BARINGS

fixed income quarterly

HIGH YIELD
EMERGING MARKETS DEBT
STRUCTURED CREDIT
INVESTMENT GRADE

JAN
2020

HIGH YIELD

Sentiment Shift Fuels Lower-Rated Rally

Uncovering relative value across high yield in 2020 may require looking in less obvious places.

The positive streak continues for global high yield. Risk assets are back in favor, which combined with improving sentiment and the continued search for yield has contributed to strong performance across the markets. U.S. and European high yield bonds have led the way, registering the strongest performance in recent years (13.98% and 10.74%, respectively).[1] U.S. loans (8.17%) and European loans (4.38%) also ended the year in decidedly positive territory.[2] In the context of a relatively healthy fundamental backdrop and low default outlook, the asset class looks to be on solid footing overall.

With this renewed "risk-on" mentality, the bifurcation that characterized much of the last year has started to reverse. While spreads on BB assets have tightened, spreads in the lower-rated parts of the market are still relatively wide. This, combined with decent economic conditions, stable fundamentals and higher-than-expected earnings contributed to a fourth-quarter rally in select, lower-rated CCC assets that has extended into 2020. While this trend has been more pronounced in Europe—a market with less exposure to energy—it has also materialized in the U.S., where CCC bonds (5.3%) significantly outperformed BBs (1.3%) and single-Bs (2.1%) in the fourth quarter.[3]

All of this said, risks continue to punctuate the investment landscape—tensions in the Middle East are escalating, Brexit turbulence continues, and the U.S. faces what is sure to be a politically charged year in the run-up to November's presidential election. Not to mention the persistent concerns around commodity prices, trade, monetary policy and economic growth.

We can't say with any certainty how these factors may impact high yield going forward. What we can say, based on history, is that financial markets typically don't price risk very well. They also have a history of overreacting to headlines and a tendency to exhibit short-term pricing inefficiency during periods of dislocation or volatility. But these periods can—and often do—lead to opportunities.

We've seen this in the loan market in particular. Increasingly dovish U.S. Federal Reserve (Fed) policy contributed to material outflows from loan retail funds through much of last year. As the yield differential between bonds and loans shifted in favor of loans, an attractive—and somewhat contrarian—opportunity emerged. While the outflows have reversed in recent weeks, loans continue to offer attractive yields relative to bonds, in our view, particularly given their higher historical recovery rates—a result of being senior in the capital structure and secured by some or all of a borrower's assets.

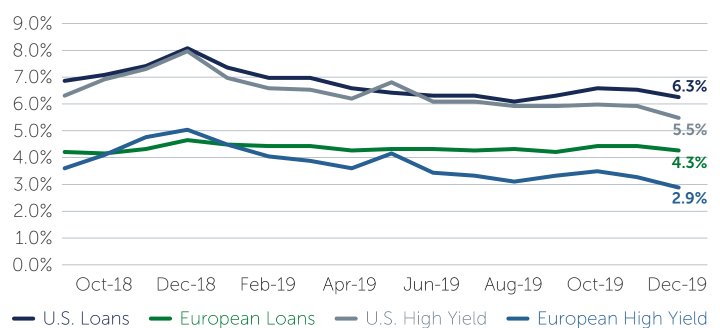
1. Source: Bank of America Merrill Lynch. As of December 31, 2019.
2. Source: Credit Suisse. As of December 31, 2019.
3. Source: BAML. As of December 31, 2019.

Pricing discrepancies also exist at the sector level, and may emerge as an additional source of opportunity over the coming months. Health care, for example, is one sector that will almost certainly experience election-induced turbulence in the months ahead. But health care is a vast industry, comprising many different types of companies that produce widely different products and services. As the market reacts to headlines over the coming year, buying opportunities may very well emerge in good credits that have essentially been weighed down by headline risk.

Outside of traditional high yield bonds and loans, some of the most interesting opportunities we see today are in areas like collateralized loan obligations (CLOs), distressed debt and emerging markets debt. In this continued slow growth, low-rate environment, investors can potentially earn incremental yield by intentionally expanding their opportunity set in a strategic way in these less traditional asset classes.

Now is not the time to 'buy the market' when it comes to high yield. It's a time to be thoughtful, deliberate and nimble. Markets are reactionary, and will move in response to risks and headlines—often in a different direction than what fundamentals would suggest. When they do, those with the ability to move quickly and efficiently will be best positioned to potentially capitalize on the resulting opportunities.

Yield Comparison
(3-Year Discount Yield for Loans, Yield-to-Worst for Bonds)



SOURCES: Credit Suisse, ICE BAML. As of December 31, 2019.

Martin Horne

Head of Global Public Fixed Income & Head of Global High Yield

David Mihalick

Head of U.S. Public Fixed Income & Head of U.S. High Yield

BARINGS

EMERGING MARKETS DEBT

EM Local Debt's Time to Shine?

Emerging markets (EM) local currency denominated debt may be poised to outperform.

EMD performance was strong across the board in 2019, and the fourth quarter was no exception. It's perhaps no surprise that sovereign hard-currency denominated bonds were the star performers throughout much of the year—typically viewed as somewhat lower-risk than their local-currency denominated counterparts, the asset class benefited from higher duration in a year when rates largely trended downward.

Toward year-end, this trend began to reverse. And while attractive opportunities remain across the sovereign hard-currency universe—particularly in countries like Brazil, where credit risk appears to be overpriced—attractive value has also emerged elsewhere.

In the fourth quarter, EM local currency bonds (5.2%) were the standout, outperforming both sovereign debt (1.81%) and corporate debt (2.2%).[1] There are a few factors that may have contributed to this. Following the global financial crisis, the economy went through a massive deleveraging that resulted in an exodus out of riskier assets, EMs chief among them. Because of these outflows, EMs have been running smaller account deficits over time. As a result, the financing needs of EMs have come down over the last decade—meaning their balance sheets are in much better shape today. The headwinds faced by EMs have also battered their currencies and, based on measures that consider currencies' real effective exchange rates relative to their terms of trade, EM currencies are now trading close to their cheapest levels in a decade.

The alignment of these factors suggests that the stage may now be set for the decade-old aversion to risk to begin to reverse course in 2020—paving the way for EM currencies to outperform, and potentially driving strength in EM local debt.

Another area that remains attractive is EM corporate debt, which has one of the highest Sharpe ratios of any major asset class over the last decade. Fundamentals remain stable, with many companies exhibiting positive revenue and EBITDA growth in recent years. Balance sheets have remained healthy and default rates have stayed low.

Drilling down, short-duration high yield debt looks particularly attractive, and its lower interest rate sensitivity could prove valuable if global economic conditions improve this year. Given the various idiosyncratic risk flare-ups in several high yield rated countries over the last few years, corporate spreads have in many cases widened, despite relatively strong fundamentals. The spread differential between EM investment grade corporates and EM high yield

EM Currencies Trade Near Cheapest Levels in Last Decade
(Real Effective Exchange Rate/Terms Of Trade)

SOURCE: Haver Analytics. As of September 30, 2019.

High Yield Continues to Offer Good Relative Value Versus Investment Grade in EMs

SOURCE: Bloomberg. As of December 31, 2019.

corporates also remains at elevated levels compared to the averages of recent years, suggesting that relative value is still on offer in the high yield segment of this universe.

Despite these market opportunities, it's important to remain mindful of the risks that come alongside them. As we discussed in our 2020 Outlook, we believe the single largest risk facing investors in the year ahead is the potential for a material slowdown—or even a recession—in China. While we view this as an extremely unlikely scenario, if it were to occur, it could have serious repercussions on the broader global economy. ▶

1. Source: J.P. Morgan. As of December 31, 2019.

EMERGING MARKETS DEBT *CONTINUED*

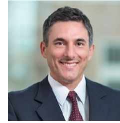
The discord in the Middle East is another concern, and any missteps could have very serious ramifications—particularly considering that the region represents about 30% of the world's energy supply, 20% of global trade passages and 4% of global GDP. This, combined with a number of ESG concerns, has led us to believe that the geopolitical risk in the region is underpriced.

Despite the recent U.S./China trade agreement, we expect to see mixed headlines throughout 2020, and it seems with each passing day another emerging market suffers from political unrest or popular uprising. From Chile to Colombia to Ecuador to Hong Kong, there is no shortage of hot spots. A number of idiosyncratic risks have emerged as well, with Venezuela, Lebanon and Argentina chief among them—in each of these countries, bond prices dropped precipitously as tensions escalated. In fact, during the fourth quarter, nine countries were in default or distress scenarios—the most in a decade.

All of these factors undoubtedly represent risks, and these risks must be taken into account in the form of country and credit analysis. But they also represent opportunity.

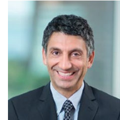
When corporate debt issuers are unduly punished for the country in which they are domiciled, or when negative headlines result in an overreaction in a country's currency, active managers, and therefore their investors, can possibly benefit. Likewise, when it comes to EM sovereign debt, country selection matters—and it matters a lot. And while there are certainly a number of bad apples, there are also bright spots.

The bottom line is that value opportunities exist today across all three of these markets, and will continue to appear going forward. But it's not a time to 'buy the market.' Rather, it will take careful analysis of macro, country and company-specific risks, and the willingness and ability to move quickly, and with intention, when opportunity arises.



Dr. Ricardo Adrogué

Head of Global Sovereign Debt & Currencies



Cem Karacadag

Head of Emerging Markets Sovereign Debt

Omotunde Lawal, CFA

Head of Emerging Markets Corporate Debt

STRUCTURED CREDIT

Risk-on, Risk-off & Repeat

Sentiment continues to swing back and forth in the collateralized loan obligation (CLO) market, but bifurcation remains the constant.

Not all CLOs (or CLO managers) are created equal. We know this from experience and the fourth quarter served as a good reminder, as the CLO market swung from its almost panicked state in October to what can be characterized as a “risk on” market to close the year.

This sentiment shift was evident in the BB-rated portion of the market, where spreads on high-quality BB new issues swung from the low-700s (over LIBOR) at the end of September to the low-800s in October—and then retraced this, even pricing tighter than September levels as the year concluded.

A similar story played out in the BBB part of the market, where high-quality deals priced in the 380 range in late September, only to push into the 400s in October, and then back again to end the year.

But it’s not as simple as risk-on, risk-off. Even during the so-called risk-on periods, we have continued to see investors exhibiting a strong preference for “clean” new-issue deals (meaning those with a low proportion of loans trading at stressed levels—typically below $80) versus older, vintage “storied” deals, which may be weighed down by stressed credits, particularly in the energy sector. The pricing in the market has very much reflected this trend, as well as the continued trend of investors preferring deals from perceived high-quality managers—which continue to trade inside of deals from less established players.

U.S. BB-Rated Clo Spreads Widened Before Tightening Toward Year-End

SOURCE: JP Morgan. As of December 31, 2019.

Some market players attempted to capitalize on the stress witnessed in the underlying bank loan market last year by issuing CLOs with the ability to invest in a significantly higher proportion of CCC-rated credits, with some managers creating buckets with as much as 25% of the portfolio allocated to them (versus a more typical 7.5%). Our view is that while there may ultimately be some value in the equity tranches of such deals, we would expect to see better entry points.

We do, however, see a variety of opportunities and risks on the horizon. On the risk side, in addition to monitoring credit market conditions for signs of stress, we are closely following the U.S. presidential election. One notable tail risk to be aware of would be if Senator Elizabeth Warren—a strong critic of securitized markets in the past—gains steam, but recent polls show the Senator trailing Vice President Joe Biden and Senator Bernie Sanders by fairly significant margins—though a Sanders win would also hardly be taken well by securitized markets, in all likelihood. We expect to see volatility stemming from election-related headlines throughout the year—but this also tends to be when we find the most attractive value opportunities, and we would expect 2020 to be a similar story.

From an opportunity perspective, we continue to see attractive entry points across the risk-return spectrum, albeit somewhat less attractive than the value we saw and discussed in a recent podcast back in October. In particular, new-issue BB tranches offer attractive value, in our view. Further up the capital stack, AAA and AA-rated tranches also offer value, especially relative to investment grade corporate bonds. We continue to see insurance buyers in this space, and discussed the attractions of these market segments in a recent Viewpoints paper. Finally, as we move further into 2020, we expect to see opportunities arise in secondary equity—where market technicals are driving what we expect to be a compelling value opportunity.

The risk-on, risk-off cycle will likely to continue to play out in 2020—especially with geopolitics in particular focus. So while value opportunities exist and will likely continue to show themselves throughout the year, credit and manager selection will be especially paramount in 2020.

Taryn Leonard
Co-Head of Structured Credit Investments

Melissa Ricco
Co-Head of Structured Credit Investments

BARINGS

INVESTMENT GRADE

Rates, Rallies & Risks

Investment grade credit markets posted a banner year in 2019; can the good times continue to roll?

Falling interest rates, tightening credit spreads and continued investor demand drove strong returns for investment grade credit in 2019—particularly in U.S. corporates—and while a number of trends look supportive heading into 2020, question marks remain.

As always, all eyes have been on the Fed, which ended its mini easing cycle in October after three rate cuts—inspiring market confidence that fears of imminent economic recession were perhaps overblown. Rate markets responded accordingly with Treasury yields rising across maturities and the yield curve steepening—after inverting multiple times over the past year—further quieting fears that economic doom lay just beyond the horizon.

Investment grade rated corporate bonds—perhaps unsurprisingly—have benefited the most from this move to a more "risk-on" mentality, as well as from falling rates for most of 2019. The positive performance has, however, left us wondering if significant value still exists at current levels. With the Bloomberg Barclays U.S. Corporate Bond Index closing the year at a spread of 93 basis points (bps), spreads are not far off from their all-time tights, which notably were achieved when the index composition was both lower duration and higher credit quality. That said, flows into the asset class remain strong and the search for yield—especially from overseas investors into U.S. corporate credit—shows no signs of abating. Attractive FX costs serve as an accelerant to this.

Heading into 2020, some of the best investment grade rated opportunities appear to be outside of traditional corporate bond indexes. We see particular value, for instance, in investment grade rated CLOs, which offer investors the potential to earn a significant incremental credit spread, while also offering structural protections and diversification away from idiosyncratic credit risks. To put this into perspective, at the end of the year, BBB quality CLOs traded with a spread of 376 bps, well ahead of single-B quality high yield corporates, which traded with a spread of 324 bps. The ability to access the CLO market is not only a way of diversifying away from corporate risk, but also a way to capture attractive spread at an investment grade rating.

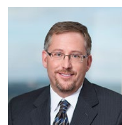
Similarly, asset-backed security (ABS) markets offer some of the most compelling value opportunities in the IG space today. The ABS investment universe continues to expand in depth and breadth, and we see opportunities in areas as diverse as student loans, whole business franchise and commercial aviation. The sector also provides a way to invest in the U.S. consumer—which remains on solid ground amid strong employment and rising wages, and continues to be the driving force buoying the economy. But it does so in a way that—similar to CLOs—offers incremental spread and diversification away from idiosyncratic credit risk, which is particularly valuable late in the economic and credit cycles. It's also worth noting that heavy new ABS issuance in 2019 resulted in spreads pushing wider for various consumer sectors, despite firm underlying fundamentals—which we believe presents a very compelling entry point for new allocations in 2020.

What the Fed does in 2020 will surely be among the biggest drivers for corporate credit markets. All signs are that the easing is done—at least for now—but with the Fed's balance sheet expanding substantially, some market participants question if what we're really seeing is QE4, by another name. Additionally, questions about the repo market's "plumbing" loom large after liquidity scares in 2019. Whether the Fed has truly provided a solution by injecting liquidity at year-end, or simply a Band-Aid, is an uncertainty that needs resolution, or another technical risk flare-up could be slated for 2020.

Finally, as we look ahead in 2020, we see no shortage of risks—valuations (as previously discussed) and geopolitics (U.S. elections, trade wars, Middle East tensions, Brexit, etc.) chief among them. But if the past offers any help in picking credits or managing allocations across investment grade rated asset classes, we can be reasonably confident that the coming onslaught of geopolitical headlines will result in overreactions, and therefore value opportunities. The key is to recognize them when they emerge, and be nimble enough to capitalize upon them. And, as discussed, some of the best opportunities will very likely be outside of traditional bond indexes.

U.S. Corporate Spreads Inch Near All-Time Tights

SOURCE: Bloomberg Barclays. As of December 31, 2019.



David Nagle, CFA

Managing Director, Investment Grade Fixed Income

Barings is a $338+ billion global financial services firm dedicated to meeting the evolving investment and capital needs of our clients and customers. Through active asset management and direct origination, we provide innovative solutions and access to differentiated opportunities across public and private capital markets. A subsidiary of MassMutual, Barings maintains a strong global presence with business and investment professionals located across North America, Europe and Asia Pacific.*

IMPORTANT INFORMATION

Any forecasts in this document are based upon Barings opinion of the market at the date of preparation and are subject to change without notice, dependent upon many factors. Any prediction, projection or forecast is not necessarily indicative of the future or likely performance. Investment involves risk. The value of any investments and any income generated may go down as well as up and is not guaranteed by Barings or any other person. PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS. Any investment results, portfolio compositions and or examples set forth in this document are provided for illustrative purposes only and are not indicative of any future investment results, future portfolio composition or investments. The composition, size of, and risks associated with an investment may differ substantially from any examples set forth in this document. No representation is made that an investment will be profitable or will not incur losses. Where appropriate, changes in the currency exchange rates may affect the value of investments. Prospective investors should read the offering documents, if applicable, for the details and specific risk factors of any Fund/Strategy discussed in this document.

Barings is the brand name for the worldwide asset management and associated businesses of Barings LLC and its global affiliates. Barings Securities LLC, Barings (U.K.) Limited, Barings Global Advisers Limited, Barings Australia Pty Ltd, Barings Japan Limited, Baring Asset Management Limited, Baring International Investment Limited, Baring Fund Managers Limited, Baring International Fund Managers (Ireland) Limited, Baring Asset Management (Asia) Limited, Baring SICE (Taiwan) Limited, Baring Asset Management Switzerland Sarl, and Baring Asset Management Korea Limited each are affiliated financial service companies owned by Barings LLC (each, individually, an "Affiliate").

NO OFFER: The document is for informational purposes only and is not an offer or solicitation for the purchase or sale of any financial instrument or service in any jurisdiction. The material herein was prepared without any consideration of the investment objectives, financial situation or particular needs of anyone who may receive it. This document is not, and must not be treated as, investment advice, an investment recommendation, investment research, or a recommendation about the suitability or appropriateness of any security, commodity, investment, or particular investment strategy, and must not be construed as a projection or prediction.

Unless otherwise mentioned, the views contained in this document are those of Barings. These views are made in good faith in relation to the facts known at the time of preparation and are subject to change without notice. Individual portfolio management teams may hold different views than the views expressed herein and may make different investment decisions for different clients. Parts of this document may be based on information received from sources we believe to be reliable. Although every effort is taken to ensure that the information contained in this document is accurate, Barings makes no representation or warranty, express or implied, regarding the accuracy, completeness or adequacy of the information.

Any service, security, investment or product outlined in this document may not be suitable for a prospective investor or available in their jurisdiction.

Copyright and Trademark
Copyright © 2020 Barings. Information in this document may be used for your own personal use, but may not be altered, reproduced or distributed without Barings' consent.

The BARINGS name and logo design are trademarks of Barings and are registered in U.S. Patent and Trademark Office and in other countries around the world. All rights are reserved.

LEARN MORE AT BARINGS.COM

*As of December 31, 2019

20-1062073