It's going to be a credit picker's market

Our panel of experts believe that the credit market will be volatile this year, but there will be opportunities in European credit and additional tier one bonds, trups CDOs and unitranches

by Michelle D'Souza

Fund managers operating in a variety of credit sectors believe that fundamentals are strong, which bodes well for the year ahead. However, those operating in high yield, structured finance and macro credit are concerned about trade tensions between the US and China and the impact this could have on corporate credit spreads. Whichever way things go, our selection of credit portfolio managers say that a dispersion in spreads means that credit selection is going to be incredibly important, and they believe Europe may be the place to source the best opportunities.

High yield

European high yield spreads have taken a battering, but fundamentals remain sound and Barings is tilting allocations towards Europe over the US

Chris Sawyer

Managing director in European high yield, Barings

Bullish on: ***European high yield***

"The last few weeks of 2018 saw sharp and severe moves in global markets that might dictate which direction the high yield market is heading in 2019.

The starting point from a spread perspective has changed significantly in recent weeks, with Brexit, US-China trade tensions and concerns over global growth, combined with outflows from the asset class and seasonally low liquidity, causing material spread-widening. This is particularly noticeable in Europe where spreads are getting close to double what they were a year ago.

"Remember that this correction has been driven by a revision from strong to weaker growth

We don't view the recent spread widening as an accurate reflection of underlying fundamentals which, for the most part, remain sound, highlighted by the Q3 earnings season, which was one of the best in recent years. There's no getting away from the fact that 2019 is going to be a more challenging year for companies given the macro backdrop and tougher year-on-year comps. But we think it's important to remember what has driven this correction in valuations — a revision from strong to weaker growth, not a global recession. As high yield investors we are generally lending to companies at conservative loan-to-value ratios and are focused on cash flow generation and debt serviceability. Even under low growth (or worse scenarios) many high yield issuers continue to generate solid free cash flow.

We have shifted allocations in our global funds more towards Europe, as European spreads have widened more than the US despite fundamentals remaining largely intact. One of the reasons the US has held in better is because we saw net high yield issuance fall and the market there shrink for the second consecutive year, providing a slightly better technical environment for most of 2018; whilst in Europe we saw a large increase in M&A-driven financing.

The upcoming year will force managers to focus on fundamentals, and this will be the main driver of performance disparity in the market. Companies that are missing on numbers are now getting beaten up in the secondary markets, dropping sometimes up to 10 points or more in one day."

Fraser Lundie

Co-head of credit, Hermes Investment Management

Bullish on: ***higher-rated high yield***

"Accommodative monetary policy and strong underlying consumer demand in the US remain, but both have likely peaked. Slower growth, tighter financial conditions and potentially higher inflation make for a year of headwinds. However, we expect that credit metrics will remain strong with the growth in earnings and deleveraging of recent years, particularly in some cyclical sectors, providing a welcome buffer to aid navigation of rougher seas ahead.

Escalation of the current tensions between the US and China could exacerbate matters though, as sentiment among both consumers and companies is likely to be highly sensitive to both trade and, of course, central banks' ongoing attempts to tighten monetary policy. But valuations have already opened multiple opportunities. Better risk-adjusted returns in investment grade and the higher-rated segment of high yield are now available, as interest rates and sovereign volatility have caused underperformance that is unlikely to continue."

Mitch Reznick

Co-head of credit, Hermes Investment Management

Bullish on: ***UK ABS***

"In the ABS market, better value remains in UK assets as Brexit concerns drive discounts for UK over European ABS. Leveraged loans, which have so far been insulated from heightened volatility, are likely to become increasingly challenged as covenant lite structures and poor convexity weigh. European and emerging credit now looks attractive versus US credit, especially taking into account the better average credit quality and draconian hedging costs facing international buyers of US assets."

Distressed

Fund managers can act as liquidity providers to distressed businesses, taking on a role that banks previously performed

Josh Baumgarten

Co-chief investment officer, Angelo Gordon

Bullish on: ***US CMBS and European credit***

"Since the financial crisis, the investment grade credit and high yield markets have doubled in size. This year we expect Europe to follow the US in transitioning from quantitative easing to tightening. In 2019, we expect the market will be predicated on fundamentals. Broader flows from central banks have also changed, creating more dispersion, and as such, more investment opportunities. That said, what has not changed from previous cycles are the micro-cycles, which have occurred in telecom, healthcare, media and retail.

We believe that with banks no longer serving as buffers, there is the potential for a firm like Angelo Gordon to act as a liquidity provider, agnostic of where we are in the cycle, to stressed and distressed businesses by offering the right duration of capital during periods of increased volatility.

There are good opportunities arising from the increased volatility in CMBS. Defaults in significant retail names, such as Sears and Toys R Us, paint the entire sector with a broad brush and affect the valuations of such sectors. There are opportunities to find good real estate tied to retail — the volatility in the retail sector should provide real estate investment opportunities.

European corporate credit should provide attractive opportunities in the short term: the ECB no longer acts as a price setter and there will be bouts of volatility in the market. You should see several names with a 10 to 15-point decrease that one can take advantage of given that the transition mechanism between buyer bases is quite disjointed.

Investment grade and leveraged credit flows from mutual funds and retail ETFs should also provide an opportunity to be a liquidity provider. Q4 saw seven straight weeks of $1 billion-plus outflows in the leveraged loan market and the resulting price action was quite volatile — such disorderly transitions between different buying bases should provide volatility in marks."

Direct lending

Unitranche volumes could grow substantially with private equity sponsors prizing certainty of execution above all else

Walter Owens

Chief executive officer, Varagon

Bullish on: ***Unitranche debt***

"The credit outlook for 2019 really depends on the state of the market we are in now. Presently, the market is figuring out if this is a dislocation like we experienced in 2015/16, or worse.

Volumes for the unitranche market are

> **Volatility in the retail sector should provide real estate investment opportunities**

likely to grow in 2019, and, if the market continues to be dislocated, we see an attractive opportunity to utilise unitranche products in the upper mid-market with sponsor partners. In 2018, unitranche volumes were lower as a result of first lien and second lien cov-lite takeouts, which we think presents a real risk in today's volatile market to sponsors who would prefer to receive guaranteed loans with no pricing or condition flexibility.

For direct lenders, we believe there will be opportunities in banks' syndication warehouse facilities that are unable to go to market. Banks are waiting on syndicating a number of broadly syndicated deals, and there are discussions in the market for direct lenders looking to buy those positions.

Given where we are in the cycle, we are focused on sponsored deals that are either lightly correlated or non-correlated to the economy, such as the healthcare, tech and software industries. We are staying away from cyclical industries and businesses with high cap-ex. We are also cautious about smaller companies with less than $15 million in ebitda, which are not providing a price or structural premium as compared to $20-$40 million ebitda companies.

If the market returns to being aggressive and overall conditions deteriorate, a manager needs to be highly selective in the deals it pursues. For example, while a company may appear to be a strong performer, it may have aggressive ebitda adjustments as a result of an aggressive roll-up strategy. As a direct lender, we must be careful. Terms and conditions have lagged so managers must ensure they do deals that take this into consideration.

Randy Schwimmer

Head of origination, Churchill Asset Management

Bullish on: **defensive sectors such as healthcare**

"No one really knows how late we are in the cycle. One market survey predicted a 1% likelihood of recession this year, while a survey of economists put a 25% probability on a slowdown in the next 12 months. Technicals for the year ahead, however, look good. Demand for loans remains strong, the leveraged loan index still maintains a low default rate of around 1.4%, and sponsors are committing significant equity checks to deals — between 40-50% for overall middle market. There remains around $500 billion of private equity dry powder and private credit fundraising is robust, with around $100 billion raised in the past 12 months.

Wherever we are in the cycle, Churchill stays conservative from a risk perspective, focusing on originating for the best credits. Our emphasis since the last recession is in defensive sectors such as healthcare, software and business services.

Our sweet spot is investing in middle market companies between $10 million and $50 million ebitda. That segment historically provides a 100bp yield premium to the broadly syndicated loan market.

2019 could see further development of the unitranche structure. Direct lenders offer this financing option, combined with hold levels of $150 million and higher, to compete against syndicate banks. Sponsors are willing to pay more for flexibility and time saved avoiding syndication."

Japanese risk retention could hit small CLO managers

Structured finance

In structured finance it's all about credit selection in 2019. With that in mind, trups CDOs could be the place to go

Dushyant Mehra

Co-chief investment officer, Hildene Capital Management

Bullish on: **Trups CDOs and CLO equity**

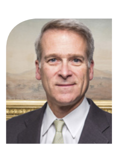
"We're finding the best opportunities to be in structured credit and community bank bonds, including trups CDOs. The recent sell-off in bank stocks has created attractive value metrics for supporting bank mergers and acquisitions — which is a primary driver of prepayments in trups CDOs.

US CLO equity is an attractive opportunity given the loan market sell-off, which was driven by retail fund outflows. The sell-off was not fundamental-driven and any snap-back in the loan market will trickle down the equity and create an attractive trading environment for CLO managers.

We believe volatility is here to stay. As such, 2019 will be all about credit selection — consideration of fundamentals and structural factors will be key. Market uncertainties, like the one created by the backdrop of uncertain Fed action and US-China trade tensions, can result in volatile sell-offs as yield bogeys for the marginal liquidity provider are much wider than pre-2008."

Loans

Credit selection will be key but right now the new issue loan market could be the place to extract value with double B credits pricing at around 320bp



John Fraser

Head of US, Investcorp Credit Management

Bullish on: **new issue US loans**

"Although the economy is relatively stable, now is the time to start thinking defensively to minimise credit risk. 2019 will be all about individual credit selection — investing in companies without business model challenges and overleveraged balance sheets. We think that loans are one of the better places to invest, particularly if the Fed continues to tighten monetary policy.

There has been a pullback of prices, leading to attractive relative and absolute returns with coupons around 6-7%. In particular, investing in new issues of high single B and low double B-rated companies looks attractive, with low double Bs pricing around the low to mid 300s, and single Bs around the high 300s to low 400s.

Japanese risk retention could have an impact on smaller CLO managers and rearrange the deck chairs in the CLO space. Larger managers who either had access to capital or were able to access risk retention capital gained a significant market share when US risk retention was in play. Japanese investors make up a significant proportion of triple-A investors, so the return of risk retention could see the smaller CLO managers struggle."

Jens Vanbrabant

Head of European loans and high yield, Wells Fargo Asset Management

Bullish on: **European loans**

"The European loan market outperformed European high yield (+1.5% versus -3.6%) in 2018 and I think that positive momentum will continue into 2019. But this view is not the consensus.

In Q4, we saw large outflows from US leveraged loans, and European loans outperformed the US loan market. In 2019, we expect European loans to continue to represent a better investment opportunity than US loans for three reasons.

Firstly, the European loan market benefits from tighter regulation: in the US, the leveraged lending guidelines and CLO risk retention rules have been abolished or blunted. Secondly, the European economic cycle is at an earlier stage than the US economic cycle. Over the next two to three years, we expect European rates to rise and yield curves to flatten, making European loan yields even more competitive versus fixed rate asset classes such as European high yield and investment grade, as well as versus US loans. Finally, from a structural perspective, there are stronger fundamentals in Europe — for example, larger equity cushions and lower leverage.

We are more negative about the trajectory of US and European rates, particularly after the late 2018 treasury and bund rally. US growth is expected to remain strong and US inflation is close to target and therefore we expect US monetary policy to tighten at a faster pace than priced in by the market. Growth is moderating in the eurozone, but we expect it to be above potential.

When it comes to European HY we are broadly neutral – the market has cheapened relative to European loans and US HY to the point of not appearing rich. Outflows not only from core HY investors but also IG accounts have driven weak technicals.

The Q4 sell-off could present meaningful opportunities for managers to deploy capital: we are seeing attractive valuations in the European loans market in particular.”

Macro credit & derivatives

AT1s could be the best way to pick up yield. But Donald Trump's stand-off with China could shape credit markets in 2019

Alberto Gallo

Partner and head of macro strategies, Algebris Investments

Bullish on: ***AT1 bonds***

“We think some of the best credit opportunities in 2019 could be European additional tier one bonds (AT1s), as well as mispricing of Argentina, Ukraine and Venezuela debt. Investors have fled European markets due to political risks, including Brexit, Italy's budget negotiations and the upcoming European elections. We believe these do not pose a risk to topple the current low, but positive growth trend.

We are also relatively positive on political developments in Argentina, Ukraine and Venezuela. Emerging market credit is generally becoming less attractive, however, as are US triple B-rated credits.

For credit derivatives as for other asset classes, liquidity remains the biggest challenge. Even in indices, the size of trades you can put on is a fraction of what it used to be. We generally avoid exotic strategies, as they can be difficult to exit.

The key drivers for market disruption in 2019 are most likely to be Donald Trump's stand-off with China over trade, as well as signs of a China slowdown.”

Multi-strategy

Another big-short type opportunity may emerge in 2019, but be mindful of going long assets popular among daily liquidity funds

Loïc Fery

Chief executive officer and chief investment officer, Chenavari Investment Managers

Bullish on: ***select bonds at quasi-stressed levels***

“The 2019 opportunity in credit is truly about relative value. There will be times this year to buy bonds offering strong fundamental value while trading at a quasi-stressed price. It will also be possible to capture another version of the "big-short opportunity", as this cycle is getting closer to its end, and there will be specific sub-segments of the market that will suffer most, due to a combination of non-supportive technicals and weak fundamentals.

You don't want to be too long assets which are predominantly held by asset managers with daily liquidity funds as outflows should accelerate. Watch technicals and fund gating as the asset-liability mismatch has become more common in credit.”

“Watch technicals and fund gating as asset-liability mismatches are more common

Investment grade

Investors should get used to bouts of volatility, but fundamentals remain sound

Jeff Boswell

Head of developed market credit, Investec Asset Management

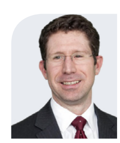
Bullish on: ***selected non-cyclical sectors***

“Underlying corporate fundamentals remain reasonably sound, although certain cyclical sectors are showing early signs of strain. Market price behaviour has been the key driver of credit in 2018 and is likely to continue its starring role.

As we progress further into an era of reduced central bank support and tightening liquidity, we believe that while fundamentals and valuation will play a role, market price behaviour will remain the key driver in 2019. We still see good opportunities for investment in some credit markets, but increased bouts of volatility are likely.

The general fundamental backdrop remains sound. The robust growth experienced through much of 2018 is slowing rather than turning negative, although we have started to see a moderation of momentum in several cyclical sectors, such as autos, industrials and homebuilders. As individual issuers within these sectors have reported weaker financial performance, we have typically seen aggressive repricing of their equity or credit spreads.

However, this localised stress has yet to filter through into broader measures of market health. As such, default rates have continued to moderate, alongside continued positive ratings drift (more upgrades than downgrades) momentum.”



Garland Hansmann

Portfolio manager, Investec Asset Management

Bullish on: ***selected European issues in USD***

“Certain subsets, such as US high yield, are trading close to post-crisis lows. European high yield however has repriced wider since the start of the year.

Credit markets, along with most financial markets, have benefited significantly in recent years from a wave of central bank liquidity. Easy money has rippled through all credit market subsets, providing a strong tailwind for tighter valuations, supported by improving underlying fundamentals. However, the recent shift from QE to QT, in our mind, is likely to have a material impact on market momentum. The retrenchment of tourist investors who don't consider credit a mainstay of their investing leaves some areas of the market susceptible.

Selectivity and dynamism is going to be key in the year ahead, not only in terms of individual credit selection, but also in selection of subsets of the credit market.”