OBSERVATION

4th QUARTER 2020

A YEAR TO REMEMBER …

… and it's not over yet! 2020 started with markets worried about the next world war as US air strikes killed Iranian General Soleimani when retaliating against Iranian aggression. As that news story began to fade reports came in from China about the building of huge hospitals at unprecedented speed.

Markets were unsure and authorities, on the whole, behind the curve. Singapore and South Korea moved fast to try and stop the spread with pandemic status only eventually being reached in March. The new virus was given the label «COVID-19» ultimately emanating from Wuhan, China. As if that didn't create enough volatility we then experienced Russia and Saudi Arabia seeking to collapse the price of oil effectively attacking US shale production with unprecedented determination. For a variety of reasons oil touched a low point of -$39 pb as oil storage became the new precious resource.

The US authorities reacted swiftly to the severe downward movements of the markets which saw their low in March.

Unprecedented levels of stimulus turned the negative sentiment around and in late August took US indices to new highs and a handful of stocks to near nose bleed valuations.

Next on the agenda are two events specific to the United States, namely the elections for the US President as well as for the Senate. However, the US Presidential election, despite all the speculation, razzmatazz and flag waving, economically isn't that important. The degree of polarization between party supporters and leaders is unlikely to result in much meaningful change for the next few years. Yes, with Trump we could get a re-escalation of the trade dispute with China or with Biden the realization of the campaign promise to increase taxes and regulations. However, although markets may have moved to new highs and levels of optimism economically the picture is a lot more troubling. Whoever wins and enters the Oval Office will have to concentrate their energies on stabilizing the economy well before they can even think about tightening conditions by increasing taxes, for example.

We are six months into the impact of the virus and are still feeling the initial effects.

Job losses are still being announced from firms as diverse as Goldman Sachs to Disney to Bayer. Therefore, of more immediate concern is the announcement of a new fiscal package to replace the CARES Act in particular. The CARES Act was announced in March and ended in July. In essence, it gave unemployment benefit cheques to the unemployed in the wake of the onset of the virus. These cheques

S&P Year to Date (Price in USD)

Source:
Banque Heritage,
Bloomberg

supported consumption. It allowed people to pay their rent, mortgages and car loans etc.

Consumption is 70% of the US GDP and with over 25 million people unemployed (8.2% unemployment rate) fiscal policy is going to be a recurring necessity to support the economy and create jobs. At the time of writing the politicians are still arguing over the details and amount of the next package. A short term fix will be released but without it the US economy is at real risk as the squabbles continue. Looking forward it is becoming our base case that continued fiscal stimulus by the US government and monetary stimulus by the Federal Reserve is now standard with a direct impact on markets.

Fiscal stimulus has so far proven disinflationary.

Indeed this time may be different but the experience after the Global Financial Crisis is clear. The inflation we witnessed was through assets and with the likelihood of yet more stimulus markets will undoubtedly benefit. However it may also give rise to more boom and bust conditions as markets become addicted to the same stimulus.

It would be wrong to completely write off the importance of the election. In the short term it has the capacity to cause severe volatility if the result is not immediately clear. Indeed what ultimately matters now is who controls the Senate. Obama didn't control the Senate and got nothing through – he was a lame duck. Issues include the increased use of postal votes thanks to COVID and additionally the likelihood that these won't be counted until well after the election night. Could they change the result? Legal challenges could result, too, as we saw years ago with Bush junior and voting in Florida. Voter turnout after the disastrous (for both candidates) first Presidential debate could also be an issue with no common ground between candidates and a polarized electorate. The polls as at the time of writing gave the lead to Biden but the polls were useless in 2016 with both the last US election as well as Brexit.

So it's been a year to remember and it's not over yet, but what do we expect for the rest of the quarter and into 2021?

Worst case scenario is we will have to await early January for who wins control of the White House and the Senate. The inauguration is on the 20th of January and by the 6th a result must be announced. Best case scenario is we see a clean sweep of both the White House and the Senate but we would not know that either before the 6th of January when the Senate vote is announced. We therefore have a period of uncertainty whereby volatility and unease is likely. A fiscal package could come tomorrow or may be postponed indefinitely. It is the fiscal package that matters most for markets with expectations that a package will be delivered eventually. The risk is markets becoming increasingly impatient.

Given these events we remain ultimately defensive. We reduced equity market exposure by 5% in September ahead of the new quarter. Into 2021 we are reasonably optimistic for stock markets however there may well be more attractive buy levels to come this quarter. We are therefore in no rush to add risk however are fully aware that a new fiscal package could be released at any time which would see a renewed rally. We would therefore welcome weakness as an opportunity to add exposure, however, the current quarter's outlook looks more like a lottery of differing events and hence we believe a more defensive nature to portfolios is warranted.

Whoever wins the White House next year will inherit a wide variety of economic and social issues. These are also global in nature. We truly hope that a vaccine for COVID can be released soon and the virus is one less issue for the world to deal with next year.

EQUITIES	LAST PRICE	YTD %
S&P500	3483.81	7.83
Eurostoxx 600	369.29	-11.19
Nikkei	23671.13	0.06
China A shares	3471.88	8.63
Brazil	98309.10	-14.99
India Nifty	11871.25	-2.44
Russia RTSI$	1132.85	-26.86
MSCI World Local	1848.30	2.70
MSCI EM Local	64025.9900	4.16

COMMODITIES	LAST PRICE	YTD %
Crude Oil	40.63	-33.46
Natural Gas	2.70	23.12
Gold	1900.80	24.80
Silver	24.79	38.33
Copper	307.75	10.03
RICI Global	2031.83	-17.22
RICI Agriculture	787.22	3.76
RICI Energy	188.65	-50.93
RICI Basic Metals	1206.94	3.42
RICI Precious Metals	2332.36	23.36

FIXED INCOME	LAST PRICE	YTD %
US Govt	417.51	7.43
EU Govt	252.03	7.63
US IG Corp	3241.31	14.57
US HY Corp	2154.67	12.85
EU IG Corp	151.37	8.09
EU HY Corp	410.62	11.67

CURRENCIES	LAST PRICE	YTD %
Dollar Index	93.5360	-2.96
Euro	1.1738	4.68
GBP	1.3005	-1.90
Yen	105.3500	3.09
AUD	0.7097	1.08
CHF	0.9132	5.85
Brazil Real (BRL)	5.6460	-28.71
Turkish Lira (TRY)	7.8917	-24.59
India Rupee (INR)	73.3650	-2.71
China Yuan (CNY)	6.6908	4.07
JPM EM FX	54.6380	-11.16

As of October 19, 2020

SAYONARA TO BONDS?

Bond yields peaked in 1981. COVID has taken yields to yet a new low, interest rates are at zero, where to now for bonds?

Should we say Sayonara, Au Revoir or Cheerio to bonds after a 30 year bond bull market which has taken the 10 year US Treasury down from a yield of 16% to a yield of 0.7%?

Interest rates have been taken to negative or zero by global central banks fighting the latest headwind to economies – COVID-19. Global monetary policy is now all but exhausted unless we see moves to copy the Swiss National Bank and deeply negative interest rates. In view of a further crisis, this seems unlikely and has yet to prove to be an advantageous policy, especially in Europe. Indeed we have already seen the Swedish Riksbank move interest rates back out of negative.

Inflation is the biggest risk to a bond holder and the future remains very uncertain as to whether increasing excess levels of money supply can be turned into inflation especially given the current output gap (made worse by COVID) and decreasing velocity of money.

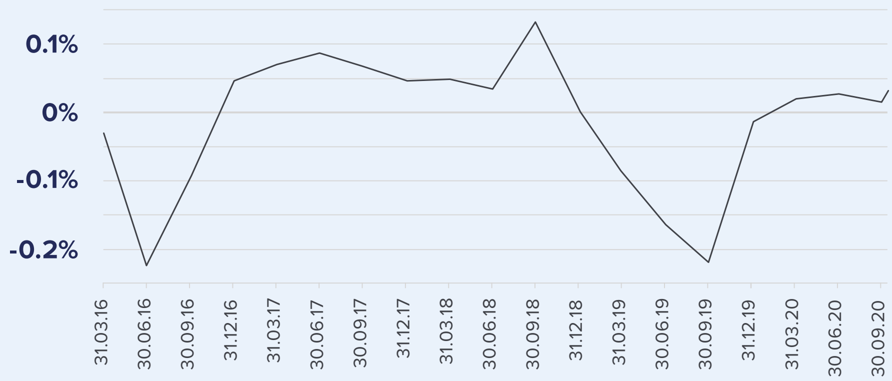
Additionally, many countries now simply cannot afford higher yields. The US is one of them and so we could see yield curve control re-introduced, last seen in 1951. The Japanese have been controlling their yield levels since 2016 and with no inflation pressure are potentially an example of one scenario where yields remain a lot lower for longer.

If we do see any inflationary pressure then yields should rise before being capped by central banks. In that environment nominal returns would be stable but real returns i.e. after inflation would be very poor.

Corporate bonds are the new cash proxy and can continue to do ok. Central banks in Europe and the US are now actively purchasing and hence supporting these markets. However looking forward with such an uncertain and almost binary world between the Japanese type environment and one where we see inflation the returns available from bonds look weak. Bonds are priced for the Japanese type world, a world where governments are actively working against seeing inflation and erosion of the debt levels held on their balance sheets.

US Treasury 1970 to 2020

10yr Japanese yields under yield curve control



Sources: Banque Heritage, Bloomberg

COULD BIDEN TRUMP THE MARKETS?

Forecasting both the winning US presidential candidate and the related market impact proved hazardous in 2016. The first surprise was the Trump win, quickly followed by another unforeseen event, equity markets rallying while everybody was short.

Today's widely held expectation is a positive market reaction to a Trump win, whereas a Biden presidency is seen as a trigger to a market reversal. Could we see a repeat of the same surprise pattern in the upcoming election cycle?

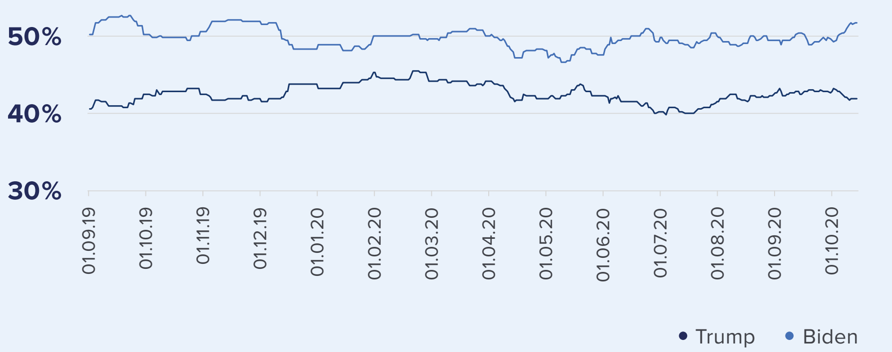
Our view is not as binary. In essence and with a longer term perspective we think that with whatever president is elected and with a more settled political situation (probably in the first months of next year), equities in general should do well. A Republican win likely means continued tax cuts and light regulation ahead while a Democrat win should lead to significant deficit spending. Coupled with the prospect of a Fed that is on hold for a very long time, there is a strong case in favour of equities. The issue at hand is that the period between now and then is likely to be volatile.

Sector allocation is probably where wider differentiation might take place

The most obvious area is the energy space with the candidates having opposite views. Trump is a fossil fuel supporter while Biden is strongly backing a green energy plan. Markets were quick to acknowledge the higher interest in environmentally friendly policy according to the powerful rally seen in the renewables space. Another sector with a divided outlook is financials, where more regulatory oversight and a generally less friendly stance from democrats stand in contrast to Trump's views. Big tech is seen at risk as well in case of a push for break-ups from the Biden camp, but this is not our biggest concern.

From a geographic standpoint, it is interesting to note that European equities tend to outperform their US peers into presidential elections, having outperformed in 6 of the last 7 elections. A Biden victory, with less de-globalisation and more green-tinted infrastructure, should be a net positive for Europe. A democrat win is also seen as more favourable to Emerging Markets, especially China, where a more diplomatic tone to relations is more likely.

Election polls



Invesco Solar ETF (Price in USD)

Sources: Banque Heritage, Bloomberg

NOT ALL STRUCTURED CREDIT IS CREATED EQUAL

Often mistaken for their cousins, the Global Financial Crisis triggering CDOs, CLOs are an often overlooked segment of the credit world.

CDOs (Collateralized Debt Obligations were responsible for igniting the Global Financial Crisis (GFC) more than ten years ago. They were unregulated and dealt almost exclusively with residential mortgages which themselves suffered from a conflict of interest leading to bad mortgage debt being repackaged into seemingly more secure tradable paper. CLOs (Collateralized Loan Obligations) are different and often overlooked.

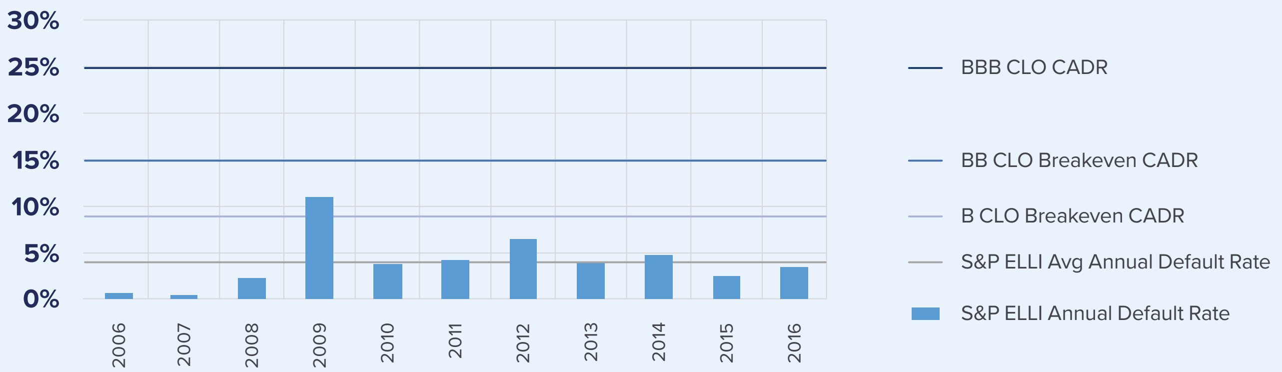
CLOs are bundles of high yield syndicated loans which are enhanced through a credit structure (tranches) and sold to investors. Among CLO managers are recognizable names such as Oak Tree, Pinebridge, Apollo, Carlyle etc. who usually manage between 100 and 225 underlying loans, actively buying and selling over the life of the CLO. The loans are mostly the result of leveraged buyouts and have been around for decades. While they are high yielding in nature, they sit at the top of the debt structure, making them less vulnerable to defaults, they are floating rate, making them immune to duration risk.

Most importantly: They are regulated.

Despite strong negative returns in certain years (e.g. -29% in 2008), going back to 1993 the Credit Suisse leveraged loan index never had an August to July negative year with returns of less than ~3%. While some loan covenants have deteriorated over the past decade («Cov-lite»), which could lead to a higher historical default rate or at least a lower recovery rate in case of default, syndicated loans have been eating up shares of the financing market against high yield and are here to stay.

The most senior CLO tranches are rated investment grade (~70% of the structure) thanks to diversification, over-collateralization and risk mitigation techniques, and go down in rating all the way to equity tranches, which usually do not receive any cash flow over the life of the CLO but have a direct participation in case of a sale.

Structural Resilience of the CLO Market



Source: Banque Heritage, Cartesia SAS

By buying a portfolio of 100 loans, the risk is spread across all these names, rather than concentrated on a few, limiting idiosyncratic risk.

CLOs also hold more loans than they issue tranches, and managers co-invest at a minimum of 5%, all providing a cushion in case of deterioration and alignment of interest. Importantly, CLO risk mitigation mechanisms (i.e. the diverting of cash flows from the riskier tranches to the safer ones) are triggered by realized losses or inability to service interest, rather than by market value which may fluctuate, and controlled by independent trustees. Excess cash flows are further used to rebuild and maintain protection over time. As a testament to their robustness, of the 1'956 tranches of European CLOs rated by S&P between 1997 and 2016, only 10 have seen a default – a rate of only 0.51%.

CLOs are highly regulated, and even more so in Europe.

As a result of the above protection mechanisms CLO tranches rated BB and BBB can generally tolerate a constant annual default rate (or annual default rate of the underlying loans over each year of their life) in excess of 15% and 25% respectively. That is 4 to 6.7 times the average default rate observed between 2006 and 2016! CLOs were already around during the GFC, proving particularly resilient. Since then, regulation has further enhanced their robustness and the COVID-19 crisis put them to the test once again. Defaulted assets are avoided through active trading keeping exposure well below 1%, while European corporate defaults have surpassed their 2009 financial crisis levels.

Each manager will have their own style and regional / sector strengths. Some will focus on credit picking and be rather offensive, posting high portfolio turnover. They will tend to be the ones best suited to equity tranche investors. Others will rather focus on style diversification, be conservative in their models and have moderate leverage. They will typically post a rather low turnover. Finally, very conservative managers will focus on a good average rating, are typically new comers needing to build a track record and will offer decorrelation benefits in case of a stressed market. Whatever the style, good CLO managers need to remain consistent with their own biases in terms of documentation, leverage and over-collateralization per tranche.

CLOs, especially in Europe, remain a niche asset class. It is prone to liquidity issues in case of market stress, its analysis is a highly specialized business, and since no crisis ever happens for the same reasons one needs to reckon that there may come a day when CLOs resilience is put to a greater test. There will ultimately always be forced and panicked selling putting pressure on smaller, lesser known asset classes. During the coronavirus market melt-down, mezzanine CLO tranches (rated BB & B) were down 25%, the kind of drawdown usually only experienced in equity markets. Banque Heritage had never invested in CLOs until then and owing to the analysis detailed in this article, decided to enter the space on the back of what we believed was too strong a dislocation to be fundamentally sound. From April to September, the fund we selected was up more than 27%, which speaks to the resilience of this asset class and the importance as asset allocators to keep an eye out for each and every opportunity, investing away from the herd and relying on analysis to identify opportunities, with an ability to move quickly.

INSPIRATION

CONTRIBUTORS

Jean-Christophe Rochat, CIIA
Jack Loudoun
Michel Mazenauer, CAIA
Mikaël Safrana, CIIA
Stéphane Trezzini

EDITORIAL

Nik von Guérard

DESIGN

Now Werbeagentur AG
Basel, Switzerland

PHOTOGRAPHS

Patric Pop

HERITAGE.CH