Insight

RISK, RESILIENCE AND INCOME OPPORTUNITY

Every month that passes by brings more visibility on the economic impact of the Covid-19 virus; past, present and future.

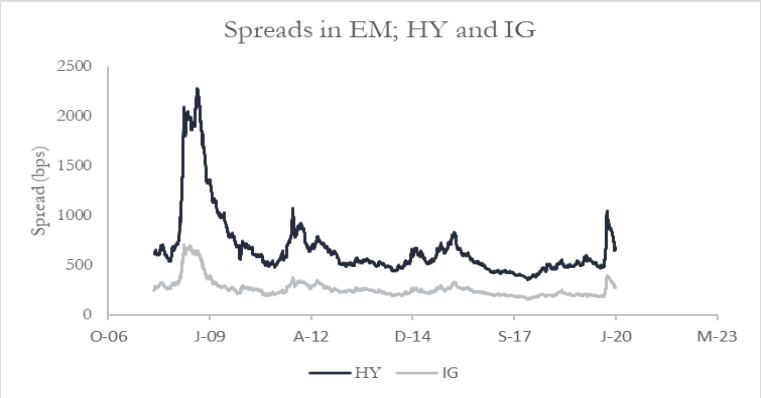
Reported economic and corporate data highlights the extent of the damage inflicted, and most governments are now rushing through measures to re-open economies whilst managing the end of the first wave of infections and preparing for the possible second wave later in the year. Most risk asset classes have seen substantial price recovery, supported by central bank and government policy stimulus.

In this uncertain environment some certainties have been crystalized: the underlying quality of the companies targeted is more critical than ever. Similarly, the race for yield in a uniquely low interest rate setting is full on.

A cornerstone of J. Stern & Co.'s investment philosophy is our focus on the quality of companies in our selected investment universe. Recent performance across markets has been mostly driven by such securities. By contrast, high yielding equities with weaker underlying business models fell foul to the current harsh economic realities and had to cut their dividends, prompting sharp share price underperformance.

With central banks flooding financial markets and economies with liquidity in order to avoid a global economic collapse, a record $11tn of debt is currently yielding less than zero! Beside the actions of central banks, demand from institutional investors is as strong as ever, but negative yields are forcing investors further out along the risk curve to deliver income.

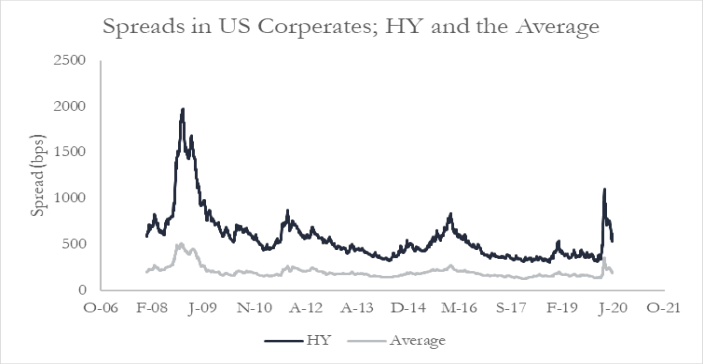
Despite this, the corporate debt asset class is providing investors with a unique opportunity to generate an attractive income, with fundamental downside risks being mitigated by the liquidity support and corporate bond purchases from central banks. The month of February and March saw one of the most violent selloffs in credit markets on record, with falling bond prices leading to a rapid widening of credit spreads across both developed and emerging markets. Spreads were trading at their widest in 11 years, levels not seen since the global financial crisis. This rapid adjustment is understandable given the unprecedented nature of Covid-19 and the uncertainty which it has created. However, the massive outflows from riskier asset classes was exacerbated by a total lack of liquidity.



Source: Bloomberg

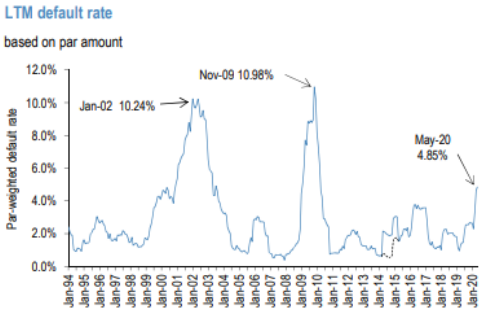
J. Stern & Co
4 Carlton Gardens
London SW1Y 5AA
United Kingdom

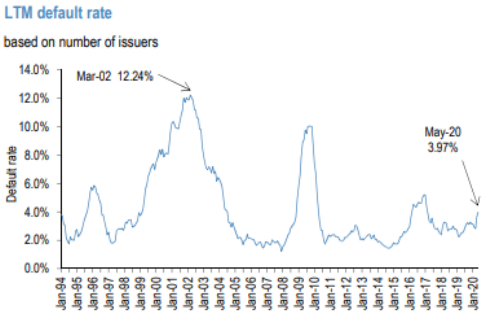
Tel: +44 20 3478 1800
Fax: +44 20 3478 1799
info@jsternco.com
www.jsternco.com



Source: Bloomberg

The rebound that followed has been almost as spectacular with high yield spreads now less than 200 basis points wide of levels at the end of February. This does not necessarily mean that the level of overall risk has declined. Indeed, this point is demonstrated by the level of rating agency downgrades versus upgrades for corporates, as well as default rates which are already fairly high year-to-date and set to increase. The default rate at the end of May was 4.9% in the US high yield market, and it is expected to rise to 8% by year-end. In emerging markets, default rates are still low at 1.7%, but we expect this number to pick up meaningfully and end the year closer to 10%. It's interesting to note that historically, years with the highest default rates have also tended to have some of the strongest returns. One of the most recent examples of this occurred in 2009 when default rates were above 10% but the US high yield market also returned 58% that year. Again in 2016 during the commodity rout, default rates spiked above 4%, yet the market delivered a 17% return. This not only shows the relevance of staying invested but also the importance of selecting the best companies, with a strong market positions and solid balance sheets and liquidity.





Source: JP Morgan

We also looked at the three most recent credit events which took place over the last fifteen years and the effects it had on emerging market credit. As you can see in the table below, although sell-offs can be brutal, they are normally short-lived, and the successive rebound is oftentimes as fast and even more pronounced. In just under one month, the threat of Covid-19 caused an almost 22% decline in the emerging market high yield index, however by the end of May, just two months since credit spreads peaked, it has regained 17% and we expect this positive performance to continue into year end. At J Stern & Co. we invest for the long term across our strategies and our time horizon for fixed income investments average around 5 years or less, typically holding bonds to their maturity. Our approach has always been to make the most of the opportunities offered by these events, enhancing the return profile

whilst improving credit quality and ultimately benefiting from the types of recovery shown in the table below.

Credit Crises	Date	Credit Spread Prior to Event *	Peak Credit Spread	Time to Reach Peak Credit Spread (months)	Downside Return	Time to Recover to Prior Credit Spread Level (months) **	Upside Return
Great Financial Crisis	Jun 2008	560	2,280	9	**-35.00%**	13	**96.60%**
European Debt Crisis	May 2011	560	1,075	4	**-16.87%**	15	**33.53%**
Commodity Crash	Jul 2015	563	834	7	**-6.11%**	6	**14.29%**
Covid-19	Feb 2020	504	1,052	1	**-21.75%**	2	**16.97%**

**All spreads are measured using JP Morgan Emerging Market HY Index*

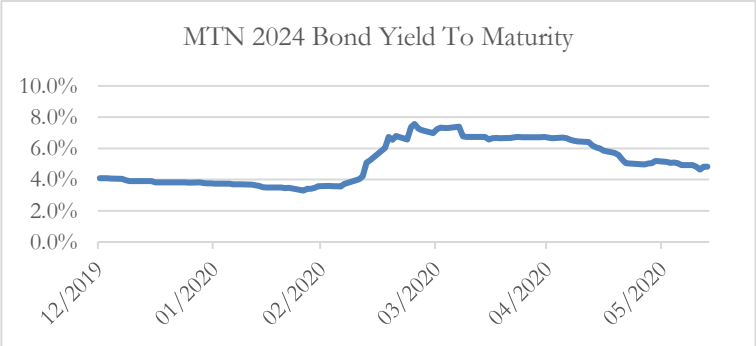
***Time to recover measures the time taken for peak spreads to drop back to the 10y average credit spread of 560bps*

Source: Bloomberg, JP Morgan

As has been the case in the past whether the crisis is global or country specific (Turkey in 2018), there has been a broad-based sell-off, with no differentiation between the lower and the higher quality credits. This has provided us with an opportunity to selectively invest, enhancing the credit quality of the portfolio as well as the expected total returns to maturity.

Similarly, and as highlighted in our insight last month, the Covid-19 pandemic has worked as a catalyst, motivating many companies' managers to accelerate existing trends like the adoption of digital services or technologies.

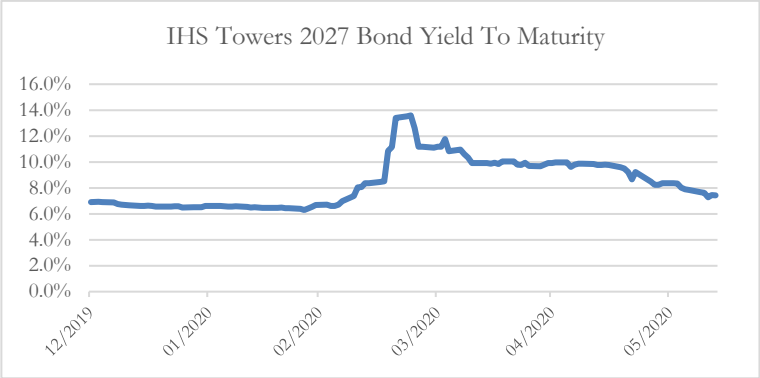
As a result, demand for fixed and mobile data has been surging around the globe. However in many parts of Africa, for instance, the infrastructure for broadband and "fibre to the home" solutions are either lacking or non-existent in some cases. In such an environment, mobile network operators ("MNOs") are a key beneficiary of the insatiable need for data and we therefore decided to take a position in *MTN* – Africa's largest MNO when their bonds were caught up in the market sell off in March/April (yielding 7.5% per annum for a 4-year bond is extremely attractive considering the quality of the business). In May we saw the benefits of this when *MTN* reported their first quarter results and management spoke about the pickup in demand for data and their digital offerings which they had experienced in April. This, in turn drove data traffic significantly, for example, in their 3 largest markets, Nigeria, South Africa and Ghana, data traffic was up 156%, 85% and 181% year-on-year respectively.



Source: Bloomberg

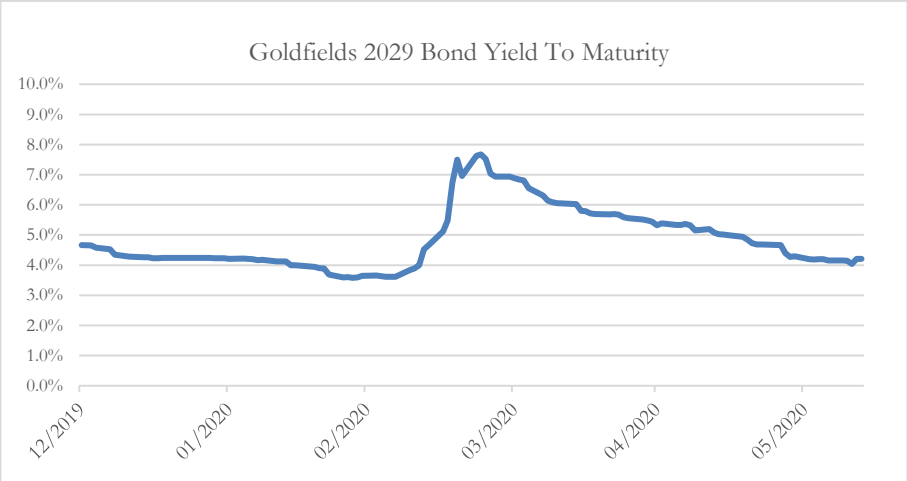
One of the outcomes from the increased demand for data is that it can put strains on mobile networks and MNOs need to invest in capital expenditure in order to support the network

and maintain reliability. The main beneficiaries of this are the independent mobile tower operators which host the MNOs equipment. This was the driver behind our decision to invest in IHS Towers. As the leading independent tower operator in Africa, Europe and the Middle East, it is well placed to take advantage of the anticipated increase in spending by the MNOs. We also view the infrastructure-like characteristics of the tower companies as particularly attractive in this environment as they provide stable, highly visible cash flows. Revenues are secured via long-term contracts which have inflation escalators and, in most cases, is in hard currency, minimising foreign exchange risk. The sell off provided another very attractive entry point into the bonds which at their trough were yielding around 13.5% per annum.



Source: Bloomberg

Warren Buffett once said that "Gold is a way of going long on fear" and in the course of history gold has shown itself, particularly in times of weak economies, to be a rock-solid store of value. This was our rationale behind our investment in the company Goldfields earlier this year. Our main priority has always been to find quality companies at attractive yields, and an investment grade name like Goldfields trading below par and offering 7.5% at its trough, ticked those boxes for us. As one of the world's largest gold miners with geographically diversified operations, and cash costs of around $1,000 per ounce we could think of fewer companies that were better placed to do well during the pandemic. With interest rates set to stay lower for longer and gold prices already above $1,700 per ounce the company is on course to generate significant cash flow in 2020 and further deleverage their already strong balance sheet.



Source: Bloomberg

In as much as the global economic outlook is currently uncertain and it is not yet possible to assess what the post Covid-19 "new normal" will look like, all three companies are likely to do well. Furthermore, as we expect the heavy monetary policy support to continue for some time, credit spreads should tighten further and provide investors with both attractive income and capital gains in a very low yield environment.

Jean-Yves Chereau and Devin Cameron
June 2020