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International

Global research and insights from Frontier Advisors

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Debt and Currency

North American Research Trip

FRONTIER ADVISORS

Frontier regularly conducts international research trips to observe and understand more about international trends and to meet and evaluate, first hand, a range of fund managers and products.

In conjunction with insights we share with our Global Investment Research Alliance partners, these observations feed into our extensive international research library.

This report provides a high-level assessment on the key areas and observations unearthed during this recent Real Assets' trip. We would be pleased to meet with you in person to provide further detail on these observations.

AUTHOR

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Andrew Kemp joined Frontier in June 2016 as a Senior Consultant, was promoted to Principal Consultant in 2018 and leads our Debt and Currency team. Andrew has around twenty years of experience in the asset management industry both domestically and globally, having worked in Australia, Singapore and the UK. Andrew was Head of Fixed Income at DBS Asset Management (Singapore) for three years and prior to that spent a decade as Fixed Income Portfolio Manager at Alliance Bernstein Australia. Andrew joins Frontier from Chimaera Capital, where he was the Director of Asset Management. Andrew holds a Bachelor of Commerce (Finance) from Otago University (NZ) and a Graduate Diploma of Applied Finance and Investment from Finsia.

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Nam Tran joined Frontier as a Consultant in 2017 and is a member of the Debt and Currency team. Previously Nam worked with NAB in the institutional banking area, undertaking industry and credit analysis in the Resources, Energy and Utilities sectors for ten years. Prior to this, he spent three years with KPMG and the Sarbanes Oxley team at NAB, undertaking financial and operational analysis of clients in the financial services industry, and three years with HSBC in Vietnam in corporate and institutional banking. Nam holds a Bachelor of Business from Monash University, a Master of Commerce from the University of Sydney and a CFA, and is a Chartered Accountant

Introduction

Members of the Debt and Currency team recently completed a research trip to the United States of America.

The trip focused primarily on meeting with a number of debt managers, broadening our understanding and research coverage. The strategies covered on the trip were varied and include global bond, investment grade credit, high yield, bank loans, multisector credit, private lending, opportunistic credit, and distressed debt.

The objective of this trip was to get a better understanding of where we are in the credit cycle and uncover how fund managers are responding to current market conditions.

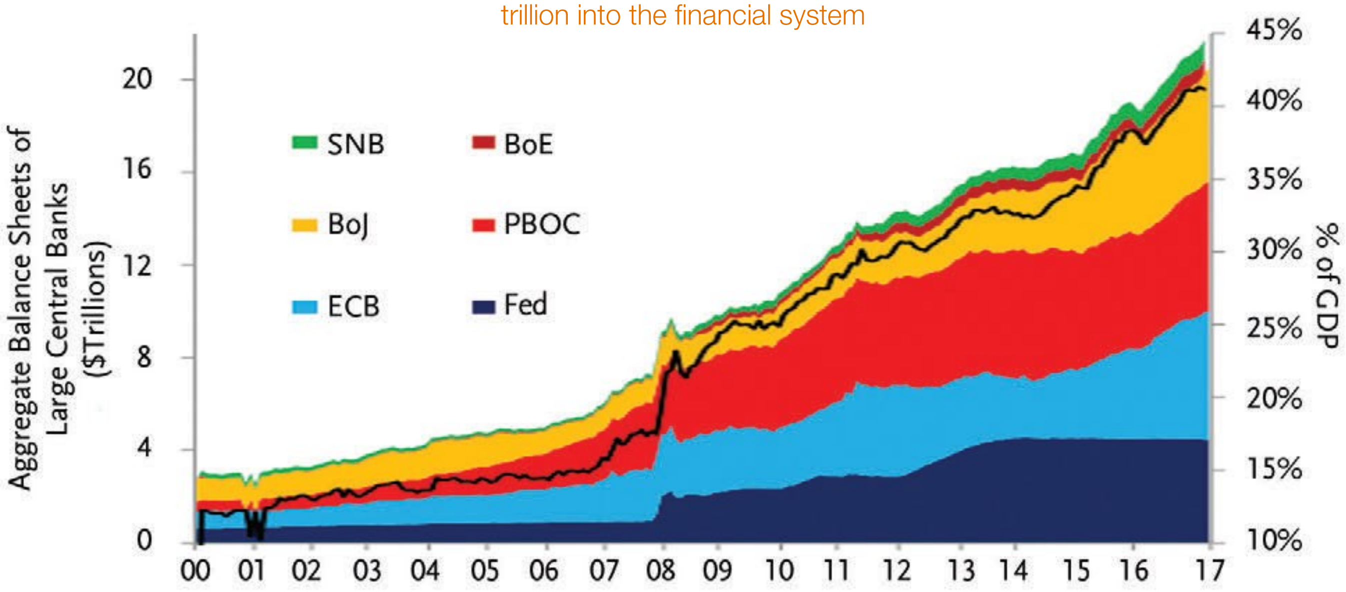
Credit cycle

The majority of managers we met with share the view we are late in the credit cycle. This is consistent with Frontier's view, although the prevailing sentiment among managers was for a soft landing for economic growth rather than a recessionary outcome. Notwithstanding macro conditions, the managers believe they can navigate the current market conditions and find value in the market through a combination of skill, experience, dedicated resources and discipline. Indications of the cycle lateness can be seen across the credit spectrum in both investment grade and non-investment grade credit.

A stand out feature of the current cycle has been quantitative easing of the central banks.

The bond buying by large central banks has resulted in their aggregate balance sheets standing at over US$20 trillion, estimated at about 40% of GDP of the respective countries. As the central banks slow their quantitative easing and start quantitative tightening, some managers speculated that the impact could be material for asset prices, credit availability and affordability, and market interest rates.

Chart 1: Central banks have pumped over US$20 trillion into the financial system



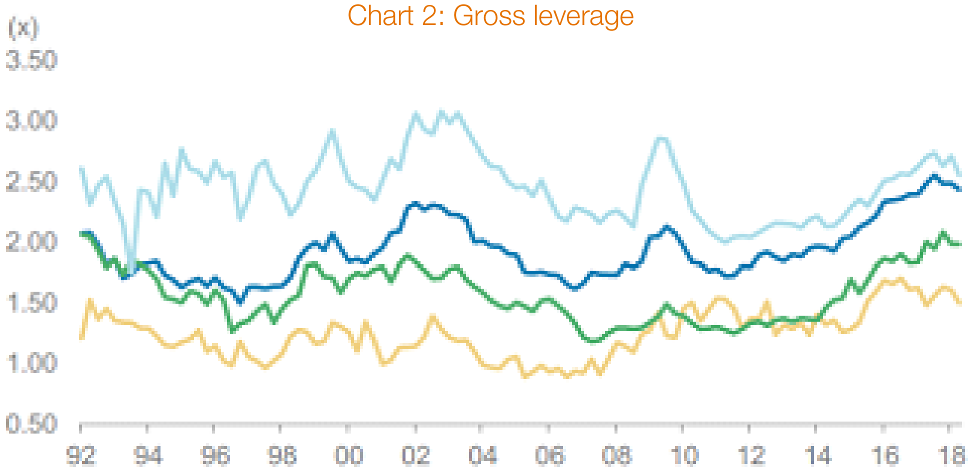
Source: National central banks, Citi

Investment grade (IG) market

Gross leverage in the non-financial US IG corporate market has increased over recent years and in aggregate is currently at a level higher than was seen in past late-cycle environments (2000-02 and 2007-09). As shown in Chart 2, gross leverage since 2010 has moved higher in all IG rating buckets, but the increase is more noticeable in the lower rating bands (“BBB” and “A”).

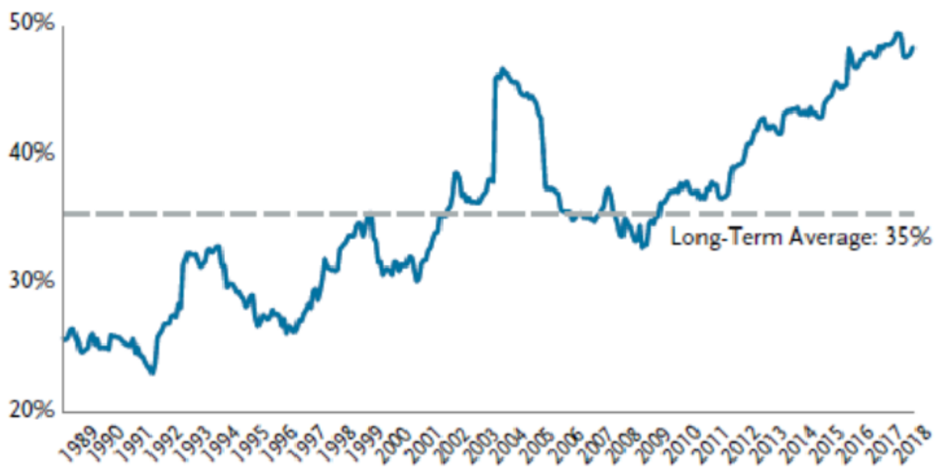
Chart 3 indicates one notable change is the higher proportion of BBB rated names in the IG market. Currently at about 50% of the overall IG market, this exceeds the long-term average level of 35%. After substantial growth in many years, BBB credit now represents US$2.5 trillion in par value, which is higher than value of the Bank Loan and High Yield Bond markets combined.

Chart 2: Gross leverage



Source: Morgan Stanley

Chart 3: BBB rates bonds comprise half of IG corporate index

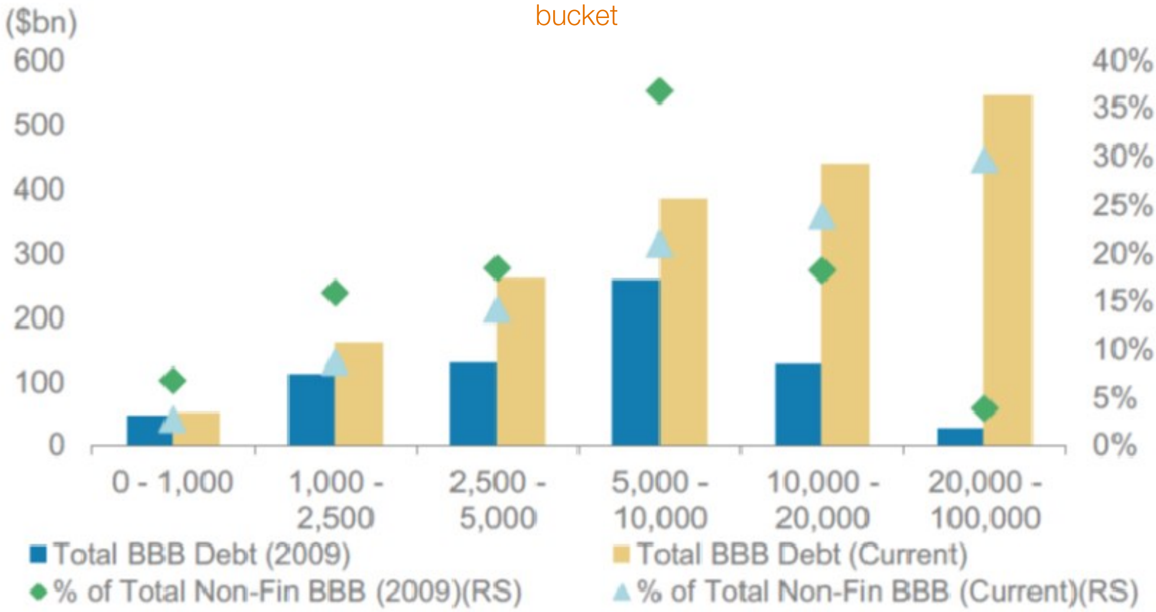


Source: Morgan Stanley

The growth in the BBB market since 2009 has been driven by a combination of a higher number of BBB issuers and larger issue sizes. The number of BBB issuers has increased by about 60% over the last ten years. Chart 4 illustrates there is more BBB debt in each debt bucket, however the increase in BBB debt has been more pronounced in large issuer buckets (above US$10 billion).

The "mega" bucket where debt outstanding is above US$20 billion (per issuer) went up from less than 5% of total non-financial BBB outstanding in 2009 to about 30% in 2018

Chart 4: Total non-financial BBB outstanding by bucket



Source: Morgan Stanley

Table 1 lists the top 25 non-financial BBB issuers and illustrates the increase in size of issuers since 2009. In 2009, the top 25 non-financial BBB issuers in total had \$257 billion of debt, compared to \$685 billion of debt in 2018.

The following data in Table 1, provided by Morgan Stanley, did not reflect the downgrade of General Electrics (GE) in October 2018, which would have put GE as one of the largest BBB issuers with its \$97 billion of long-term debt.

Table 1: The top 25 non-financial BBB capital

Top Non F nanc al BBB Names							
1Q09				Current			
Rank	Ticker	Sector	BBB Par in Current 1Q09 Rat ng	Rank	Ticker	Sector	BBB Par Rat ng n Current 1Q09
1	CMCSA	Media	25,540 A	1	T	Telecommunication Services	81,912 A
2	TWC	Media	17,154 BBB	2	VZ	Telecommunication Services	75,772 A
3	TWX	Media	14,952 BBB	3	CVS	Consumer Staples	58,682 BBB
4	MDLZ	Consumer Staples	13,800 BBB	4	GM	Consumer Discretionary	37,848 Rising Star
5	EXC	Utilities	12,484 BBB	5	F	Consumer Discretionary	35,285 Rising Star
6	MO	Consumer Staples	11,900 A	6	KMI	Energy	29,360 BBB
7	DT	Telecommunication Services	11,250 BBB	7	ETP	Energy	27,294 BBB
8	TITIM	Telecommunication Services	11,071 Fallen Angel	8	BATSLN	Consumer Staples	24,959 BBB
9	FE	Utilities	10,291 BBB	9	CHTR	Media	23,839 New
10	KMI	Energy	10,011 BBB	10	KHC	Consumer Staples	22,445 BBB
11	FOXA	Media	9,396 BBB	11	D	Utilities	21,344 BBB
12	HD	Consumer Discretionary	9,250 A	12	WMB	Energy	20,781 BBB
13	BRKHEC	Utilities	8,867 A	13	AGN	Health Care	20,057 A
14	RIOLN	Materials	8,850 A	14	EPD	Energy	20,050 BBB
15	APC	Energy	8,275 BBB	15	CELG	Health Care	19,850 New
16	CTL	Telecommunication Services	8,160 BBB	16	ABT	Health Care	19,535 AA
17	XOM	Energy	7,997 AA	17	VOD	Telecommunication Services	17,945 A
18	PCG	Utilities	7,980 BBB	18	MCD	Consumer Discretionary	17,900 A
19	SUCN	Energy	7,675 A	19	AVGO	Information Technology	17,506 New
20	ARNC	Industrials	7,639 BBB	20	PCG	Utilities	17,505 BBB
21	WMB	Energy	7,203 BBB	21	DELL	Information Technology	16,250 A
22	EPD	Energy	7,200 BBB	22	TWX	Media	15,041 BBB
23	BRITEL	Telecommunication Services	7,000 BBB	23	BDX	Health Care	14,994 New
24	UNP	Industrials	6,950 A	24	FOXA	Media	14,989 BBB
25	AEP	Utilities	6,950 BBB	25	DISCA	Media	14,086 New
Total			**257,845**				**685,229**

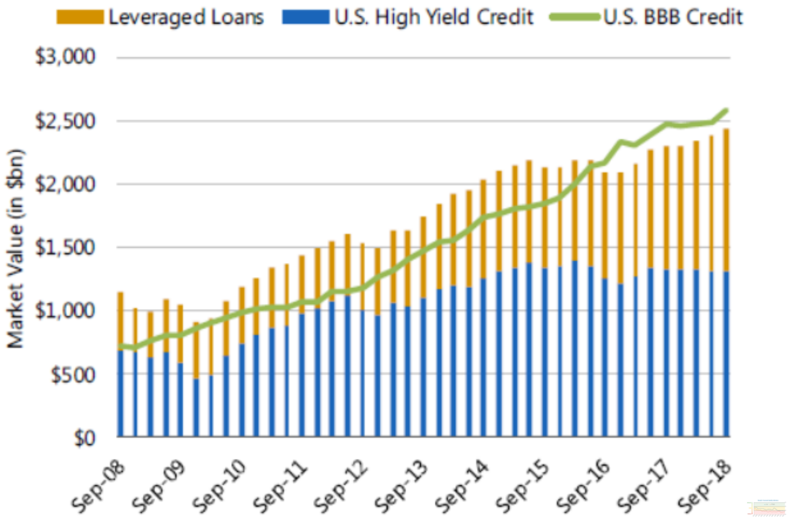
Bank loans and high yield bonds

Market size

The bank loans and high yield bond markets have both grown in size since the GFC although we note the growth in the past three years in high yield bonds has been relatively flat. Interestingly, the BBB market size since 2017 has for the first time exceeded the size of bank loans and high yield bonds combined.

This brings some uncertainty as to whether potential falling angels can be absorbed on an orderly basis by the sub-investment grade market.

Chart 5: Bank loans & high yield bonds



Source: Moody's

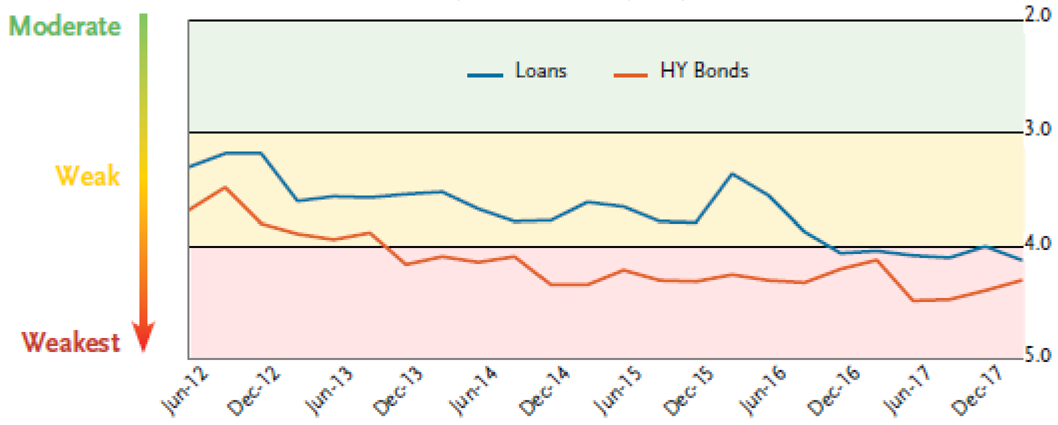
Common trends

A number of trends have persisted over the last few years. We believe the trends collectively represent a warning signal for market participants. This is in line with the recent decision by Frontier's Capital Markets and Asset Allocation team to change the view of bank loans market to Negative from Neutral.

Covenant quality

Covenant quality has dropped gradually over the years for both bank loans and high yield bonds as per Moody's assessment.

Chart 6: Moody's covenant quality indicators



Source: Moody's

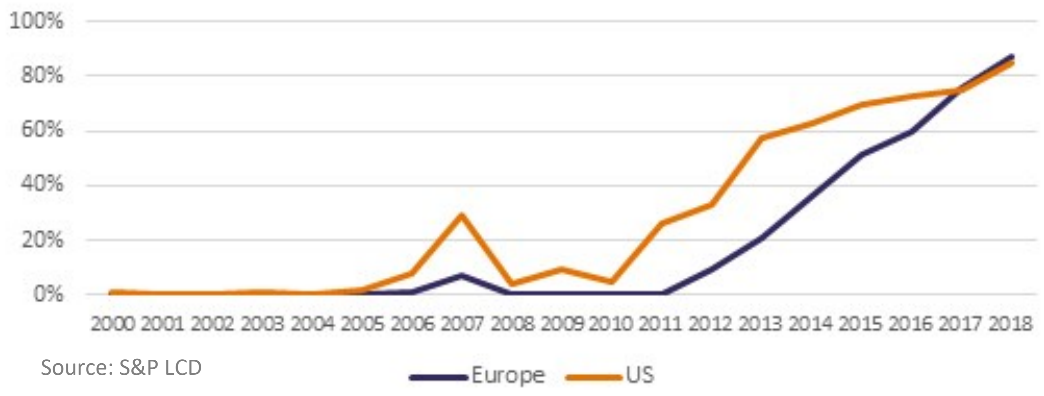
Proportion of bank loans covenant lite

The bank loan market is now effectively a covenant lite market with the percentage of covenant lite loans reaching 90% in both the US and Europe. Our managers have the view, which we agree with, that covenant itself is not necessarily a key determinant of the credit risk and it is important to assess the full term and conditions of a transaction.

EBITDA adjustments

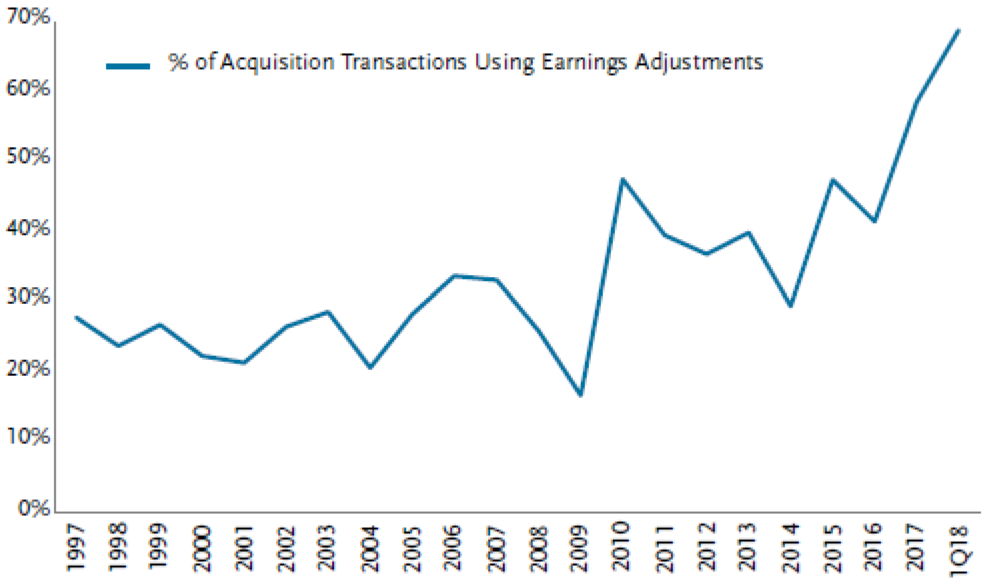
The level of EBITDA adjustment has been higher, in particular for M&A transactions. This means headline leverage level may not represent the true leverage level in a transaction.

Chart 7: Covenant Lite—share of institutional debt



Source: S&P LCD

Chart 8: Transaction EBITDA adjustments Increasing



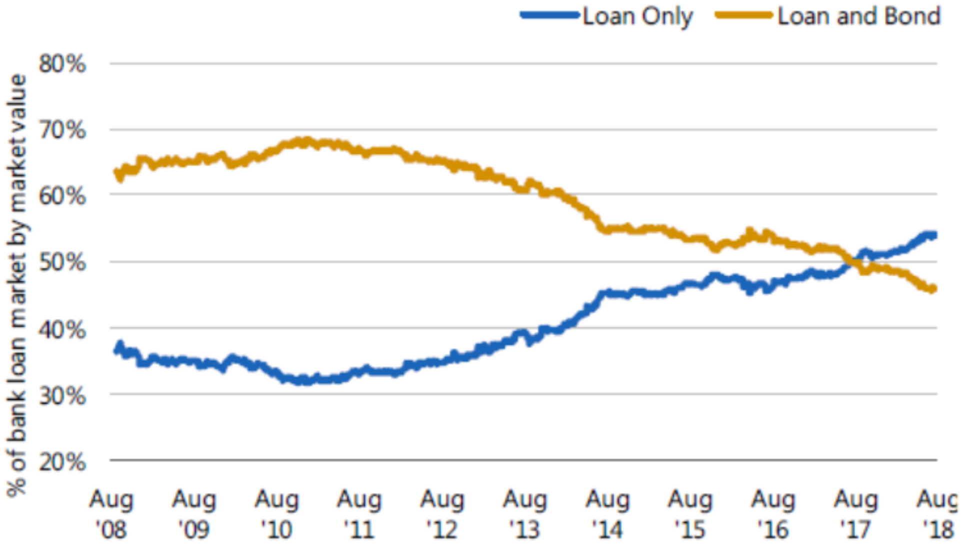
Source: JP Morgan

Issuance patterns

The level of loan-only issues has been increasing whilst loan and bond issues are steadily decreasing. As a consequence, the level of debt subordinated to bank loan investors in capital structure has been decreasing.

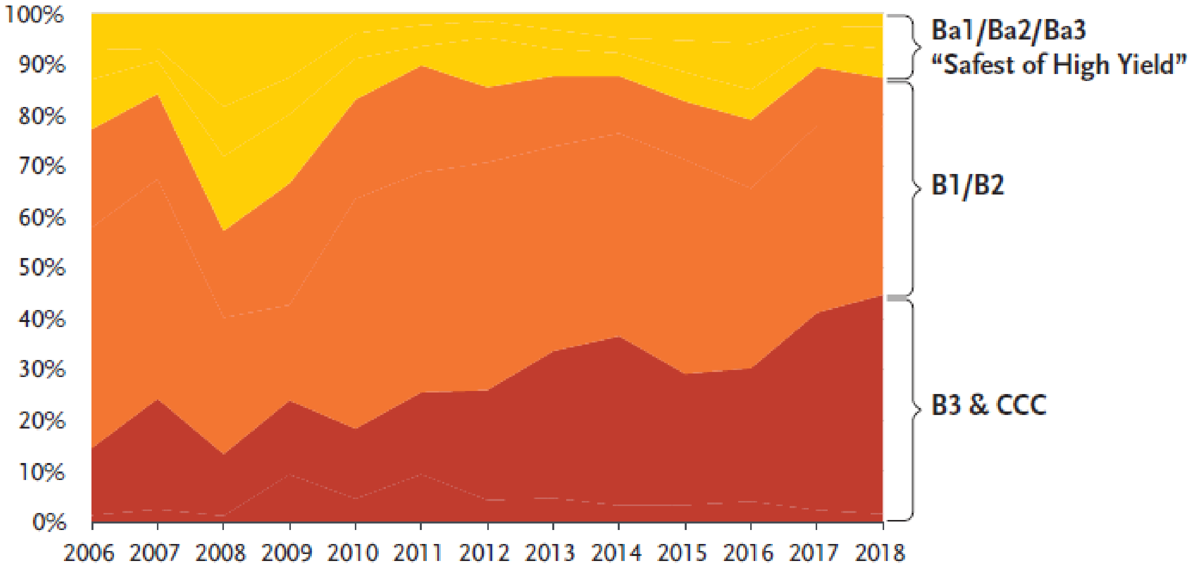
In aggregate, the proportion of first-time bank loans and high yield bonds issuers rated below BB has increased to above 80% in 2018 from about 60% in in 2008. The overall bank loan market has become of lower quality with the growth of single B rated loans over the past number of years.

Chart 9: Loan vs Loan and Bond



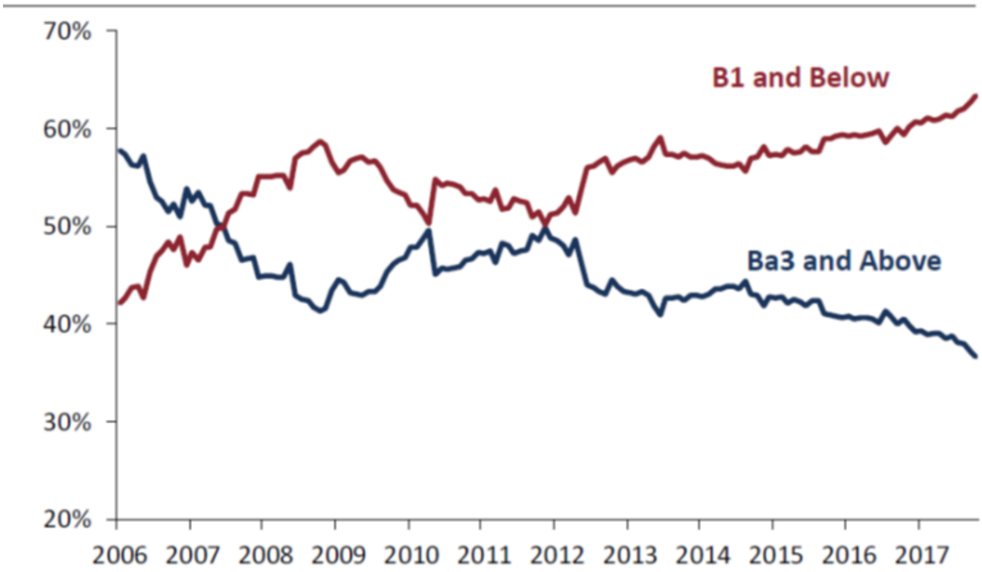
Source: PIMCO, BofA, JPMorgan

Chart 10: first time U.S. leveraged loan and high yield bond issuers' quality distribution



Source: Moody's, TCW

Chart 11: Overall bank loan market



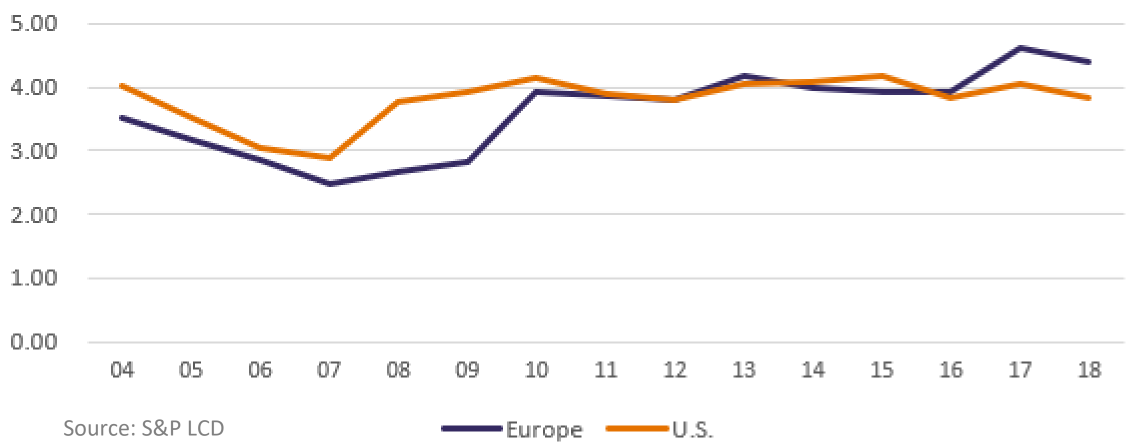
Source: GMO, JPMorgan

Interest cover is positive

Positive and supportive factors remain present across both bank loan and high yield markets. Interest coverage is still healthy, thanks to solid corporate earnings and low interest rates. Chart 12 illustrates healthy interest coverage in the bank loans market.

A similar trend is observed in the high yield bonds with US high yield interest cover (EBITDA/Interest expense) at above 4.5x. In addition, there remains a reasonable level of equity cushion today compared to the years prior to GFC.

Chart 12: EBITDA/Cash Interest (x)



Source: S&P LCD

Bank loans and support from CLO market

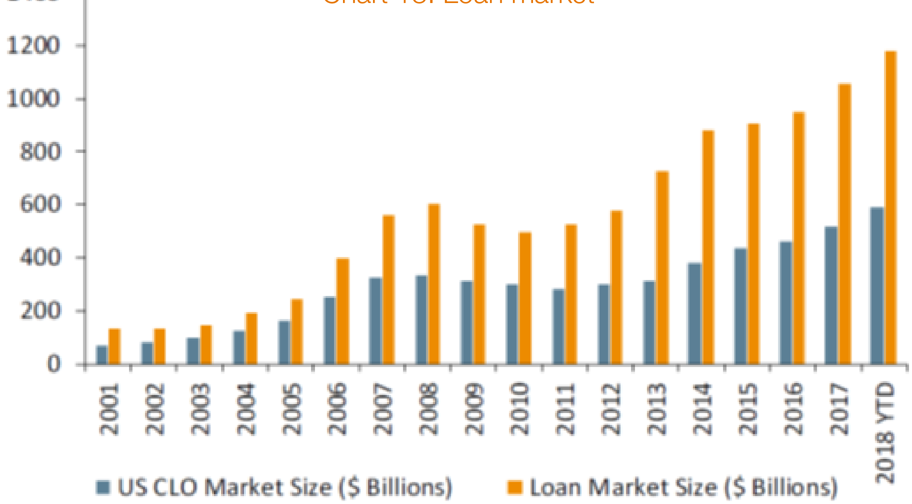
Chart 13 indicates that one of the supportive factors for US bank loans demand has been the strong growth of CLO market, which now accounts for more than 50% of the bank loans market.

Typically pools of loans are warehoused and subsequently securitised into CLO structures that are actively managed. The managers of CLO pools do substitute various names depending upon the credit outlook for a business, but the pools themselves are rarely liquidated mid-term.

Therefore, the loan market benefits from the buying support from CLO originations, but rarely sees selling activity. CLO tranche performance however can be affected by sentiment and market to market impacts should be understood.

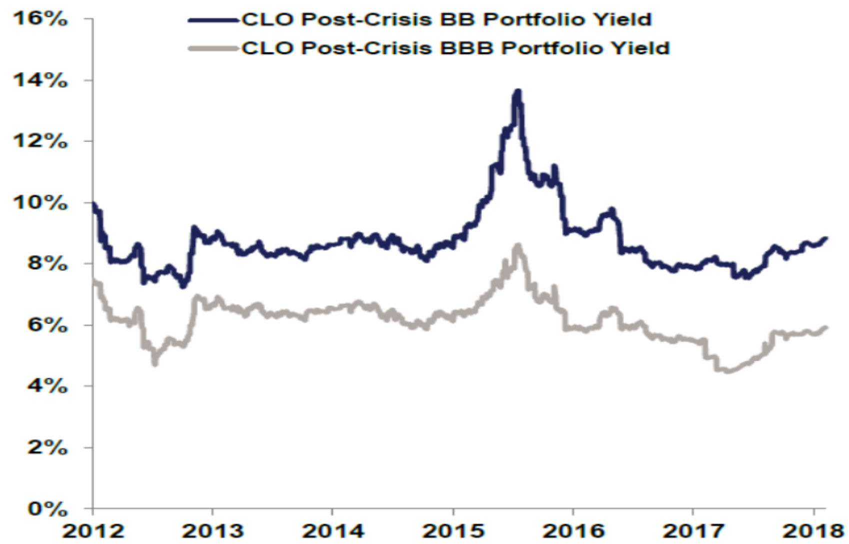
Structured credit funds and CLO investing has become a well understood and commonplace exposure for US investors. Frontier intends to do further research on CLO's and other structured credit products in 2019.

Chart 13: Loan market



Source: GMO

Chart 14: CLO Yield research



Source: Bain Capital; JP Morgan

Manager responses

Below, we summarise the thoughts, investment approach and portfolio actions taken by a number of managers rated by Frontier.

Multi sector credit managers

- Improve credit quality and increase IG exposure.
- Reduce exposure to sub-investment/high yield investments.
- Reducing risk and improving flexibility by increasing cash holdings.
- Reduce credit beta of the portfolio.

Liquid credit managers

- Being selective and cautious; using the bottom up credit selection process to differentiate and find relative value.
- Managers of IG credit felt the issue of increased BBB market share had been somewhat overlaid by media and some of the changes had resulted from company specific capital structure changes ie GE, AT&T.
- Bank loan managers emphasised that bottom up credit work, paying attention in particular to earnings adjustments, issuer's capital structure and transaction's terms and conditions.
- The managers believe recovery rates in the bank loan market going forward will be lower than the historical average level of 70%. Forecasting future recovery is difficult but it is estimated the range is about 40%-60%. It is likely recovery will be case specific with a widely dispersed outcome.
- Managers believe there is value in structured credit. A large exposure to structured credit remains across sub -sectors such as CLO, ABS, non-agency RMBS, and CMBS.

Private credit managers

- Private credit is considered to be an established source of credit for borrowers, even for large companies that can easily access the liquid market.
- The return remains attractive however the market overall has become competitive.
- Managers believe there is less competitive tension for the large borrower segment (EBITDA >$50-75 million) of the market due to only a number of market participants being available.
- Established credit managers are using their strengths across the investment process (origination, underwriting and monitoring) to compete against peers.
- Most managers noted rejection ratio between deals reviewed and deals executed remain broadly unchanged, indicating credit discipline.

Opportunistic/distressed credit managers

- Being higher up in the capital structure.
- Broadening the opportunity set, identifying and working on uncorrelated investment ideas.
- Indications retail and energy are the two sectors where corporate distress remains most prevalent. Most distressed managers noted that in retail, value was unlikely to be found in many cases, given business models were simply broken.
- Managers remain watchful and waiting for the opportunities to present themselves. Some believe the future may be represented by a series of credit downturns/dislocations (i.e. "mini crisis"), rather than an event like the GFC.

The final word...

Learnings from this trip have supported our view that we are in the late credit cycle. This is a view shared with most debt managers although, for most high valuations in credit markets had made it an easier justification to reduce exposure.

We take comfort that managers rated by Frontier are keenly aware of risks in the market and the late credit cycle.

Their actions with regards to portfolio positioning and investment approach are generally deemed appropriate. We believe caution is required for investors in this environment. Higher level of monitoring is also warranted.

We observed a sizable exposure to structured credit by our managers and a number of sub-sectors such as ABS/RMBS and CLO are likely to be areas of research focus for Frontier in the future.

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