Investment Strategy

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بنك أبوظبي التجاري
ADCB
ASSET MANAGEMENT LIMITED

US credit- Follow the Fed

Prerana Seth
Fixed Income Strategist
Tel: +971 (0)2 696 2878
prerana.seth@adcb.com

Luciano Jannelli, Ph.D., CFA
Head Investment Strategy
Tel: +971 (0)2 696 2340
luciano.jannelli@adcb.com

Kishore Muktinutalapati
Equity Strategist
Tel: +971 (0)2 696 2358
kishore.muktinutalapati@adcb.com

Mohammed Al Hemeiri
Analyst
Tel: +971 (0)2 696 2236
mohammed.alhemeiri@adcb.com

Noor Alameri
Analyst
Tel: +971 (0)2 696 2340
noor.alameri@adcb.com

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Upgraded our allocation to US Investment Grade

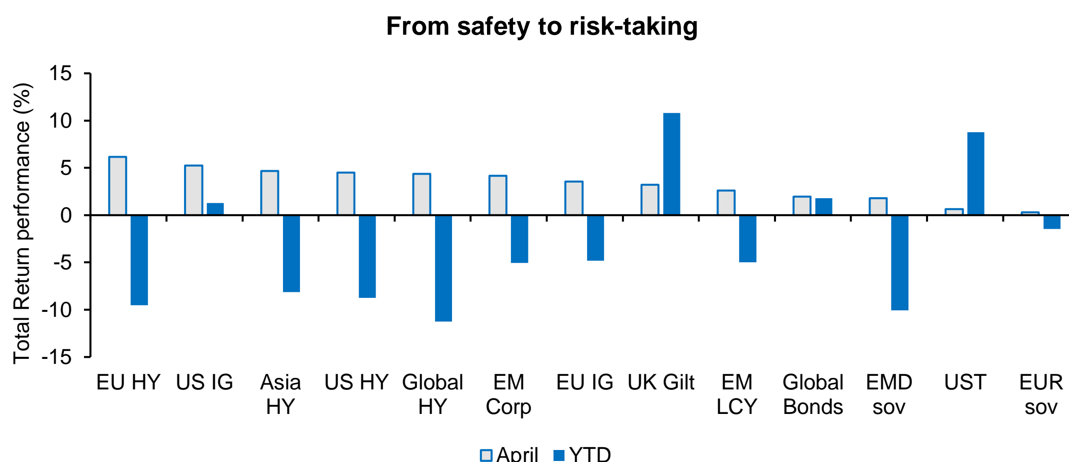
- **We upgrade our allocation to US Investment Grade (IG) credit from "underweight" to "neutral"**
  - **Fed's policy measures extending to US credit will keep US IG spreads anchored**
  - **The overall impact will be limited given the restricted scope and selective nature of the Fed's corporate programs (at least for now), explaining our neutral stance**
- **We remain underweight on US High Yield (HY) credit**
  - **HY spreads unlikely to rebound much with corporate downgrades likely to continue**
  - **Volatility in oil prices to remain a headwind for the US HY sector**
  - **HY credit fundamentals were showing signs of stress even before the Covid-19 outbreak**

Fed's corporate dive to contain IG spreads

There is no doubt that central banks across the globe have undertaken unprecedented policy measures to combat the economic damage caused by country lockdowns due to the Covid-19 outbreak. The Federal Reserve has led the pack, outdoing itself and going beyond the policy measures that it had introduced during the 2008 Great Financial Crisis. The central bank has been proactive in its monetary policy stance to support liquidity in the markets and could possibly step-up its stimulus if the economic situation fails to improve. Taking into account the current stimulus of USD2.3trn announced by the Fed, the central bank balance sheet is estimated to reach close to USD10trn by end of this year (Chart 2). Monetary stimulus of such a magnitude will no doubt provide support for fixed income asset classes, going beyond the government bonds. Especially because the Fed's latest bag of emergency measures has ranged from open-ended QE purchases, arranging dollar swap lines, providing loans to small and medium enterprise to the latest dive into corporate bond markets.

The Fed plans to buy corporate bonds through the introduction of *Primary Market Corporate Credit Facility (PMCCP)* and *Secondary Market Corporate Credit Facility (SMCCP)*, via which the central bank acts as a funding backstop for corporate debt issued by eligible issuers. The Fed's backing has been the main driver of the April rally in US credit. In fact, investors' preference moved towards risk-taking and yield fetching within fixed income asset class in April, from flocking to safe-haven US treasuries during times of increased volatility. In case of US IG bonds, the QE tailwind has helped completely reverse the previous losses made during the sell-off in March In fact, US IG has also outperformed its European counterpart. Central bank's provision of making fallen angel debt eligible for both its primary- and secondary-market facilities (rated BBB- as of March 22 2020) has been one of the biggest support for IG credit. With Fed being a purchaser of some of the fallen angel debt category, this has relieved some widening pressure on the IG spreads given the concerns on rising share of BBB-category of bonds. With the Fed stimulus now extending to US IG category, the answer is simple i.e. demand will be high for what the central bank buys. As a result, ***we believe that it no longer makes sense to stay underweight on US IG bonds and recommend upgrading to "neutral" on US IG stance.***

Chart 1: Global fixed income performance



Source: Bloomberg and ADCB Asset Management

Limitations of Fed's program refrain us from going overweight

However, we would like to stress that there are still limitations on coverage and eligibility criteria of the Fed's corporate buying program (Table below). Firstly, both the programs are restricted to corporate bonds rated BBB- as of March 2020. Some of these bonds have been downgraded since then (fallen angels) and now are rated BB+ under the HY category. Hence, the purchases of corporate bonds and ETFs which includes these bonds is only restricted to few bonds in the top category of BB rating in the HY index. Secondly, another restrictions comes in terms of the average maturity. Both the PMCPP and SMCCP will be targeting only the short-duration bonds (1-5yr segment). Thirdly, there are restrictions on the limit of the ETFs that the Fed can buy and in terms of pricing, the Fed will refrain from purchasing shares of ETF which are trading above the NAV.

The overall size of the secondary-market program ranges up to USD250bn. Within the limit of USD250bn, it is impossible that the Fed's corporate purchase will cover even majority of the US IG segment. The US IG Index has total outstanding of approximately USD6trn, of which the 1-5y maturity bonds sum up to roughly around USD1.9trn. So while the announcement of Fed venturing into buying corporate bonds in the secondary market has resulted in tightening of spreads across the IG index, there is limit on the IG bonds that would ultimately benefit from the asset purchases.

Facility	Amount (USDbn)	Criteria coverage	Limits	Rating of corporate bonds	Maturity	Length of program
PMCCF	500	1) Eligible corporate bonds 2)Eligible syndicated loans and bonds purchased at issuance	1) Bond, loans upto 25% of syndication, 10-to-1 leverage for IG assets, 7-to-1 for HY 2)bonds/loans <130% of maximum debt outstanding bonds/loans between Mar 22, 2019 and Mar22, 2020 3)Max amount of instruments capped at 1.5% of the combined potential size of the Facility and the PMCCF 4)Facility fee: 100bp (bonds), 100bp plus syndicate fee (loans)	at least BBB-/Baa3 as of March 22 2020 and atleast BB- at the time of purhase	1-4yr	ends 30th Sep 2020
SMCCF	250	1) Eligible Individual corporate bonds 2) Eligible ETFs a)exposure to US IG bonds b)exposure to US HY bonds	1)Max amount of instruments capped at 1.5% of the combined potential size of the Facility and the PMCCF 2)purchase from the secondary market capped at 10% of the issuer's maximum bonds outstanding on any day between Mar 22, 2019 and Mar 22, 2020. 3) Not purchase shares of a particular ETF if after such purchase the Facility would hold more than 20% of that ETF's outstanding shares 4) Not purchase shares of ETF trading at prices above NAV	at least BBB-/Baa3 as of March 22 2020 and atleast BB- at the time of purhase	1-5yr	ends 30th Sep 2020

Source: Federal Reserve

Quality is still important – Remain underweight on US HY

HY spreads have tracked the tightening in the IG spreads and have also benefitted from the Fed' corporate announcement. The CDS spread- measuring the possibility of corporate default- has narrowed in case of both IG and HY segment (Chart 4). However, in case of HY, the CDS spread still hovering above the wide levels seen during early 2016- period marked by heightened volatility in oil prices (Chart 5). Overall, the quality of the HY segment is likely to improve mainly on the back of the fallen angels (Chart 6). Yet, the performance of bonds segregated by three ratings shows that the CCC bond spreads have not moved much in spite of overall tightness in HY spreads (Chart 7). This has been the case even before the massive dip in oil prices seen recently.

I would stress that these are lending powers, not spending powers. The Fed is not authorized to grant money to particular beneficiaries. The Fed can only make secured loans to solvent entities with the expectation that the loans will be fully repaid

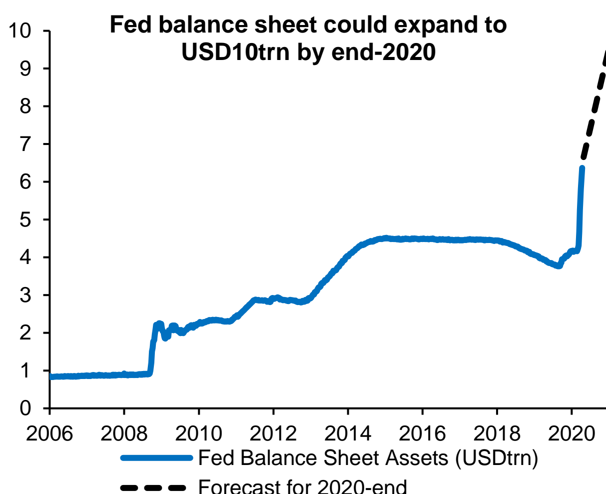
Fed Chair Jerome Powell

In spite of the Fed's backstop, the central bank has made it clear that these programmes are mainly lending powers and not spending powers. Through these programmes, the Fed could only provide temporary relief to companies facing cash issues, allowing these businesses to remain afloat during these difficult times. Also, this relief is limited to US companies as we have outlined before (paragraph above). Fed's QE purchases will not stop rating company's actions and many companies still face risk of being downgraded. S&P ratings expects that the default rate through 2020 will reach 10% in an "optimistic" scenario while in case of a "pessimistic" outcome, the default rate could even reach 13%. Before the Fed's move into fallen angels, the HY spreads

were pricing in this correctly. But now spreads are pricing in less than 10% probability for a 20% recovery rate (Chart 10). While we believe that Fed stimulus will remain baked in the spreads, but the HY spreads are unlikely to witness massive tightening as they will continue to price in default risk.

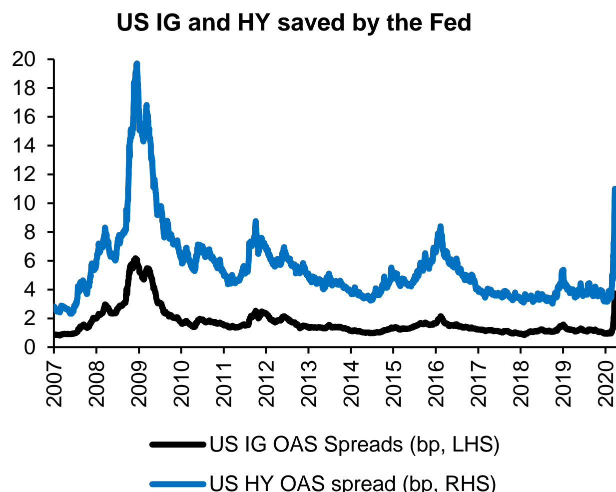
Corporate fundamentals have been deteriorating in the HY space, particularly the lower-rated category of bonds, even before the onset of the Covid-19 crisis. The low-rated corporates have accumulated high levels of debt over the years, taking benefit of the pinned down borrowing rates. This build-up of corporate debt taken against the corporate earnings has been high across various sectors. The debt-to-earnings ratio is likely to rise further with incoming weak earnings report of Q1 and further downside expected in Q2 earnings. Furthermore, volatility in oil prices remains a significant headwind for the HY sector. Even though, the composition of energy has been reduced to 11% of the Index, many energy corporates still rely on risky debt for running their businesses. With the sharp drop in oil prices, many oil and gas companies are under extreme risk of default. While their debt levels in the higher-rated segment may not be source of concern, the low levels of cash buffers pose challenges for the companies. However within CCC category, the energy sector has the highest debt-to EBITDA of 14x along with FCF-to-total debt being negative (Chart 8 and 9).

Chart 2: Fed balance sheet could expand to USD10trn by end-2020



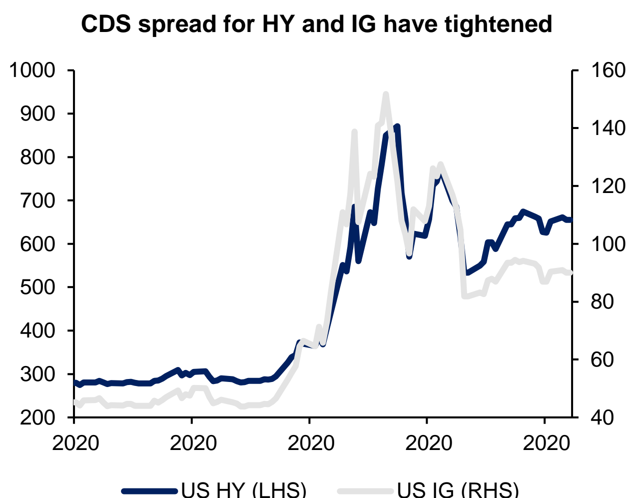
Source: Bloomberg, ADCB Asset Management estimate

Chart 3: US and IG spreads have tightened from their March wide levels



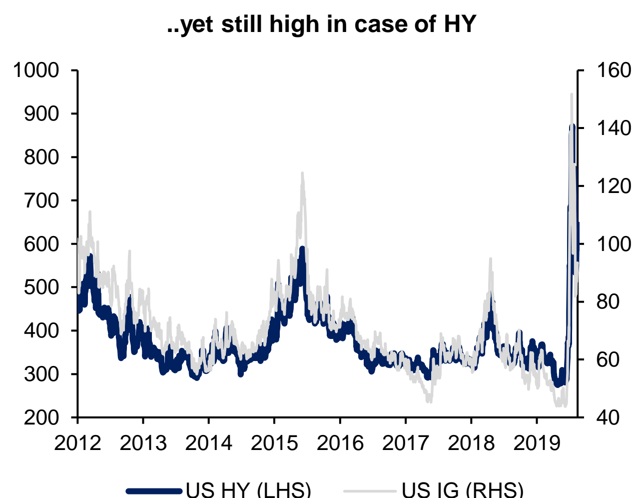
Source: Bloomberg and ADCB Asset Management

Chart 4: CDS spread has come down...



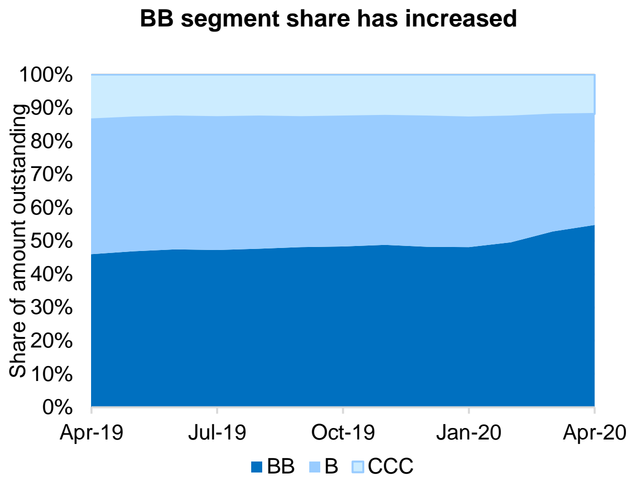
Source: Bloomberg and ADCB Asset Management

Chart 5: ..yet still higher than 2016 levels in case of HY



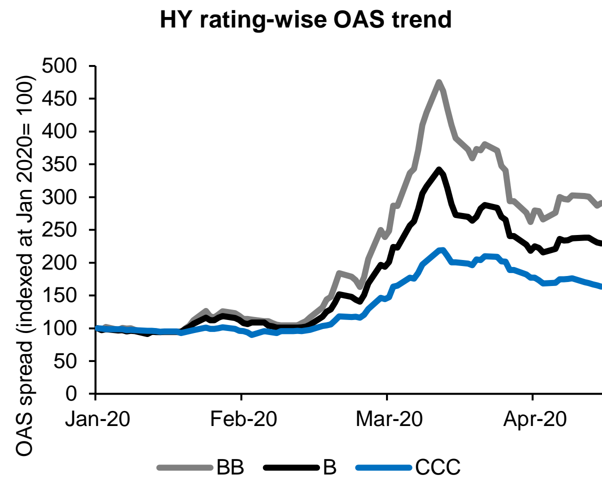
Source: Bloomberg and ADCB Asset Management

Chart 6: Junk improves in quality due to Fed's fallen angels



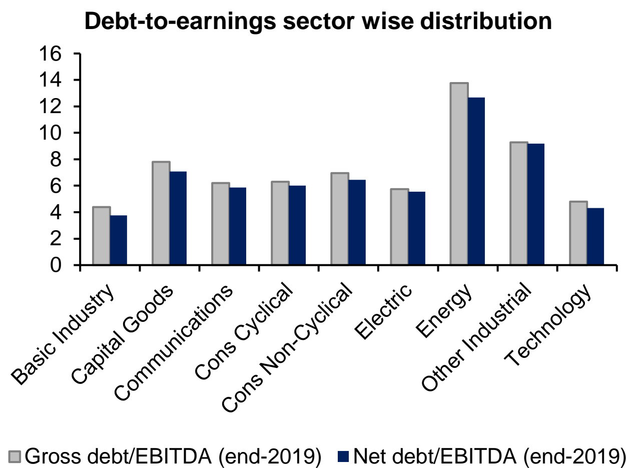
Source: Bloomberg and ADCB Asset Management

Chart 7: CCC spreads have seen less recovery



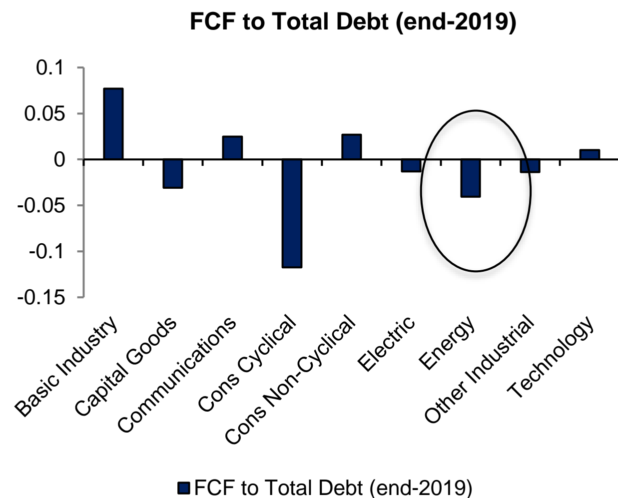
Source: Bloomberg and ADCB Asset Management

Chart 8: CCC energy debt/earnings almost 14x



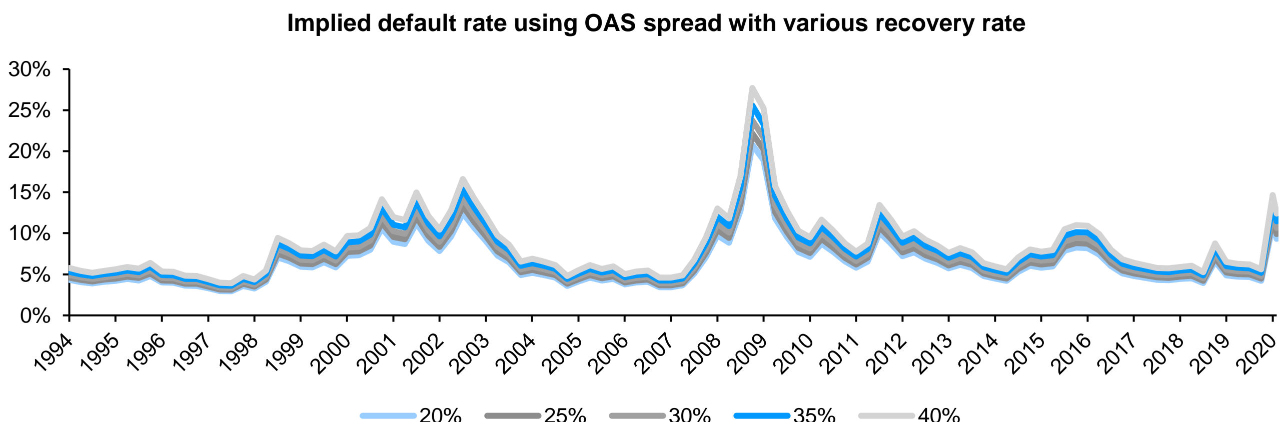
Source: Bloomberg and ADCB Asset Management

Chart 9: Energy sector in CCC has negative cash buffer



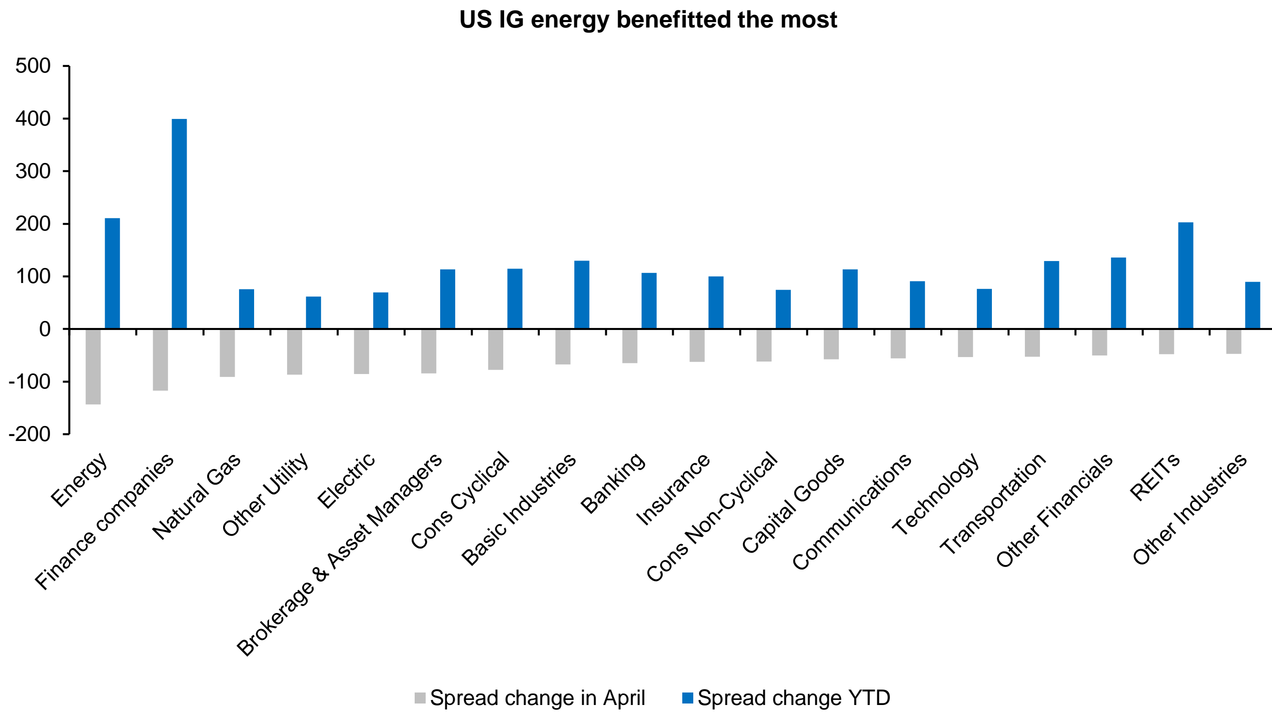
Source: Bloomberg and ADCB Asset Management

Chart 10: HY spreads now pricing in less than 10% rate of default



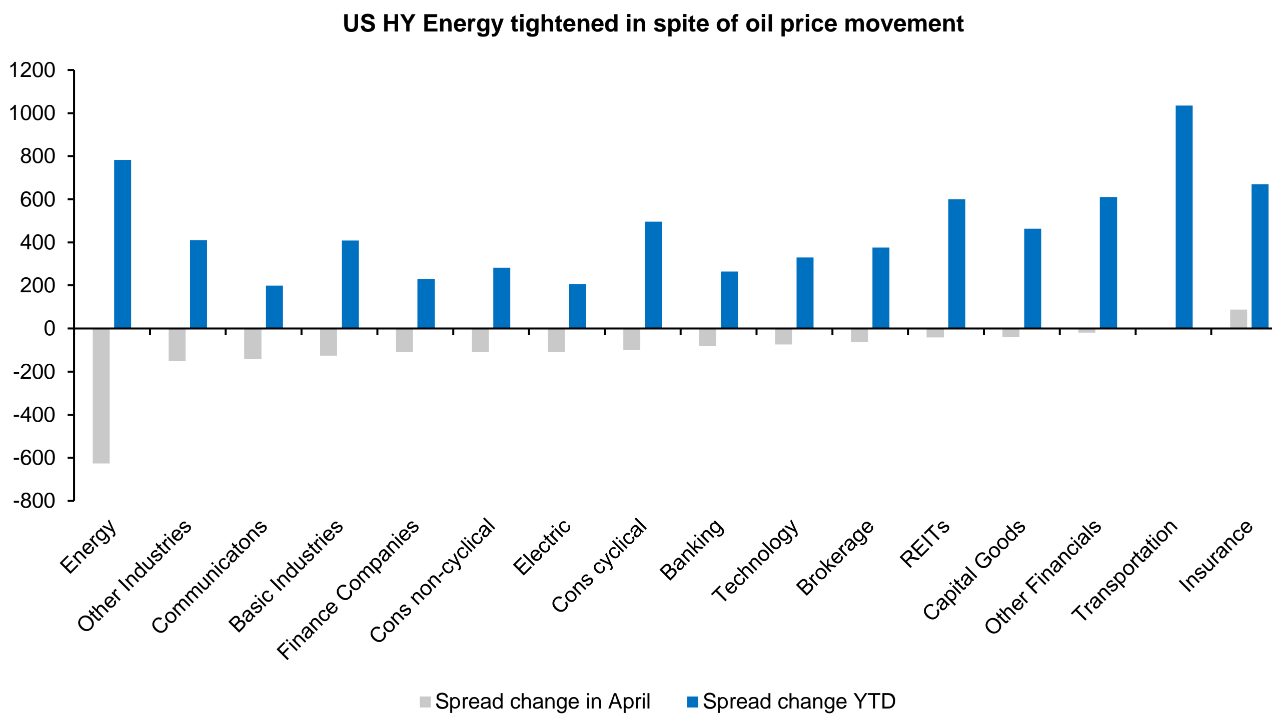
Source: Bloomberg and ADCB Asset Management

Chart 11: US IG performance sector breakdown



Source: Bloomberg and ADCB Asset Management

Chart 12: US HY performance sector breakdown



Source: Bloomberg and ADCB Asset Management

Sources

All information in this report has been obtained from the following sources except where indicated otherwise:

1. Bloomberg
2. Wall Street Journal
3. RTT News
4. Reuters
5. Gulfbase
6. Zawya

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