

Credit where credit is due

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**Calibrating the current
default cycle**

p.8

At a glance

- Corporate bond markets sold off in Spring 2020, then pulled back somewhat, helped by unprecedented central bank intervention. In addition, central bank measures also eased the financial doom loops in funding markets.
- The Federal Reserve has delivered extraordinary firepower and is now effectively backstopping credit markets. We expect the European Central Bank to broaden the scope and size of its asset purchases to more closely mirror the Fed.
- This monetary stimulus is strongly supporting credit spreads and liquidity, and is likely to continue until the COVID-19 economic shock has eased significantly, in our opinion.
- We consider which sectors are potentially most negatively affected by the virus. We argue that the March valuation shock impacted all sectors, and selling did not differentiate on the basis of fundamentals. This creates opportunities for active managers and brings back higher yields after the past decade of low rates.
- In past periods after severe shocks, we find credit drawdown typically reverses over 6-12 months. The accelerated nature of the pandemic and aggressive monetary stimulus could shorten the present drawdown period.
- Historically, credit spreads have significantly overestimated defaults. In fact, investment grade or even highly rated high yield (BB ratings) issuers have tended to default at a much lower rate than is priced by the market.
- Lastly, we calibrate the current default cycle in terms of government measures and impact by ratings buckets. Increased fallen angel supply could present opportunities: we present Ford as a case study.
- We see compelling opportunities in crossover credit, Swiss credit and convertible bonds.

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The indiscriminate selloff in Spring 2020 creates opportunities for active managers and investors, and brings back higher yields after a sustained period of low-for-long.

Introduction

The COVID-19 pandemic has irrevocably changed life, unleashing a healthcare crisis requiring confinement and, in turn, wreaking global economic havoc. Growth trajectories have plunged across the world while unemployment surges and entire sections of the economy shut down, raising the spectre of widespread bankruptcy and default.

As universal lockdowns neared in March 2020, corporate bond markets seized up, plagued by the fractured liquidity environment that led to an indiscriminate selloff across credit issuers, regardless of underlying fundamentals. While markets appear to have pulled back from peak volatility (helped by unprecedented central bank actions), credit spreads are indisputably wider.

As higher yields come back into play after the long drought of low-for-long, we look at the salient issues facing corporate bond investors. For instance: does the selloff in credit and widening of credit spreads correctly reflect the actual risk of default? What about the liquidity squeeze that prevented markets from correctly pricing assets according to fundamentals and the ensuing central bank support. Ultimately, are investors being adequately compensated for the risk as the global business cycle turns?

We begin with macroeconomic developments since March 2020, tracking massive stimulus announced by the major economies that has led to the Federal Reserve effectively backstopping a significant proportion of the US credit market.

We then analyse which sectors are potentially most negatively affected by COVID-19 on a more sustained basis, as well as comparing the present crisis to the 2008 financial crisis. We consider market valuations, arguing that the March valuation shock impacted all sectors, not just high impact ones and further dispersion amongst sector performance is likely.

Next, we turn to how credit drawdown has behaved in previous periods after shocks. Historically, investment grade or even highly rated high yield (BB ratings) issuers have tended to default at a much lower rate than is priced by the market. Lastly, we calibrate the current default cycle in terms of government measures and impact on different ratings buckets. We see increased fallen angel supply as an opportunity, and present Ford as a case study.

Both from a sectoral perspective and a historical default perspective, we believe credit spreads do not reflect borrower fundamentals and more than reward investors for the risk especially given the backstop now provided by key central banks.

COVID-19: unprecedented global monetary firepower

A thorough analysis of the underlying macroeconomic context is crucial to understanding why corporate bond markets sold off so acutely in March 2020 before stabilising somewhat since. We believe that the Federal Reserve acted decisively and with unprecedented monetary firepower, helping to provide a floor under credit markets. In addition, central bank intervention also eased the financial doom loops in funding markets that were an important factor driving wider credit spreads.

A framework to assess complex shocks

The COVID-19 pandemic presents an extremely complex shock to the global economy that requires inter-connected analysis at multiple levels. We use a four-dimensional framework to analyze the evolving nature of the economic upheaval, distill which areas monetary policy is addressing and thereby calibrate asset market trajectories going forward.

We see four key issues at play:

- The healthcare crisis (the origin of the shock) leading to economic shutdown
- The ensuing economic damage and policy response
- Fractured liquidity (in fixed income, USD and funding markets)
- And supply side shocks (including oil)

The pandemic is firstly a healthcare crisis, as containment measures were widely enacted to protect healthcare system from being overwhelmed by a surge in cases. As lockdowns swept Europe and the US, economies went into hibernation, with only essential businesses and services continuing, pummeling global growth in the process. Governments then attempted to contain the ensuing economic damage with a flood of fiscal and monetary policy stimulus.

In late March 2020, the healthcare crisis and ensuing economic shock in turn triggered a connected (but distinct) shock to liquidity and funding markets. More specifically, this involved hoarding of US dollars, a run on corporate bonds and budding concern about so-called peripheral state debt in the Eurozone. This dangerous run on US dollar cash funding markets by all sectors of the system led to echoes of the 2008 global financial crisis.

The dollar funding crunch in March also accompanied hugely fractured liquidity situation in corporate bond markets. Since 2017, we have highlighted such **fractured liquidity**, which stems from post-2008 regulations that significantly weakened the ability of banks to warehouse risk as per the traditional broker-dealer model. Fractured liquidity increases the potential for market volatility and compromises the market's ability to price assets correctly. In March, this pre-existing vulnerability was exacerbated by the COVID-19 shock, and created an additional financial doom loop.

Lastly, supply side issues emanated from the crisis, including shocks to the labour force and shocks to oil prices. While the oil price war has reversed, it nonetheless seriously damaged the logistical constraints of the physical crude market. A lack of physical storage capacity coincided with the looming WTI physically-settled futures expiry in April, leaving the front end WTI future hitting -40USD as the contract moved towards expiry.

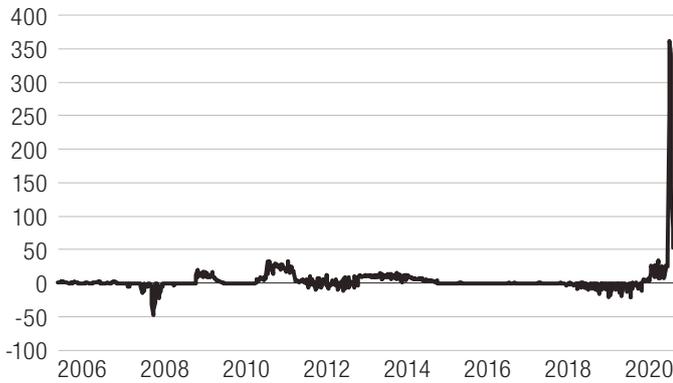
That said, the negative supply implications of such a damaging move generate the risk of a sharp upside shock to oil going forward as demand recovers and supply falls off, leading to continued severe swings in energy markets.

Fed leads the charge

With this framework in mind, we now assess the unprecedented global monetary policy response, led by the US, in order to understand its impact and likely effectiveness. In the space of only a few weeks, the Federal Reserve unleashed extraordinary firepower and liquidity support that underpinned credit markets; was critical to reducing tail-risks; and disrupted financial doom loops that had begun to build.

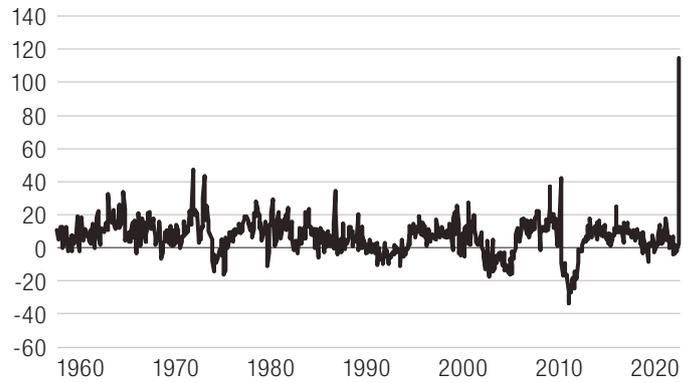
As corporate bond markets seized up, The Fed reacted with swift and compelling action on **23 March** to expand quantitative easing. It created the Primary Market Corporate Credit Facility (PMCCF) for new bond and loan issuance, and the Secondary Market Corporate Credit Facility (SMCCF) to provide liquidity for outstanding corporate bonds. Crucially, the SMCCF enables the Fed to purchase corporate bonds issued by investment grade (IG) US companies and US-listed exchange-traded funds in the secondary market.

FIG. 1 TREASURY SECURITIES HELD OUTRIGHT BY THE FED (USD BILLION, WEEKLY CHANGE)



Source: Federal Reserve, Bloomberg.

FIG. 2 US COMMERCIAL AND INDUSTRIAL LOANS (% CHANGE AT ANNUAL RATE)



Source: Federal Reserve Bank of St Louis.

Even greater accommodation soon followed. After including corporate bonds in its asset purchases, the Fed on **9 April** announced a strong top-up of purchases to include borrowers that were downgraded below IG after 22 March. It also committed to continuing purchases until at least 30 September.

The Fed's moves mean that fallen angels are now eligible credit securities for central bank buying. The policy aims to address the ratings-driven doom loop that gripped credit markets as major ratings agencies downgraded a significant proportion of IG borrowers due to COVID-19 shocks, and thereby amplified the initial economic shock.

These moves created an astonishing new reality: the Fed is now effectively backstopping a significant proportion of the US credit market, both in primary and secondary space. This essentially makes the Fed a lender of last resort for corporate bonds.

According to our analysis, the Fed's buying universe is around USD 1.7 trillion of eligible assets, and central bank purchases could amount to more than USD 400 billion in light of the given issuer limits.

We believe the Fed is likely to increase its amount of purchases going forward as has been highlighted by recent comments from Chairman Powell, who is expecting lasting harm from the virus.

ECB likely to follow – OMT in the cards

The European Central Bank (ECB) appears likely follow the Fed's move, and particularly the decision by the Fed to disregard rating actions after 22 March, in our view. The rise in political noise in Europe couldn't have come at a worse time. The jurisdiction fight between the German constitutional court and the European Court of Justice has increased pressure on the central bank at a time when political unity in the Eurozone is once again under spotlight.

Given pressure on periphery spreads, we see a strong likelihood that the ECB will activate its **Outright Monetary Transactions** (OMT) programme if concerns about peripheral Eurozone states such as Italy continue to worsen. OMT allows the ECB to purchase bonds from specific member states in secondary markets, provided certain conditions are met and will be critical in ensuring that another financial doom loop does not take hold as the pandemic shock passes through.

Investment implications

From a top-down macro perspective, we have identified the following key investment implications for investors:

- The Fed has created a strong backstop for credit markets, in our opinion, essentially becoming the lender of last resort
- We expect the ECB to broaden the scope and size of its asset purchases to mirror the Fed despite the rise in political noise in Europe in recent days
- We believe such unprecedented monetary policy is already strongly supporting credit spreads and fluid credit market conditions, and will do so until the COVID-19 economic shock has eased
- With systemic risks under control, we expect a significant amount of dispersion in both economies and markets
- On the risk front, a potential rise in precautionary savings by households could pose renewed risk to the recovery by blunting the efficacy of the strong fiscal stimulus delivered thus far
- Rising tensions between US and China are worth monitoring closely, however we think risk of immediate confrontation is low given US reliance on China when it comes to medical supply chains. Long-term the COVID shock has accelerated the ongoing fracturing between the two economic superpowers, a trend, which was already in place pre pandemic.

A sectoral credit analysis of the pandemic

What sectors are most impacted by COVID-19?

Despite the reduction in systemic risks on the back of aggressive central bank moves, we are acutely aware that the COVID-19 pandemic negatively influences some sectors more than others. Indeed, the impact of the pandemic's sudden economic stop and consequent shift in behavioural norms varies substantially between sectors.

In this section, we address sectoral risks arising from the pandemic because these will impact companies' longer-term economic future. We then consider market valuations to highlight where opportunities could arise for investors.

The pandemic has created a harsh reality for a number of corporates: near-zero revenues for the foreseeable future. While total confinement measures are being eased, social distancing appears set to persist, perpetuating the revenue drought.

Sectors closest to the consumer that offer discretionary and deferrable goods and services are likely to suffer a high, negative impact. Sectors that supply or support high impact sectors are likely to be moderately impacted.

The heatmap in Figure 3 summarises our view.

A historical comparison: 2020 versus 2008

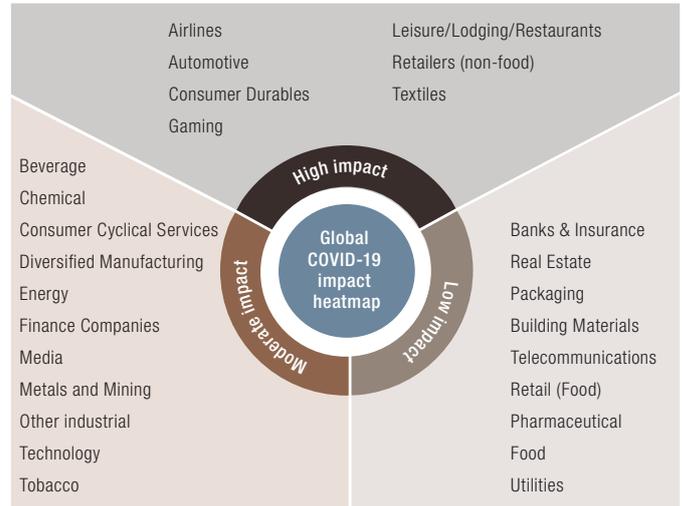
Historical crises each have their own winners and losers: the characteristics of the crisis determine which sectors fall into which category, and, consequently, what percentage of the market is highly exposed.

Increasingly, the 2008 global financial crisis is used as a lens to evaluate the fallout of the current pandemic. We believe the roots of the two crises are very different, and as such will generate a different sectoral outcome.

In Figure 4 we evaluate the global corporate bond universe as of September 2008 and March 2020, weighting the respective high impact sectors versus other sectors. High impact sectors refer to areas with the most negative consequences from the pandemic, whereas other sectors are less or not affected.

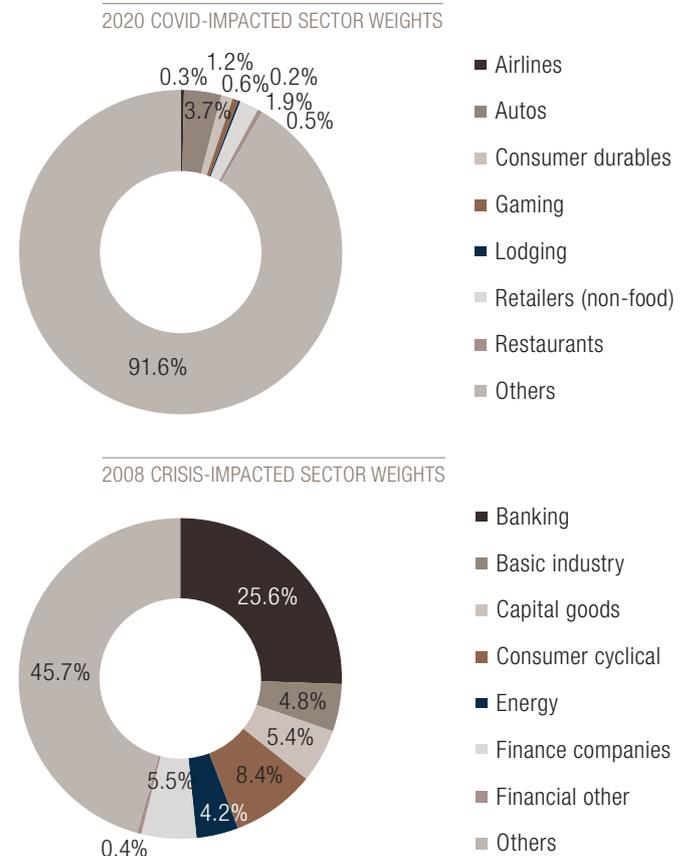
We find the 2020 pandemic made a more limited sectoral impact than the 2008 crisis in terms of the overall universe. Indeed, COVID high impact sectors make up ~8-9% of the universe, while in the 2008 crisis, ~54% of the universe fell under sectors we deem highly impacted.

FIG. 3 COVID-19 SECTORAL HEATMAP



Source: LOIM, Moody's.

FIG. 4 GLOBAL CORPORATE BOND SECTOR IMPACT: 2020 VERSUS 2008 COMPARISON



Source: Bloomberg, LOIM calculations.

Little valuation differential in indiscriminate selloff

Fundamentals suggest that the Spring 2020 corporate bond selloff should be well differentiated because the pandemic will not impact all sectors equally. It stands to reason that the high impact sectors should suffer the most valuation shock. This did not occur, however, and credit markets sold off across the board. Part of the selloff stemmed from a flight-to-liquidity (or dash-for-cash) and exacerbated this trend.

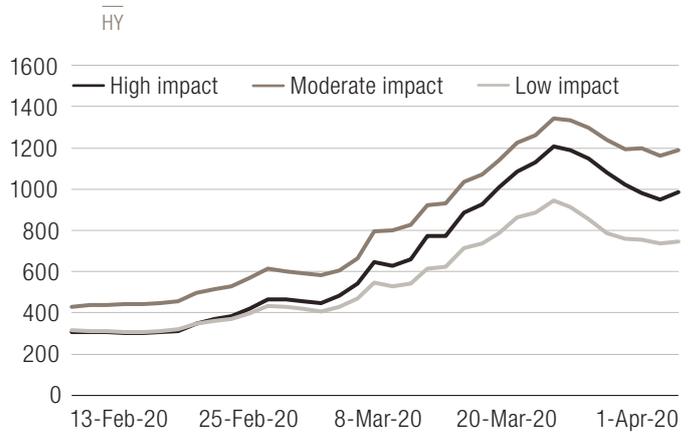
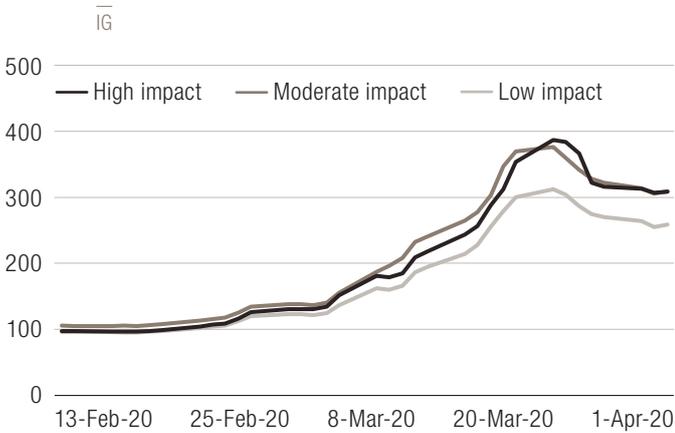
Such an indiscriminate selloff creates opportunities for actively managed portfolios, in our opinion, and brings higher yields back into play after the past decade of low-for-long.

In Figure 5, we plot average credit spreads of high, medium and low impact sectors.¹ The graph shows very little differentiation, with many low impact sectors also hit in the broad-based, market-wide selloff.

We also analyse sector spreads relative to their long-term averages. We find that many low impact sectors are trading at levels well above long term averages, and in some cases at levels higher than high impact sectors (on a normalised basis).

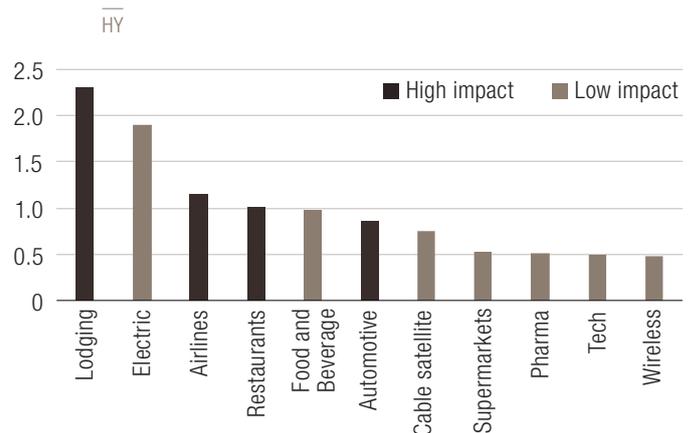
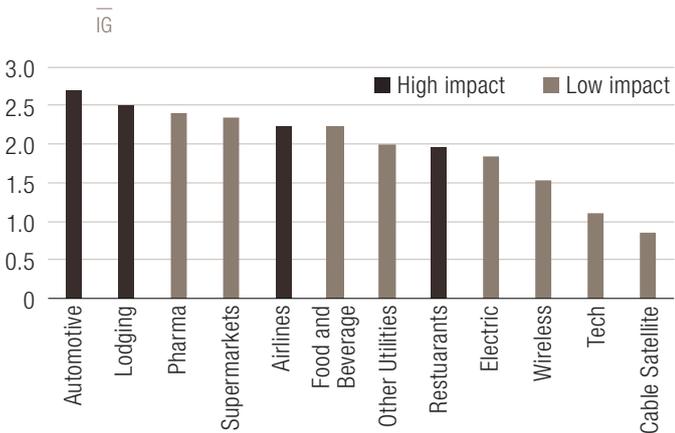
We believe that such relative mispricing represents a substantial alpha opportunity for active managers to harvest additional credit spreads in low impact sectors.

FIG. 5 GLOBAL CREDIT (IN BPS) SPLIT BY IMPACT OF COVID-19 ON BUSINESS ACTIVITY



Source: Bloomberg Barclays, LOIM calculations. Yields are subject to change and can vary over time. Past performance is not indicative of future results.

FIG. 6 NORMALISED SPREAD AS AT 31 MARCH BY SELECTED SECTOR



Source: Bloomberg Barclays, LOIM Calculations. Universe consists of EUR and USD corporate bonds. Normalised using monthly spread data since January 2002. As data is normalised, y axis represents number of standard deviations above historical average spread level. Historical average and standard deviation calculated using monthly data from January 2002 – March 2020.

¹ High, moderate and low impact sectors defined as illustrated in Figure 3.

Assessing the after-shocks in credit

Beta of credit versus equities

Moving beyond sectoral dispersion, we turn to assessing the characteristics of credit as an asset class and the viability of direct comparisons with prior market shocks. We find that credit behaves similarly to equities over the short-run, especially on the downside. This reflects a combination of the left-tail nature of the asset-class (eg exposure to negative returns), and significantly lower market liquidity in recent years.

Over longer horizons and especially in a recovery, we find that the “mean-reverting” nature of credit provides useful diversification to equities. Figure 7 shows that the beta of credit to equities is significantly lower in an up-market.²

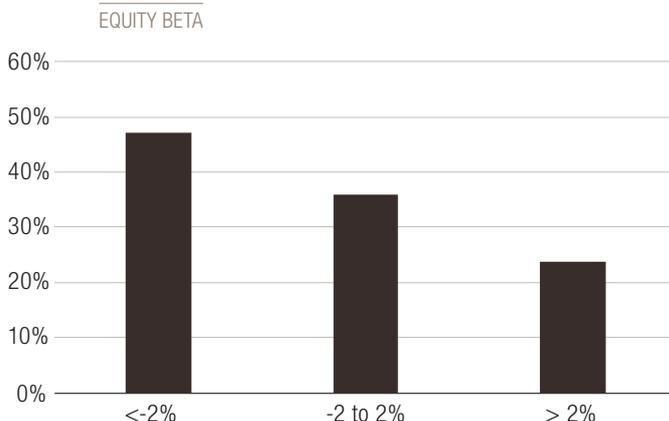
Company measures and government incentives (given the link between bankruptcies and unemployment) help differentiate credit from equities over longer periods. Credit returns tend to mean-revert more rapidly than equities as companies and governments prioritise survival and employment over growth.

Figure 8 charts equity and credit (HY) drawdowns, and indicates that drawdowns, while deep, tend to reverse much faster for credit markets than for equities. Credit drawdown typically reverses over 6-12 months whereas equity drawdown reversal takes more than a year. We caveat this conclusion by emphasizing that the accelerated nature of the COVID-19 crisis could shorten the drawdown for both equities and credit, especially given the broad and aggressive stimulus in both the US and Eurozone.

Clearly, companies are prioritising survival over growth by reducing dividends and buybacks, and drawing on bank credit lines, government support for employment, and central bank interventions.

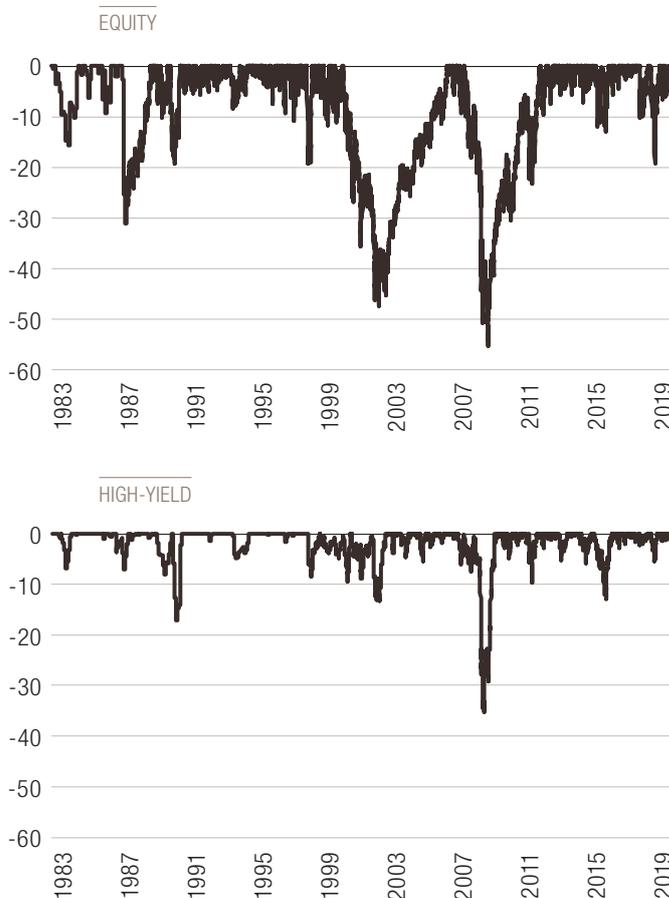
However, we emphasize that this does not prevent companies at the brink of default from falling over the edge. In the next section, we show that B and CCC-C issuers face high default rates because many of them struggle to be viable in a deep shock. Conversely, we find that higher rated issuers (including BBs) tend to bounce back as viable businesses in the long-term.

FIG. 7 US HIGH-YIELD MONTHLY EQUITY BETA CONDITIONAL ON EQUITY PERFORMANCE (JAN 1989 – MAR 2020)



Source: Bloomberg, Bloomberg Barclays indices and LOIM calculations.

FIG. 8 RELATIVE DRAWDOWNS FOR EQUITIES VERSUS HIGH-YIELD CREDIT



Source: Bloomberg Barclays, LOIM Calculations. Universe consists of EUR and USD corporate bonds.

² We calculate the beta by regressing high-yield credit monthly excess returns on equity returns multiplied by a dummy variable indicating the size of the equity move.

Credit spreads tend to overestimate default risks

As credit spreads have widened significantly in recent weeks, it is important to remember that credit is a mean-reverting asset (in the absence of defaults) through the pull-to-par effect. A long-term buy-and-hold investor would receive the spread of a bond to compensate for future defaults.

Historically, credit spreads have significantly overestimated defaults. The excess spread over future defaults, also called the credit spread premium, has reached highs in times of credit distress. Multiple academic studies attribute a large chunk of this credit spread premium to a combination of liquidity (Chen et al, 2007, Helwege et al, 2013, Lin et al, 2011, Van loon et al, 2014) and jump-risk premium (Collin-Dufresne et al, 2001, Driessen, 2005).

Jump-to-default events, however, appear to be relatively rare for viable non-financial corporates, even during times of stress because, often, the banking sector as well as governments tend to be a backstop if the business is deemed viable.³ Indeed, as noted previously, we see this dynamic in play from the very strong fiscal and monetary support provided during the current crisis.

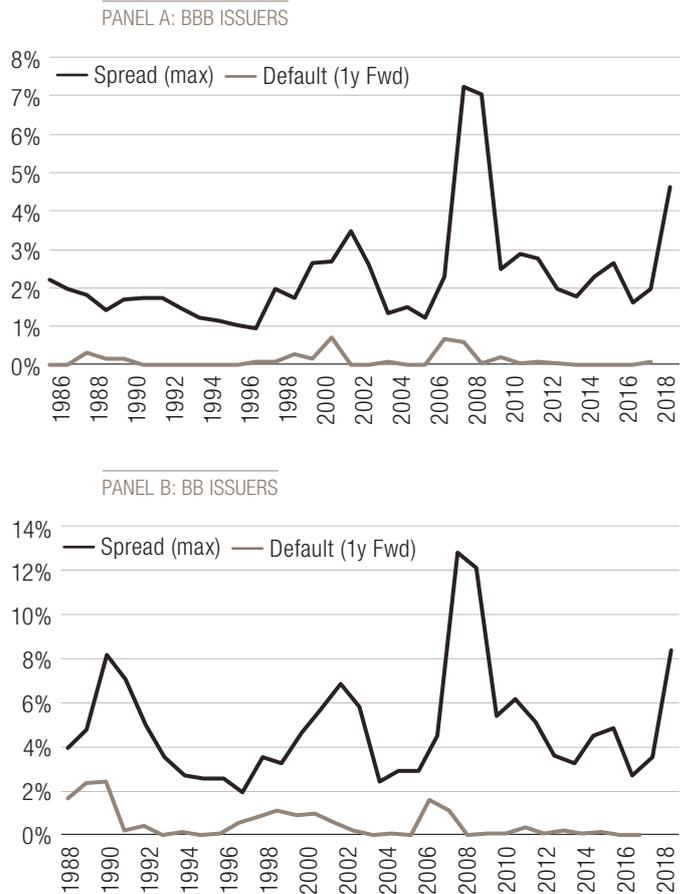
Our empirical analysis shows that outside of accounting scandals,⁴ investment grade or even highly rated high yield (BB ratings) issuers tend to consistently default at a much lower rate than is priced by the market.

In Figure 9 we plot maximum spreads each year against 1-year forward default losses from Moody's for the BBB and BB universe. Spreads – which should normally compensate for defaults – have exceeded future default losses by as much as 10x in crisis periods. The maximum annual 1-year default losses⁵ has been in the range of 0.6% for BBB⁶ and 1.5% for BB issuers. Credit spreads however reached 7% and 12% respectively in the 2008 financial crisis and 4.5% and 8% in the current crisis.

In the current crisis, US credit spreads hit their highest since the 2008 crisis, and EUR spreads are just below the peak hit during the Eurozone sovereign crisis.

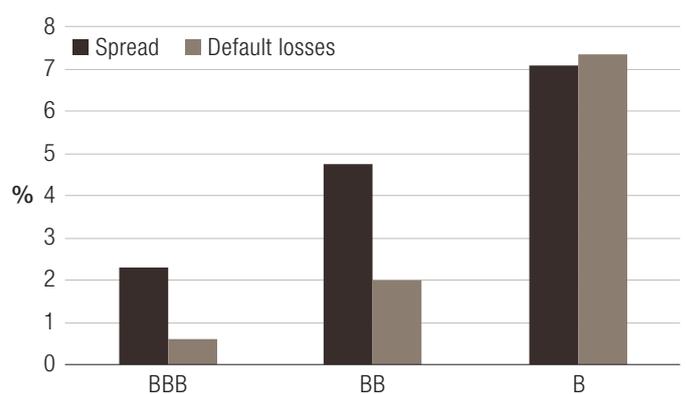
As an anchoring exercise, Figure 10 compares current spreads with the highest average default losses over the past 40 years. Current spreads are almost 4x the historical worst-case defaults in BBBs and almost 2.5x historical worst-case defaults in BBs. In contrast, lower-rated HY issuers such as Bs have spreads that are in line with worst-case defaults.

FIG. 9 SPREADS (MAX ANNUAL) VS 1-YEAR FORWARD DEFAULTS



Source: LOIM Calculations, Bloomberg Barclays indices, Moody's. Past performance is not necessarily indicative of future returns.

FIG. 10 CURRENT SPREADS (29 MAY 2020) VERSUS MAXIMUM HISTORICAL DEFAULT LOSSES



Source: LOIM Calculations, Moody's Investor Services, Bloomberg Barclays indices.

³ High-grade financials have a higher jump-to-default risk from bank runs and liquidity shocks in the absence of government support. The recognition of this fact has led to significant changes in liquidity and regulatory capital requirement for banks and the issuance of bailable debt (such as AT1's).

⁴ Worldcom (2002), Enron (2001), Steinhoff (2017) are some example of accounting scandals leading to jump-to-defaults for a large IG company.

⁵ Similar results if we annualize 3y or 5y default rates.

⁶ Longer term analysis shows that even in the great depression BBB default losses were below 1%.

⁷ We use the 90% CVAR of default losses i.e. the worst 4 default episodes in history. The annual default losses used are higher than those experienced in the 2008 financial crisis.

Calibrating the current default cycle

Defaults are expected to be substantially higher in the wake of the sudden economic shutdown. However, unprecedented government support should help mitigate defaults, and we believe impacts will vary.

Rating agency and broker research estimate issuer-weighted speculative-grade default rate of 10%,⁸ almost 3x pre-COVID crisis levels, and only rivalled by the 2008 crisis, as shown in Figure 11. However, we think that even at these stressed default levels, credit spreads more than compensate for defaults within standard bond indices.

It is important to note that speculative grade default estimates are not comparable historically or with standard bond indices because of composition effects. Rating agency cohorts are dominated by CCC-C rated issuers from the proliferation of smaller companies raising funding from public markets. Bond indices, such as the Bloomberg Barclays high-yield corporate index, have a very different composition. This is both from differences in the issuer mix as well as the weighting scheme.

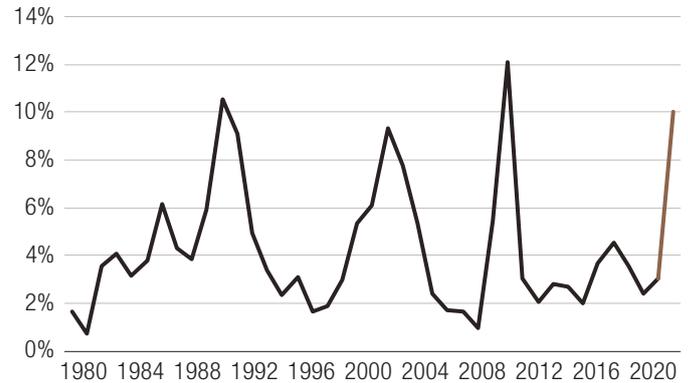
For example, Bloomberg Barclays indices have a USD 150M outstanding constraint for high-yield issuers that eliminates many small companies that are low-rated. In addition a large proportion of very low rated issuers (B- and below) are private equity owned companies that are financed by bank loans.⁹ Finally, market-cap weighting also reduces the CCC-C rated exposure as BB-rated companies are substantially larger.

Panel A of Figure 12 shows that high-yield bond indices are dominated by BB issuance which constitutes ~ 55%, and B constituting 35%. Panel B shows that the default rates increase exponentially¹⁰ when moving down the credit spectrum, therefore composition effects can be very significant.

Adjusting for compositional effects,¹¹ we find that default rates in high yield bond indices are 50% of the speculative-grade issuer-weighted default estimates from rating agencies. In other words, a default rate of 10% translates into a 5% bond-index default rate. Given recovery rates of 30%, we find that this translates into a high yield default loss of 3.5% and BB default losses of 1.4%. Current spread levels are 2x for HY and 4x for BB-rated issuers, indicating a significant risk-premium.

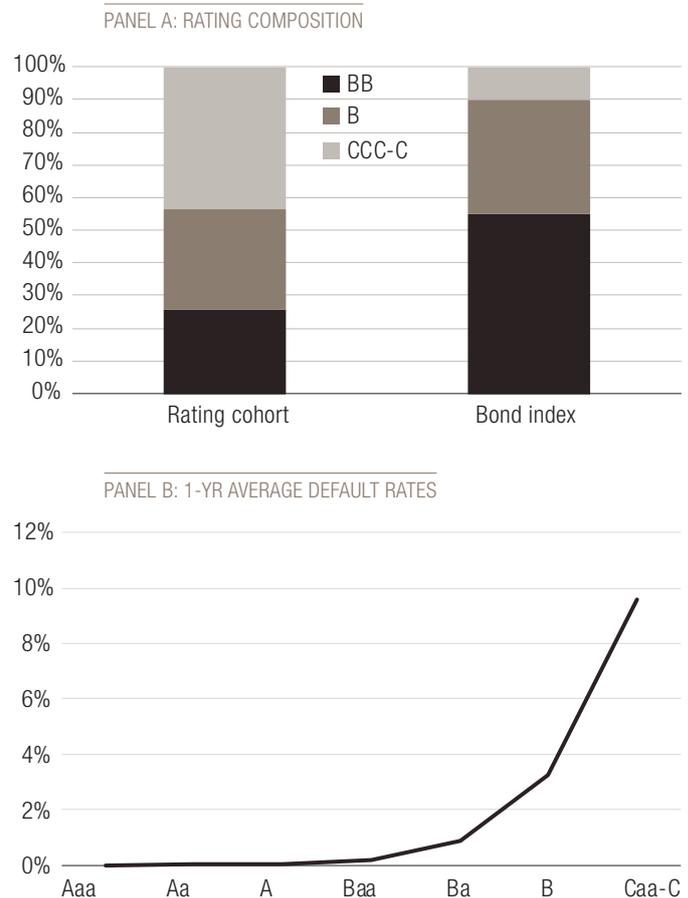
This reaffirms our belief that spreads more than compensate investors for the default risk.

FIG. 11 GLOBAL MOODY'S SPECULATIVE GRADE DEFAULTS



Source: Moody's 2019 default study.

FIG. 12 RATING COMPOSITION AND DEFAULT RATES BY RATING



Source: Moody's, Bloomberg Barclays indices.

⁸ Estimates sourced from Barclays, S&P, Fitch and Deutsche Bank.

⁹ Based on our analysis, we find that over two-thirds of the lowest rated corporates rated by Moody's in the US are private equity backed and therefore financed by bank loans.

¹⁰ While in stress periods default rates are higher, we find that the increase is proportional. For example, a recessionary periods sees all default rates higher by around 2-2.5x than the average. For example, the 2008 global financial crisis had 2.5x higher default rates for all ratings.

¹¹ We use ratio of default rates for BB:B:CCC as roughly 1:3:9 consistent with historical and stress case episodes. This allows us to get the ratio of default rate for the two compositions which is 50%.

Fallen angels: supply and opportunity

Rating agencies reacting to the economic shutdown by downgrading issuers has created a record amount of fallen angel supply. March 2020 marked the largest monthly supply of fallen angels in US history, and since the Eurozone crisis in Europe. Fallen angels in the energy, leisure and auto sectors totalled over 90 billion in USD for March, and 17 billion in EUR.

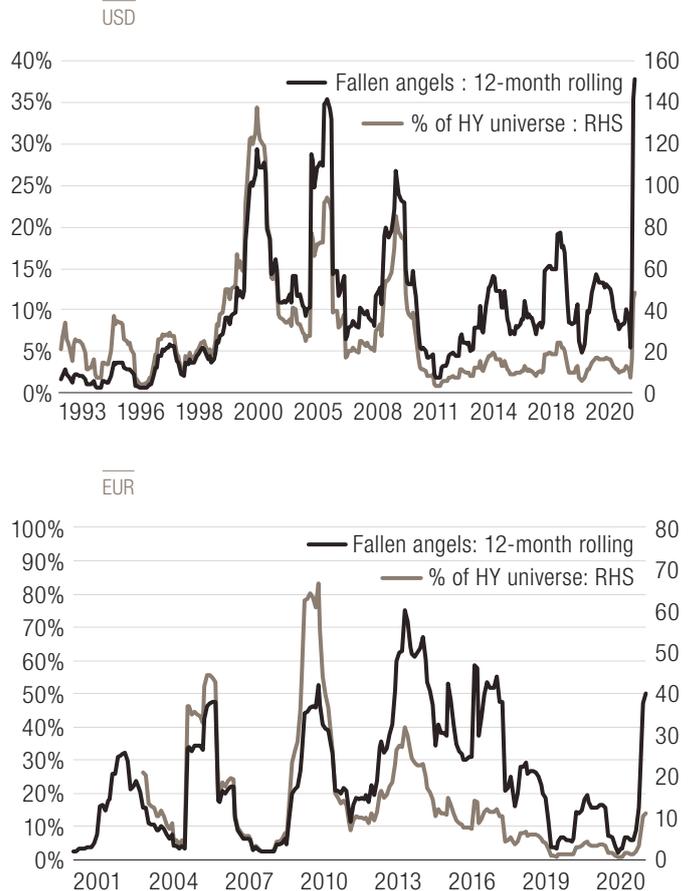
A larger and more diversified HY universe means that the supply is still proportionally lower than in previous crises, but estimates from rating agencies and sell side researchers project that supply could increase to USD 200 billion and EUR 50-75 billion, i.e 25-35% of the respective high yield universes in the next 12 months.

Historically, fallen angels tend to outperform their peers once downgraded. Ellul and Lundblad (2011) and Ben Dor & Xu (2011) show that the outperformance is often from price pressure upon downgrade as investment grade investors rush to sell bonds. Additionally, Ben Dor & Xu (2015) show that the underperformance and subsequent outperformance of fallen angels is a function of the supply of fallen angels relative to the size of the HY market. With fallen angels' proportion expected to peak at the highest level since the 2008 crisis in the US and the Eurozone crisis in Europe, we think dislocations can rise once again.

In Figure 13, we compare the performance of fallen angel bonds relative to their peer group, in the 2 years before and after downgrade from BBB. Underperformance begins around 18 months prior to downgrade, with a sharp underperformance in the final 9 months. Following the downgrade, fallen angels reverse most of the negative performance over the next 24 months.

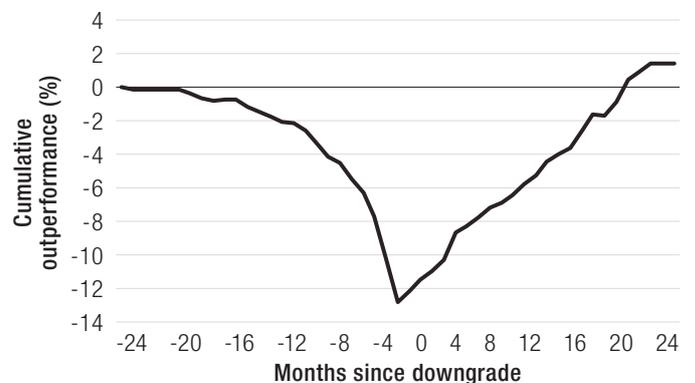
In the current cycle, we think this effect may be supercharged due to the Fed's direct intervention in US corporate bond markets, and its decision to ignore rating downgrades occurring after 22 March.

FIG. 13 FALLEN ANGELS SUPPLY



Source: Bloomberg Barclays indices and LOIM.

FIG. 14 FALLEN ANGELS CUMULATIVE OUTPERFORMANCE OVER PEER GROUP



Source: Bloomberg Barclays indices and LOIM calculations.

Fallen angels case study: Ford

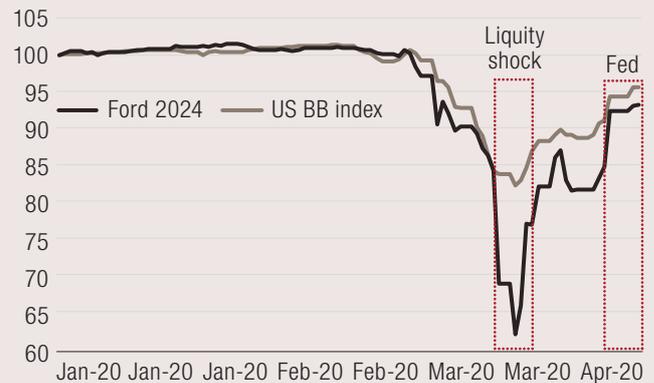
The downgrade of Ford on 25 March 2020 is a case study of fallen angel outperformance in the current crisis. This was the largest downgrade in the month of March 2020, representing 36 billion notional of a total 90 billion in debt downgraded for the month.¹²

Ford was rated BB (Moody's) and BBB- (S&P and Fitch) until S&P downgraded its rating by a single notch (with negative outlook) to BB+ on 25 March. The downgrade coincided with the March liquidity shock, with prices almost 20 points below that implied by the average move in BBs. The price reversed equally rapidly with an improvement in the liquidity situation, and additional support from the US Federal Reserve's 9 April announcement about broader conditions for its Corporate Credit Facility (SMCCF) purchases.

We believe this case study illustrates both the overreaction of market pricing in fallen angels, which is even more exaggerated

in times of stress, as well as the additional price support that central bank intervention is bringing to such issuers.

FIG. 15 FORD 3.66' 2024 VERSUS THE US BB INDEX: PERFORMANCE



Source: Bloomberg and LOIM.

Conclusion

Corporate credit markets today present highly compelling prospects for investors.

The market has sold off across sectors in an indiscriminate grab-for-cash that has uncoupled valuations from fundamentals. While defaults are expected to be substantially higher in the wake of the sudden economic shutdown, we believe unprecedented government support should help mitigate defaults, especially in better quality high yield where the Fed is now acting as a backstop.

Credit spreads have generally overestimated default risk in the past, and we find that even at these stress default levels, credit spreads more than compensate for defaults within standard bond indices.

Long-term investors able to look beyond the current situation could select mispriced names that retain robust fundamentals, meeting higher yield targets in the process.

Reflecting this, opportunities at the time of writing include crossover credit, Swiss credit, and convertible bonds.

Pricing in the BBB to BB **crossover segment** reflects strong value in global credit, in our opinion. We see the greater supply of fallen angels presenting prospects because fallen angels tend to outperform peers once downgraded – this process could play out faster in today's market because central bank purchases are occurring in this bucket.

The return to widespread positive yield for **Swiss credit** marks a phenomenon not seen in years. At end-February, roughly 94% of the SBI index (AAA-BBB) was negative yielding. As of end-March, however, 63% of the SBI index offered positive yield.

Parts of the global convertible bond market are now behaving like bonds, except they are offering **higher yields than straight credit** with the same seniority and from the same issuer, all whilst including an equity option.

There are clear openings in credit markets for specialised, active managers to deliver alpha, while long-term investors could finally resolve the low yield conundrum of recent years.

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