# Global Credit Perspectives
3Q 2020

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## Overview

We recently published a blog referencing the words from REM's hit song "It's the End of the World as We Know It (And I Feel Fine)" in which we contemplated whether it really is the end of the world as we know it. From a global pandemic facing the world...

- that saw GDP contract sharply,
- redefining working from home,
- educating students remotely,
- curtailing business and leisure travel, and
- challenging political and business leaders in every corner of the globe,

...to an unconventional presidential contest in the U.S., to the never-ending saga known as BREXIT, to numerous natural disasters, it would be simple to conclude that it is the end of the world.

*Just as we concluded back in April, we do not believe it is the end of the world as we know it.*

The pandemic should be viewed through the lens of a natural disaster. The strength and will of the people have been astounding in response to the challenges faced—the ability to persevere in the face of these challenges is a testament to the resiliency of humankind. As the medical community continues to learn how to better treat the virus while awaiting the development of better therapeutics (including vaccines), the burden is on the global population to help protect the vulnerable portions of the population.

And policymakers, on both the monetary and fiscal fronts, have come out in force to support global institutions and societies. They have acted swiftly and decisively to provide the necessary support during these tumultuous times. By acting in a timely manner, they have allowed the global economy to weather the storm.

As we discussed in our last letter, risks abound. Investors must assess the impact of these challenges on business models going forward and assign probabilities to the various outcomes. Some industry sectors will benefit while others will struggle and need to adapt. Technology should benefit significantly as companies look to enhance margins and productivity through the deployment of more automated and efficient technology. Airlines and hotels may struggle as business and leisure travelers are slower to return to pre-COVID levels. Management teams will reassess their need for office space as work from home may become a more attractive option for them. To that extent, investors must assess this new environment to determine the viability and wherewithal of companies to operate and survive. Liquidity will be paramount.

Although our emotions (and portfolios) have ridden a roller coaster through much of 2020, as we look forward—through the end of the year and into 2021—we see a very high likelihood of a cyclical recovery whereby investors could see attractive total returns from further spread tightening due to stronger global GDP growth. To the question around the impact of a new administration in the U.S., we envision a scenario where the monetary and fiscal support outweighs any headwinds from increased corporate tax rates and regulations.

*We do not believe it is the end of the world as we know it.*

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# Index Summary AS OF SEPTEMBER 30, 2020

## INVESTMENT GRADE

- After significant spread widening and tightening in the first and second quarter, the third quarter provided solid, if not unspectacular, returns for investment grade (IG) credit. While central banks remain supportive, they have increased their calls for governments to carry out more fiscal policy to help revive the economy.
- IG spreads tightened to 138 basis points (bps) from 159 bps over the third quarter with yields tightening to an all-time low of 1.635% at the end of the quarter.
- Issuance remained solid in the third quarter at $390 billion. Although down from the record $761 billion issued in the second quarter, this is on pace with historical third quarter issuance.
- Credit rating agencies have ceased their downgrade action and are starting to show some tentative signs of upgrade activity.
- Over $1 trillion of green bonds have been issued since their introduction in 2009, including $192 billion in 2020 year-to-date issuance. The recent increase is due, in part, to more diverse sectors beginning to issue green bonds. In addition, the upcoming European Union (E.U.) recovery fund will require the E.U. to issue over EUR 200 billion of green bonds next year, which is expected to further diversify and increase market depth.

| | 9/30/2019 | | 7/31/2020 | | 8/31/2020 | | 9/30/2020 | |
|---|---|---|---|---|---|---|---|---|
| SPREAD/YIELD SUMMARY (bps/%) | SPREAD | YIELD | SPREAD | YIELD | SPREAD | YIELD | SPREAD | YIELD |
| ICE BAML Global Corporate Index | 121 | 2.27% | 140 | 1.59% | 132 | 1.62% | 138 | 1.64% |
| ICE BAML AA Global Corporate Index | 65 | 1.60% | 77 | 0.87% | 73 | 0.94% | 77 | 0.92% |
| ICE BAML A Global Corporate Index | 96 | 2.01% | 106 | 1.26% | 101 | 1.31% | 107 | 1.33% |
| ICE BAML BBB Global Corporate Index | 153 | 2.61% | 182 | 2.00% | 171 | 2.00% | 177 | 2.02% |
| ICE BAML U.S. Corporate Index | 122 | 2.97% | 141 | 1.93% | 136 | 1.99% | 144 | 2.06% |

| PERFORMANCE SUMMARY (%) | QTD | YTD | 1 YEAR | 3 YEAR | 5 YEAR | 10 YEAR |
|---|---|---|---|---|---|---|
| ICE BAML Global Corporate Index | 3.14% | 5.87% | 7.73% | 4.93% | 5.17% | 3.93% |
| ICE BAML AA Global Corporate Index | 2.74% | 6.48% | 7.72% | 4.39% | 4.30% | 2.88% |
| ICE BAML A Global Corporate Index | 2.73% | 6.51% | 7.95% | 4.87% | 4.85% | 3.58% |
| ICE BAML BBB Global Corporate Index | 3.59% | 5.12% | 7.46% | 5.01% | 5.64% | 4.67% |
| ICE BAML U.S. Corporate Index | 1.69% | 6.61% | 7.84% | 6.38% | 5.96% | 5.14% |

## STRUCTURED CREDIT

- The quarter saw a significant increase in household savings, robust housing recovery, continued low interest rates, and a sharp decline in unemployment, all of which boosted investor confidence and served as a tailwind for residential mortgage-backed securities (RMBS) fundamentals going forward. However, uncertainty around the course of the pandemic and the political landscape amid the approaching election contributed to a sharp and brief sell-off of risk assets in September, and these risks continue to hang over the outlook for the remainder of the year.
- Structured credit markets continued to recover from the lows seen in the wake of the coronavirus pandemic. Performance over the quarter was generally positive down the credit stack, with lower-rated tranches seeing better improvement. However, the basis between lower and higher tranches remains wider than pre-COVID levels.
- Encouraging remittance data indicated a slowdown in the rate of delinquencies and the early stages of borrowers exiting forbearance. However, 60+ day delinquencies remain elevated and uncertainty abides over future borrower payments with the delay in a renewed support package.
- Supply-demand technicals continue to appear positive with significant investor interest and low issuance this year. We expect spreads to compress further so long as credit concerns stay in check. However, we remain cautious due to uncertainty from the recent new increase in COVID-19 infections, the potential economic effects of the upcoming presidential election, and the lingering uncertainty of additional government support to businesses and individuals who continue to need it.

| | 9/30/2019 | | 7/31/2020 | | 8/31/2020 | | 9/30/2020 | |
|---|---|---|---|---|---|---|---|---|
| SPREAD/YIELD SUMMARY (bps/%) | SPREAD | YIELD | SPREAD | YIELD | SPREAD | YIELD | SPREAD | YIELD |
| ICE BAML U.S. Mortgage-Backed Securities Index | 55 | 2.51% | 89 | 1.45% | 80 | 1.47% | 81 | 1.45% |
| ICE BAML U.S. Fixed Rate CMBS Index | 84 | 2.47% | 178 | 2.04% | 164 | 1.98% | 156 | 1.89% |

| PERFORMANCE SUMMARY (%) | QTD | YTD | 1 YEAR | 3 YEAR | 5 YEAR | 10 YEAR |
|---|---|---|---|---|---|---|
| ICE BAML U.S. Mortgage-Backed Securities Index | 0.11% | 3.74% | 4.42% | 3.78% | 3.04% | 3.03% |
| ICE BAML U.S. Fixed Rate CMBS Index | 2.17% | 5.50% | 5.17% | 5.00% | 4.07% | 4.38% |

## GLOBAL HIGH YIELD & LEVERAGED LOANS

- Index up 4.7% for the quarter despite 1% negative return in September
- Leisure, retail, autos, basic industries, and capital goods all were strong performers with energy lagging the index
- OAS tightened to 535 bps (September index) from 644 bps (July index)

| | 9/30/2019 | | 7/31/2020 | | 8/31/2020 | | 9/30/2020 | |
|---|---|---|---|---|---|---|---|---|
| SPREAD/YIELD SUMMARY (bps/%) | SPREAD | YIELD | SPREAD | YIELD | SPREAD | YIELD | SPREAD | YIELD |
| ICE BAML Global High Yield Index | 425 | 5.65% | 547 | 5.63% | 520 | 5.40% | 559 | 5.76% |
| ICE BAML BB Global High Yield Index | 268 | 3.98% | 393 | 4.11% | 376 | 3.99% | 414 | 4.33% |
| ICE BAML B Global High Yield Index | 476 | 6.31% | 625 | 6.37% | 594 | 6.11% | 648 | 6.65% |
| ICE BAML CCC & Lower Global High Yield Index | 1134 | 12.79% | 1312 | 13.24% | 1225 | 12.39% | 1216 | 12.31% |
| ICE BAML U.S. High Yield Index | 402 | 5.87% | 516 | 5.46% | 502 | 5.36% | 541 | 5.76% |
| ICE BAML European High Yield Index | 366 | 3.00% | 487 | 4.26% | 446 | 3.93% | 472 | 4.13% |
| Credit Suisse Leveraged Loan Index | 478 | 6.32% | 629 | 6.50% | 589 | 6.13% | 579 | 6.02% |

| PERFORMANCE SUMMARY (%) | QTD | YTD | 1 YEAR | 3 YEAR | 5 YEAR | 10 YEAR |
|---|---|---|---|---|---|---|
| ICE BAML Global High Yield Index | 4.91% | 0.48% | 3.90% | 3.63% | 6.65% | 6.08% |
| ICE BAML BB Global High Yield Index | 4.74% | 2.73% | 5.95% | 4.57% | 6.85% | 6.30% |
| ICE BAML B Global High Yield Index | 4.57% | -1.39% | 2.11% | 3.13% | 6.18% | 5.73% |
| ICE BAML CCC & Lower Global High Yield Index | 7.04% | -7.07% | -2.97% | -0.51% | 6.30% | 5.70% |
| ICE BAML U.S. High Yield Index | 4.71% | -0.30% | 2.30% | 3.83% | 6.61% | 6.28% |
| ICE BAML European High Yield Index | 7.13% | 1.80% | 6.89% | 1.46% | 5.30% | 4.24% |
| Credit Suisse Leveraged Loan Index | 4.13% | -0.83% | 0.84% | 3.16% | 4.03% | 4.44% |

## EMERGING MARKETS (EM)

- Valuations in the Corporate Emerging Bond Index (CEMBI) universe are broadly fair at this point; spreads appear attractive while yields are at or near all-time lows. This leaves returns going forward likely in the mid-single digits.
- Emerging Market Bond Index (EMBI) IG and HY remain very wide. Valuation opportunity appears attractive in EMBI HY; the question around debt sustainability risks could outweigh apparent degree of cheapness in some cases.
- As we head into the final quarter of 2020, we continue to weigh signs of economic activity recovery, COVID vaccines/treatments, government response to increasing COVID cases, and valuations across EM.

| | 9/30/2019 | | 7/31/2020 | | 8/31/2020 | | 9/30/2020 | |
|---|---|---|---|---|---|---|---|---|
| SPREAD/YIELD SUMMARY (bps/%) | SPREAD | YIELD | SPREAD | YIELD | SPREAD | YIELD | SPREAD | YIELD |
| JP Morgan (JPM) CEMBI Broad | 276 | 4.87% | 354 | 4.36% | 324 | 4.26% | 346 | 4.42% |
| JPM EM Bond Index Global Diversified | 335 | 5.15% | 400 | 4.68% | 383 | 4.70% | 396 | 4.81% |
| JPM GBI-EM Broad Diversified | - | 5.44% | - | 4.43% | - | 4.54% | - | 4.57% |

| PERFORMANCE SUMMARY (%) | QTD | YTD | 1 YEAR | 3 YEAR | 5 YEAR | 10 YEAR |
|---|---|---|---|---|---|---|
| JPM CEMBI Broad | 2.63% | 2.93% | 5.09% | 4.92% | 6.57% | 5.67% |
| JPM EM Bond Index Global Diversified | 2.28% | 0.37% | 2.47% | 3.27% | 6.03% | 5.21% |
| JPM GBI-EM Broad Diversified | 1.01% | -6.07% | -1.04% | -0.79% | 3.78% | 0.74% |

# Investment Grade

The ICE BAML Global Corporate Index returned 3.14% in the third quarter while its yield tightened to 1.6% and closed the quarter with a spread of 138 bps. For the trailing 12 months, the index returned 7.73%. Lower-quality investment grade bonds (BBB) returned 3.59% for the quarter and 7.46% for the trailing 12 months, better than AA and A-rated corporate bonds, which returned 2.74% and 2.73% for the quarter and 7.95% and 7.72% for the trailing 12 months, respectively.

After two quarters of intense volatility caused by synchronized global lockdowns, the third quarter was more muted in terms of spread tightening and total return. G4 central banks continued their asset purchases, lending programs, and other support. However, while the level of government balance sheets continued to increase, the velocity of the increase slowed.

Within the IG corporate bond space there has been considerable dispersion in year-to-date returns between sectors. Packaging, utilities, and healthcare lead performance returns, but energy and gaming, hotels & leisure lagged significantly (see Figure 1). With strong year-to-date returns in US Treasuries, there has been next to no excess return for any sector.

The second quarter of 2020 was the largest U.S. investment grade issuance on record: $761 billion (Bloomberg). Many of this issuance was used to pay back revolvers drawn down during the peak of the pandemic. During the third quarter, issuance dropped to $390 billion, which is on par with the long-term average for the third quarter and the traditional summer lull in issuance. The bulk of this issuance was focused in financials (35%), healthcare (11%), and consumer discretionary (10%).

**Figure 1** Investment Grace Sector Returns
%, As of 9/30/2020

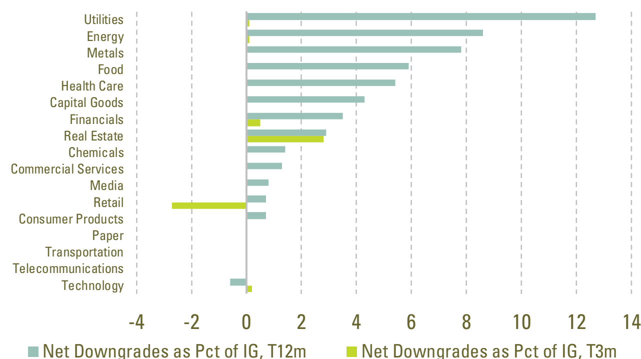
Source: Deutsche Bank

## CREDIT RATING ACTION

The second quarter saw significant rating downgrade action from the rating agencies. As spreads recovered to pre-pandemic levels and economies began to reopen, the pace of rating downgrades abated in the third quarter and several sectors, including real estate, financials, and techonolgy, saw positive rating action.

Among the worst affected sectors over the last 12 months (utilities, energy, and metals), the downgrades have all but stopped (see Figure 2), and many of these are no longer on a negative watch. Rating agency expectations of strong rebounds in the third and fourth quarter appear to be playing out. Considering this trend, along with the very supportive monetary and fiscal responses from global central banks and governments, the worst of the rating action may be behind us for the time being, barring a reversal of economic activity.

**Figure 2** U.S. Investment Grade Sector Net Downgrades/Upgrades
As of 9/30/2020




Source: Deutsche Bank
(Total face value of downgraded bonds less face value of upgraded bonds, as a percent of sector face value, over 3m and 12m horizons)

## GREEN BONDS

Green bond issuance rose significantly in the third quarter, especially in Europe. Since their creation in 2009, over $1 trillion of green bonds have been issued, including $192 billion year to date, according to data compiled by Bloomberg. Over 85% of 2020 issuance was issued by governments (36%), financials (33%), and utilities (18%). An interesting development this quarter, however, is the diversification of issuance into other sectors, namely consumer discretionary and communications.

E.U. legislation on Green Bond Standards is expected to clarify the criteria for classifying underlying projects as green as well as enhanced reporting on use of proceeds. Once these measures are taken, the E.U. Recovery Fund can be funded by the issuance of EUR 200 billion green bonds. Having such a large new issuer in the market for green bonds will help standardize issuance and encourage more borrowers and investors to see green bonds as part of their funding or investment mix. This, in term, will drive the market to enable greater issuance and to finance environmentally responsible projects at attractive rates.

# Structured Credit

## OVERVIEW

The quarter saw a moderation in the rate of new COVID-19 cases during the summer months, as lockdowns slowly lifted across various parts of the country. The CARES Act passed by Congress in the first quarter created a transfer of wealth that enabled a significant increase in household savings. The housing market is experiencing a robust recovery due to a shortage of supply, low mortgage rates, and a secular shift toward home ownership. These factors, along with low interest rates and a sharp decline in unemployment, contributed to a boost in investor confidence, and they serve as a tailwind for RMBS fundamentals going forward. However, the CARES Act expired in July and political wrangling has delayed the passing of a new support package. Furthermore, the failure to contain the virus remains one of the largest challenges for the economy. Uncertainty around the course of the pandemic and the political landscape amid the approaching election contributed to a sharp and brief sell-off of risk assets in September. Although markets have improved, these underlying concerns have not fully abated, and they continue to hang over the outlook for the remainder of the year.

Structured credit markets continued to recover from the sell-off that occurred in the wake of the coronavirus pandemic, building on the gains of the second quarter. Though lagging comparable credits for much of the quarter, structured markets were largely spared the general sell-off in credit over the month of September, causing them to outperform comparable credits for the month. Performance over the quarter was generally positive down the credit stack, with lower-rated tranches seeing better improvement. However, the basis between lower and higher tranches remains wider than pre-COVID levels.

Near-term technicals continue to appear supportive of further spread tightening based on low issuance year to date, continued support from the Federal Reserve (FED), stable residential housing prices, and low mortgage rates. However, significant risks continue to linger. The level of new COVID-19 infections has begun to rise once again in several states, and this may lead to a resumption of lockdowns. Democrat and Republican lawmakers have failed to agree on a new support package for struggling businesses and laid-off workers. This causes uncertainty in the performance of borrower payments as more time passes since the expiration of the initial support package in July. While the pace of delinquencies has moderated substantially, the backlog of 60+ day delinquent loans has continued to build over the quarter. Elevated global tensions with China and the potential of a Democratic sweep and/or a contested election in November bring added political risks.

We remain constructive and generally maintain our current positioning while seeking better relative value opportunities as they materialize.

## U.S. RMBS

New issuance of Agency mortgage-bascked securities (MBS) totaled $916 billion in 3Q 2020 compared to $464 billion over the same period in 2019, supported by purchases from the Fed. Non-agency MBS, which received no such support, saw new issuance reach nearly $22 billion in the quarter versus $29 billion in 3Q 2019. The positive performance that began in the second quarter continued into the third quarter. Performance in the quarter continued to see broad-based improvement from the lows seen in March and April, although some non-investment grade credits remain below their levels from the start of the year. Investor sentiment generally improved based upon positive collateral performance over the quarter. Delinquencies in most categories moderated or improved over the quarter. With September's remittance, the first wave of loans that had entered forbearance saw 7.7% go back to current status while the remainder either extended forbearance or had their missed payments deferred. Current-to-30-day delinquency rolls have now dropped to rates seen before the COVID-19 crisis. Nevertheless, uncertainty remains due to a resurgence of new COVID-19 cases in some states and a lengthy delay in passing new fiscal spending legislation after the expiration of the initial support package in July. We will continue to watch the pace of delinquencies, loan forbearance outcomes, and the ability of servicers to continue advances on non-performing loans.

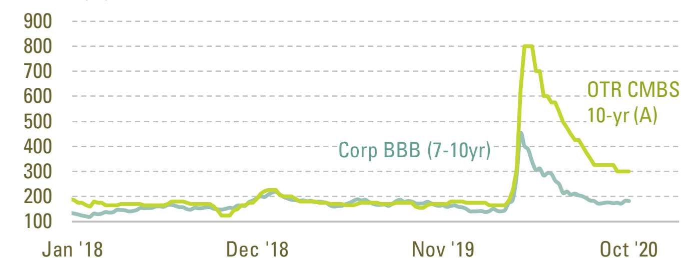
Agency MBS continues to benefit from the Fed's lending and asset purchase programs, but non-agency, credit risk transfer (CRT), and legacy MBS continue without any such support, making them vulnerable to further adverse developments. While spreads in the space have tightened closer to comparable credits, we continue to view non-agency and CRT MBS notes as providing attractive carry and potential for further spread tightening given favorable technicals. We also see value in the single-family rental ("SFR") sector, which offers exposure to the lower-tier housing market, a segment that is experiencing relatively better price appreciation.

## COMMERCIAL MORTGAGE-BACKED SECURITIES (CMBS)

Issuance reached $58 billion in 3Q 2020 vs. $65 billion in 3Q 2019. The retail and hotel sectors, hit hard by the effects of COVID-19, saw some mixed improvement. Hotel revenues per available room gradually improved, though economy and limited service hotels fared better than luxury hotels and those relying on tourism or business travel. In retail, performance varied between open air centers, which improved, and indoor malls, which continued to struggle. Even here, performance among malls depended on location. In the South, malls generally experienced better results than those in the Northeast and West Coast. Although the rate of COVID-19 infections moderated over the quarter allowing for local economies to reopen further, a recent spike in new cases once again raises the risk of negative impact to these sectors.

The Fed's lending and asset purchase programs for the agency CMBS market and the TALF 2.0 lending programs for the asset-backed securities (ABS) and non-agency CMBS secondary markets remain in effect. Although their direct impact appears limited, these support mechanisms provide markets with some confidence. CMBS conduits from AAA to single-A credit continue to offer relative value at current levels. We are constructive but selective in the single-A segment of the capital structure, where we see attractive relative value to comparable corporates (see Figure 3). We also favor deals exposed to industrial and life sciences, as well as single asset single borrower (SASB) deals backed by trophy assets.

**Figure 3** Cross-Sector Spreads
As of 10/2/2020




Source: BofA Merrill Lynch Global Research

## ABS

Total ABS issuance came to nearly $61 billion in 3Q 2020 compared to $55 billion in 3Q 2019. Performance for the quarter was positive for most ABS sectors, with down-in-credit tranches generally outperforming senior tranches. We see attractive value in BBB/BB subprime auto bonds by top tier issuers with enough credit enhancement to withstand potential shocks. We expect such credits to benefit from a nascent cyclical recovery of the auto market, a secular shift back to car transportation, and rising used car prices, which would indicate higher recovery values.

## COLLATERALIZED LOAN OBLIGATION (CLO)

U.S. CLO supply summed to $25 billion in 3Q 2020, the same level issued over 3Q 2019. Quarterly performance was mostly positive across the sector, with BB classes outperforming on average. Performance varied based upon the ability of collateral managers to navigate the challenges of this year. Senior AAA tranches offer relative value, but risk abounds lower down the capital structure. This remains a highly-levered sector exposed to borrowers with fundamental credit weakness in a time of continued uncertainty.

## INTERNATIONAL RMBS

U.K. and European RMBS saw a resurgence of new issuance over the quarter, with distributed volume of more than EUR 3.7 billion. This brought the year-to-date total to EUR 37.1 billion, narrowing the gap versus 2019 year to date to -28%. Although European countries appear to have been relatively more effective in containing COVID-19, the region has recently seen a noticeable increase in infections. Credit performance of U.K. and peripheral European mortgages generally improved over the quarter supported by declining delinquencies and low default rates. However, we recognize that a new wave of increases in COVID infections will bring further challenges to the European economy. Various forbearance and stimulus measures implemented throughout the region should help borrowers to muddle through the adversity. We continue to closely monitor the situation and reassess both the fundamentals and valuations as more information becomes available.

# Global High Yield & Leveraged Loans

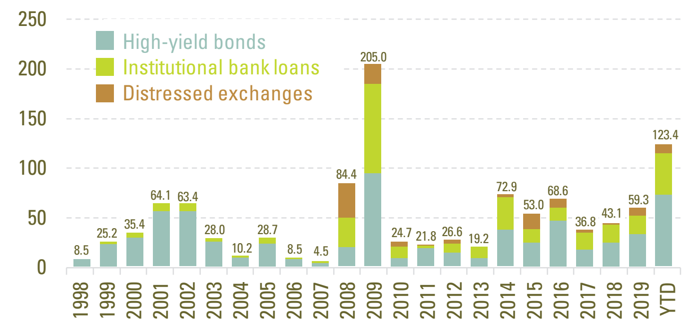
The ICE BAML US HY Index returned 4.7% in the third quarter, including a 1% drawdown in September, as sentiment around a COVID vaccine waned, Congress failed to pass another round of fiscal stimulus, and election uncertainty weighed on risk assets. The leisure, transportation, automotive as well as cyclical sectors, such as basic industries and capital goods, posted the strongest performance in the quarter despite a tough September. The lower quality segment of the index outperformed during the quarter. Energy is still lagging with oil failing to stage a meaningful rally beyond $40/bbl WTI due to a lack of clarity around demand, mostly stemming from greatly reduced airline travel.

During the third quarter 26 companies defaulted, or $19.3 billion par value including distressed exchanges, versus 51 companies in the second quarter, or $80.3 billion par value including distressed exchanges, using JPMorgan data. Default volumes decreased significantly in July and September compared to the March through June period (Figure 4). As of the end of the third quarter, the CS leverage loan default rate stands at 3.6%, driven by retail and energy. Loan recovery rates of 44% are low versus history but similar to the low experienced in 2016 and above the 39% rate experienced during the Global Financial Crisis.

The Euro high yield market has thus far experienced a lower default rate than the U.S. and Sterling markets, but distress ratios remain elevated versus pre-COVID levels within the Euro segment. The European Central Bank (ECB) remains supportive and has been voicing concerns over persistently low inflation and the impact of COVID-19 lockdowns. The potential for continuation of the ECB's PEPP (Pandemic Emergency Purchase Programme) and CSPP (Corporate Sector Purchas Programme) should help to put a ceiling on credit spreads while spurring a continued reach for yield.

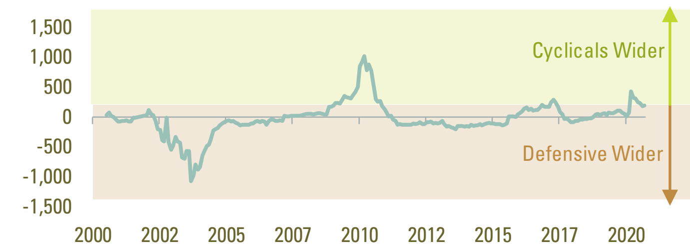
The monetary ingredients are in place with global central banks willing to help finance massive fiscal responses to the COVID crisis. We continue to favor pro-cyclical sectors, such as metals and mining, that experienced a supply rationalization during lockdowns and present more attractive valuations (Figure 5), remaining mindful of working capital needs as inventories are rebuilt. Our outlook is cautiously optimistic and focused on credits with substantial access to liquidity and few short-term financing needs to weather prolonged economic uncertainty and lack of clarity on a vaccine.

**Figure 4** JPMorgan Default Monitor
Default Volume, $Billions, As of 10/1/2020




Source: JPMorgan

**Figure 5** High Yield - Cyclicals Less Defensive - OAS
As of 9/30/2020




Source: ICE/BAML

# Emerging Markets

The pandemic has blown the global economy into an unfamiliar place. Government budget deficits have mushroomed; public debt ratios have surged in both developed and emerging markets. The Organization for Economic Cooperation and Development (OECD) projects debt ratios 18 percentage points higher, on average, across the organization. This forecast could rise to 26%, depending on the fiscal response to a second viral wave. Many EM central banks have reduced nominal policy rates to all-time lows and are negative on an inflation-adjusted basis. Fixed income emerging markets have been strong despite budget and monetary conditions that might have triggered a stampede out of them 10 or 20 years ago. This is partly due to local banks soaking up much of the supply of local debt issuance as well as purchases from central banks in some EM countries. As we head into the final quarter of 2020, we continue to weigh signs of economic activity recovery, COVID vaccines/treatments, government response to increasing COVID cases, and valuations across EM.

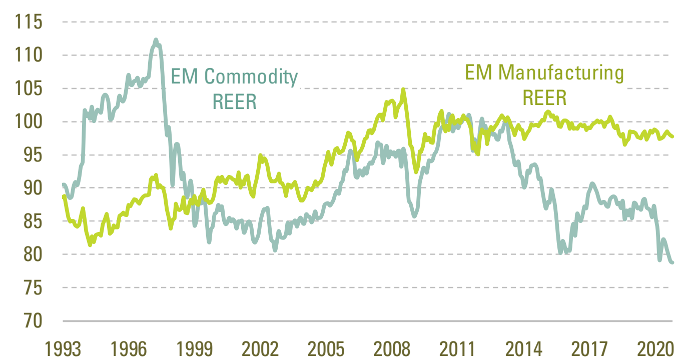
## CORPORATE

The J.P. Morgan CEMBI Broad Diversified Index returned 2.75% for the quarter and 2.58% year to date. On a quality basis, investment grade and high yield returned 2.63% and 2.90% during the quarter, respectively. Year to date, investment grade is up 4.61% while the high yield index is up slightly at 0.16%. The yield-to-worst on the index rallied 71bps (basis points) during the quarter to finish at 4.00% while spreads tightened about 70 bps to 346 bps. Primary markets printed $140 billion during the quarter with $100 billion coming from Asia. Valuations in the CEMBI universe are broadly fair at this point with spreads appearing attractive while yields are at or near all-time lows. This leaves returns going forward likely in the mid-single digits. We believe there are still some opportunities in banking and cyclical industries that would benefit from global recovery. Energy sector remains wide given challenges in the oil market; however, some oil related quasi-sovereign curves appear attractive as well as some lower leveraged oil companies with track records of managing through the cycle. Finally, the transport sector remains wide and has experienced several bankruptcies this year, but there are a few select opportunities. Despite the global macro shock felt this year, emerging corporate high yield default rates have been well-behaved at 2.7%.

## SOVEREIGN

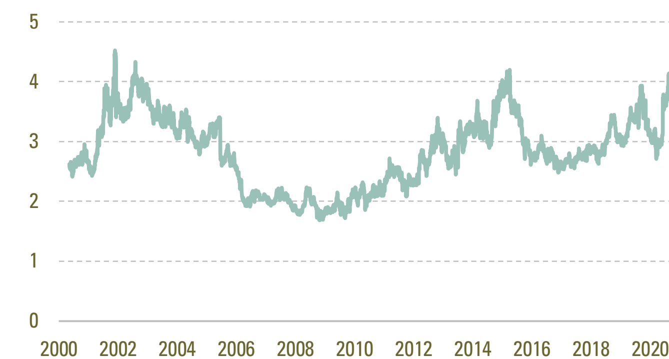
JPM GBI-EM Global Diversified Index and the hard currency J.P. Morgan EMBI Global Diversified Index returned 0.61% and 2.32% during the quarter and are now -6.32% and -0.51% year to date. The price and interest components of local emerging market index have returned close to 5.5% this year with the nominal yield of the GBI-EM Diversified Index falling to all-time lows this August, although the currency component of the index remains down -11% year-to-date. As an asset class, emerging market currencies display one of the largest price anomalies relative to traditional metrics such as real effective exchange rate (see Figure 6), especially the commodity-oriented countries. However, they have not gained much traction, which in some ways speaks to the broader macro outlook. Global growth is picking up but a sense of strength to the expansion is not there yet. Two near-term catalysts that could clear up some uncertainty are the U.S. elections and a stimulus package. Another lingering question, mostly in lower-quality hard-currency markets and to an extent across a few local-currency sovereign markets, is debt sustainability. While there has been some debt relief provided to lower income countries via the DSSI program, the drop in GDP coupled with large fiscal deficits this year and possibly next has resulted in sizable increases in the debt/GDP and interest costs as a percent of revenue metrics. In hard-currency markets, this is likely one of the reasons why the ratio of spreads between EMBI IG and HY remain very wide. Valuation opportunity appears attractive in EMBI HY; the question around debt sustainability risks could outweigh apparent degree of cheapness in some cases (see Figure 7).

**Figure 6** EM REER Commodity Producers and Manufacturers
As of 10/14/2020




Source: J.P. Morgan

**Figure 7** Ratio of EMBI HY/EMBI IG Spread
As of 10/14/2020




Source: J.P. Morgan

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Qualifying securities must have an investment grade rating (based on an average of Moody's, S&P, and Fitch), at least 18 months to final maturity at the time of issuance, at least one year remaining term to final maturity as of the rebalancing date, and a fixed coupon schedule. The ICE BAML AA Global Corporate Index is a subset of the ICE BAML Global Corporate Index, including all securities rated AA1 through AA3, inclusive. The ICE BAML Single-A Global Corporate Index is a subset of the ICE BAML Global Corporate Index, including all securities rated A1 through A3, inclusive. The ICE BAML BBB Global Corporate Index is a subset of The ICE BAML Global Corporate Index, including all securities rated BBB1 through BBB3, inclusive. The ICE BAML U.S. Corporate Index tracks the performance of U.S. dollar-denominated investment grade corporate debt publicly issued in the U.S. domestic market. Qualifying securities must have an investment grade rating (based on an average of Moody's, S&P, and Fitch), at least 18 months to final maturity at the time of issuance, at least one year remaining term to final maturity as of the rebalancing date, a fixed coupon schedule, and a minimum amount outstanding of $250 million. The ICE BAML Global High Yield Index tracks the performance of USD-, CAD-, GBP-, and EUR-denominated below investment grade corporate debt publicly issued in the major domestic or eurobond markets. The ICE BAML BB Global High Yield Index is a subset of the ICE BAML Global High Yield Index, including all securities rated BB1 through BB3, inclusive. The ICE BAML Single-B Global High Yield Index is a subset of The ICE BAML Global High Yield Index, including all securities rated B1 through B3, inclusive. The ICE BAML CCC & Lower Global High Yield Index is a subset of The ICE BAML Global High Yield Index, including all securities rated CCC1 or lower. The ICE BAML U.S. High Yield Index tracks the performance of USD-denominated below investment grade corporate debt publicly issued in the major U.S. markets. The ICE BAML European High Yield index tracks the performance of below-investment grade corporate bonds publicly issued in Europe. The Credit Suisse Leveraged Loan Index tracks the investable market of the U.S. dollar-denominated leveraged loan market. It consists of issues rated "5B" or lower, meaning that the highest-rated issues included in this index are Moody's/S&P ratings of Baa1/BB+ or Ba1/BBB+. All loans are funded term loans with a tenor of at least one year and are made by issuers domiciled in developed countries. The ICE BAML U.S. Mortgage-Backed Securities Index tracks the performance of U.S. dollar-denominated fixed rate and hybrid residential mortgage pass-through securities publicly issued by U.S. agencies in the U.S. domestic market. The ICE BAML U.S. Fixed Rate CMBS Index tracks the performance of U.S. dollar-denominated investment grade fixed rate commercial mortgage-backed securities publicly issued in the U.S. domestic market. The JP Morgan Corporate Emerging Market Bond Index (CEMBI) Broad is a global, liquid corporate emerging markets benchmark that tracks U.S. denominated corporate bonds issued by emerging markets entities. The JPM EM Bond Index Global Diversified is composed of U.S. dollar-denominated Brady bonds, eurobonds, traded loans, and local market debt instruments issued by sovereign and quasi-sovereign entities. The JPM Government Bond Index-Emerging Markets (GBI-EM) Broad Diversified is a comprehensive emerging market debt benchmark that tracks local currency bonds issued by emerging market governments. The unique diversification scheme ensures that weights among the index countries are more evenly distributed by reducing the weight of large countries and redistributing the excess to the smaller-weighted countries with a maximum weight per country of 10%. All data current as of the date at the top of the page unless otherwise noted. This information should not be considered a solicitation or an offer to provide any Brandywine Global service in any jurisdiction where it would be unlawful to do so under the laws of that jurisdiction. Past performance is no guarantee of future results.

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