

High yield: Where to from here?

Excess returns and the default cycle

PUBLISHED
9 April 2020

READ TIME
10 minutes

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A historical quarter – facts and figures

Having registered an enticing +14% return in 2019, global high yield markets have taken barely six weeks to erode all of these gains. Experiencing the worst quarterly fall since Q4 2008 (in which global high yield (GHY) tumbled -18%), the first quarter of 2020 saw GHY markets retreat -13.63% as a realisation of the spread, scale and potential impact of COVID-19 took hold.

There were few hiding places during this period with meaningful losses registered across all rating classes with US HY BBs, Bs and CCCs losing 10%, 14% and 22% respectively over the quarter (displaying a similar ratio of reaction to that seen during the 2008 global financial crisis when the respective rating categories fell 13%, 19% and 27%).

With something of a double whammy dealt with the collapse of OPEC+ talks and the subsequent increase in supply and precipitous fall in oil prices, the energy sector was naturally

the worst hit, registering declines of 40% over the quarter (ex-energy the US HY market declined -9%). There were few places to shelter with all industry sectors registering significant declines.

Energy aside, directly consumer-facing industries were the worst hit with leisure and airlines both recording losses of -25% while food, retail and telecoms were at the more resilient end of the spectrum but still with losses of -3% and -7% respectively.

Given the nature of the sell-off, larger issuers (typically with more diverse and resilient capital structures) fared better over the duration. Although often the first to react, as was the case this time around (investors typically sell what they can as opposed to what they would like to were time and liquidity on their side), the desire to position in more liquid capital structures with sustainable long-term balance sheets prevailed with the largest US issuer HY index recording losses of -12% versus smaller issuers declining -15%.

CHART 1: GLOBAL HIGH YIELD SPREADS PEAKED AT 1094 ON 23 MARCH 2020



Source ICE BofAML as at 31 March 2020

Record movement in spreads

During March alone, GHY spreads traded in a 600+bps range, troughing at the start of the month at 480bps before peaking just below 1100bps on 23 March prior to recouping around a quarter of this widening as risk asset prices rebounded across the board to end the period at 915bps.

To put these levels in context, GHY spreads peaked around 860bps during the 2015/16 energy crisis, while during the sovereign crisis spreads broke just beyond 900bps. For completeness, the 2008 global financial crisis peak was significantly higher with spreads temporarily breaching 2000bps.

No component left unscathed – leveraged loans no exception

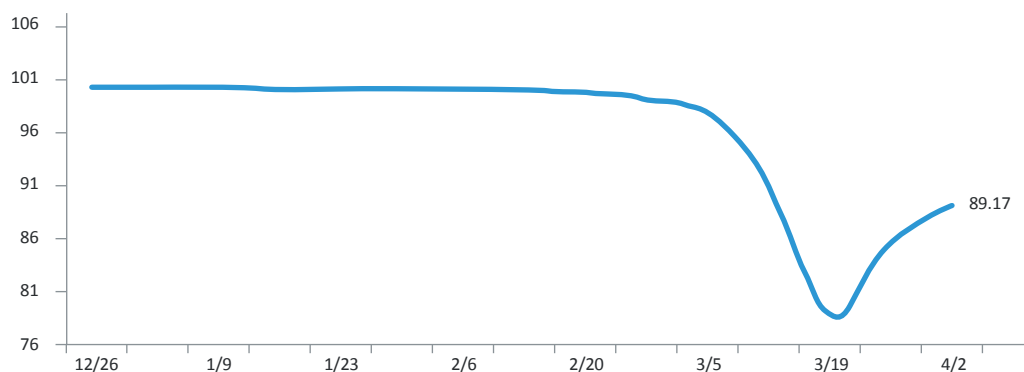
Unlike previous episodes, the pace and magnitude of the reversal in leveraged finance was apparent across all components. We have become familiar with leveraged loans offering a degree of shelter,

with their seniority in the capital structure and sometimes more stable investor base (at least in Europe) providing a degree of comfort.

This time around, the origin, nature and scale of the sell-off meant risk asset price moves in leveraged finance were a little less discerning. Coupled with the dilution in covenant protection and an asset class that has become increasingly more bond-like in nature, it perhaps isn't surprising that moves in leveraged loans this time around weren't particularly different from those experienced in the HY bond market.

Indeed, in Europe where the trend toward more aggressive (bond-like) loan structures is clear and the investor base perhaps a little less diverse than in the US (there's more of a reliance on the CLO and institutional investor base as the marginal buyer in Europe), leveraged loan declines were essentially identical to those of European HY bond markets, registering losses of -14.43%

CHART 2: EUROPEAN LOAN AVERAGE PRICE OVER THE PAST FOUR MONTHS



Source S&P LCD as at 2 April 2020

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and -14.53% respectively with loan prices moving indiscriminately lower having previously been unerring around par.

Valuations – are we nearly there yet? Yes!

Given the historic moves in asset prices and the resultant spreads and yields currently available from the various segments of the leveraged finance market, do today's levels constitute a compelling entry point for a long-term investor?

From a valuation perspective alone, we believe the answer to this would certainly be yes.

Looking back over the return history that we have (and using the US HY market with its longer available time series), we believe today's entry levels look compelling.

As noted in a recent study by JPMorgan, an investor has not lost money on any time horizon (1, 2, 3, 5-years) when they have bought the US HY market at a spread greater than 900bps. There have been 25 such opportunities to do so. The median annualised return (in USD) over the next 12, 24 and 36 months when spreads cross 900bps is 36.9%, 25.5% and 20.8%. As per the JPMorgan US HY index, spreads as at 3 April 2020 stood at 1009bps.

Cross-asset comparison – compelling volatility-adjusted returns

History certainly suggests current entry levels have led to a compelling forward-looking return profile. However, investors have many opportunities and varying asset classes from which to hopefully earn excess returns over the coming years.

When comparing HY to equities, which we consider to be the most natural risk comparison, studies suggest that the risk/reward profile offered by the HY asset class is worthy of attention.

Over the prior 25 years to the end of 2019, US HY credit has observed half the annualised return volatility of the S&P500 index (7.8% vs 14.6% using standard deviation of monthly returns) while providing slightly lower annualised returns (7.8% vs 10.2%). Expressing this as a simple unit of return per unit of risk equates to 1.00 for US HY and 0.70 for the S&P 500.

Focussing a little more closely on how the HY market performs in down years and the subsequent period emerging from recession is perhaps a more revealing analysis at this time.

How then should investors position themselves best for the current economic contraction and the re-emergence from recession?

In short, HY typically outperforms equities during down years and in the subsequent years as the economy emerges from recession. For instance, from 2000 to 2005, US HY outperformed S&P 500 by 55%. Looking further back to 1990-93, HY returns exceeded those of the S&P by 33%.

While history can only ever be a guide as to what has happened in the past, the evidence is certainly suggestive that the HY asset class has the potential of offering a comparable, if not better, return profile to equities, even more so when expressed in risk-adjusted returns and with the additional benefit of coupon income during a period when equity dividends are likely to be more challenged.

Looking back over the return history that we have (and using the US HY market with its longer available time series), we believe today's entry levels look compelling

HISTORICAL RETURN PROFILE BUYING US HY WHEN SPREADS EXCEED 900BPS

HIGH-YIELD ANNUALIZED RETURNS AS SPREADS CROSS 900BPS

	1yr	2yr	3yr	4yr	5yr
Average	34.7%	24.6%	19.6%	16.7%	15.3%
Median	36.9%	25.5%	20.8%	17.1%	16.6%
High	61.4%	36.9%	25.9%	23.5%	20.5%
Low	0.5%	4.9%	11.8%	11.0%	9.7%
Positive	25	25	25	25	25
Negative	-	-	-	-	-

B ANNUALIZED RETURNS AS SPREADS CROSS 900BPS

	1yr	2yr	3yr	4yr	5yr
Average	29.21%	22.25%	18.16%	15.70%	14.52%
Median	29.43%	22.39%	17.37%	16.61%	14.75%
High	46.82%	31.50%	26.98%	20.30%	19.29%
Low	3.18%	6.64%	9.28%	11.56%	10.17%
Positive	25	25	25	25	25
Negative	-	-	-	-	-

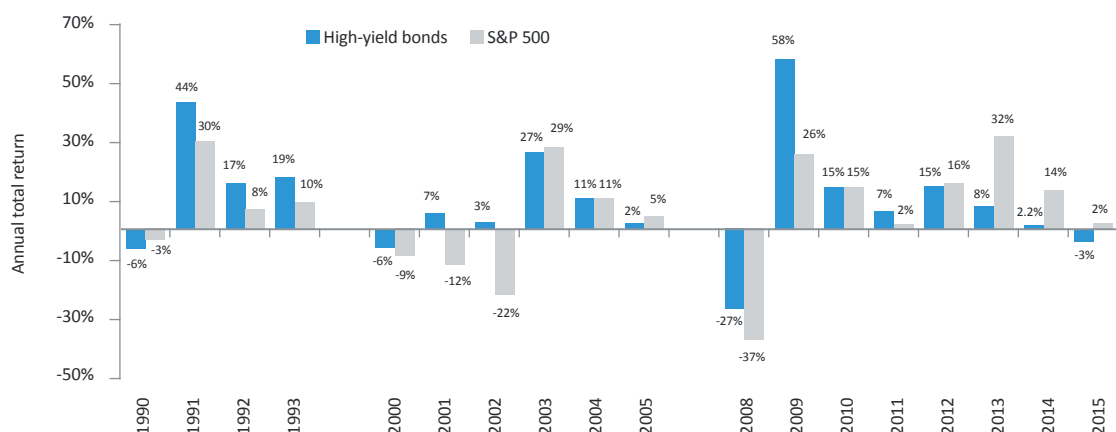
BB ANNUALIZED RETURNS AS SPREADS CROSS 900BPS

	1yr	2yr	3yr	4yr	5yr
Average	22.41%	17.66%	14.98%	12.93%	12.01%
Median	21.77%	18.19%	15.42%	13.00%	12.64%
High	43.87%	28.65%	21.23%	19.61%	16.55%
Low	5.60%	8.55%	9.14%	8.95%	7.79%
Positive	25	25	25	25	25
Negative	-	-	-	-	-

CCC ANNUALIZED RETURNS AS SPREADS CROSS 900BPS

	1yr	2yr	3yr	4yr	5yr
Average	62.79%	38.76%	29.32%	23.71%	21.31%
Median	59.26%	37.01%	29.50%	22.10%	21.59%
High	128.38%	67.80%	43.66%	35.86%	31.05%
Low	-8.35%	-2.96%	13.25%	14.40%	10.74%
Positive	22	24	25	25	25
Negative	3	1	-	-	-

CHART 3: US HY VS S&P 500 RETURN PERFORMANCE DURING AND AFTER RECESSION



Source: JPMorgan as at 31 December 2019

Given the number of unknowns in our equation and the lack of any comparable set of facts, accurately predicting the extent and breadth of the default cycle is extremely challenging

Fundamentals – an inevitable deterioration in credit metrics

As noted, history is only ever a reflection of what has happened in the past – today's events are incomparable.

Accordingly, the prospects for HY returns over the coming months and years must also be considered in the context of the potential for significant credit deterioration, impairments and the impact that they may have.

To efficiently predict HY defaults, both the degree of contraction and its duration are the key influencers (alongside starting levels of leverage, maturity walls and ease with which corporates are able to access credit).

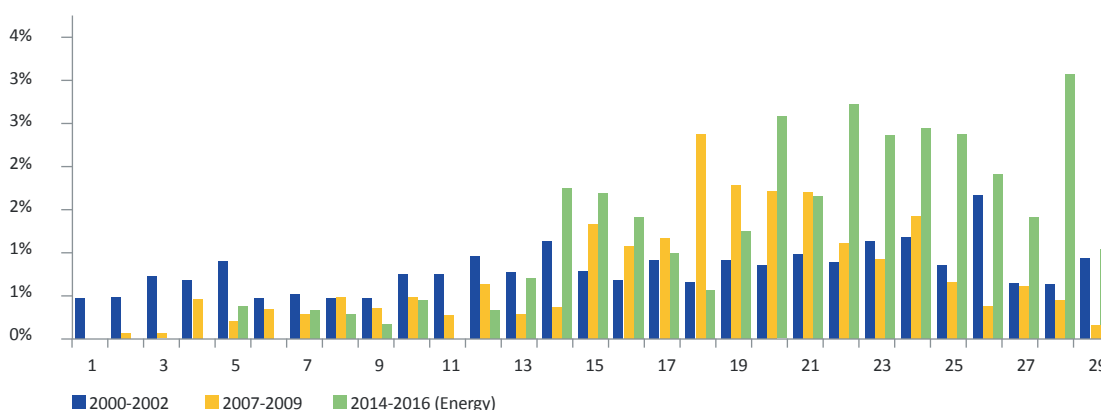
At this point, both the degree of economic contraction and its duration are highly uncertain.

Although estimates range widely, market forecasters are predicting an unprecedented contraction in US GDP of up to 30% in 2Q 2020, which given the pace of the decline, ought to be followed, in our view, by a strong rebound later in the year or early in 2021, making this recession theoretically shorter (but perhaps no less severe) than typical episodes. Additionally, offsetting the decline in economic activity is a package of fiscal and monetary support, the quantum and speed of which has never been witnessed before.

Given the number of unknowns in our equation and the lack of any comparable set of facts, accurately predicting the extent and breadth of the default cycle is extremely challenging.

Indeed, as shown in chart 4, in the last three periods of contraction, default rates don't meaningfully accelerate until we are some way into the recessionary period. The reality is that we don't know until we have meaningfully progressed

CHART 4: MONTHLY DEFAULTS EXPERIENCED AFTER THE START OF EACH RECESSIONARY PERIOD



Source: Bank of America as at 3 April 2020

into the recession the true extent of the stress felt (and this is likely to be even more the case this time around as the impacts of unusually quick and meaningful monetary and fiscal support are digested and their effects take hold or otherwise).

What we can say with a little more certainty is what we believe the level of impairment current spreads compensate for.

To that effect, current spreads in the US HY market imply a default rate of around 13%. As shown in chart 5, this is the level of defaults reached during the global financial crisis.

While we acknowledge that we have limited visibility at this point, our current opinion is that the scale and extent of current monetary and fiscal response is likely to contain defaults at a rate which while elevated, ought to be below that of the global financial crisis.

Accordingly, in our view, current spreads appear to compensate appropriately for the default cycle to come.

Credit selection and capital preservation remains paramount to achieving returns

While defaults may not hit the peak experienced in 2009, and valuations – certainly from a historical point of view – are suggestive of a very appealing return profile over the medium term (which we believe looks even more compelling on a risk-adjusted basis), the pain across issuers and wider sectors will be meaningful and naturally should be avoided wherever possible.

Accordingly, we firmly believe a cautious standpoint is still required. We believe high yield as an asset class does indeed offer value, but now, more than ever, the medium-term sustainability of a corporate's balance sheet and access to short and medium-term sources of financing to weather the demand shock are key to survival.

Our efforts in recent weeks have therefore been focussed on re-underwriting every one of our investments with this new set of (still uncertain) parameters, identifying those candidates that do not have liquidity and a balance sheet sufficient to cope with this shock and exiting those positions in a nimble and forceful manner.

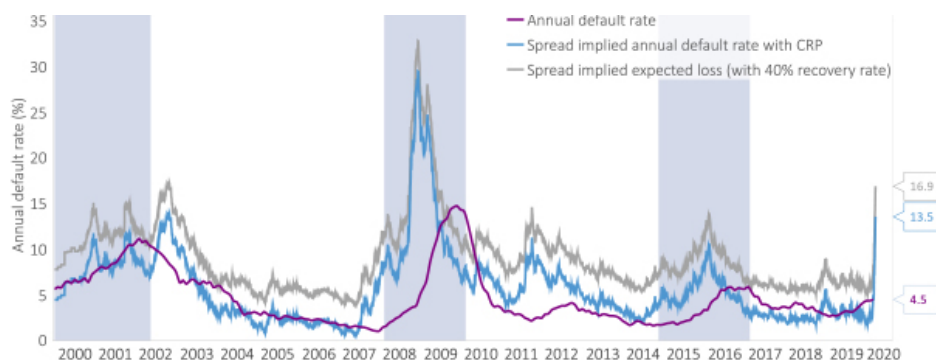
As such, we are more heavily skewed toward larger/ more liquid issuers and have a clear bias in our portfolios to less cyclical sectors.

There will be a time to reposition forcefully for the rebound and indeed one must be respectful of the scale and force of fiscal and monetary support being deployed. However, until we have greater clarity around the containment of the spread of the disease (and the potential for its re-emergence) and the duration of the economic impact, we do not believe it is appropriate to do so yet.

At this stage, investing with a focus on capital preservation remains key and we believe the best way to achieving compelling future returns from the asset class.

We believe high yield as an asset class does indeed offer value, but now, more than ever, the medium-term sustainability of a corporate's balance sheet and access to short and medium-term sources of financing to weather the demand shock are key to survival

CHART 5: USHY SPREAD IMPLIED EXPECTED LOSS AND DEFAULT RATE ESTIMATES



Note: CRP is credit risk premium - spread in excess of that required to compensate for expected losses (default X recovery rate) - and assumed to be 250bps,

Source: Bloomberg Barclays US High Yield index; shaded blue columns denote Moody's default cycle indicator marking consecutive quarter increases in the training 12-month default rate above the long-term (4.9%) latest data at 20 March 2020.

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