to concentrate on corporate bonds offering high quality interest income opportunities and choosing issuers that are well placed to navigate – and even thrive in – the post COVID recovery.

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<sup>1</sup> Forecast results are predictions only and may be affected by inaccurate assumptions and/or by known or unknown risks and uncertainties. Forecast results or returns may differ materially from results or returns ultimately achieved.

In contrast, some industries and issuers will face headwinds in the next phase of this cycle, while others will eventually adopt an equity-friendly, credit-negative strategic direction. As we've previously noted, not all high-grade credit is created equal – in a yield-hungry market there may be a propensity to under-price these idiosyncratic risks and this makes discerning, nimble security selection as important as ever.

## FINDING THE SWEET SPOT WITHIN CREDIT

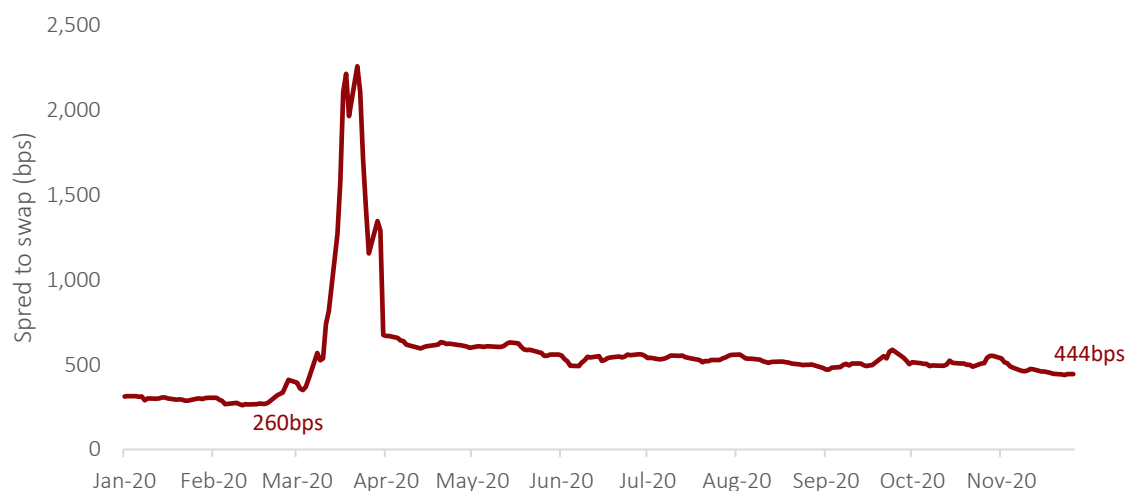
### Bank subordinated debt and AT1

Within the corporate bond universe, we see bank subordinated debt and AT1 as currently offering exceptional relative value. We discussed the compelling value of bank subordinated debt in our recent LMG Insight piece entitled "While Yield is Elusive, Attractive Income Opportunities in Bank Credit Still Exist".

AT1 spreads also remain attractive in comparison to pre-COVID levels and on a relative basis. Given the resilient performance of global and national champion banks through the COVID-19 crisis we expect a strong re-rating of the bank capital structure will occur in 2021, underpinning both further outperformance by the sector into next year and also the sector's lower beta to equities in future stress environments than was the case during COVID.

As the current crisis is not driven by bank-related issues, we do not see banks coming under the same stress as in 2008. In this unique situation, we see banks being an integral part of the economic recovery. While credit losses are likely to increase significantly above through-the-cycle average levels – for example, we expect domestic bank FY21 credit losses as a proportion of gross loans and advances to increase to around 50bps from mid-teen bps in recent years – we note both domestic and global banks are considerably better positioned to absorb these losses, benefitting from significantly stronger capital and liquidity positions as well as supportive regulatory measures.

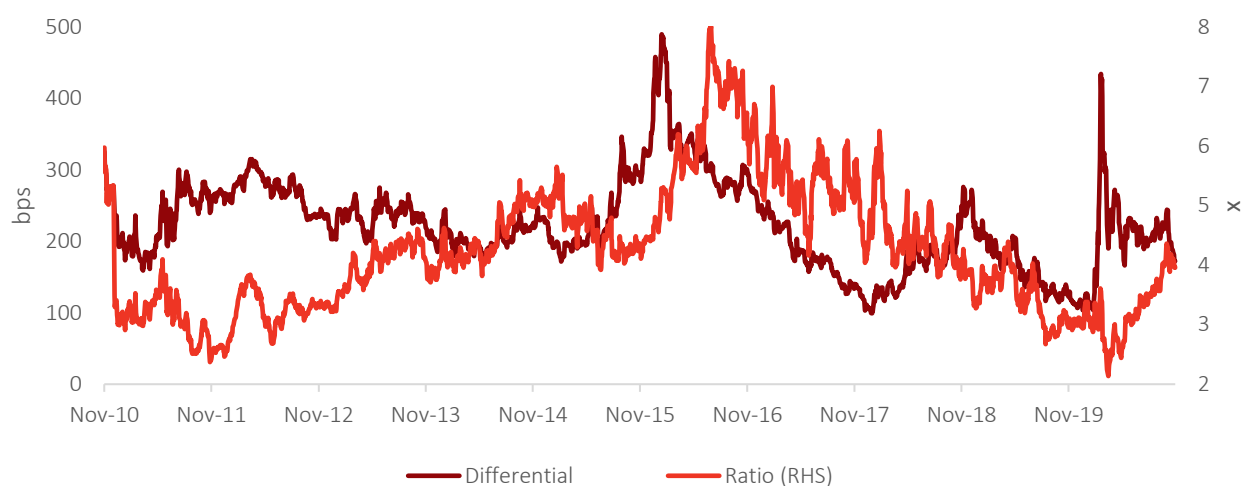
### € AT1 Index is still 184bps wider than the tightest level year-to-date



Source: Credit Suisse as at 27 November 2020

As discussed above, we will remain discerning in our security selection. In a similar vein to our bank selection above, we favour allocating from senior bonds to subordinated bonds of the same company, to enhance yield in a company where one remains very comfortable in its ability to see out this crisis. As in the chart below, the multiple pick up in spreads remains attractive versus the senior bonds of the same company. Within the corporate hybrid universe our preference is high quality issuers in defensive sectors or select cyclical issuers that are well placed to benefit from pandemic recovery such as those in the auto sector.

### Historical relationship between European IG Rated Non-Financial Corporate Senior and Subordinated debt



Source: Credit Suisse as at 27 November 2020

### Emerging market bonds

Another sweet spot remains in emerging market bonds. With all-in yields of close to five per cent plus, the absolute and relative valuations remain attractive. These valuations will continue to be supported by strong fund in-flows, sentiment and the continued suppression of developed market bond-market volatility. Within emerging markets, our outlook for Asian bonds is “outperform”.

Chinese government and corporate bonds are also attractive, given the revaluation seen in H2 2020.

### JP Morgan Emerging Market Bond Index (Spread to Worst - bps)



Source: Bloomberg as at 4 December 2020

### In conclusion, global reach, flexibility and credit selection will remain key

Investors who remain watchful, flexible and prepared to take advantage of future dislocation opportunities by using some of the ammunition built up from surplus liquidity raised through the depths of the COVID19 crisis will benefit. This is especially as the emerging global recovery takes hold and potentially accelerates in the months ahead. Being active and global in reach to seek out the pockets of opportunities will deliver consistent value in future, and as always, a discernible selection of corporates is always warranted.

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