NEWPERSPECTIVES

Commentary from New Century Advisors – December, 2020

OPPORTUNITIES IN CREDIT: LOOKING THROUGH ALL-TIME TIGHTS

- IG spread at the index level may be close to pre-Covid tights, but dispersion in spread performance at the sector level is providing compelling opportunities for outperformance.
- Sectors directly impacted by the pandemic, such as lodging and aircraft lessors have lagged spread recovery and present interesting set-ups appear to be going into a recovery period.
- The record amount of fallen angels this year have provided us with a set of compelling opportunities to generate outperformance for our clients.

SPEEDY RECOVERY IN CREDIT SPREADS

The credit spread on the Barclays Investment Grade (IG) Corporate Index is 110 basis points, just 16 basis points shy of the all-time tight of 93 basis points at the end of December 2019. At the height of the Covid-19 pandemic, the IG corporate spread widened out to 373 basis points, nearly 275 basis points over its pre-pandemic tight. *Although the spread at the index level is close to reaching its pre-Covid tights, at the sector level there appears to remain a fair amount of dispersion in spread performance.*

The speed of recovery in credit spreads, due to a combination of monetary and fiscal stimulus and a Fed backstop for investment grade corporates, understates the wild ride investors have had in the IG fixed income markets in 2020.

Despite IG spreads moving tighter, the recovery in the various sectors has been uneven YTD, driven by pandemic sensitivity, the volume of fallen angels and new issuance.

The table below shows spread widening at the sector level in March 2020 and subsequent spread tightening since the March wides. The last column shows to what extent spreads have recovered from March levels. Spread retracement of 100% and above means that sector spreads are now trading flat to tighter than where they were before the spike in March.

Sector	**Spread widening in March 2020**	**Spread tightening *since* March 2020**	**Spread retracement**
Corporate	280	-264	94%
Automotive	648	-675	104%
Supermarkets	207	-209	101%
Food and Beverage	244	-240	98%
Banking	244	-237	97%
Technology	239	-227	95%
Healthcare	226	-215	95%
Energy	476	-435	91%
Other Industrial	140	-124	88%
Lodging	821	-704	86%
Finance Companies	620	-530	85%
Healthcare REITS	232	-197	85%
Aerospace/Defense	279	-213	77%
Office REITS	183	-135	74%
Retail REITS	218	-160	73%
Airlines	351	-142	40%

Source: Barclays Live

Although at the index level Investment Grade corporates have been able to retrace 94% of the March widening, not all sectors have recovered at the same pace. Supermarkets, Food and Beverage and Technology, sectors that have benefited from pandemic-related disruption as more people eat at and work from home, have been able to recover far more quickly than sectors directly impacted by social distancing restrictions like Airlines and Lodging. Finance Companies have also lagged, as the primary constituents of this sector are aircraft lessors and BDCs. Although the Auto sector appears to have recovered faster than one would expect given its cyclicality, this could be distorted by the deletion of Ford from the index after it became a fallen angel.

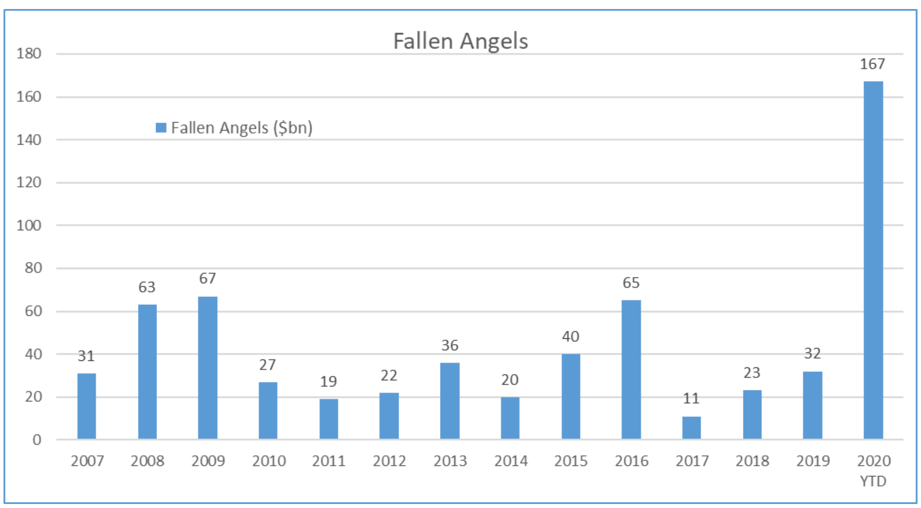
- We think that sectors and issuers that have lagged spread recovery are an attractive starting point to generate investment ideas. For example, some of the larger players in lodging are trading at reasonably attractive levels. These companies have built up sizeable liquidity since March, and have successfully tapped the bond market to refinance maturities. We think that these companies have profitable business models, and with the boost in liquidity, will successfully navigate through this period.

- Another area that seems attractively priced and leveraged to the recovery theme is aircraft lessors. Like other high-grade issuers, these companies have built sizeable liquidity to get through the pandemic period, and very manageable maturities and capital expenditures in 2021.

FALLEN ANGELS

One key driver of spread changes at the sector level has been the record amount of fallen angels in 2020.

Through the end of 3Q 2020, $167bn, or nearly 4%, of IG bonds have been downgraded to HY. To appreciate this scale of fallen angels, consider that during the period 2008-2009, two years following the financial crisis, there were approximately $130bn of fallen angels. Furthermore, there were only $23bn and $32bn of fallen angels, respectively, in 2018 and 2019. The impact on HY was even more extreme, with fallen angels amounting to 11% of the universe.



Source: J.P. Morgan, HG Ratings Review, October 7, 2020

The Energy sector has seen the largest volume of fallen angels at $67bn or 13% of sector market value at the beginning of the year. *Because of the large percentage of lower quality and wider trading names departing the index, the Energy sector has optically retraced approximately 90% of its spread widening.*

Two other sectors where fallen angels have impacted YTD spread performance are Autos and Food and Beverage.

- The Auto sector has seen the second highest volume of fallen angels this year with the downgrade of Ford to high yield. Approximately $37 billion of Ford bonds, 30% of sector market value at the beginning of the year, have exited the index. The current spread for the Auto sector is actually 27 basis points tighter than where it started the year, again demonstrating the effect of a large, underperforming constituent leaving the index.

- In Food and Beverage, with the downgrade of Kraft Heinz to high yield, $21 billion of bonds dropped out of the index, or 10% of sector market value at the beginning of the year. The current Food and Beverage sector spread of 102 basis points is nearly flat to where it started the year.

We are also finding opportunities for spread pick-up in recent fallen angels. Some of these issuers have suffered a ratings downgrade to high yield, because of their dividend policy, or because of a pandemic-related delay in deleveraging. The fundamentals for most of these businesses remain strong, and we find these issuers may have less credit risk than a typical high yield issuer.

CONCLUSION: OPPORTUNITIES REMAIN

Although investment grade spreads have retraced nearly all of the spread widening suffered in March this year, we remain constructive on IG corporates and are finding attractive opportunities to source alpha in sectors and issuers that have lagged the recovery. The uneven recovery in sectors and the universe of recent high quality, fallen angels has provided us with a set of compelling opportunities to generate outperformance for our clients.

For more information on any of the data, trends, or trading strategies in this piece, or to discuss how New Century Advisors might help your fixed income allocation, please contact Leigh Talbot, CFA, Director of Client Relations at 240-395-0012 and ltalbot@ncallc.com

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