JOHCM GLOBAL INCOME BUILDER FUND

GLOBAL VALUE AND INCOME DISPATCH

13 MARCH 2020

Lale Topcuoglu, Senior Fund Manager & Head of Credit

Don't be like Alice – have a plan!
Stick to your investment process and revisit your shopping list

"If you don't know where you're going, any road will get you there"

"Would you tell me, please, which way I ought to go from here?"
"That depends a good deal on where you want to get to," said the Cat.
"I don't much care where," said Alice.
"Then it doesn't matter which way you go," said the Cat.

(from Lewis Carroll's 'Alice in Wonderland')

Dislocations and market volatility create opportunities for those who are patient. We have been patient for most of the last few months as we continued to find valuations both in equities and credit expensive. As a result, our cash, Treasury and short-dated corporate holdings (which we define as "buying power") continued to increase to mid-teens percentage weights. We are now finding more value in equities and selectively deploying capital while awaiting a better entry point for high yield.

Below are some FAQs that we have received this week and our thoughts.

Q: Is it like 2008?

No. Unlike 2008, we don't see this as a funding crisis. The Federal Reserve is increasingly providing a backstop to ensure that the funding (i.e. Repo) markets operate smoothly. And there is certainly much more urgency to respond in a timely manner, which was not the case in 2008. But low volatility is a common theme between now and then. Given the change in the market structure with the growth of ETFs, quant-driven investing strategies and the overall size of the debt markets in the face of shrinking dealer balance sheets, it is no time to be complacent.

As we mentioned in our first Active Intelligence podcast, "The upside down world of credit markets" in October 2019, back in 2008 the plumbing was perhaps too thin for the house we had built. The markets will always be creative in supplying the type of solution that investors demand. Yield-chasing behavior has led to dramatic growth in asset classes.

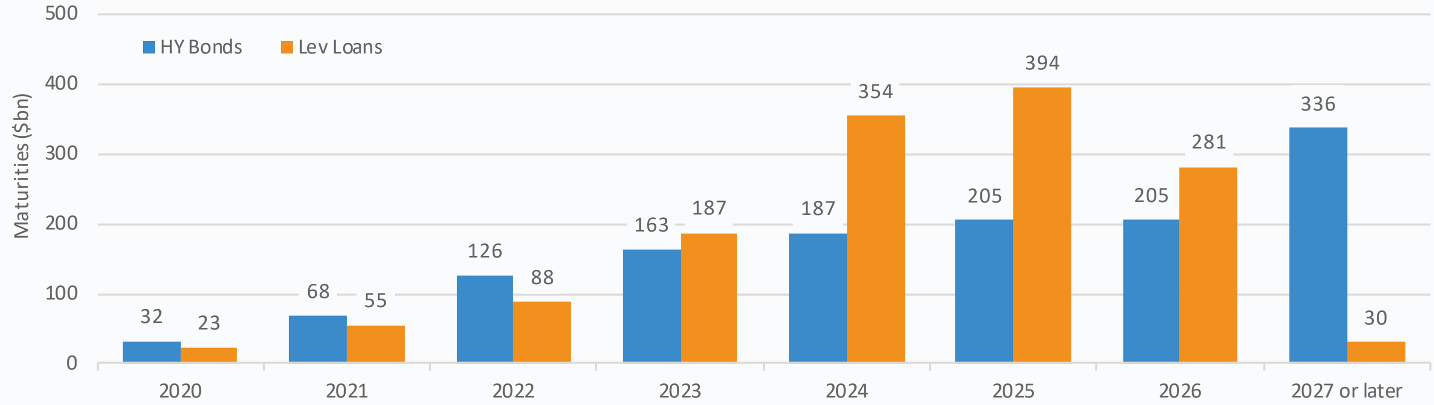
Private markets, which have virtually zero secondary market liquidity, have mushroomed to nearly US$1 trillion. ETFs and passive mutual funds worldwide represent nearly US$8 trillion of AUM, while daily liquid mutual funds that invest in credit stand at about US$1.1 trillion between US and Europe. The challenge is the mechanism where risk is transferred from one party to another is still done by the dealers. That has not changed. In fact, due to strict regulatory requirements around capital that is effectively designed to avoid a bank run, the dealer inventory which facilitates this transfer mechanism has shrunk to ~US$60 billion of inventory against trillions of dollars of assets. Put differently, prior to the GFC dealers had two functions: the first was to facilitate risk transfer, i.e. be a dealer; the second was to warehouse risk so at times of stress they could use their balance sheet to absorb some of the shock. In the new regime, dealers are just agents matching buyers and sellers.

Unlike 2008, when money market funds and banks could not value the underlying securities, we may find out what assets may have been overpriced. In the previous cycle, it was a combination of leverage and dubious asset pricing that got the system into trouble. This time around it may be the search for liquidity.

Q: what are the differences vs. 2008 for the credit markets?

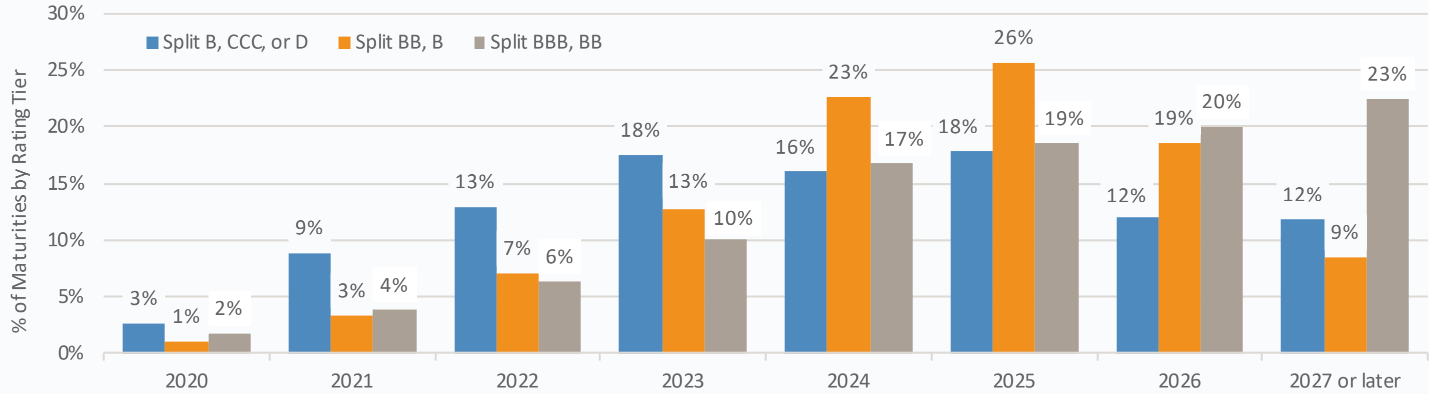
1. The high yield market's maturity profile is much better this time, with near term funding only needed for the companies that already have a balance sheet issue or a refinancing possibility due to M&A. There are no large debt financing commitments overburdening the banks' balance sheets.

US HY and leverage loan maturity profile by amount outstanding



Source: JP Morgan Research.

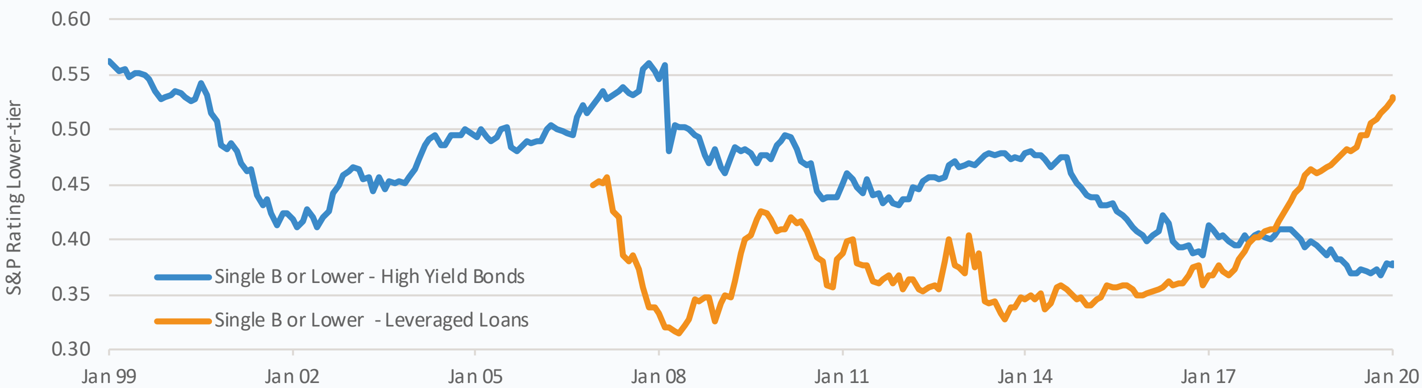
US HY and leverage loan maturity profile by rating



Source: JP Morgan Research.

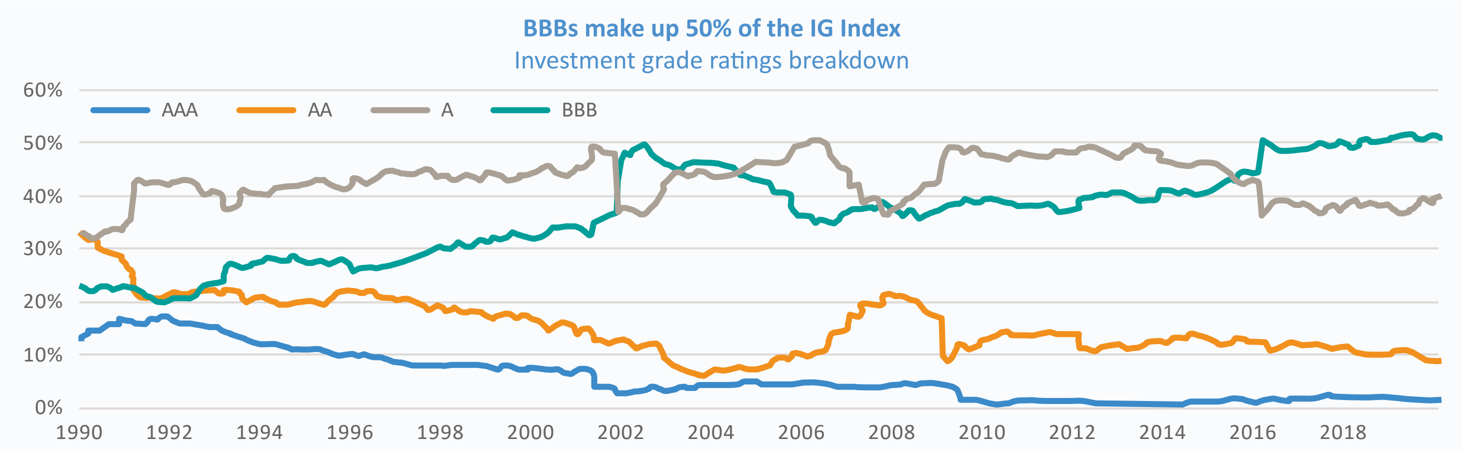
2. Bank loans will be in the hot seat due to notable rating deterioration. In 2008, it was the supply (i.e. committed LBO deals) that pressured the market along with the economic slowdown. With the growth of CLOs and the cheap financing available, the credit quality deterioration is notable in the loans market relative to the HY bond market. The growth in single B-rated loans matters greatly for the CLOs. Many of the CLOs own as much as 25% in B-rated debt, which, if downgraded to CCC, will pressure their tests, specifically the maximum CCC ownership limits and the consequent negative impact on the OC (Over collateralization) ratios. As a reference point, CLOs represent ~51% of the US$1.25 trillion leveraged loan market.

Leverage profile has deteriorated in the leveraged loan market relative to HY



Source: JP Morgan Research.

3. Investment grade: back in 2008, the index was heavily weighted toward financials and insurance – financials represented 43.2% of the index at 2006 year end vs. 18.5% today. What changed, however, is the credit quality of the index. Nearly 50% of the US investment grade index is BBB-rated. Furthermore, with cheap financing, the absolute amount of debt outstanding is staggering. For instance, the largest BBB issuer, AT&T, has US$188bn in total debt, followed by VZ, with US$133bn, and Anheuser-Bush InBev, coming in third with US$103 billion in total debt.
   - ~20% of the BBBs have >4x gross leverage
   - ~1/4 of BBB-rated issuers have total (bond) debt that would place them among the top 50 high yield issuers
   - Overall, the BBB market is 4.8x larger than the BB market



Source: Morgan Stanley Research, FTSE Fixed Income.

4. The game of hot potato: post the GFC, leverage has moved from households and banks to government, corporates and shadow/ private lending. As per JP Morgan's view, there could be a notable fallen angel risk stemming from sovereigns:
   - Post-GFC, downgrades increased the share of BBB-rated sovereigns to 15% of global GDP versus 8% in 2007, since no major developed market country carried a BBB rating in 2007. Italy now accounts for 40% of the total BBB-rated sovereign debt universe.
   - EM sovereigns have already re-rated lower since 2012, with some of the largest EM countries (Brazil, Russia, Turkey and South Africa) downgraded to the BB range during 2014-2018, while the number of B-rated sovereigns is now more than double the number of BBB-rated sovereigns at 31% of all rated sovereigns. (Source: JP Morgan).

Q: What can the Fed do? Can the Fed buy other assets such as equities or corporate bonds?

Unlike the ECB, the Fed can only buy Treasuries, agency debt, foreign sovereign debt and mortgage-backed securities. To do anything differently, it would have to seek approval from Congress. Frankly, as a former Fed official recently said, the Fed didn't pursue this avenue in 2008 when the banking system was melting away. To pursue it right now would be an uphill battle.

The Fed responded proactively on 15 March to ensure smooth operation of the funding markets. Announced measures included: a) a 100bp rate cut; b) an increase in bond purchases by US$700bn (split US$500bn Treasuries / US$200bn MBS); c) reduced reserve requirements for banks as well as letting banks borrow at the discount window for up to 90 days; and d) a 25bp lower rate on US dollar liquidity swap arrangements in coordination with five major foreign central banks. These measures were taken to ensure that the Treasury and the mortgage-backed securities markets function smoothly and safeguard US dollar availability to foreign central banks.

The challenge is that the crisis created by covid-19 will pressure earnings for many companies. This could then lead to lay-offs, reduced work hours or missed pay-rolls, which will not be solved entirely by rate cuts. In other words, monetary policy can soften the blow to the economy and the consumer a bit. But it won't be able to solve it entirely, as it is not a debt problem as was the case in 2008. The Fed's tools are limited in its capacity to target specific groups that are severely affected by the economic slowdown. Fiscal policy, however, can complement the monetary measures already taken by the Fed to limit the economic downside.

Q: Do you think the Fed saw this rout coming and that's why it cut rates?

No. We have very smart folks at the Fed but they don't have a crystal ball.

Q: Does this resemble the 2015/2016 energy sell-off?

The moves in energy credit spreads and energy stocks certainly resemble that sell-off. The difference perhaps coming into this sell-off was that most high yield and bank loan fund managers were not overweight energy, so the surprise element was less. Nonetheless, energy bonds moving 15 to 50pts lower is a notable pain and forces managers to manage their exposures. There are also other similarities, as well as differences.

1. China's currency devaluation in August 2015 and the EM pressure started to weigh on expectations of slower growth. Brazil was downgraded to high yield status in September 2015. We see similar slow growth pressure today.
2. In the US, the market was concerned about a Fed policy mistake after it raised rates in December 2015 in the midst of worries about slower growth coming from China and wider EM. Today, it's the opposite. Central banks around the world continue to follow an accommodative monetary policy.
3. In the midst of this sell-off something to watch out for are idiosyncratic stories unfolding as capital is withdrawn from high yield companies. In 2015, these were Valeant and Sprint (the latter being the largest high yield issuer at the time and which was downgraded to CCC), followed by concerns around the European banks, particularly Deutsche Bank and Intesa Sanpaolo. We have not seen that play out yet. That said, the longer markets remain shut, the more exposed weaker corporates that have gorged on cheap funding and been irresponsible with capital allocation and leverage will become.
4. HY spreads continued their widening path (445bp in March 2015 to 887bp in February 2016) until February 2016 when OPEC cut production and central banks, particularly the ECB, launched aggressive accommodation policy. At this point, we don't know if OPEC and Russia can come to an agreement to calm the markets.

Q: What has surprised you the most?

The speed of the sell-off has been the most surprising. When you go into an economic slowdown, it is very reasonable to expect spread widening as risk premium increases. However, the speed of the widening was shocking. On Monday 9 March, the US HY index closed @668bp (308bp wider YTD). A 104bp widening of spreads was the third-largest single day move since 1998 (after 9 October 2008's 145bp and 10 September 2001's 119bp widening). The energy sell-off was violent as bonds moved down 15 to 40 pts lower, with HY energy spreads moving 333bp on the day (nearly 4x the worst daily move we witnessed during 2015/16 energy sell-off).

Q: Are you concerned about BBB downgrade risk?

This is where approaches by company management teams will be critical. In 2018, the more levered BBB companies found religion and aggressively focused on debt reduction. In 2019, however, as investors reached for yield and pushed BBB spreads notably tighter, some management teams became more relaxed about their debt reduction plans and instead increased share buy-backs and dividends. This reset in valuations could actually be a positive catalyst in reminding managements that putting your ratings at risk is not an ideal option.

Q: What should you be watching for additional signs of stress?

An investor can hypothesize about potential earnings and what multiple to pay for a company. But if the funding markets cease to function, the foundation is threatened. With that in mind, we focus on the funding markets to assess whether the plumbing is working:

- **LIBOR – OIS spread:** Libor is a 3-month rate while OIS is overnight. This represents the credit premium for lending unsecured for three months as opposed to overnight. In 2008, it peaked at just under 250bp but started showing signs of stress much earlier in 2007. It is also helpful to look at the FRA-OIS spread, which represents the market expectation of Libor-OIS spreads at a future date
- **Lending tenors:** whether they are being shortened or not.
- **Cross-currency basis:** the primary driver for the cross-currency basis is the asset demand from foreign investors. It is influenced by foreign investor demand for the FX hedged US dollar assets as well as the willingness of market participants to earn the cross-currency basis through taking the other side of the funding demand (a balance sheet-intensive activity). An increasing negative basis implies that there may be a shortage of US dollars that could stress banks. Quoting the outgoing Bank of England Governor Mark Carney; "the global financial cycle is a dollar cycle."
- **The duration of this market stress and the snowball effect:** pay attention to the money markets flows. This was best explained by JP Morgan CEO Jamie Dimon in his 2014 annual report:

"While crises look different, the anatomy of how they play out does have common threads.

When a crisis starts, investors try to protect themselves. First, they sell the assets they believe are at the root of the problem. Second, they generally look to put more of their money in safe havens, commonly selling riskier assets like credit and equities and buying safer assets by putting deposits in strong banks, buying Treasuries or purchasing very safe money market funds.

Often at one point in a crisis, investors can sell only less risky assets if they need to raise cash because, virtually, there may be no market for the riskier ones. These investors include individuals, corporations, mutual funds, pension plans, hedge funds — pretty much everyone — each individually doing the right thing for themselves but, collectively, creating the market disruption that we've witnessed before.

This is the 'run–on–the–market' phenomenon that you saw in the last crisis."

Q: is there value in high yield after the big move in spreads?

The expected slowdown in US growth, earnings pressure on a wide range of industries due to covid-19-related disruptions and energy sector pressure are all manageable on their own. But all of them combined can challenge high yield's already understated leverage (thanks to adjusted EBITDA) and lackluster cash flow growth. For instance, autos, energy, leisure and retail represent 22% of the US HY index (as of 9 March 2020 close). Add in 2.5% of other stressed credits that were trading >1,000bp on 20 February before the big repricing, this means that a quarter of the HY index could come under pressure. Assuming a 5.5-6.0% default rate and average 250bp in risk premium, this would imply fair value spread in HY would be something like 625-650bp. The index closed at 742bp on 12 March 2020. Historically, taking a hard look at HY once the spreads cross 800bp has been rewarding on a one to two-year outlook. Having a long-term perspective is key since timing the bottom is practically impossible.

Q: what would make you more positive on the markets?

From a top-down point of view, there are a few indicators that can be relevant while bottom-up valuation work determines the case for individual investment.

- Look for a flat lining of the new infections rate. This should help to calm the public fear.
- Aggressive and coordinated public policy to deal with health emergencies and financial hardship delay/relief for those who are affected by the crisis.
- Active Fed and Treasury involvement to ensure the funding markets continue to function and pursue global coordination with other central banks. The key is to avoid a full on global liquidity crunch that may lead to solvency concerns (similar to 2008). That said, the Fed's goal is to enhance liquidity and assure smooth operating of funding markets. It is not to assume credit/default risk away from the market. These two should not be confused!
- Fiscal policy announcements.

JOHCM Global Income Builder Fund

5 year discrete performance (%)

Discrete 12 month performance (%):

	29.02.20	28.02.19	28.02.18	28.02.17	29.02.16
A GBP Class	7.65	-	-	-	-

Past performance is no guarantee of future performance.

Source: JOHCM/MSCI Barra/Bloomberg Index Services Limited, NAV of Share Class A in GBP, net income reinvested, net of fees. The A GBP Class was launched on 30 April 2018. Performance of other share classes may vary and is available on request. BLOOMBERG® is a trademark and service mark of Bloomberg Finance L.P. and its affiliates (collectively "Bloomberg"). BARCLAYS® is a trademark and service mark of Barclays Bank Plc (collectively with its affiliates, "Barclays"), used under license. Bloomberg or Bloomberg's licensors, including Barclays, own all proprietary rights in the Bloomberg Barclays Indices. Neither Bloomberg nor Barclays approves or endorses this material, or guarantees the accuracy or completeness of any information herein, or makes any warranty, express or implied, as to the results to be obtained therefrom and, to the maximum extent allowed by law, neither shall have any liability or responsibility for injury or damages arising in connection therewith.