DEBT, DISTORTION AND NAVIGATING CREDIT MARKETS

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Markets have been distorted by unprecedented central bank intervention. In spite of talk of policy normalisation, the burden of debt is a significant constraint. Finding opportunities in credit markets will require innovative investment approaches, writes Insight Investment's Head of Credit, Alex Veroude

In *Through the Looking Glass, and What Alice Found There*, Lewis Carroll places his eponymous character in a fantastical world which is a reflected vision of her own house. Investors this summer can have been forgiven for feeling that they too had entered a strange parallel universe. At one point $4 trillion of debt globally traded at negative yields and at their lows French, German and Swiss sovereign yields were negative out to five, nine and 15 years respectively.

Negative bond yields at long maturities should not exist. The idea of lending money to a government with a guarantee of negative returns over 15 years is investment through the looking glass. However, it also reflects the zero interest rate policies pursued throughout the developed world and the side-effects of quantitative easing. These have been particularly acute in Europe. The European Central Bank has cut its deposit rate to -0.20% and is expanding its balance sheet by €60 billion each month.

Investors are trying to navigate an environment combining an unparalleled low level of policy rates with unprecedented levels of quantitative easing. For example, the net supply of German bunds in 2015 will be zero. The risk-free asset, the foundation of pricing across financial markets, is no longer being influenced by price sensitive investors. Central banks have distorted markets. The question for these investors is whether this is the final aftershock of the global financial crisis or the new normal.

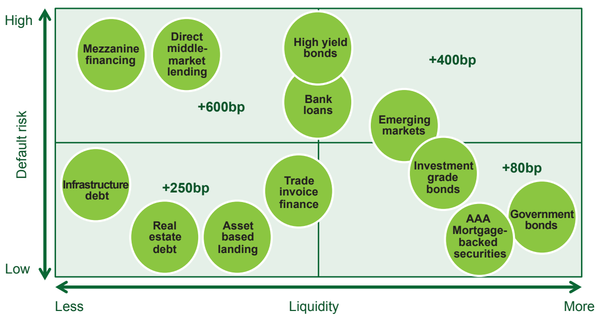
We would argue the latter case. The new reality faced by central banks is an enormous debt burden built up in the run up to and in the aftermath of the global financial crisis. Deleveraging has been honoured more in the breach than the observance. Bank debt has been replaced by increasing government borrowing in many countries. If all the different elements of debt are included – government, corporate and household – even fiscally prudent Germany is running a debt-to-GDP ratio of 188%, an increase of 8% since 2007. China has almost doubled its debts over the same short period.

SHELTER FROM THE STORM

This debt burden has been accompanied by an anaemic economic recovery. Nominal GDP growth in the US has seen the weakest rebound from any post-war recession. The European economy is stuck in first gear. The burden of debt combined with low growth confronts central bankers with a new dilemma: debt sustainability. Managing sustainable debt levels, rather than inflation-targeting, may be the new priority.

The terminal rate of interest may be closer to 2.5% than the 5% (and more) seen in prior cycles. But even at these levels defaults will increase. Cheap borrowing costs have been a catalyst for frenzied new bond issuance. By the end of July this year, $900bn of new investment grade credit was issued in the US, a 19% increase on 2014 and the highest year-to-date figure ever recorded, according to data from Dealogic. More worryingly, the rating agency Standard & Poor's has reported that speculative grade corporates (BB+ and lower) issued 80% of all new debt in 2014, up from 45% in 2008.

Figure 1: Mapping the credit universe



Figures refer to indicative spread above Libor, for illustrative purposes only.
Source: Insight Investment

For credit investors there are few places to hide. Rising interest rates are rarely favourable for nominal bonds. Too much leverage and the likelihood of rising defaults make a potentially toxic brew especially if policy is directed at keeping real yields low. At Insight we have identified two areas of credit markets that may offer investors some shelter from the likely forthcoming storm: illiquid credit and secured finance. In Figure 1, the assets most familiar to investors are in the bottom right quadrant. However, the more esoteric assets in the bottom left quadrant offer a significant yield pick up over mainstream credit for similar or less default risk.

There are two trade-offs to be made. The first is liquidity. By definition making a direct loan to a real estate development tends to be an investment that is held to maturity. However, secondary market trading in supposedly liquid assets has been fragmented by new capital requirements placed on banks and other intermediaries in bond markets. The negative of holding supposedly illiquid assets is becoming increasingly illusory.

The second trade-off is complexity. Making a loan requires a far more specialised middle and back office infrastructure than trading a bond. Similarly, understanding the collateral pools, subordination and structural protections built into different tranches of Asset-Backed Securities is complex and requires deep investment expertise. However, we believe the additional effort is commensurately rewarded.

Lending against assets, be they buildings, bridges or pools of loans backed by residential or commercial property, provides an additional layer of protection against default. Even if the borrower experiences distress, the assets in the collateral pool remain in the ownership of the lenders. For example, during the credit crisis commercial real estate values in the Netherlands fell precipitously (around 35% peak-to-trough). However, senior loans written with conservative loan-to-value ratios of between 60% and 70% experienced no material arrears or losses.

Structured credit became a pariah asset class during the financial crisis. But Collateralised Loan Obligations (CLOs. typically backed by senior bank loans), in spite of mark-to-market losses, generally matured at par. Only around 20 individual tranches of CLOs have defaulted over the past 15 years from a universe of over 2000. We would argue that the CLOs being issued now are structurally superior, further improving the prospects of an already attractive asset class.

As well as being backed by assets, secured finance investments typically offer floating interest rates. The interest received is reset regularly in line with market rates. That ameliorates one of the biggest headwinds to generating returns from credit.

Navigating this investment environment will be far from easy. It will require a willingness to innovate and an ability to understand and analyse new investment opportunities. But for managers with the right skills this is not as daunting as it sounds. We believe perceived liquidity is significantly overpriced and opportunities in less well understood areas of the credit market remain compelling.

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