For Investment Professionals only

M&G INSTITUTIONAL

Covid-19 update

Current credit market perspectives

18 March 2020

M&G Institutional businesses

- Credit markets have been experiencing increased volatility, as a consequence of the advance of the Covid-19 coronavirus, much like equity markets have, though to a lesser degree.
- We believe that to serve our clients best, we should maintain the discipline of investing where we can identify strong and attractive value opportunities being available, and where we believe we will be rewarded sufficiently for the risk we undertake.
- In uncertain market periods, such as those we currently face, liquidity, even where one most expects it to be available, may become compromised, but we believe that central banks and market authorities will act in order to prevent any material disruption.

The value of investments will fluctuate, which will cause prices to fall as well as rise and you may not get back the original amount you invested. Where past performance is shown, please note that this is not a guide to future performance.

Credit in public debt

The rapidly expanding footprint of the new Covid-19 coronavirus, has shaken investor confidence, with significant falls in global equity markets as investors focus on the likely recessionary impact on global growth, as well as the direct sectoral impacts in key areas such as tourism, retail, autos and at company level on supply chain exposures to China. This has also fed into global credit markets. Putting the sell-off in risk assets in the past weeks in specific context of the credit markets, considering a longer time horizon, many sectors are now back to valuation levels seen in early 2016, following the sell-off driven by weakness in commodity and emerging markets. This has completely discounted the new round of ECB quantitative easing.

The sectors mentioned above tend to be those such as travel and leisure, and higher beta sectors like financials. In other more robust sectors, valuations have not yet reached the early 2016 levels – therefore focusing on individual valuations is key. We are now looking at selectively closing our underweight credit position and buying credit in this sell-off across a broad range of sectors.

Figure 1. Euro Investment grade credit spreads

Source: M&G, ICE Euro Corporate indices (Ref: ER00), government OAS spread, as at 16 March 2020

High yield markets have demonstrated volatility on a similar scale, with spreads now rising above those of early 2019, and this week, above those seen in early-2016.

Figure 2. Euro high yield credit spreads

Source: M&G, ICE Euro Corporate indices (Ref: HPIC), government OAS spread, as at 16 March 2020

Multi-asset credit

The market impact headlines are impressive, and not a little disturbing but the sell-off in riskier assets should be considered in the context of a longer time horizon than just the last two or three weeks. From January 2019, credit markets have seen yield spreads tightening impressively. Between January 2019, when spreads were widest, to mid-February 2020, when spreads reached their recent lows, the credit spread on the Euro BBB index tightened 93bp.

Having reduced credit risk throughout the second half of 2019 and early 2020, our multi-asset credit strategies have held a significant amount of high quality defensive assets such as cash, covered bonds and AAA rated UK residential mortgage-backed securities (RMBS). These have acted as a buffer during this latest bout of volatility and reduced sensitivity to the recent sharp widening in spreads.

The market effects caused by the Covid-19 outbreak, have led us to begin adding risk back into the portfolio in a scaled and measured manner, as spreads have continued to widen. While we cannot know the full extent of the disease's ultimate effects, we have been able to identify some attractive opportunities in the market.

Asset-backed securities

Asset-backed securities (ABS) are no exception to the weakness in credit markets generally. However, in our view the ABS market is reacting to movements elsewhere rather than leading price action which is a key difference from what occurred during the 2008 global financial crisis (GFC). Within investment grade, ABS liquidity remains reasonable with approximately €700 million traded last week according to bank estimates. However, the market feels weaker again this week. There is definitely a sense that investors are both using investment grade (IG) ABS as a source of liquidity but also as a means to take advantage of greater selling pressure elsewhere, ie. selling AAA RMBS in order to finance purchases of lower rated corporate debt, which has itself fallen further in price, than the ABS market.

Currently, generic AAA spreads are now in the Libor + 100-200 bps range (which represents approximately 50-100bps of widening).

The remainder of the ABS market is using the pricing of AAA debt as its reference level. Consumer ABS such as RMBS and Autos has moved less than corporate ABS (CLOs) and commercial ABS (CMBS). Given a sharp recession is now a near certainly in Europe, we see significant opportunity for investment within the IG area, given the downside protection that exists within these structures.

Within non-investment grade ABS, liquidity is much more limited and very little has actually traded. Some investors have tried to sell bonds opportunistically on bid lists, but have not wished to trade at the prices bid. Where bonds have had to trade, price action has been quite brutal with bonds up to 20 points lower than just a few weeks ago. The price movement reflects the fear of a very severe recession, and certainly we think when looking to add bonds, that scenario has to be the sensible underwriting case, in which case the price action is understandable.

Leveraged finance

The correction in spreads of loans and all sub-investment-grade assets are at their post-crisis wides. European loans have oscillated the least of the four sub-investment grade markets, in part thanks to the institutional nature of the investor-base (after 2009, unstable, leveraged capital was flushed out of the loan-buying community). Nor is the asset class a component of mutual funds nor ETFs and there is no single-name or index CDS market in European loans. Consequently, there is no forced selling apparent in the European loan market at this time of global illiquidity.

That is not to say that the European loan market has been unaffected. Flow-name bids are down 6.8 points this week (91.13) – much more than the broad composite's 4-point fall – given that the group represents the largest and most liquid

names. This means that they have taken the full force of the dislocation rather than being fundamentally challenged, the inclusion of Merlin Entertainments therein notwithstanding. The US flow-names declined by 7.5 points largely for the same reason though its cohort includes some aerospace and cinema issuers, areas which are being substantially affected by the current dynamics.

While the US market is also weighed down by the troubled energy sector (10% of the bond market), this is an industry that barely features in the European loans (0.6%).

The market is also geographically diverse. While a pandemic knows no borders, such risk-spreading gives texture to the timing of macro-economic swings. Just as not all countries are experiencing the virus at the same rate nor intensity, so the impact on each economy may not be equivalent. Italy went into this uncertainty with significant structural challenges already – state indebtedness and a weak banking system – but not so France or Spain, for example. As a result, the ability to weather a downturn will vary across Europe.

Restructuring

This situation is fast moving but indicators do point to a potential uptick in distressed situations. This is nothing new for us and we are ready for it, like we were in 2008 and (in a milder downturn) in 2012.

Our role is to invest in distressed and default situations, and/or negotiate the best possible outcomes from them, wherever possible actively managing them back to full financial and commercial health.

We have been integral to M&G’s fixed income business for nearly 20 years and our resource is available to any distressed situations that arise in public or private fixed income assets we hold, to target the greatest possible value from investments.

Today, we have one of the largest and most experienced teams of its kind in Europe, with a proven track record both in restructuring and in investing. The team comprises 17 legal, credit and accounting specialists and has undertaken more than 300 European restructurings to date.

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