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What We Are Hearing And Seeing

Envestnet offers one of the largest asset manager networks in the industry. Given the current environment, we want to share what we are seeing and hearing – perspectives from our trading & operations and Envestnet | PMC teams.

Monica Sengelmann, CFA, and Brandon Rick

Navigating the 2023 Banking Crisis

As the saying goes during monetary tightening cycles, "The Fed will hike until something breaks." Silicon Valley Bank (SVB), a mid-sized regional US bank well known for lending to the venture capital community, was the first domino to fall after a massive bank run where investors withdrew over $40B from the bank in just a few hours. This type of modern-day bank run had not been seen before. It was spurred by social media and exacerbated by the interconnectedness of SVB's depositor base. Stock prices of other banks, particularly US regional banks with a similar mix of commercial and retail deposits, but also the prominent Swiss bank Credit Suisse, fell precipitously as investors feared they would see the same fate as SVB. Indeed, Signature Bank was shut down on March 12, and by March 19, Credit Suisse was put through a forced merger as the Swiss government pushed UBS to take over its flailing rival.

After several weeks of calm, banking stress came back to the forefront in early May as First Republic Bank was seized by the FDIC and sold to JPMorgan Chase. Despite markets experiencing some initial stability, they were roiled after the Fed raised rates again on May 3. Almost immediately after Fed Chairman Powell ended his speech, shares for Western Alliance Bancorp, PacWest Bancorp, and First Horizon Corp. tumbled on news that PacWest was considering strategic options including a sale. The situation remains unclear but reemphasizes the effects of rapidly rising interest rates on the economy.

So how are investment managers navigating the situation? Many managers on Envestnet | PMC's Select List were able to avoid the situation all together and didn't have any exposure to these doomed banks. With the benefit of hindsight, many of these managers had questions around the depositor base, leverage, or plainly due to their process identifying other more enticing investment opportunities. However, there were several managers that held positions in one or more of these banks. SVB seemed to be the most hotly debated position as the bank was a fast and consistent grower with many high-quality attributes that active managers seek, and it also received high praise from an ESG perspective. Fundamentals seemed strong leading up to the collapse. However, managers who had exposure here seemed to underestimate the interconnectedness of the bank's depositor base, the unlikely effect social media had on spurring a bank run, and how quickly sentiment could turn on a stock.

As a research team, we are certainly evaluating risk-management practices. Was this something managers should have seen coming? For those managers who held these troubled bank positions, what was the rationale behind their investment thesis? What did they learn or change in their process that may help them avoid these types of landmines in the future? We think the results are still unclear as the situation continues to unfold and managers take time to self-reflect on their exposures and the risks they identified. One thing is clear, though: Active management can play an important role in an investor's portfolio when markets are troubled.

Michael Wedekind, CFA

High Yield Ferment Favors Active Management

Tightening monetary policy and slowing economic growth are stirring up the high yield market. Last month, Barclays reported that $11.4 billion of bonds were downgraded to high yield in Q1 2023, which the firm noted was 60% of the dollar volume downgraded for the entirety of 2022.[1] The bank expects downgrades to total $60-80 billion for 2023, accelerating in the second half of the year to produce the highest volume of downgrades since 2020, when around $200 billion in bonds dropped to high yield. While "fallen angels" (bonds that have suffered credit rating downgrades into junk territory) are increasing in number, the same report (perhaps counterintuitively) notes that upgrades to investment grade, or "rising stars," are on pace to total $60-70 billion this year. While this churn is happening at the top of the high yield market, the lowest-rated borrowers are also struggling. S&P, for example expects US high yield defaults to reach 4.0% by the end of the year versus 2.7% for the 12 months ended March 31, 2023. Notably, "distressed exchanges" are becoming an increasingly common tactic during defaults, which tend to weigh on recovery rates.[2] Even with US high yield finally justifying its moniker with yields-to-worst of approximately 8%, these late-cycle developments support an active approach to capture potential opportunities and help avoid downgrades and defaults.

While our high yield bond managers' views vary, they agree that the economic outlook has become more fraught in recent months and that elevated defaults and price volatility are the base case for the coming year. None of the investment teams that we speak with are meaningfully overweight the lowest-quality tier in the market, CCC-rated bonds–though some increased exposure during March weakness–and all have taken a skeptical approach to issuers with significant floating rate debt in their capital structures. These asset managers also agree that rising interest rates and a weakening consumer, particularly at the low end of the income distribution, are softening corporate fundamentals from a strong level in a broad-based manner. These managers are riding rising stars up their increasing valuation trajectory, avoiding troubled credits that are increasingly being priced as such in the market, and identifying pockets of value linked to China's reopening and shifting labor and policy dynamics in the Healthcare space. Overall, PMC is pleased with their results so far during a turbulent year in which the outlook is anything but certain.

1 https://www.bloomberg.coam/news/articles/2023-04-19/corporate-bonds-are-being-cut-to-junk-at-fastest-pace-since-2020

2 https://www.ft.com/content/0bae034a-2d6f-4f9b-99d0-10c20ba2018e

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Alfie Manuel

Emerging Market Debt: A Tale of Twists and Turns

The narrative within Emerging Markets (EM) in Q1 2023 was largely dominated by China's reopening and robust domestic expansion, led by surging exports and consumer demand. The quarter also marked the first anniversary of the Russia-Ukraine conflict, which continues with no signs of a resolution. As credit markets in the developing world were roiled with banking crises, EM largely remained resilient. Contrary to the market themes that currently dominate developed markets, inflation in EM appears likely to have peaked[3] in the early part of the first quarter of 2023 with most of the major EM central banks having slowed or paused their tightening cycles. Flows within the EM debt asset class were not as encouraging, however, as investors shied away from this riskier sector due to elevated global market volatility.

EM local currency debt, as represented by the JP Morgan GBI-EM Global Diversified Index, returned 5.1% in Q1. Latin American countries, including Columbia and Mexico, were the top performers within this category on the backdrop of positive economic data.[4] EM hard currency bonds (bonds issued in a major foreign currency), as measured by the JP Morgan EMBI Global Diversified Index, returned 1.8% in Q1 with major contributions coming in from CCC-rated issuers Venezuela and El Salvador.[5]

T. Rowe Price, among other managers, stated that they maintained overweight positions in economically stable and fundamentally strong countries like Mexico and Indonesia.[6] They also benefitted from underweight positions in vulnerable economies, like Egypt, which had its currency devalued for the third time in a year, as well as Bolivia which is facing a balance of payments crisis. Managers are expecting volatility to persist over the medium term and would look to add to their highest-conviction issuers as dislocations create attractive entry points. Moreover, market scenarios within EM remain largely fluid. Higher interest rates and weak global growth could push several emerging economies that are facing soaring refinancing needs, including Tunisia, Kenya,[7] and Pakistan, into debt difficulties. With the US Federal Reserve widely expected to pause monetary policy tightening, it remains to be seen if the EM debt asset class becomes more appealing to allocators. PMC shares the view of our asset managers, that prudent credit selection in this asset class can offer compelling risk-reward opportunities, particularly for income-seeking investors.

3 https://am.jpmorgan.com/content/dam/jpm-am-aem/asiapacific/regional/en/insights/portfolio-insights/2q-emd.pdf

4 https://www.ssga.com/library-content/pdfs/global/q1-23-emd-monthly-commentary.pdf

5 Refer to 4

6 https://www.troweprice.com/literature/public/country/us/language/en/literature-type/quarterly-review/sub-type/single-class?productCode=EMB¤cy=USD

7 https://african.business/2022/06/finance-services/african-countries-face-rollover-risk-as-bonds-mature

Deepankuran Kumarapuram, CFA, CAIA

Is It Finally Listed REITs' Time to Shine?

The publicly listed REIT market continued its underperformance compared to broad equities market in Q1 2023. However, despite the ongoing weakness in REITs, the managers we cover think the opportunities ahead are bright for the category, especially compared to private market real estate counterparts. Public REITs posted a mammoth 41% total return in 2021, the second-best calendar year return since the inception of the FTSE Nareit All Equity REITs Index in 1971. Unsurprisingly, this REIT index corrected sharply in 2022 due to rising interest rates, shifting work and consumption patterns, and increased geo-political tensions. Although conventional wisdom holds that REITs should perform well in a rising rate environment, the unprecedentedly sharp increase in the Federal Reserve's short-term policy rate has taken a toll on the asset class. As a result, the FTSE Nareit All Equity REITs Index corrected more than 25% in 2022. While investors are still cautious about REITs as a sector, many managers feel this is the perfect opportunity to tap into listed REITs due to several factors.

The arbitrage opportunity created by the lagged pricing nature of the private real estate markets is a well-known anomaly, but some of our managers believe that the magnitude of the price differential between the public and private markets is historically wide at present. The performance divergence of more than 30% in 2022 created a huge valuation gap between the public and private markets. Several fund managers expect this to correct in the coming quarters, either by a downward repricing of private market real estate assets or by a reallocation of capital to the public market, which would increase the value of listed REITs.

Many REIT managers also believe that public REIT fundamentals are strong and secular growth opportunities are still intact. Consequently, in contrast to 2008, these managers believe the sector is well positioned to sail through any anticipated recession in 2023. Additionally, the weight of struggling sectors, like Office REITs, is more limited in public REIT benchmarks compared to private markets, which may boost public REITs versus their private counterparts. Although it remains to be seen whether the US economy will enter a recession this year and what form such a recession might take, the historical tendency of public REITs to outperform private real estate during and immediately after recessions may provide some hope for public REIT investors burned by a year and a half of weak relative performance.

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