XO 20 ANS INVESTMENTS

MONTHLY COMMENT

June 2020

MARKET REVIEW

A recovery dynamic that's running out of steam

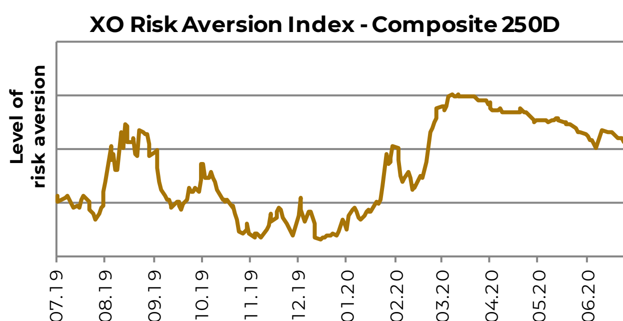
The beginning of June allowed the financial markets to continue the recovery that began in April. This momentum even allowed the U.S. Federal Reserve, in the second half of the month, not to increase the size of its balance sheet. A first for the quarter! However, the result ofthe slowdown in these injections, penalised the markets, which ended the month in scattered order. The United States, under the double pressure of community demonstrations and new Covid-19 cases, was the most penalized. Brazil was the best market in June, but the worst over the year.

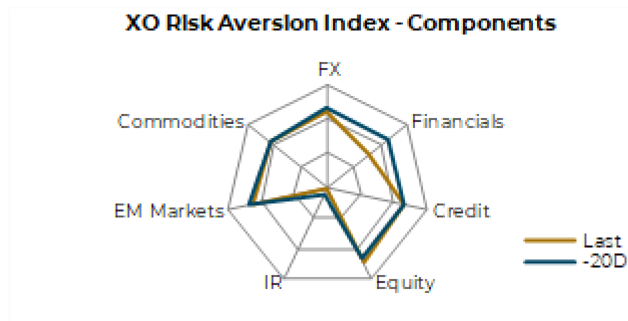
The CHF continues its role as a safe haven, with currencies losing ground against it, particularly the USD. Bonds are slightly positive for the month, while Swiss real estate is down by more than 3%.

Oil stabilized and is approaching $40 a barrel. As for gold, it is on the verge of 1'800 USD per ounce.

Our risk indicators are easing slightly but remain relatively high.

	Value	June	2020
Equity markets			
Switzerland (SMI)	10 045	2.17%	-5.38%
United States (S&P500)	3 100	1.84%	-4.04%
Europe (Euro Stoxx 50)	6 966	6.40%	-12.37%
Japan (Nikkei)	22 288	1.88%	-5.78%
China (Shanghai SE)	2 985	4.64%	-2.15%
Brasil (Bovespa)	95 056	8.76%	-17.80%
Currencies			
USD/CHF	0.947	-1.53%	-2.00%
EUR/CHF	1.064	-0.31%	-1.92%
GBP/CHF	1.175	-1.07%	-8.43%
EUR/USD	1.124	1.31%	0.12%
Other asset classes			
Swiss Real Estate		0.25%	-1.64%
Swiss Bonds		0.18%	-0.48%
Foreign Bonds		0.41%	2.87%
Commodities		5.09%	-36.31%
Oil	39.27	10.65%	-35.69%
Gold	1 783.68	2.89%	17.13%
Rates / Indicators			
10 years Swiss rate		-0.44%	-0.47%
10 years US rate		0.66%	1.92%
US Unemployment		13.30%	3.50%
US GDP		0.30%	2.30%
US CPI		1.20%	2.30%





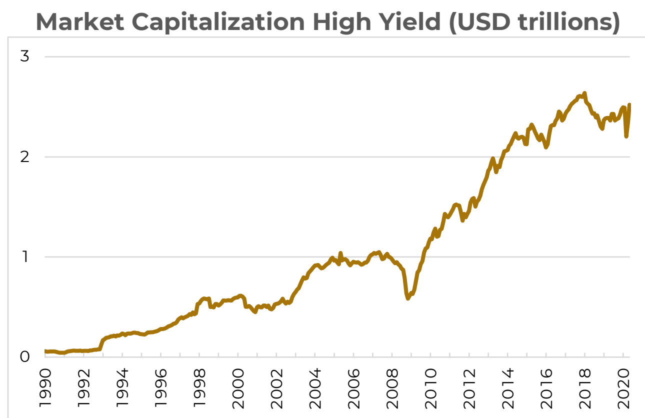
CRISIS-PROOF HIGH YIELD

The economic crisis linked to the coronavirus epidemic has severely affected high-yield credit. As a small market, this segment presents interesting investment characteristics. The current lack of interest in this segment could be an investment opportunity.

A small market

High Yield bonds, or High Yield, are bonds that are rated by international agencies at a level of BB+ or lower, which is a lower quality than bonds rated between AAA and BBB- (Investment Grade). This segment of the bond market is a "small" market, with USD 2.5 trillion in market capitalization, compared to the USD 60 trillion investment grade market.

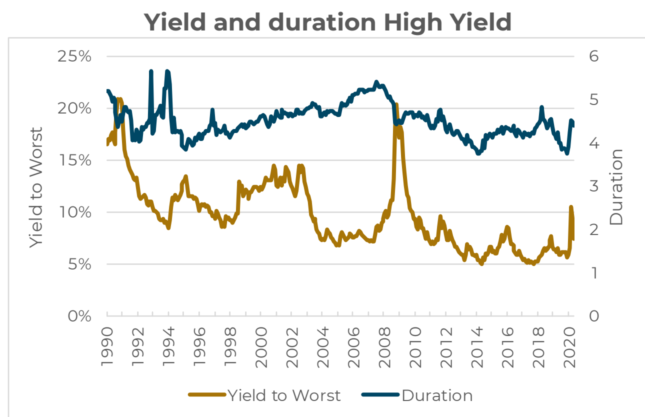
Market Capitalization High Yield (USD trillions)



Source : Bloomberg, XO Investments SA

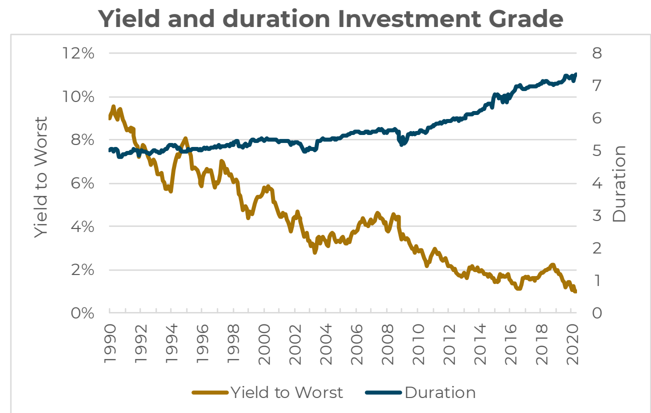
The high-yield market constituents have different characteristics to the investment grade segment. Companies are riskier with higher levels of debt. In return, higher returns are offered. The current yield to maturity is around 7%, compared to 1% for Investment Grade. Although this yield has declined over the years, it remains high in the current environment.

Yield and duration High Yield



Source : Bloomberg, XO Investments SA

Yield and duration Investment Grade



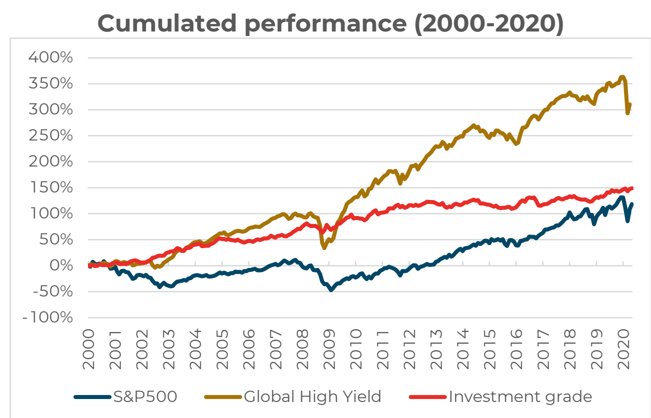
Source : Bloomberg, XO Investments SA

As the High Yield Universe consists mainly of companies, whereas Investment Grade includes many states, the average loan term is much lower: 4.5 years compared to 7 years for the Investment Grade subgroup. Thus the duration risk, i.e. the risk of interest rate changes, is much lower on high-yield bonds.

Attractive performance

Over the last two decades, High Yield has outperformed the equity market or Investment Grade bonds.

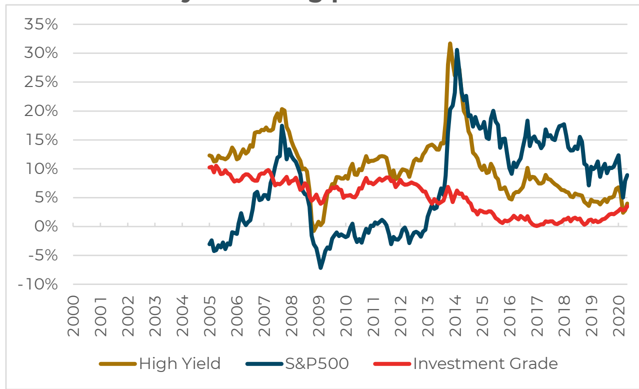
Cumulated performance (2000-2020)



Source : Bloomberg, XO Investments SA

If a 5-year rolling performance calculation is performed, only one period shows negative performance over 5 years. This is the interval 2004-2008 ending November 30, 2008. All other time periods show positive returns. This is obviously not the case for equities that have experienced 3 fairly long periods over the last 20 years where the 5-year return was negative.

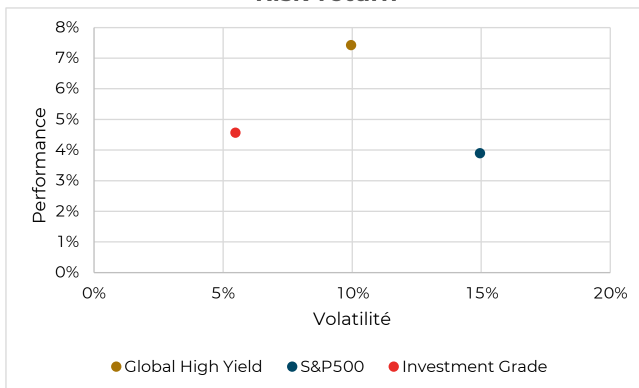
5-yeat rolling performance



Source : Bloomberg, XO Investments SA

However, the High Yield segment presents a higher risk than the higher quality segment. This is easy to formulate with a risk-return chart. The High Yield segment is riskier than the Investment Grade segment but offers better characteristics than equities over a 5-year period, i.e. less risk and more return.

Risk-return



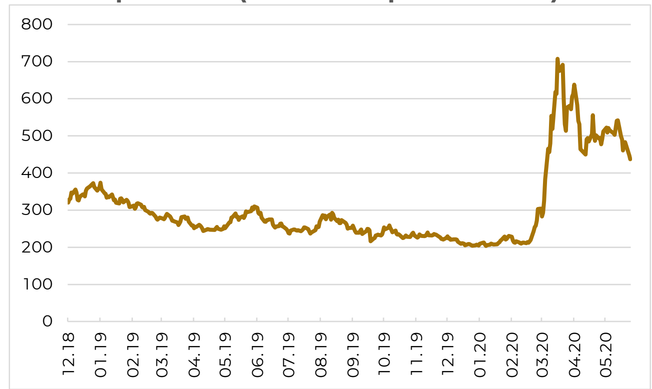
Source : Bloomberg, XO Investments SA

March Dislocation

The Coronavirus crisis, like other crises, has not left the High Yield market unscathed. While the first days of the crisis only impacted equities, the complete de-risking of the market and the panic generated by the virus quickly spread to all other assets, including bond assets.

In the middle of March, a real race for liquidity began. Bond assets, high yield in particular, were sold massively. The yield spreads offered by the credit market (credit spreads) diverged widely. In other words, the risk perceived by investors on bonds of lower quality has increased, and the remuneration required to bear this risk has consequently also risen.

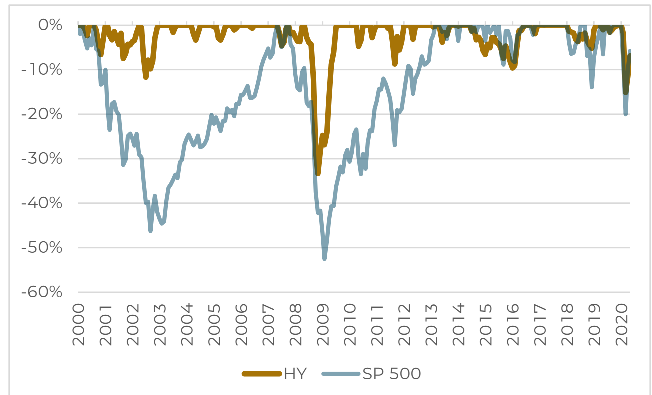
Spread HY (iTraxx Europe Crossover)



Source : Bloomberg, XO Investments SA

If the scale is exceptional, so is the speed of the movement. In mid-February the high yield market was paying on average 200 points more than a government bond. In other words, before the crisis, an investor was asking for an additional 2% yield to assume the excess risk due to the lower quality of the bond. By mid-March, this figure had risen to 700 points or 7%. In price terms this means a correction of around 20% for the market as a whole. This is less than equities (-35%), but double that of Swiss real estate (-10%) over a similar period.

Maximal Loss



Source : Bloomberg, XO Investments SA

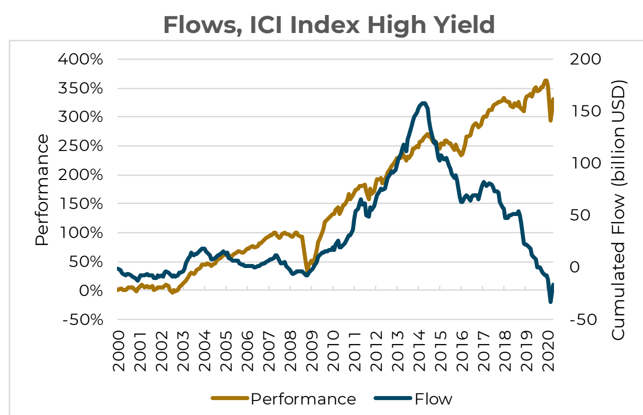
This 15% correction over the month is important but it has already been experienced,as historically, the High Yield market proved to be resilient in 2000-2002 and 2015-2016, with falls of around 10%. On the other hand, it was much more affected in 2008, with a more significant correction of 35%, but spread over almost a year. The market had returned to its starting point 7 months later in July 2009.

In contrast to the equity market, the high yield market benefits from an important recall force. Indeed, high coupons allow, month after month, a recovery even if the quotation levels remain unchanged.

Negative flows

The longer the crisis lasts, the longer it will take for the high-yield segment to return to normal and the higher the individual risks of companies. As central banks have focused their efforts on equities and investment grade credit, the high yield segment is currently benefiting very little from the positive flows.

Flows that have been negative for many years. After a very positive period between 2009 and 2014, nearly USD 150 billion have been withdrawn from this asset class. The month of March alone saw USD 21 billion removed from the ICI index.

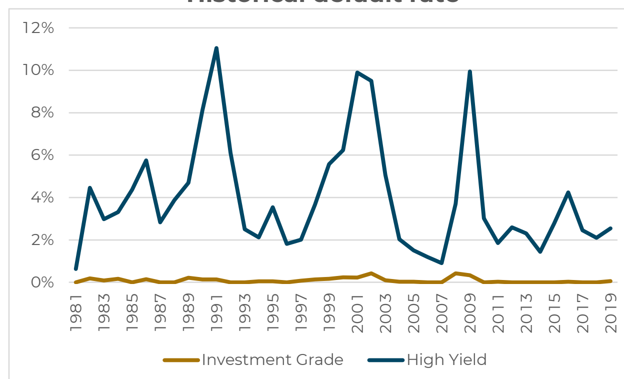


Source : Bloomberg, XO Investments SA

A segment to watch

High-yield debt has been greatly impacted by the coronavirus crisis. A crisis that will penalize companies for a significant period of time. Forecasts range from a 25% to 50% decline in growth. A pessimistic scenario this that the return to pre-crisis levels could be spread out between 2021 and 2023.

The default rate, which in 2019 was around 2.5% for this high-yield segment, could therefore rise to a level reached at the peak of the crises, i.e. 2008, 2001 or 1990. In 2019, 118 companies defaulted. A majority of them (78) were American companies, 15 in Europe and 22 in emerging markets. 84% of these companies were rated at the beginning of the year B- or better.



Source : Bloomberg, XO Investments SA

Despite these risks, the profile of these loans seems attractive tous. The low duration and the high coupons create a real reminder force and a form of immunity to rising interest rates. The recovery capacity is therefore faster (companies pay off their debts first before paying dividends) and the risk/return ratio is historically much better than what good quality equities or credits offer.

The massive fall in March 2020 should not cause us to lose sight of the horizon and objective of these investments. The gap between bid and ask prices and the liquidation of many positions are short-term effects. The key parameter to monitor is the ability of these companies to refinance themselves. Central bank injections, government aid, abundant liquidity and falling nominal rates are all factors that should be structural elements that should make it possible to imagine a less turbulent future for this segment. The historical performance of the sector as a whole, points to better days ahead. The risk is historically well remunerated.

The best sign of the segment's ability to overcome this crisis was given by Carnival. This cruise giant is at the heart of one of the most impacted sectors. Despite all the concerns about the shutdown, the company was able to raise USD 4 billion in early April. A considerable amount showing the confidence of investors. Confidence that comes at a price: 11.50% per year! Enough to offset the Covid risk!