MERCER

Time to buy

High yield debt

March 30, 2020

Time to buy

In late 2008, Mercer advised that it was an opportune time for investors to buy corporate credit. Credit spreads were still widening but we believed the spreads at that time more than compensated for the risk. We believe the time has come for investors to consider this strategy once again.

Why now?

Investment grade credit spreads have widened from around 90 bps at the beginning of the year to around 330 bps and global high yield spreads have moved from around 400 bps to over 1,000 bps over the same period.[1] Not only has the move been aggressive, but also the speed of this deterioration has been more rapid than during the global financial crisis (GFC). Both indices are now trading at their 95th percentile over the last 20 years (as at March 23, 2020).[1]

We have witnessed large redemptions in mutual funds and exchange-traded funds (ETFs) in both asset classes, as investors have scrambled for liquidity. As is usual in these market environments, liquidity has also deteriorated. We have seen a marked widening of bid-offer spreads, and physical securities have underperformed credit derivatives, with ETFs now trading at a marked discount to their respective indices.

Although the initial sell-off was led by the energy sector, after the breakdown in discussions between Saudi Arabia and Russia, this has since been overshadowed by price falls in all sectors, as the unknown impacts of COVID-19 started to take hold.

What is different this time is the manner in which the market is being tested. Banks, brokers, asset managers and other financial intermediaries are coming to terms with how to maintain their existing trading protocols, with the vast majority, or all, of their staff working remotely. This is adversely affecting liquidity, but we know from experience that these things are often short lived and the market will come to terms with these issues and return to some form of normality.

Although spreads in all sectors look to be good value in comparison with where they were trading only a few weeks ago, we feel the best opportunity lies within the sub-investment grade sector and notably high yield.[2]

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[1] Source: Barclays Global Aggregate Corporate Index, as at March 23, 2020

[2] See our recent article on US High Yield spreads for further information (http://www.mercer.com/our-thinking/wealth/time-to-buy-high-yield.html)

There is always a risk that investing at the start of a credit downturn can result in further substantial mark to market losses — however we believe delaying an investment by more than a quarter at its peak could also have a meaningful impact on performance results. It is always impossible, unless exceptionally lucky, to pick the top or bottom of any market dislocation.

Investment grade credit is also trading at its 95th percentile[3], but the composition of the index has changed, which makes historical comparisons challenging. Prior to the GFC, 26% of investment grade securities were rated BBB (the lowest investment grade credit rating)[4]: this number now stands at 50%.[5] As more securities are rated at the lower band within the investment grade sector, the impact of widespread downgrades by the rating agencies will be more acute. We are not saying that this sector does not currently offer good value, but rather that we continue to show some caution on how downgrades will affect the market over the short to medium term.

What are the risks?

When people think about risks within sub-investment grade debt they immediately think about default probability. We are certain that defaults will rise from their current suppressed levels and might well reach the highs experienced in 2008/09. However, we believe the most recent moves by central banks and policymakers in providing support to companies and their workforce to reduce the financial burden will reduce the level of defaults to a level that they may have been without this unprecedented support.

Central banks have reduced interest rates further and added additional liquidity to the market in the form of cheap financing or increased quantitative easing. They have also reiterated that they will do whatever it takes to ensure that the banking system and economy will return to something approaching normality once the immediate crisis is behind us.

Governments across the world have also announced policies designed to prevent small to large businesses from moving into insolvency. The full details of these plans are yet to be confirmed, and the full scale of the support needed is yet to become clear, but we believe that they will help prevent complete sectors and certain companies from becoming bankrupt. However, we do recognize that these moves will lead to an

[3] As measured by Barclays Global Aggregate Corporate Index as at March 23, 2020

[4] As measured by Barclays Global Aggregate Corporate Index as at January 2, 2007

[5] As measured by Barclays Global Aggregate Corporate Index as at March 20, 2020

explosion in public finances and may only result in "kicking the can down the road" for those companies who may never recover from the situation the world is currently facing.

Dynamic asset allocation (DAA)

Mercer's global DAA advice over the last few quarters has recommended investors being short in corporate credit in favor of other fixed income sectors, such as securitized and emerging market debt. At the end of March 2020, we decided to reverse this position and now have a long position in growth fixed income assets and in particular high yield debt. We have also moved our short position in investment grade credit to neutral relative to other defensive fixed income assets.

We have always recommended an active approach in sub-investment grade debt and believe this is particularly relevant in today's environment. COVID-19 is affecting the very fabric of society, and the impact it will have on certain sectors of the economy is unknown. Some areas will take a long time to recover; some will not recover at all. In addition, there will be companies forced into bankruptcy no matter what measures central banks and policymakers put in place.

We believe good active managers will be able to successfully manage these events and invest in companies that will deliver strong risk-adjusted performance over time. Passive styles of investment will incorporate many troubled sectors and issuers, and therefore witness many of the defaults that will occur in the coming months. However, for very fee-constrained investors, we believe that by investing passively the opportunity should outweigh the risks.

For those investors looking for a more dynamic approach, we recommend considering investing in multi-asset credit (MAC). These products have a total return style which is benchmark agnostic, investing in different asset classes, sectors and issuers across the sub-investment grade debt spectrum. MAC managers also have a greater focus on capital preservation and although they are likely, in general, to underperform in a bull market, they may well deliver a better risk-adjusted return over a full market cycle.

Finally, investors should consider the current illiquid trading conditions and where their funds will come from before making a final decision to invest in sub-investment grade. This will depend on investors' current strategic asset allocation position, and where investors are in terms of their investment journey.

Plan, don't panic

We are far from the end of this crisis, and spreads could well widen from current levels, potentially reaching the highs seen in 2008/09. However, given where yields have already risen to, we believe investors should look to start adding to or initiating an investment in sub-investment grade debt now. It is always impossible, unless exceptionally lucky, to pick the top or bottom of any market dislocation. Investors need to be pragmatic and assess the opportunity today in terms of long-term rewards. Investors should also develop a plan for implementation, one that involves lining up prospective managers, and a strategy for building exposure, whether staggering entry into the market or implementing in one move.

Paul Cavalier
Head of Fixed Income Boutique, Chair of Global Dynamic Asset Allocation

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This document summarizes Mercer's views on the medium-term outlook for relative returns from the key asset classes; by medium term we mean one to three years. The views expressed in this report are relevant for reflecting medium-term market views in determining appropriate asset allocation and manager benchmarks. We do not expect clients to make frequent tactical changes to their asset allocation based upon these views. The views expressed are provided for discussion purposes and do not provide any assurance or guarantee of future market returns.

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