We look back at the speed and scale of the March 2020 selloff, the subsequent recovery, and where asset owners can look now to find attractive risk-adjusted returns in Credit markets. Private Credit and parts of Securitised continue to offer strong relative value, while we are monitoring other areas for potential rotations. We believe the coming years will favor more alpha-oriented mandates, while diversity across credit risk remains the biggest source of portfolio resiliency against broad macro risks.

March 2020 – a month like no other

Rather than rehash the entire history of the March 2020 shock and its impact on Fixed Income markets, we think it is best summarised by the following two data points: Treasury Market Liquidity and High Yield spread widening.

March 2020 went down as one of the most vicious selloffs in credit market history. COVID-19 and oil price drops created a panic not seen since the Global Financial Crisis of 2008. However, this panic faded relatively quickly as aggressive government policy stepped in to stabilise markets. This support worked, as one year later many segments of fixed income have fully recovered. Other parts that have lagged in the recovery, such as Securitised credit, have made meaningful strides more recently amidst the global vaccine rollout and optimism around economic growth (particularly in the United States). Fixed income investors are now left wondering “what’s next?”, with the prospect of rising interest rates and tight credit spreads weighing on near and longer-term returns.

From March 9th to March 18th, the US 10 Year Treasury yield rose by over 60 basis points. This rise occurred at a time where many investors were relying on Treasuries to serve as a downside hedge while equities were selling off aggressively. It was clear that the entire fixed income market was becoming deeply illiquid. Estimates are that the transaction cost on Treasuries jumped nearly 4-5x normal, making them more difficult to transact at any time since 2008.

Within Corporate Credit, the spread widening seen in High Yield markets was extraordinary. In mid-March there were nine consecutive trading days where High Yield spreads widened, ranking among one of the longest “losing streaks” in the last 20 years. However, the severity of the selloff was even more frightening, as the index widened an average of 50+ bps per day during this selloff, far worse than any period in 2008.
On March 23rd, the Fed unleashed what is affectionately known as “the bazooka” for Credit markets, essentially promising unlimited support to get markets under control. This is typically marked as the bottom of the selloff, with Treasury yields finally stabilising and risky Credit markets beginning a rally. Subsequent direct support to the High Yield market on April 9th provided an even more favourable backdrop to Corporate credit, with continued accommodative fiscal and monetary policy leading to one of the strongest credit rallies in recent years.

Many investors are now contemplating what moves to take next as the “easy beta” trade has now been all but realised. Asset owners of all types are now searching far and wide to find attractive yield to help achieve their goals and get the most out of their Credit allocation. However, implementation is critical, necessitating asset owners to think outside of traditional market beta exposure.

As mentioned in our previous paper, we continue to believe a diversified portfolio of exposures across “the 3 Cs of Credit” – Corporate, Country, Consumer – can help investors achieve their goals and get the most out of their Credit allocation.
Three themes we find particularly attractive include:

**Private Credit**

Full retracement from March 2020 has yet to occur in private markets, with attractive illiquidity risk premiums providing a good entry point for those looking to shift exposure from liquid to illiquid. Willis Towers Watson has developed a proprietary “Illiquidity Risk Premium” metric which shows that current levels on offer remain well above pre-pandemic levels. This has improved the attractiveness of more heavily competed asset classes such as Direct Lending where we have seen returns and creditor protections improve. More complex and/or smaller segments within private credit that are less well competed offer even greater illiquidity premia, and pleasingly there are opportunities to invest in attractive segments that offer a direct, positive environmental impact, such as within renewables. We will delve further into our views on Private Credit in an upcoming paper.

**Lower quality Securitised Credit**

As mentioned before, certain parts of Securitised Credit took a disproportionate amount of pain versus other asset classes from the COVID shock. While many areas have fully retraced, on the surface certain areas like CMBS and Niche ABS provide strong relative value versus more vanilla parts of the Corporate Credit market. However, these sectors dislocated significantly for good reason given the uncertainty COVID raised on the future of commercial real estate and ability to repay consumer debt. Nevertheless, we believe skilled active managers can incorporate these risks to identify the right dislocated opportunities to capture value. In addition, these sectors have the added benefit of being less interest rate sensitive, with many parts containing a floating rate feature or just naturally shorter cash flows. This has paid off year to date as the US Treasury curve continues to steepen, signifying optimism by markets on a faster than previously expected economic recovery in the US.

**Alpha-Oriented Mandates**

In today’s credit market with generally tight spreads and yields near all time lows, strategies that emphasise alpha are arguably more important than ever. We continue to see strong merit in our Focused High Yield construct upsizing the impact of each manager’s “best picks” across a wide corporate credit opportunity set. Regional specialists in EMD are also an attractive alpha option, with a large amount of potential value embedded in LatAm Corporates as well as less beta sensitive areas such as African sovereigns, which may offer one of the best combinations of long term real GDP growth prospects and strong fiscal policies in the EM universe. Private market opportunities in developed Asia also look increasingly attractive.
Areas we are monitoring (but not making meaningful moves yet):

**Broad Emerging Market Hard Currency mandates**

Given the recent backup in rates, we have seen longer dated assets such as Hard Currency Emerging Market debt selling off versus shorter dated assets. This is an area of the market we are monitoring for potential value should the rate environment stabilise. We would note that a steepening yield curve is a normal and healthy economic sign following a recession, however US Treasury curve steepness (as measured by 2s to 10s spread) typically peaks in each business cycle between 2.0 - 2.5%, with current levels north of 1.5%. While we do not typically take directional views on rates, this provides a potential trigger point for investors to consider re-allocating to longer duration assets that could benefit from rolldown. In addition, Emerging Markets Debt can offer attractive diversity given the dispersion in varying phases of economic recoveries globally.

**Bank Loans**

We continue to prefer allocating to Corporate Credit managers with wider remits than just Bank Loans, allowing skilled managers to find the best opportunities in Loans rather than holding a structural (beta) allocation to the asset class. As noted in our prior paper, The High Yield problem, the loans market has seen fundamental shifts in quality and investor base in recent years. However, as rates have risen across most of the curve year-to-date, this market has come back into vogue for investors looking to invest in floating rate assets. Rather than making a ‘rates call’, we believe alpha-oriented managers, with the flexibility to overweight loans based on idiosyncratic reasons, are poised to outperform, particularly in an environment of relatively high dispersion. The outlook on loans is more uncertain, not only due to riskier fundamentals, but also technical nuances in the market such as LIBOR floors, which could make it less clear whether the Bank Loan market will continue to materially outperform High Yield bonds in a rate rising environment. Nevertheless, we continue to examine the loan market as a potential area to add more direct exposure should market dynamics change, though we would note that investors allocating to Securitised credit and Private Debt often get substantial floating rate exposure through these segments.

**Conclusion**

The selloff last March was vicious, and the recovery has been strong, but pockets of opportunity remain. Finding attractive value and total returns in Credit markets today is unequivocally hard, and investors need to look beyond vanilla markets and implementation routes to achieve their goals. Private Credit and Securitised can be two good places to start, as well as tilting mandates away from beta/index-oriented exposure to more alpha seeking mandates, particularly within High Yield.

**Sources**

2. Bloomberg Barclays Capital Indices, Barclays Bank PLC
3. Bloomberg Barclays Capital Indices, Barclays Bank PLC
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For more information, please contact your Willis Towers Watson consultant or:

Andrew Zurawski
Associate Director, Investments
andrew.zurawski@willistowerswatson.com

Simon James
Senior Investment Consultant
Head of Australian Credit
simon.james@willistowerswatson.com