CREDIT REPORT

January

Highlights

ECB maintaining its accommodative stance and Italy's political turbulence.

U.S. treasuries surpassing the 1 per cent barrier.

Corporate credit commence 2021 mixed.

Credit spread tightening at the low-end of the credit rating spectrum.

Sectors proving more vulnerable at the peak of the pandemic continue to outperform.

Introduction

Consequent to the unprecedented coronavirus pandemic which infected over 100 million people and led to 2.2 million deaths worldwide, 2020 was a year of extraordinary challenges.

Despite a concerted effort by governments and central banks to mitigate the impact on the economy, through substantial monetary and fiscal stimulus packages, the global economy (as estimated by the International Monetary Fund) contracted by 3.50 per cent.

Corporate credit, hindered at the peak of the pandemic by growing concerns about their ability to service debt, recovered. Credit spreads previously witnessing substantial widening (reaching significant highs of over 1000bps), tightened, with both investment grade and high yield issuers delivering strong, positive total returns. U.S. investment grade and EM high yield outperformed their European counterparts.

2021 started on a somewhat positive note as the vaccine roll-out initiated. Nevertheless, investors were concerned as the number of reported coronavirus cases continued to rise, following both the festive period and due to the newly emerging virus variants which posed the risk of more contagious strains. Consequent to the said increase in coronavirus infections, governments extended and/or intensified measures to mitigate the spread.

In January, manufacturing continued to show resilience, outperforming the services sector - a theme which we've been witnessing since the start of the pandemic inflicted restrictions.

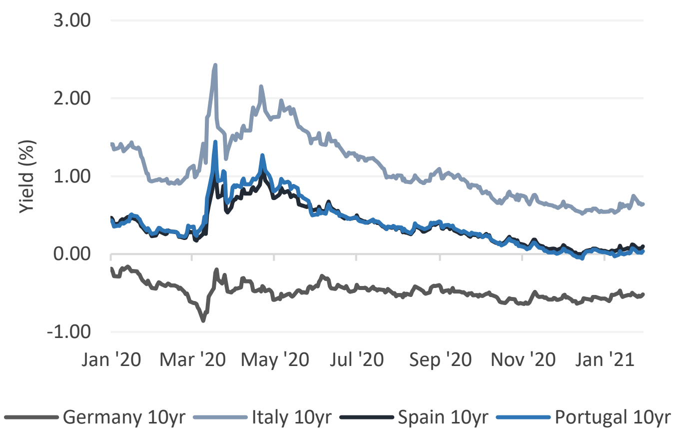
Despite a higher than average savings rate, the trend is now significantly downwards, as businesses and consumers have now better visibility over a return to normality, particularly with a vaccine roll-out underway.

Sovereign Yields

Euro Area: As the ECB maintained is accommodative stance at the end of 2020, bond yields, particularly of sovereigns within the bloc's 'periphery' - those which offer a premium over Germany's deeply negative-yielding debt, saw significant declines. The low yielding environment, at levels below the zero per cent mark, was sustained, as coronavirus restrictions and a relatively slow vaccine roll-out dominated the headlines.

Also denting sentiment was the political turbulence in Italy, which led to Prime Minister Giuseppe Conte's resignation. Giuseppe Conte's 16-month-old government was brought to an end following disputes within the governing alliance, namely with former Prime Minister Matteo Renzi who withdrew his party from the ruling coalition over the post-pandemic economic recovery package.

The risk premium on Italian debt - the gap between Italy's 10-year and Germany's benchmark 10-year bond yield, rose to its highest since November 2020.



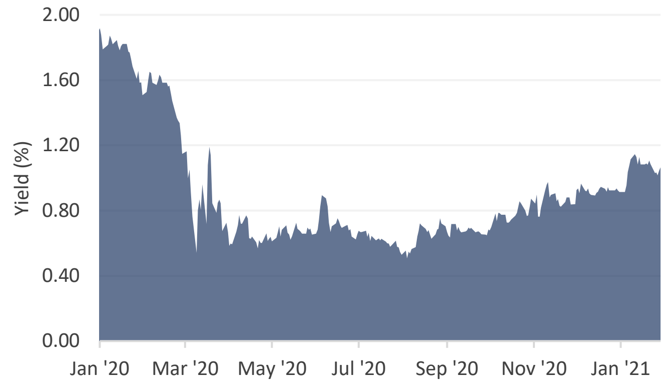
Source: Calamatta Cuschieri Investment Management

Figure 1: Benchmark 10-year European Sovereign Yields (YTD)

Europe's mostly sought benchmark; the 10-year German Bund, closed higher than the previous month at -0.52 per cent. Similarly, Italy's 10-year sovereign yield closed the month 10bps higher at 0.64 per cent.

U.S.: For the first time since the pandemic-driven turmoil in March, U.S. treasury yields, which move inversely to price, broke the 1 per cent barrier. The sell-off began as the Democrats came closer to securing control of the U.S. senate, paving the way for more fiscal spending to revive the U.S. economy.

Positive economic data, notably; Q4 GDP growth, a decline in weekly jobless benefits, and an increase in real disposable income, increased optimism.



Source: Calamatta Cuschieri Investment Management

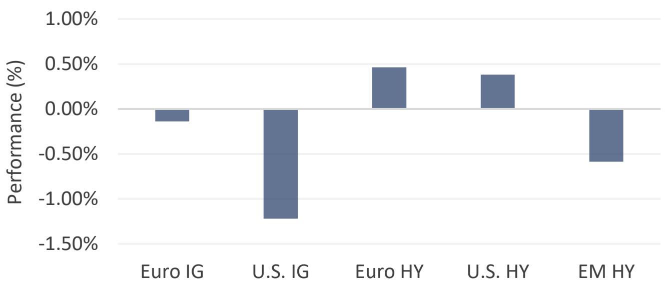
Figure 2: Benchmark 10-year U.S. Treasury yield

The U.S. 10-year benchmark Treasury yield closed the month 15.23bps higher at 1.07 per cent, as reflationary pressures kicked-in.

Corporate Credit Market

Albeit the turbulent year, primarily due to the unprecedented health crisis and subsequent disruptions, corporate credit performed well, recuperating the losses incurred during a depressed Q1 2020. Monetary intervention by respective central banks allowed corporates to tap the primary market at low favourable rates while fiscal intervention by governments allowed corporates to maintain their cash buffers and ultimately survive. The improvement in macroeconomic conditions along with coronavirus vaccine developments triggered a risk-on mode.

Corporate credit commenced 2021 mixed. Corporates within the investment grade space (the highest quality bonds as determined by credit rating agencies) inched lower. Investment grade names were conditioned by the upward move in benchmark yields, namely in the U.S., while high yield issuers (more speculative bonds with a credit rating below the investment grade tranche) except for EM high yield – conditioned by the lingering uncertainty surrounding the pandemic and vaccination programmes, generated moderate positive returns.



Source: ICE BofA Indices, Calamatta Cuschieri Investment Management

Figure 3: Corporate Credit Performance

For the first month of 2021, European and U.S. high yield names, returned 0.46% and 0.383% respectively.

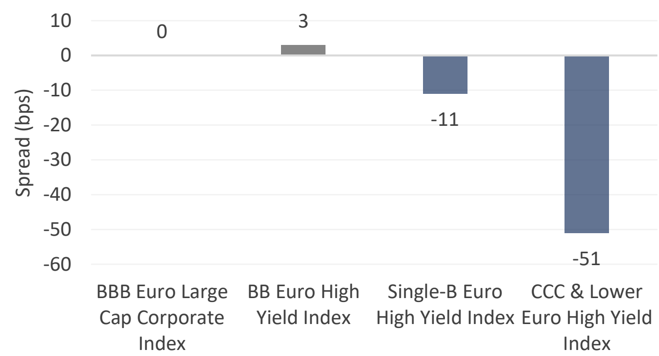
Credit Rating Implications

Although doubts surrounding the health crisis persisted, particularly as the number of coronavirus cases surged and resulted in renewed lockdown measures, spreads of corporate credit at the lower end of the spectrum continued to tighten. The fetch for yield which ultimately reflected in more spread tightening was comforted by the notion of loose monetary policy, increased fiscal stimulus, and a resumption to normality possibly in the near and not distant future.

Euro IG (BBB) and HY: After a resilient fourth quarter, during which spreads of corporate credit (across all credit rating buckets) tightened, January came in mixed.

Contrasting the low-end of the credit rating spectrum, which realized substantial tightening, European names within the investment grade space, albeit minimal, widened. Spread tightening, particularly across the more speculative rating buckets ('Single-B' and below) was observed, possibly as investors intensified their search for yield.

Notably, issuers falling within the 'CCC and lower rating bucket' witnessed tightening of 51bps.

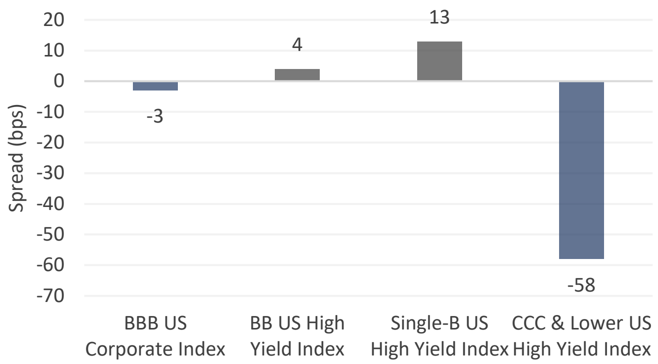


Source: ICE BofA Indices, Calamatta Cuschieri Investment Management

Figure 4: European IG (BBB) and HY credit spreads

U.S. IG (BBB) and HY: Like European investment grade and high yield, the performance of U.S. corporates, following a positive Q4, was mixed, with names at the very low-end of the spectrum, outperforming.

Corporate issuers falling within the 'CCC and lower rating bucket' witnessed tightening of 58bps.

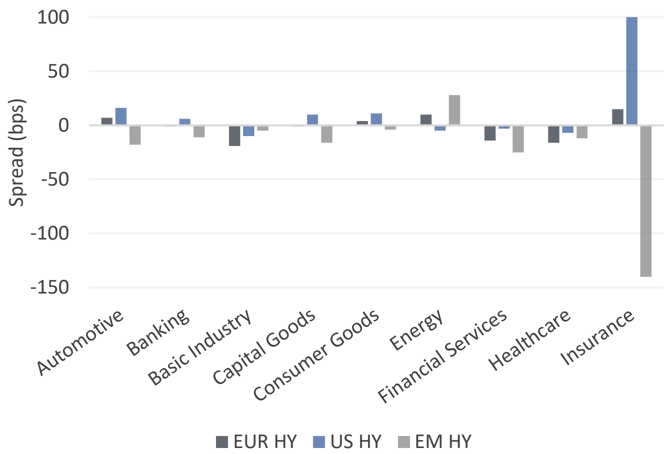


Source: ICE BofA Indices, Calamatta Cuschieri Investment Management

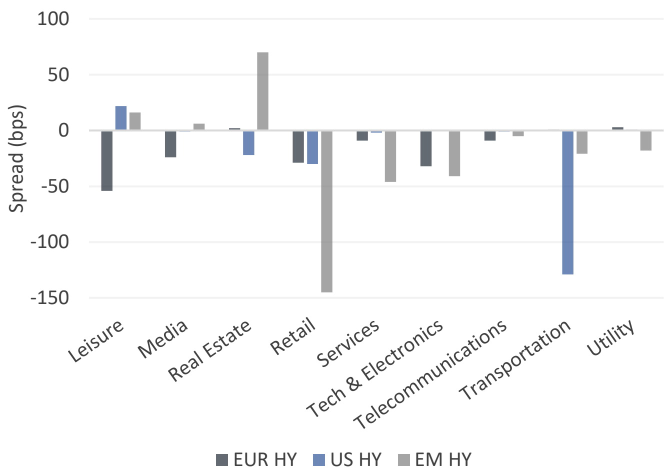
Figure 5: U.S. IG (BBB) and HY credit spreads

Sector Implications

In January the sectors proving more vulnerable at the peak of the pandemic continued to outperform, with retail, transportation and basic industry, witnessing tightening, the latter to a lesser extent.



Source: ICE BofA Indices, Calamatta Cuschieri Investment Management



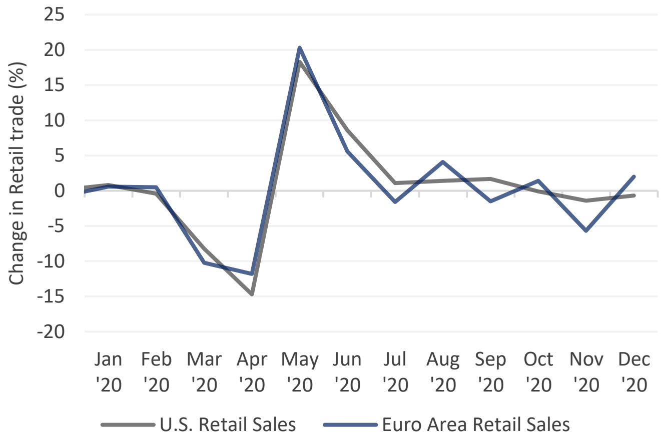
Source: ICE BofA Indices, Calamatta Cuschieri Investment Management

Figure 6 & 7: Q4 Sectorial Analysis – European, U.S., and Emerging Markets

Retail, Transportation, and Basic Industry

Retail: While the manufacturing sector showed remarkable resilience during a year characterised by movement restrictions and thus social disruption, services – reliant on direct contact, suffered.

Retail sales, albeit showing signs of improvement when social distancing measures were lifted have largely remained depressed.



Source: U.S. Census Bureau and EUROSTAT

Figure 8: U.S and Euro area MoM change in retail sales

With the ongoing vaccination drive, retail – a contact intensive service sector is expected to witness a revival. Savings rate, which has largely remained elevated during the course of the ongoing health crisis shall further bode well for the retail sector.

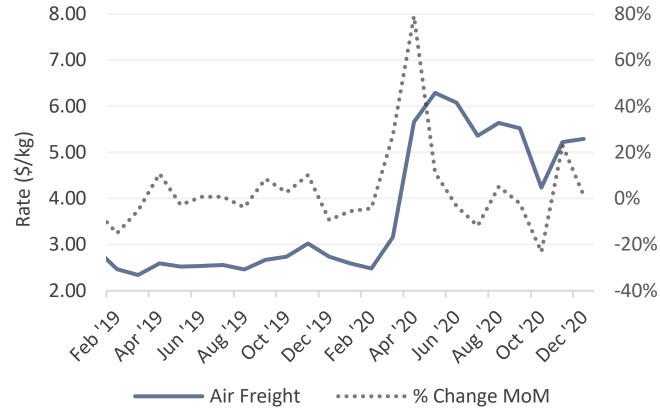
U.S., European, and EM high yield names within the retail sector witnessed spread tightening in January. EM issuers outperformed with credit spread tightening of 145bps.

Transportation: Although initially depressed, efforts made by issuers within the transportation sector, in terms of capacity management, cost reduction and other sorts of operational decisions, allowed them to survive.

With lockdowns introduced largely across all geographic regions, the world of travel was brought to a halt. Airlines undoubtedly struggled. However, an improvement in industry metrics, such as airlines' 'load factor' - an indicator that measures the percentage of available seating capacity that is filled with passengers, instilled optimism, leading to credit spread tightening. With the coronavirus vaccination now taking centre stage, further tightening is expected.

Capacity management through blanked sailings and then a surge in demand for shipments - consequent to improved macroeconomic conditions and an e-commerce boom, both led to supply chain disruptions (mainly due to container shortages rather than an underinvestment by shipping conglomerates). This is turn emerged as a catalyst for shipping conglomerates to register a positive year.

Similarly, for logistic firms a strong demand from e-commerce allowed them to partially offset for the coronavirus impact. Air-freight – the amount paid by forwarders to airlines for standard airport-to-airport airfreight services, witnessed significant increases.

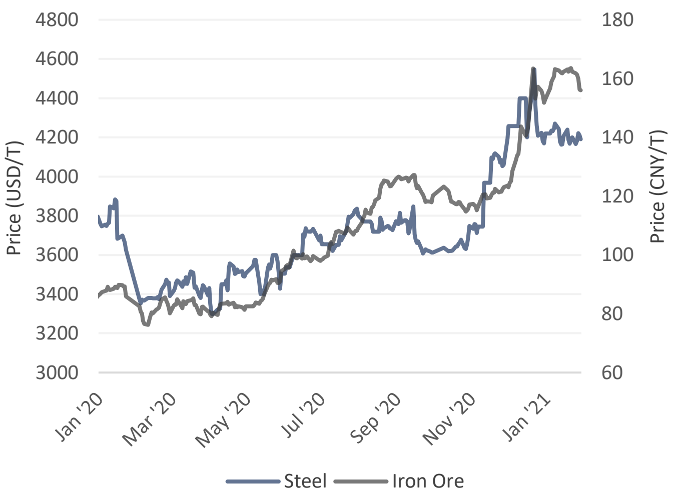


Source: Drewry Shipping Consultants, Calamatta Cuschieri Investment Management

Figure 9: Weighted average of all-in airfreight buy rates paid by forwarders to airlines for standard deferred airport-to-airport airfreight services

In January, U.S. high yield names within the transportation sector recorded credit spread tightening of 129 bps.

Basic Industry: Increased demand from China's thriving economy and infrastructural investment by governments to instil economic growth led to a significant increase in demand and thus price increases for industrial metals. Undoubtedly, companies within the sector benefitted.



Source: Calamatta Cuschieri Investment Management

Figure 10: Uptick in price of Industrial Metals following a surge in demand

Following substantial credit spread tightening in the last 9 months of 2020, Basic Materials in January have remained largely flat, to the upside. European, U.S., and EM high yield names within the basic materials sector recorded credit spread tightening of 19, 10, and 5 bps, respectively.

Credit Outlook

Central bank monetary intervention and government-led economic stimulus measures have in 2020 proved instrumental to safeguard the corporate credit market.

We believe that central banks will be keen not to disrupt the economic recovery we have witnessed in 2H 2020, by maintaining an accommodative stance throughout H1 2021, and possibly beyond, depending on economic data. Additionally, governments shall prove supportive through both fiscal incentives and infrastructural investments, which are imperative, to speed up an economic recovery. While the latter shall prove supportive and possibly lay the foundation for a quicker economic recovery, coronavirus immunisation is crucial to instil confidence in both consumer and business sentiment.

Going forward, we believe that the downward reversal in yields, envisaged in recent months, shall continue to prevail through 2021. We are less constructive on government bonds given possible inflationary threats, which may ultimately also disrupt the investment grade space. Given the lower sensitivity to benchmark yields, we are more constructive on the more speculative tranche: the high yield space, also based on an improved economic outlook. The latter is supportive for the high yield space. As corporate profits improve, companies shall register an improvement in credit metrics.

Lastly, we affirm our position on coronavirus-sensitive sectors, which we believe shall continue to outperform in 2021, should the vaccination drive offset the threat of the coronavirus variants, which are seemingly leading to the increased number of cases.