BlueBay
Asset Management

High yield update

Andrzej Skiba answers investors' high yield questions, covering performance following a period of crisis, yield possibilities and the investment landscape for H2.

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High-yield bonds often deliver strong returns following a period of crisis – why is that and will it happen in the wake of COVID-19?

Due to a higher-risk nature of its constituents (including the greater risk of default), the high-yield (HY) universe typically experiences the most pronounced price dislocation during sell-offs. Similarly, as markets subsequently rebound, HY is typically the asset class to rally back the most as fears abate.

Looking at global indices this year, HY declined by over 20% from the February highs to the March lows – the investment-grade (IG) universe decline was in low teens. From the lowest point in March, HY then rebounded almost 25%, while IG rose by around 20%.

One could argue that the rebound gap should have been even greater, however, IG gained additional support from the rally in government bond yields and the fact that many central bank bond purchase programmes directly benefitted IG issuers.

Looking at current valuations, we're still trading at wider spread levels compared to earlier this year, but valuations are nowhere near the 'crisis' levels seen in March.

As for history repeating itself, if we have another sell-off in the autumn driven by a second wave of COVID-19 or any other market-moving factor, we'd expect the sell-off to be less painful, as fiscal and monetary policy authorities have put a robust market backstop in place. Additionally, after experiencing a powerful rebound during the spring, investors are likely to think twice before dumping bonds in an indiscriminate fashion.

How did HY spreads develop during the COVID-19 crisis and what were the main reasons for the setback and following recovery?

At the tightest point in February, the spread on the ICE Bank of America Global HY index stood at 367bps. At the peak in late March, we hit 1094bps. We're now back at 535bps (as at 6 August 2020).

Three factors contributed to the initial explosion in spreads:

1. The dramatic rise in default expectations on the back of the deepest recession experienced since the global financial crisis.

2. Fears regarding a massive wave of fallen angels entering the HY index from the IG asset class.

3. A significant drop in market liquidity and falling trading volumes exacerbating price dislocations.

The subsequent spread rebound was driven by four factors:

1. The rapid global deployment of enormous monetary and fiscal policy tools to stabilise and ensure the proper functioning of markets.

2. The total volume of fallen angels underwhelmed initial expectations (it looks like we'll have USD200-250bn vs. some market participants expecting USD500bn+). The inclusion of these fallen angels in Federal Reserve bond-buying programmes helped to engineer a smooth transition from IG into HY.

3. Medical progress suggesting the faster-than-expected availability of vaccines and therapeutics could help to shorten the length

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of the recession and reduce the likelihood of further full-scale shutdowns.

4. A combination of entry levels where investors have never lost money by buying HY at such levels before and a zero interest-rate environment pushing global savings pools towards higher-yielding assets, i.e. inflows for the asset class.

Is it still attractive to invest in HY?

Yes, HY remains an attractive asset class in our view. In our base-case scenario, we expect further normalisation of spreads, mainly as a result of medical progress and economies gradually returning to 'normal', thus helping to reduce forward default expectations. We also note that market technicals are improving, with a fading supply of new issues, fewer IG names migrating to HY and continued positive flows into the asset class.

What yields are possible within HY?

While the current yield of approximately 6% doesn't strike us as particularly attractive by historical standards, when you consider that interest rates are at zero or below and that this situation is likely to persist for a number of years, then 6% doesn't look so bad. Moreover, we see spreads tightening by 50-100bps from here over the next few months. This represents only a fraction of the spread rebound from earlier in March, but is perfectly decent by historical standards.

Is there a big risk of rising default rates? What other risks are on the horizon?

We expect default rates to increase towards the high single digits in the US and approach the 5% level in Europe. This represents a significant increase from pre-COVID 2% levels in the US and just above 1% in Europe.

However, we also note that expectations regarding the level of default rates moderated in recent months for three main reasons:

1. Issuers facing liquidity problems were helped by both a variety of government programmes and willingness by the market to extend credit to issuers with sustainable business models facing a COVID-related cashflow crunch.

2. Economists now expect a painful – but not as deep as previously forecasted – recession.

3. Issuers demonstrated a robust ability to cut costs, reduce cashflow burn and address upcoming debt maturities. Some sectors fared better than others in this respect, with over 20% of the US HY energy sector defaulting so far. For many energy issuers, oil prices in the USD40s are just too low. Weaker-than-expected production and drilling efficiency, an absence of positive cash flow generation, shrinking equity valuation multiples and too much balance-sheet debt all conspired to create a perfect storm for the sector.

As for other risks, besides an obvious one associated with a potential second wave of COVID infections and/or delays in medical progress (vaccines/therapeutics), we see rising US political risks on the horizon. For the first time during this election, the prospect of a Democrat-controlled executive branch and Congress appears possible. This could result in a situation where policy moves aggressively to the left, including major changes to corporate taxation and regulation for financial institutions, pharmaceuticals, energy and other sectors. While some of these could be positive, many could turn out to be market unfriendly.

Relations with China are often cited as another risk. However, we think the recent escalation of rhetoric is more related to upcoming elections in the US and domestic issues in China and is likely to persist in the political sphere rather than lead to economic damage.

Where are you seeing the most attractive opportunities and what are you looking to avoid?

We have a slight preference for US assets over European or emerging market ones, mainly as a result of greater liquidity, the sheer multitude of supportive fiscal/monetary policy measures and USD-denominated assets being the destination of choice for global savings pools.

We maintain a preference for cash-generative issuers in non-cyclical sectors that are only moderately impacted by the COVID pandemic. TMT, food producers and power generation are a few examples of such sectors. We realise however that we're not the only ones expressing such preference, thus recognise the need to selectively look for opportunities in more directly impacted sectors, where we aim to distinguish between 'haves' and ' have nots'.

In our view, issuers/sectors with business models that are sustainable in the long run despite current disruptions fit our investment criteria. However, with so much uncertainty ahead, we prefer to gain exposure through instruments positioned higher in the capital structure, avoiding structurally subordinated debt of such issuers.

We believe the ones to avoid include issuers whose credit profile was already unsustainable before the pandemic, those with a limited ability to avoid large-scale negative cash-flow burn and those where business models might not work anymore in the post-COVID world due to changes in consumer preferences.

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