

The Covid-19 crisis shook credit markets and led to a sharp repricing of risk premia with severe market dislocations and higher dispersion across sectors and along the curve. Perhaps unsurprisingly, alternative risk premia, namely Value and Momentum, were particularly reliable, as their predictive power worked beautifully.

In this paper, we will explore the performance behavior of credit factors in both the euro and USD markets during the Covid crisis and the current recovery, and assess the potential for further performance down the road.

1) What are we expecting from alternative factors when it comes to credit markets?

They **are** about:

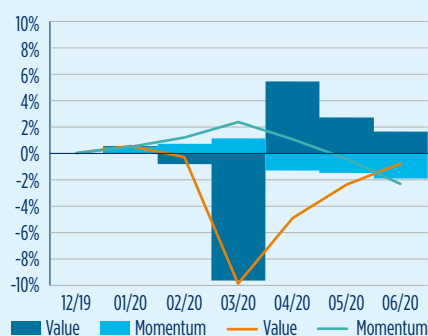
- **Achieving long-term outperformance** through strategic allocation, potentially at the cost of higher drawdowns during market turbulences.
- **Providing clarity and transparency:** clear, disciplined process with provable alpha.
- **Enhancing diversification** in a portfolio allocation of active strategies: low correlation to traditional active strategies.

They **are not** about:

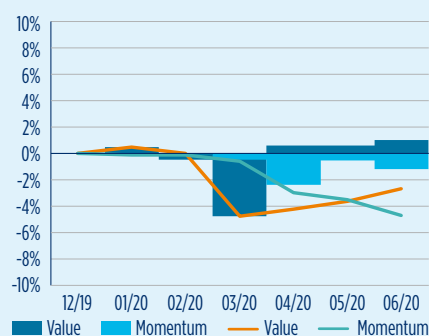
- **Timing traditional risk factors:** they are not aimed to time an increase in market exposure/duration or liquidity.
- **Minimizing drawdowns:** these strategies are not meant to minimize drawdowns in times of market stress.
- **Outperforming in all market conditions:** like any strategy, these are not all-weather strategies or magical black boxes that outperform in all market environment.

2) How did the factors behave in the COVID-crisis?

Concentrated USD IG Credit Factors - Relative Performance YTD



Concentrated EUR IG Credit Factors - Relative Performance YTD



The COVID-19 outbreak, along with its corollary – the draconian measures taken to slow its spread all over the globe – triggered a massive market sell-off across all risky assets. Credit was not spared by the general risk aversion. Rising volatility brought about a lot of uncertainty and led to higher risk premia, mainly related to liquidity pricing and potential higher default rate expectations in the High Yield space and downgrade concerns in the IG space. For USD credits, the markets were put to a historical test – as they had to battle a historical Oil price shock at the same time, exposing the energy sector in the process.

In that context, our factor investing strategies behaved as anticipated:

Our value factor strategy underperformed the market, demonstrating its tendency to exacerbate drawdowns in times of market stress. The strategy tilt towards the higher beta segment of the credit market leads to sharper falls, as our backtest had shown. Some bonds, considered as “cheap” in a value sense, were highlighted during the crisis – with considerable liquidity and price impact in the process.

The Euro IG credit market (Bloomberg Barclays Euro-Agg Corporate) dropped by

-8.43% from peak (20/02/2020) to trough (24/03/2020), while our Value Factor fund gave up -12.83% over the same period.

The value factor exhibits an asymmetric pay-off profile, with a beta higher in bull market than in bear market and tends to outperform traditional credit indices in bull markets, as was clearly seen since the start of the recovery. Even though the strategy posted a greater drawdown than the market, this did not come as a surprise and followed a predictable pattern, owing

to the straightforwardness of our process and the clarity of the value factor signal.

We will focus on future value potential in the second part of this viewpoint.

Our multi-factor strategies exhibited a more resilient performance pattern, as the momentum factor helped maintain a profile more defensive than the pure value factor strategy during the bear market, by bringing the portfolio beta closer to the market. Again, the behavior of the strategy

did not come as a surprise, and was in line with the results of our backtest.

However, due to the inherently low beta of the momentum strategy, which is often focused on the short end of the curve as well as safer names, the momentum factor will, as a consequence, tend to underperform in an environment of tightening spreads as we can see for both EUR and USD credits. It will

however outperform on a risk-adjusted basis. We use the momentum factor to complement our value factor, keeping the beta of the value factor in check.

For USD denominated Credits, a momentum strategy proved its worth, while in EUR it especially suffered in April. This is essentially due to a specific situation in the short-end credit curves where investors, mainly

corporates, tried to secure their cash position. The recovery, on the other hand, benefitted in the first instant to the long maturities as yield-hunting investors led the path.

Our Euro Multi-Factor strategy posted returns of -9.07% from peak to trough, ie. a performance similar to that of the euro IG credit market over the same period. ■

3) Is there still room for further performance?

The value premium, which has significantly increased during the Covid crisis, is not exhausted. We are still ways from full market recovery. Dispersion within credit markets is still very high. Some sectors are set to tighten while others are facing considerable challenges and will take more time before normalizing. The shape of the curve on some sectors highlights how the market remains concerned about the future health of some corporates. The curve of the Travel and Leisure sectors for example is still heavily inverted, with spreads of 1-3 year maturity bonds being wider than longer dated bonds of the same issuers.

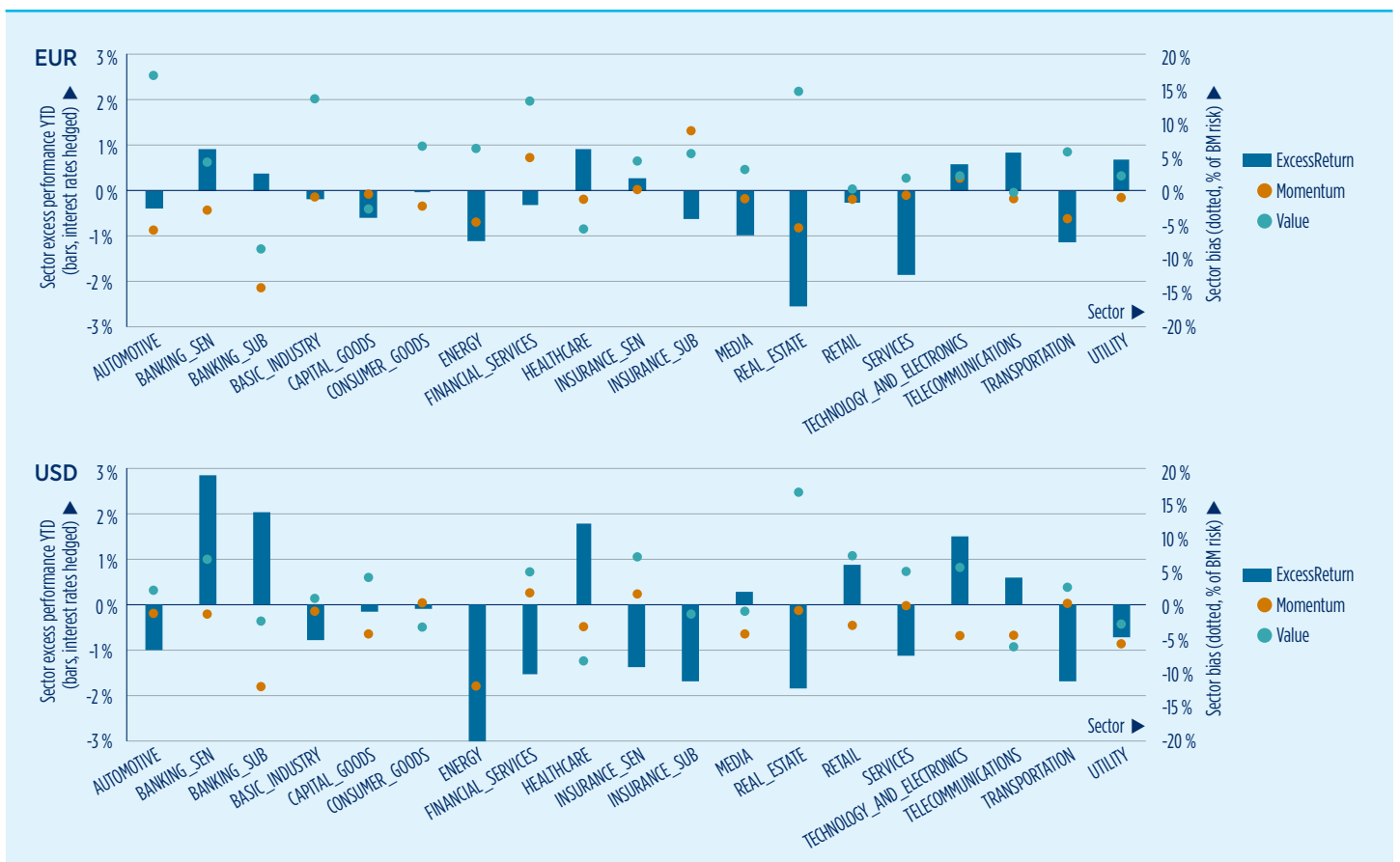
The value factor strategy therefore offers good entry points, as it is designed to capture mispricing opportunities, which are currently still plentiful.

The momentum factor braces the portfolio for the second wave, taking off the higher beta of the value factor and investing in safer, more stable names in the process.

The chart below shows the historical outperformance of a 100% investment in the sectors in the EUR and USD credit universe without any interest rate effects.

On the right axis, we see the current active positioning of the respective concentrated and unconstrained Value or Momentum in terms of BM risk. A positive value means the factor portfolio has an overexposure to this sector in terms of risk.

We see that our value portfolio is invested in sectors showing a high dispersion. Those are usually the sectors and maturities lagging the recovery. On the momentum side, we are more defensive and balance things out in many of these cases. ■



Focus on Value factor:

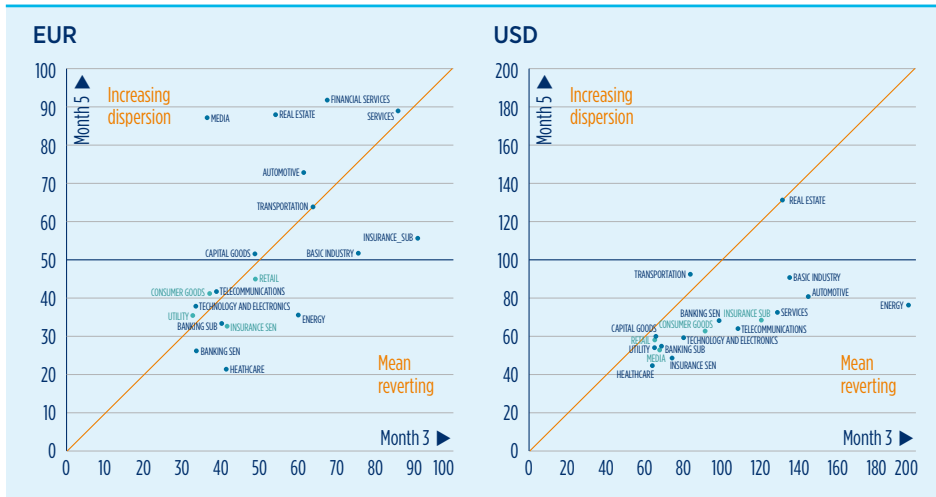
1. Sector dispersion:

We calculate the Value dispersion as the difference in Value-potential (i.e. market spread – model spread) between the 1st quartile value bonds and the 4th quartile value bonds in each

sector. The charts below show the dispersion by sector in Euro and USD market at end of March and end of May.

For Euro Credit, from March to May, with the recovery of the market, the dispersion has been reduced for sector that suffered due to high-beta component (Banking, Insurance) or not directly linked to the lockdown situation. For others sectors where impact from the lockdown is still uncertain, the convergence pace is slower, in some cases the dispersion continue to increase. For the time being, the convergence is not homogenous across different sectors, meaning that some sectors display higher Value potential.

For USD Credit, the dispersion is homogenously reduced amongst different sectors, even Energy sector that has been largely affected by the Oil crisis. This fast convergence explains the strong recovery of Value Factor since end of March



2. Catching the New Issue Premium, a unique additional source of Value in Credit:

New Issue Premium (NIP) is available when an issuer comes to primary market to issue new bonds and offer larger spreads compared to the secondary market. NIP is a source of Alpha on credit market and is part of our Factor Investing process. We assess new issues every day and participate in any new deals where the issuer is among the top Value issuers and the NIP is relevant. The primary market is also a smart

way to reduce transaction costs – by buying issuers we see identify as suitable additions, we take this shortcut to build exposure in a cost effective way.

After the crisis peak, primary market reopened with very attractive NIPs: research shows up to 50bp compared to an average of 10bp in normal market conditions. Since the beginning

of March until end of May, we bought 8% of the Value strategy via primary market. When this NIP is absorbed in secondary market, the average extra-performance was 1.6%, i.e. compared to a strategy where we only rebalance and buy bonds at the end of the month, the additional performance was +13bp over this period. ■

Conclusion:

Factor strategies in the credit space exhibited a predictable behavior during the unprecedented market stress we experienced in March. The Coronavirus crisis acted as a test and revealer of factor credit strategies' ability to behave as anticipated: the Value factor, owing to its inherent tilt to higher beta credits, underperformed the market in the heat of the crisis, but bounced back quicker and higher during the recovery. The momentum factor, associated with the Value factor in a multi-factor strategy, mitigated the performance drawdown by reducing the beta of the portfolio, at the cost of a slightly lower upside participation.

Both factor proved their worth as powerful diversifying strategies in a sound portfolio allocation.

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