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BALANCING CAUTION WITH OPPORTUNITY

MIRABAUD - GLOBAL STRATEGIC BOND FUND

Andrew Lake, Head of Global Fixed Income at Mirabaud Asset Management, talks about balancing caution and opportunity

Where have we come from?

We entered 2020 on a relatively cautious note, which was in contrast to the broader market, which took a more positive stance following the resolution of the trade deal between US and China. As a result of our approach, we did not aggressively chase yield in Emerging Market Debt or High Yield. This provided some insulation as COVID-19 took hold.

Fed versus fundamentals

In terms of our recent portfolio activity, we took off the last of the CDX hedge's we had on. We've taken the view that in the short term, optimism will emerge around the opening of economies, and the US Federal Reserve action on buying 'fallen angels', and to some extent, high yield ETF's, is trumping fundamentals in the short term. However, we'll look to re-establish the CDX hedge over the next few weeks, at higher levels, when we start placing more emphasis on fundamentals again. Any chance of a rebound is likely to be low and against this backdrop, we are likely to see an increase in defaults. As a result, we remain cautious, but with an eye towards opportunity.

Europe looking attractive relative to the US

We have not viewed Europe as a strong fixed income opportunity set for the last five to six years. However, the technicals in Europe are currently worse than the US. First, we have not seen the same degree of intervention in Europe as we have done in the US, although we do expect more stimulus from the European Central Bank. Furthermore, in Europe, some Investment Grade bonds are trading four times wider in terms of spreads than they were in February this year.

In contrast, US Investment Grade bonds are back to where they were over the same period. However, we are not looking at February as a benchmark to where we should be going back to because, back then, we already had the view that levels were already very expensive compared to a historical basis.

Finally, there are opportunities in European High Yield, which tend to be better quality than equivalent credits in the US.

New issues and opportunities

Interestingly, new issuance has been very strong and that should take some pressure off the secondary market. Most of the new issues have been in the stressed sectors, such as entertainment and consumer related industries as companies build their liquidity in anticipation of more uncertainty going forwards. These businesses still face short-term challenges, reflecting that consumer habits in the short term have changed as a result of the lockdowns. We have participated in some new issues, but we've been focusing on existing bonds that have declined in price as a result of the new issuance.

We are currently also seeing some interesting opportunities in High Yield. Many companies are putting in place measures to enhance liquidity to enable them to get through this difficult period. One example is Dufry, the global travel retailer. It recently announced upsized credit facilities, an equity raise, a dividend cancellation, a convertible bond issue and an easing of its covenants. As a result, we believe that the company is now better positioned to deal with the impact of the lockdown on its business.

Black Gold

The oil price will be another important determinant of market sentiment. It only represents 10% of the market, but it remains an important barometer, particularly while pricing pressures continue. As a result, storage and oil production rates will continue to be problematic, causing volatility in the market. Some shale companies will be taken out, perhaps permanently. The larger companies, however, will survive in our view. We also think that oil will be back to $45 by next year. However, this will be a painful time for the energy sector and we think it’s unlikely to stabilise until the lockdowns are lifted.

We continue to be involved in the sector, predominately through gas producers and gas midstream companies. As oil production comes down, so will gas production. The Gas market was already over-supplied prior to the collapse in the oil price and companies in this sector had already taken a big hit in the last six months. However, as people stay at home and we enter the summer, we are likely to see gas demand increase. In summary, we expect a tightening of the market as we head towards the end of 2020.

Defaults will rise

We believe that much higher rates of defaults are expected and these will be focused in the distressed sectors. For example, the retail sector continues to be an area of concern – for example, areas such as restaurants, travel and consumer goods. In fact, retail was already facing difficulties prior to this current crisis, which has only amplified the challenges in the sector and are likely to be at the first stage of defaults.

We also anticipate more defaults coming from the Energy sector, especially in those companies that don’t have the liquidity or optionality to survive over the next six to nine months and will need to restructure. Finally, we think the last stage of default will be in large-cap credits that were over-leveraged going into the crisis and have regular refinancing needs.

More stimulus?

We believe the market remains challenged and will move in a tight range until we see signs of the lockdowns elevating pressures and working, or we see stimulus from the US Federal Reserve and the European Central Bank. We have been adding to our positions, mainly better-quality holdings, and in the short term, at least, we remain cautious but continue to seek opportunities as they arise.

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