AIM Insights - Corporate Debt Risk Analysis

Andrew Roffey, Head of Credit

Introduction

The global economic recovery following the 2008 financial crisis has been one of the longest in history, in part due to the depth of the downturn and, by historical standards, weak growth seen in the recovery phase. The economic cycle is now perceived by many commentators to be well into the mature phase, so there is increased attention on structure and quality within the credit markets. There are also concerns that a build-up of potential risks within the system may become evident in the next downturn.

At AIM, our continued focus is on higher quality credits, which are readily available within both our investable SPECTRUM universe and the wider impact bond market, and we remain extremely cautious. This vigilance is being maintained in the face of a surge in the global universe of negative yielding debt to $13 trillion, almost double that of end-2018. Essentially a much larger proportion of global bonds would now, if held to maturity, guarantee losses for the investor due to a contraction in spreads. In order to generate returns investors are now required to consider much more risky assets.

A steady decline in overall credit quality

Moody's measure covenant quality across a 5-factor range with 1.0 denoting the strongest quality and 5.0 the weakest. Assessments are made quarterly and have been steadily—albeit slowly—deteriorating, even as the cycle extends (see Figure 1). For example, in the US, the worst score ever was recorded in Q3 2018 and, even though Q4 showed an improvement, it was only marginal, changing from 4.13 to 4.07.

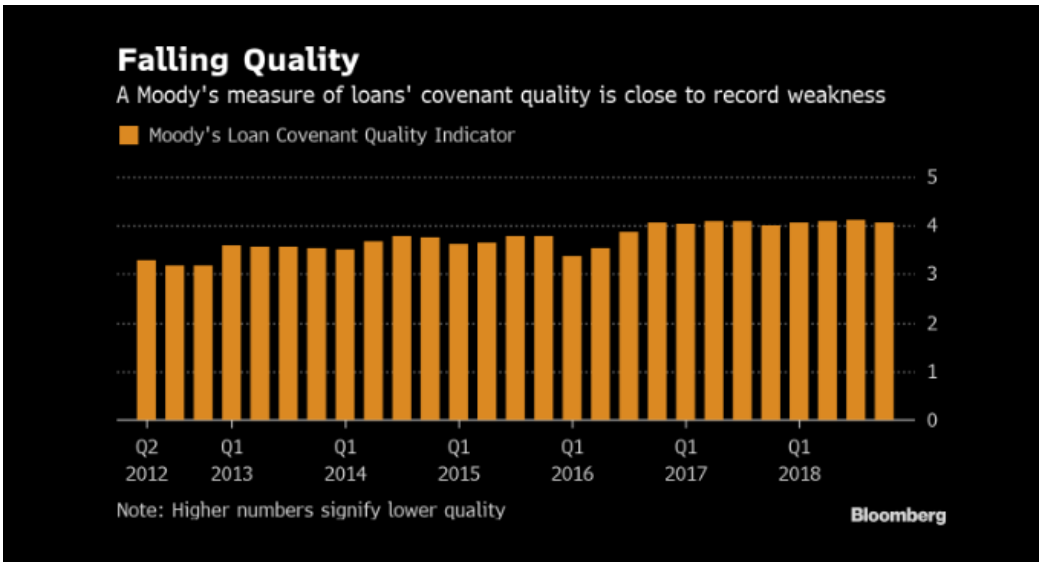

Figure 1: Historical covenant quality
Source: Bloomberg

The issue which is perhaps of most concern is that, as the cycle has lengthened, the proportion of issuers which are *just* investment grade has continued to rise and they now represent approximately 50% of all rated issuers. It is unclear at this stage whether this is a function of an increase in emerging market issuers (in China in particular), or the result of issuers seizing an opportunity to lock in low funding rates by increased use of wholesale markets to increase the weighted average maturity of their overall balance sheet debt.

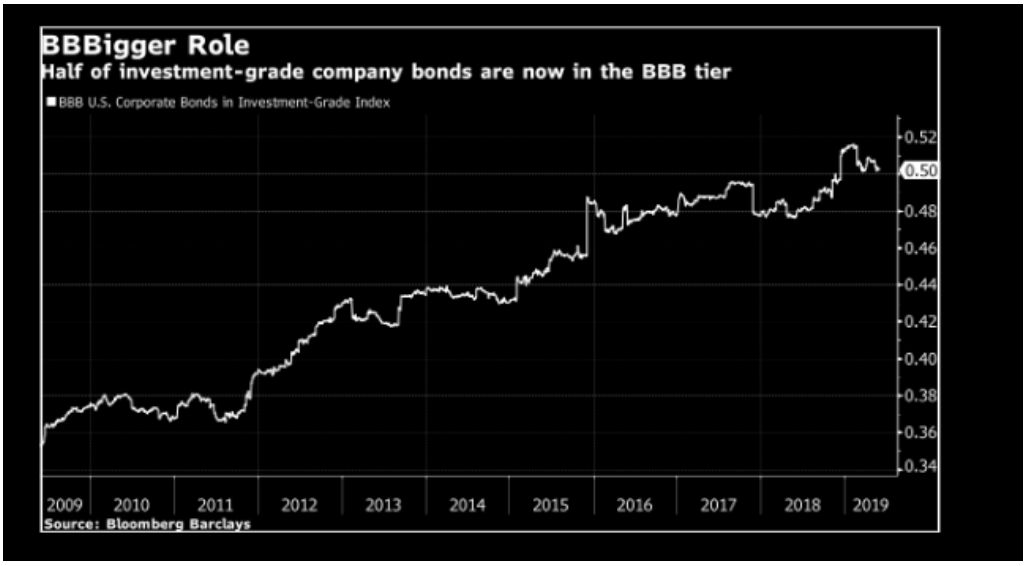

Figure 2: Proportion of BBB bonds in Investment Grade
Source: Bloomberg

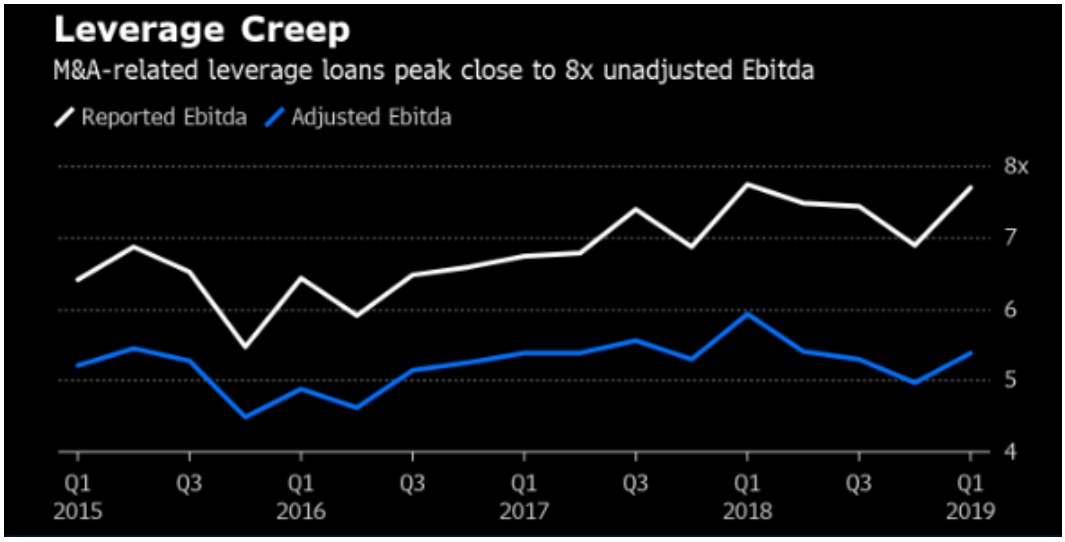

Figure 3: Reported EBITDA/Adjusted EBITDA
Source: Bloomberg

Credit cycle since the Global Financial Crisis

This cycle has been characterised by two factors - a replacement of equity with debt, and corporates preferring to acquire competing companies rather than invest in capital expenditure. Figure 3 addresses the latter and compares the ratio of debt to earnings before interest and depreciation both on an as reported basis and adjusted for exceptional items.

The following are possible reasons for banks' willingness to tolerate higher levels of debt gearing in any given transaction:

- M&A has been a source of good fee income when other areas—FICC trading, etc—have seen competition and regulatory tightening eroding returns. Accordingly, banks might be more ready to countenance slightly larger amounts of risky deals to maintain a high quality income stream.
- Absolute levels of interest rates are much lower than during previous cycles.
- Institutions across a range of industries have demonstrated that it is possible to consistently cut costs with the aid of digital transformation, and so banks believe that the higher debt can be paid down more quickly than in previous cycles.
- The global economy has, until now, been expanding, with all major regional blocs enjoying a brief period of increasing growth.
- Bankers may simply be misjudging where we are in the cycle, envisioning that we are still only just past mid-cycle which would imply a longer period of earnings growth to address higher debt before an economic slowdown.

However, until recently much of this M&A activity emanated from the US—there has not been anything like the same level in Europe (aside from banks required to issue for regulatory reasons).

Growth rates have been very different, which may indicate that default rates in the next downturn will vary significantly between regions (as shown in Figure 4).

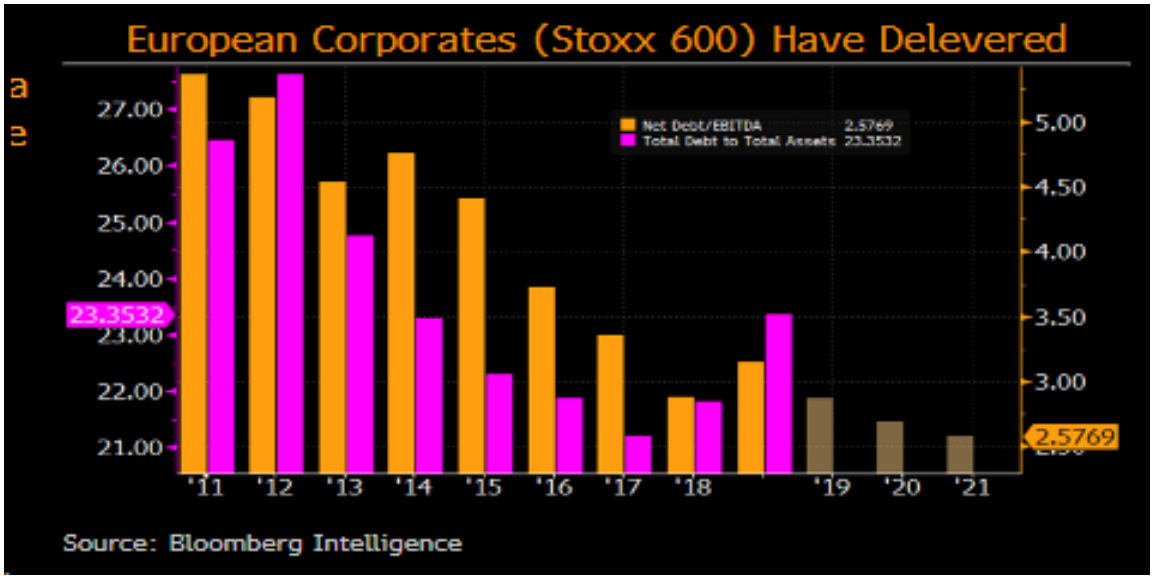

Figure 4: Debt/EBITDA and Debt/Asset ratios of European corporates
Source: Bloomberg

The key point to consider is how these factors will play out in combination with the overall decline in credit quality within the market as a whole. Extending the time for debt repayment is acceptable in the short term, but the refinancing risk will need to be managed carefully, bearing in mind the current, unprecedented period of ultra-low global interest rates, as well as the fact that higher duration bonds can be riskier when yields rise. Figure 5 below would suggest this is not a prime consideration for US corporates at present.

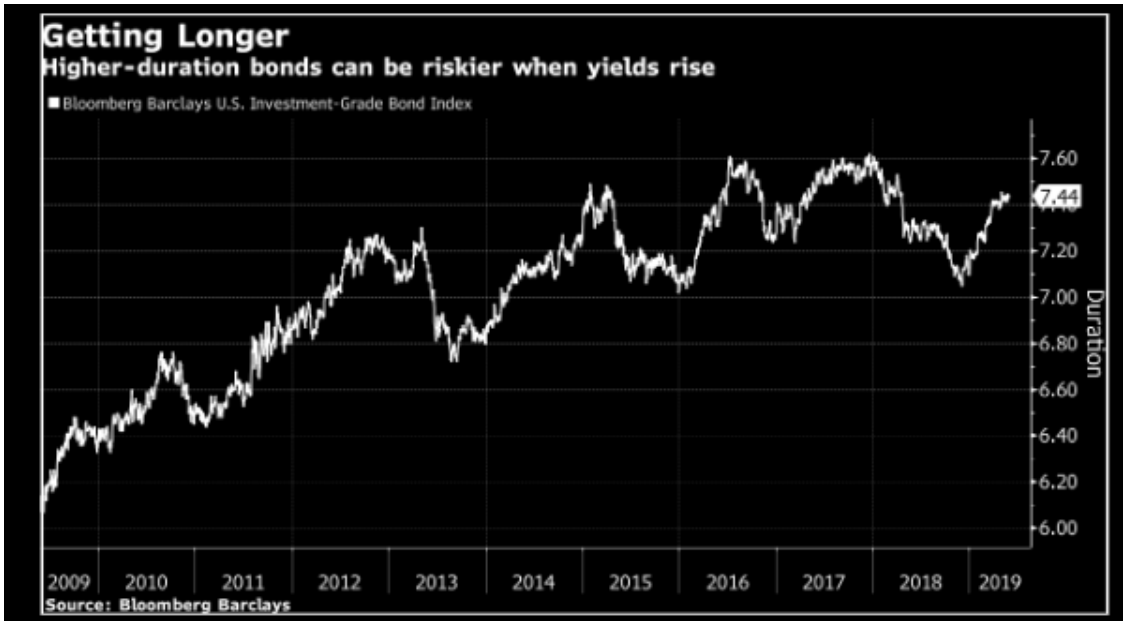

Figure 5: Historic duration of the BBG US Investment Grade Index
Source: Bloomberg

Current market analysis

Recovery from the deep economic crisis of 2008 continues, but is proving even slower and more challenging than expected. Although growth remains strong in the US and unemployment remains low, the latest reading of the Institute for Supply Management (ISM) non-manufacturing purchasing managers index (PMI) indicates the weakest pace of expansion since mid-2017, a picture largely echoed on the trade side, with new orders and prices paid at a three-year low. This reflects, to some extent, the aggressive rhetoric on fair trade practice by the President and the use of tariffs to counter imbalances. In Europe, a further round of monetary stimulus is being considered, with German manufacturing PMI falling to a seven year low in July 2019.

Furthermore, the corporate bond market has become increasingly fragile with markedly less liquidity, not helped by the fact—highlighted in the Economist and by S&P, inter alia—that fewer dealers are prepared to trade bonds in significant volumes. These factors, combined with the changing structure of the bond market and the fact that many mutual funds can only hold investment grade bonds, could precipitate a significant excess of sellers of bonds and little capacity to absorb them, in the event of an economic downturn.

Conclusion

Signals from the President of the US and the European central banks imply that the risks outlined above are recognised and there is a determination to act decisively, if necessary, even though Mario Draghi is about to be replaced as ECB head by Christine Lagarde. However, as macro credit analysis forms an important part of our investment process, this is a situation that we will continue to monitor very closely.

Our global strategies currently hold a small overweight position of investment grade corporate bonds, relative to the benchmark (Bloomberg Barclays Global Aggregate). Due to the current size and structure of the impact bond market, we reference proxy government bonds issued by high quality government agencies in order to manage the difference between our investable universe and the benchmark. For the flagship portfolio in our global strategy, we are overweight AAA issuance overall by approximately 15% relative to the benchmark, as of June 2019.

In light of these market conditions and the possibility of the continuation of the current slowdown in developed markets, while we are still positioned for slow and steady global growth, we are currently adopting a more defensive strategy relative to our original positioning by actively increasing the overall credit quality of our portfolios. This is in order to protect ourselves from the possibility of a recovery pause or an economic downturn, and to guard against any potential credit spread widening.

Affirmative Investment Management Partners Limited

Authorised and Regulated by the Financial Conduct Authority FRN 658030, the SEC CRD Number 282138

Registered in England & Wales no. 09077671

Registered Office; 150 Aldersgate Street, London EC1A 4AB