Invesco Fixed Income Investment Insights

Q&A: Discussing credit markets and opportunities for insurers

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Moderated by:
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Head of US Insurance

Panelists:
Scott Baskind
Head of Global Senior Loans

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CIO, Global Investment
Grade and Emerging Markets

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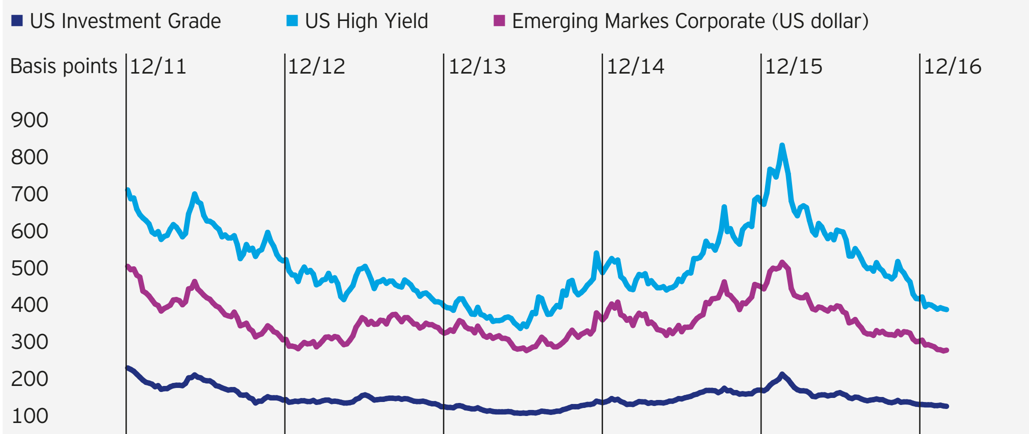
- Scott Baskind

The last several years of ultra-low interest rates have presented a challenge for insurers. Gross investment yields have declined sharply since the inception of aggressive monetary stimulus policy, making it more difficult for insurers to match bond payments to liability cash flow requirements while maintaining the appropriate balance between risk and return. Invesco believes the investment grade and bank loans asset classes offer opportunities to diversify and enhance insurers' returns while working within regulatory constraints. We speak with Scott Baskind, Head of Global Senior Loans and Mike Hyman, CIO of Global Investment Grade and Emerging Markets about their credit outlooks for 2017 and strategies for enhancing insurers' portfolio returns. Chris Marx, Managing Director, Head of US Insurance, moderates the discussion.

Chris: Let's start off with a quick recap of 2016 and outlook for 2017. Mike, investment grade credit did very well last year and high yield did even better. Has the credit cycle run its course in terms of investment grade credit?

Mike: I think the short answer is definitely no. If we look back at 2016, strong performance was largely driven by a positive reversal in the investment grade energy sector. After the election of Donald Trump, however, we saw interest rates rise. I believe a significant driver of spreads this year will be how the current administrations' policies play out. If you look at this point last year, a number of strategists were forecasting a recession sometime in 2017. We now expect that to be pushed out one or two years into the future. I think this is going to elongate the credit cycle and extend the degree to which spreads can continue to tighten. I believe the second factor that is going to drive credit spreads is global demand for yield. We are still in an environment where overseas yields are extremely compressed, leading investors to seek the higher yields available in the US. The final factor likely to drive spreads tighter during 2017 is the potential for new tax policies that could incentivize US companies to decrease bond issuance and/or maintain lower levels of leverage if, for example, interest rates are no longer tax deductible.

Figure 1: US investment grade, high yield and emerging markets corporate spread comparison

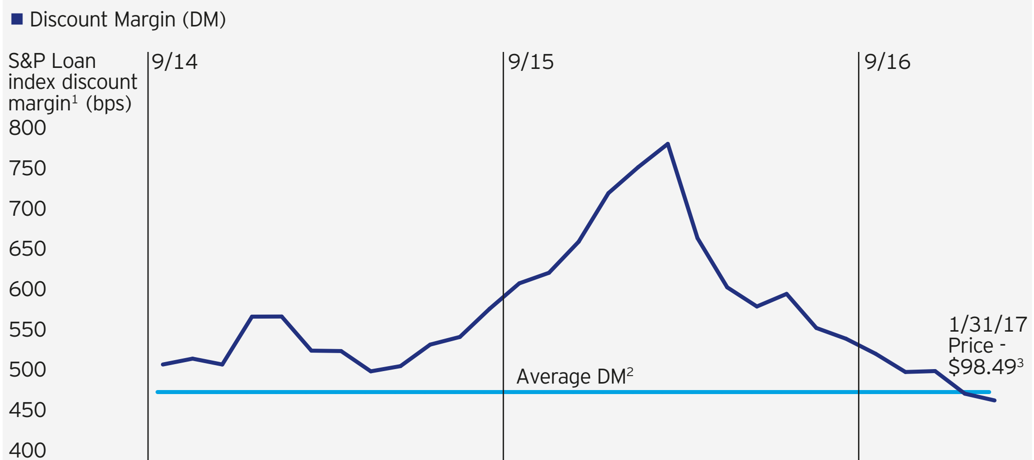


Source: Bloomberg L.P., JP Morgan, data from Dec. 30, 2011 to Feb. 24, 2017. Indices represented are the Bloomberg Barclays US Investment Grade Credit Index, Bloomberg Barclays US Corporate High Yield Index and the JP Morgan CEMBI Broad Diversified Index. Note: Average rating for the JP Morgan CEMBI Broad Diversified Index was Baa3/BBB-/BBB (Moody's/Standard and Poor's/Fitch), as of Feb. 28, 2017.

Chris: Scott, bank loans also had a great year last year, posting mid-teen returns. Given Mike's comments, how do you think about your outlook for 2017 and the bank loan space?

Scott: Mike's comments are relevant to many asset classes, especially risk-based asset classes. Loans were up about 10% in 2016, which is historically an anomaly.[1] Returns were not only driven by income, based on the coupon and the base rate (the Libor component), but were also driven by capital appreciation. The bank loan asset class appreciated multiple points in price terms in 2016.[1] Ultimately that sets up 2017 to look much more typical in terms of potential returns. We expect more of a coupon-driven environment from a returns standpoint. The main reason for that is that around 60% the asset class now trades at or above par, suggesting that 2017 will likely be a fairly stable environment.[2] We expect continued robust demand from all parts of the marketplace whether from European, Asian or US investors.

Figure 2: US current secondary market opportunity



Source: Data from Jan. 31, 2014 to Jan. 31, 2017.
1 S&P/ LSTA Leveraged Loan Index as of Jan. 31, 2017.
2 Average represents the periods Jan. 31, 2000 to Jan. 31, 2017 excluding 2008-2009.
3 Price represents the average price of the S&P Leveraged Loan Index as of Jan. 31, 2017 including Oil and Gas issues.

Chris: So we are expecting healthy returns and positive technicals in 2017. What are some of the risks to our forecasts?

Scott: When we look at the big drivers of price movements in the bank loan asset class, they have historically been systemic in nature, so geopolitical risks are clearly important. As we enter 2017, the US political environment is a bit more certain than it was last year since we are now through the election. But we need clarity around the new administration's policies to drive economic formation and growth. Brexit has been very topical and creates uncertainty that could cause additional volatility. The European election cycle and concerns over global macroeconomic performance may also be sources of volatility.

From a fundamental perspective, US corporate earnings remain quite supportive, particularly for senior secured debt, which is situated at the top of the capital structure. So from that perspective we remain comfortable with the environment. What we are ultimately investing around is an uncertain global environment that could cause near-term volatility. That said, the market has corrected itself very quickly historically and we would anticipate the same in 2017.

Mike: Something that merits watching is the potential for a focus on smaller issues to distract the Trump administration from fulfilling its tax reform agenda. Also, if we re-enter a phase of significant dollar strength, I think that would be negative for credit. It would likely also be negative for commodities and we could re-experience some of the volatility that we saw in early 2016. The final risk that I would point to is the possibility that the Federal Reserve becomes more aggressive in its stance against inflation, for example, prompted by concerns over fiscal stimulus. A more hawkish Fed may concern markets that financial conditions may tighten significantly.

Chris: Our insurance company clients are very active in the investment grade credit space. If I am an insurance company, how do I think about managing my exposure to investment grade credit, given where we are in the cycle and given your forecast for credit?

Mike: In the near term, we do not see a lot of negatives from a fundamental standpoint on the horizon. If you look, for instance, at the current mergers and acquisition cycle, it has tended to include mergers of higher quality names that have not relied heavily on leverage to complete deals, unlike 2006. Consequently, we do not foresee an enormous wave of defaults. This means investors who managed to navigate through the energy cycle last year are probably in pretty good shape as it relates to credit risk. Some of the issues that we are hearing about from our insurance clients relate more to the lack of diversification within credit. A lot of insurers, particularly on the life side, have had large structured portfolios and these are maturing very quickly. In the context of this challenge, we may be able to find private solutions or other alternatives outside of public investment grade bonds in order to keep clients invested.

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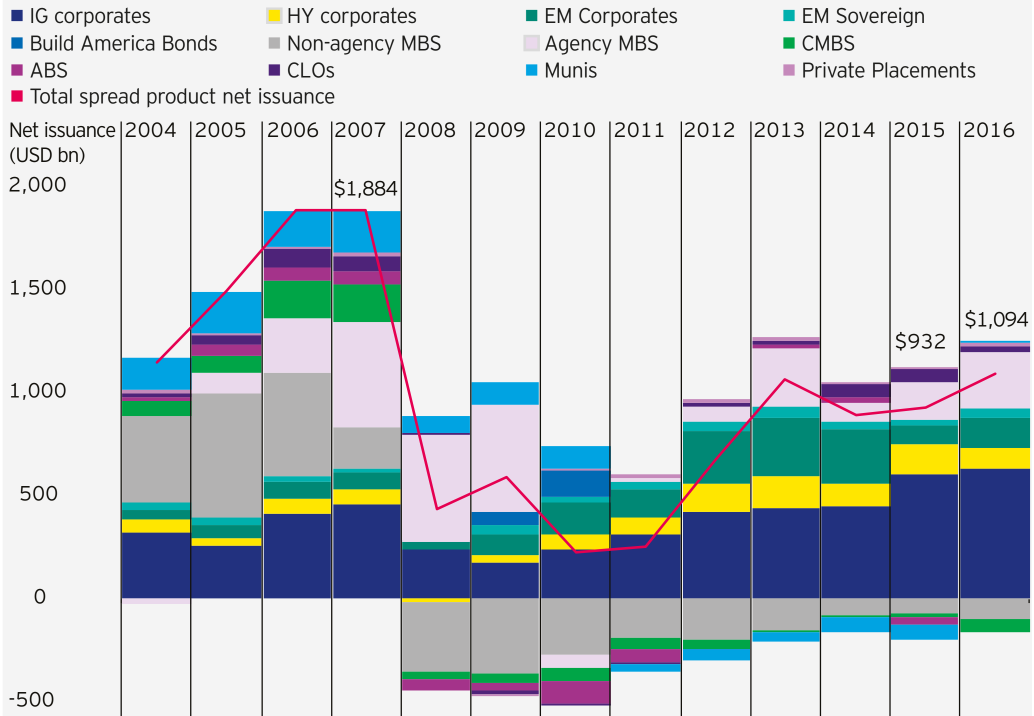
Figure 3: Net issuance across major fixed income asset classes



Source: JPMorgan, data from Jan. 1, 2004 to Dec. 31, 2016. IG is investment grade. MBS is mortgage backed securities. HY is high yield. Munis are municipals. CMBS is commercial mortgage backed securities. ABS is asset backed securities. CLOs are collateralized loan obligations. EM is emerging markets. The EM Corporates number includes IG, HY, and quasi-sovereigns and is only US dollar issuance. Net EM corporate issuance starting in 2010 subtracts call/buybacks and tenders. ABS includes credit card, auto, student loan and MH ABS, and excludes others. Agencies include FNMA, FHLMC, and FHLB. For agency MBS, the negative net issuance in 2010 is due to agency buyout of USD200 billion of delinquent loans. For CMBS coupons are based on loan interest. For CLOs, numbers represent Global Arbitrage CLOs only. Agency net issuance is for long-term (>1 year) issuance. For IG, the net issuance number excludes EM corporates. Munis figures reflect a change in calculation methodology post 2010.

Chris: Staying with the investment grade credit theme – and life insurers – we know there is a lot of discussion about potential changes to the National Association of Insurance Commissioners (NAIC) C1 risk-based capital (RBC) charges. How do we think this will play out over the coming quarters and beyond?

Mike: The forthcoming changes to the NAIC RBC charges make sense since they essentially smooth the range of capital charges across ratings buckets. If I were an insurer and had the capital capacity, I would focus on securities with more optimal capital points like BB securities in either high yield or bank loans. Due to the potential tax changes that might be realized under President Trump, issuers may seek to achieve upgrades if they are not going to enjoy interest deductibility. This would be very positive for allocations to this rating class. Another issue among insurers as it relates to diversification that we hear a lot about, particularly among life insurers, is that they struggle to get enough duration. This has forced them into utility securities, which is a source of concern for some investors due to the potential for technological disruption in that industry. I think finding a solution to the duration equation is going to be a big challenge for insurance companies this year.

Chris: If I am an insurance company thinking about the forecast for credit, the economy, rising interest rates, potential inflationary pressures fueled by fiscal policy, etc., how do I think about allocating to the bank loan space?

Scott: I think one of the true benefits of the bank loan asset class is how dynamic it can be. Many insurance companies gain exposure to the bank loan space through commingled funds or separate accounts. But another way that has been advantageous for the insurance community is by investing in Collateralized Loan Obligation's (CLOs). One of the reasons that CLO's can be so attractive is that insurance companies are able to express their risk tolerance within the capital structure. Many insurance companies invest from AAAs all the way to the mezzanine part of the capital structure (i.e. BBBs and BBs). This way they can express their risk tolerance in a floating rate asset class while getting the benefits of the underlying security in collateral form.

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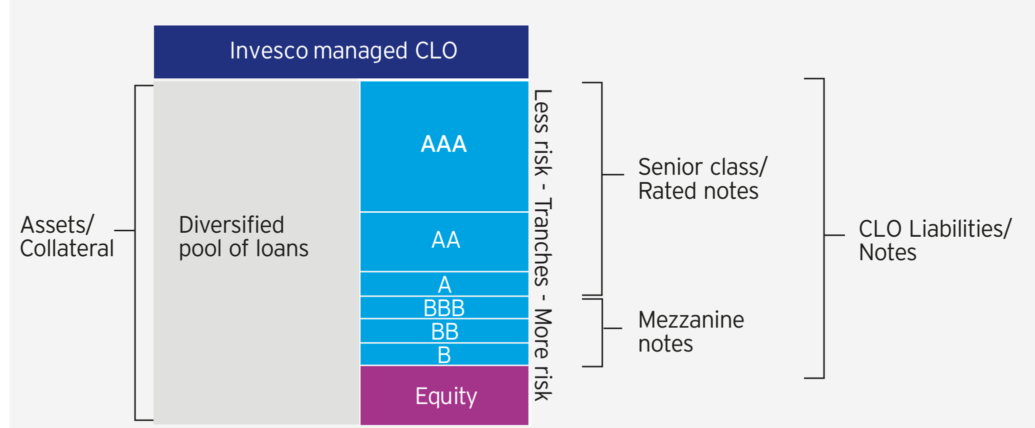
The potential regulatory changes that Mike touched on are interesting within the CLO space where AAs and As have historically been the favored investment. Changes in RBC charges could guide investment lower down the capital structure - into the BBBs and perhaps even BBs - as a solution for tightening returns globally.

Inflation can be both a positive and a negative for the bank loan asset class. Clearly, higher interest rates can burden non-investment grade borrowers from a credit perspective, putting potential stress on income and cash flow generation. But broadly across the universe, corporate America is quite healthy, in our view. Cash flow ratios are at or near all-time highs or multi-year highs, so we feel quite comfortable that the fundamentals remain intact. On the positive side, inflation can ultimately cause the Federal Reserve to remain on its normalization/tightening path, which for a floating rate asset class, has positive implications for long-term income.

Figure 4: Breaking down CLOs



Source: Invesco, for illustrative purposes only.

Chris: Scott, some insurance companies may have a bias against CLO's given their prior experience pre-financial crisis. Could you touch on how CLO's are different today?
Scott: One of the big changes to CLOs post-global financial crisis compared to pre-crisis has been the public rating agencies' methodologies for rating the top of the capital structure (AAAs). Investors who are investing at the AAA level today have significantly more subordination as it relates to additional capital than they did pre-financial crisis. This allows for a potentially smoother environment from a volatility and return expectation standpoint. However, it is important to point out that historically CLO's, particularly at the top of the capital structure, have enjoyed a low-default rate compared to securitized products in general. Even further down the capital structure, the collateral coverage, the subordination from an equity standpoint and the documentation ultimately provides protection to the debt investor, so historically CLOs have been an important component of insurance companies' portfolios. We anticipate that CLOs will likely continue to be one of the tools insurers utilize in their asset allocation.

Historically the rated tranches have been viewed as the main opportunity. However, more recently as we have undergone regulatory changes and with the advent of risk retention requirements from the regulatory bodies, some insurance companies are looking to partner with asset managers as it relates to investing in the equity tranches of CLOs. We believe risk retention funds could present an important alternative avenue of investment within the bank loan asset class.

Chris: That is a great point. Insurance companies are looking to third party managers to help think about and develop new avenues to access different risk exposures within the credit market. Mike, what are you hearing in your dialogues with insurance clients regarding broader investment grade, high yield or even emerging markets?
Mike: Clients are seeking to diversify wherever they can to obtain increased yield. If you look across the credit universe, insurers have historically been underinvested in emerging markets debt. Even within the investment grade space investors can simply change the "zip code" at the same credit quality and pick up significantly more yield. I think insurers are more readily looking into how to get yield pick-up while maintaining the same credit ratings and capital charges. We feel there is a much greater comfort level with the emerging

markets asset class given its performance through the last cycle than perhaps there has been historically. Regarding high yield, we have seen many insurers take profits given high yield's good performance last year and the challenging experiences that some investors had in the energy space.

Chris: Scott could you talk more about the risk retention rule which went into effect in December 2016? How can insurance companies that are unfamiliar with risk retention think about this new asset class and its potential benefits?

Scott: The risk retention rule is aimed at ensuring that CLO managers have "skin in the game" by requiring managers to own and hold 5% of the credit risk of an underlying CLO.[3] To facilitate that, managers broadly have looked at opportunities to partner with third party capital along with internal capital to satisfy the regulation. From an insurance company perspective, it can serve as a longer duration type of investment. Risk retention opportunities can be considered alongside alternatives. They are private equity-style in the sense that they are a fund investment that gets called over time to fund multiple CLO's. And they involve a diversified pool, so the investor is not exposed to a specific vintage of a CLO, but rather to multiple vintages, which can be quite attractive in terms of diversification benefits.

One of the great benefits of the risk retention asset class is the potential for asset managers and insurance companies to strategically align, where the asset manager provides the asset management part of the solution and the insurance company, along with other investors, provides part of the capital solution. Alternatives within the bank loan asset class are becoming more prevalent in the marketplace and risk retention is one interesting solution. Other solutions include looking at different opportunities in terms of credit quality and private debt as well as considering opportunities in the stressed and distressed segments of the bank loan market. So currently there are many ways that insurance companies can utilize the asset class - it is not a one-size-fits-all environment. As we move forward, we see a number of product extensions that we believe could make sense for the insurance community.

Chris: There is strong interest in diversifying credit exposure from both an income and return perspective. What are some of the ways that insurance companies can think about executing on diversifying credit sources of return?

Scott: As I mentioned before, one of the major advantages of the bank loan space is customization. This could include either being a liquidity provider or seeking opportunities in stressed assets. One of the developing parts of the market is in the stressed area for smaller to mid-sized companies. As opposed to the larger more liquid end of the market, in the smaller company space, the investor can add a lot of value to the transition of a company experiencing either operational or balance sheet issues where some liquidity is needed. Additionally, the stressed segment tends not to be attached to the economic cycle. Smaller companies generally run into issues due to the nature of their size. Liquidity providers can take advantage of this opportunity to invest through a cycle without being dependent on the market or economic cycle itself.

Chris: This strategy can add attractive return in addition to an income component of that return.

Scott: Yes, that is right. The hallmark of the bank loan asset class is current income. Historically, return expectations are driven by the current income component. A more stressed type of investment has the potential for not only some current income but also capital appreciation over time as many of those assets tend to trade at fairly large discounts to fair value. In these cases, the return horizon for the investor is likely to be longer-dated.

1 Source: Credit Suisse Leveraged Loan Index, data from Jan. 1, 2016 - Dec. 31, 2016.
2 Credit Suisse Leveraged Loan Index, data as of Dec. 31, 2016.
3 Source: Dodd-Frank Wall Street Reform and Consumer Protection Act, Section 941, Dec. 24, 2016.

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