COVID-19 has shaken up high yield and put opportunities on the table

The asset class is always prepared for a crisis, but the uneven impact of the virus means fundamental credit analysis is more important than ever

Highlights

- Relatively few high yield issuers should need to refinance debt in 2020 and 2021 thanks to the sector's flexibility.
- Hedging costs for UK pensions schemes has tumbled.
- The hard stop in parts of the economy will lead to defaults, likely in two waves.
- The arrival of former investment-grade issuers into the high yield universe will have a material effect on the market.
- Spreads remain elevated, but have narrowed. Intervention by central banks has been decisive and has provided a useful backstop.
- The global HY market is seeing uneven demand across the rating spectrum.

As the COVID-19 pandemic cast its shadow over our economies, the high yield debt market has seen considerable changes of its own – not least the glut of downgrades bringing formerly investment-grade (IG) issuers into the sector. However, this presents signs of resilience and opportunities for pension schemes.

Two fundamental aspects of the high yield (HY) market have given issuers a chance to weather the storm. First, HY companies tend to 'term-out' debt – habitually moving shorter-term arrangements to longer-term. Second, firms typically have a degree of flexibility from revolving credit facilities (RCFs) which allow them to access cash, up to a predetermined limit, at any time. In short there is no widespread and sudden refinancing requirement on the horizon. In a sector used to stressful conditions, the wiggle room is already incorporated.

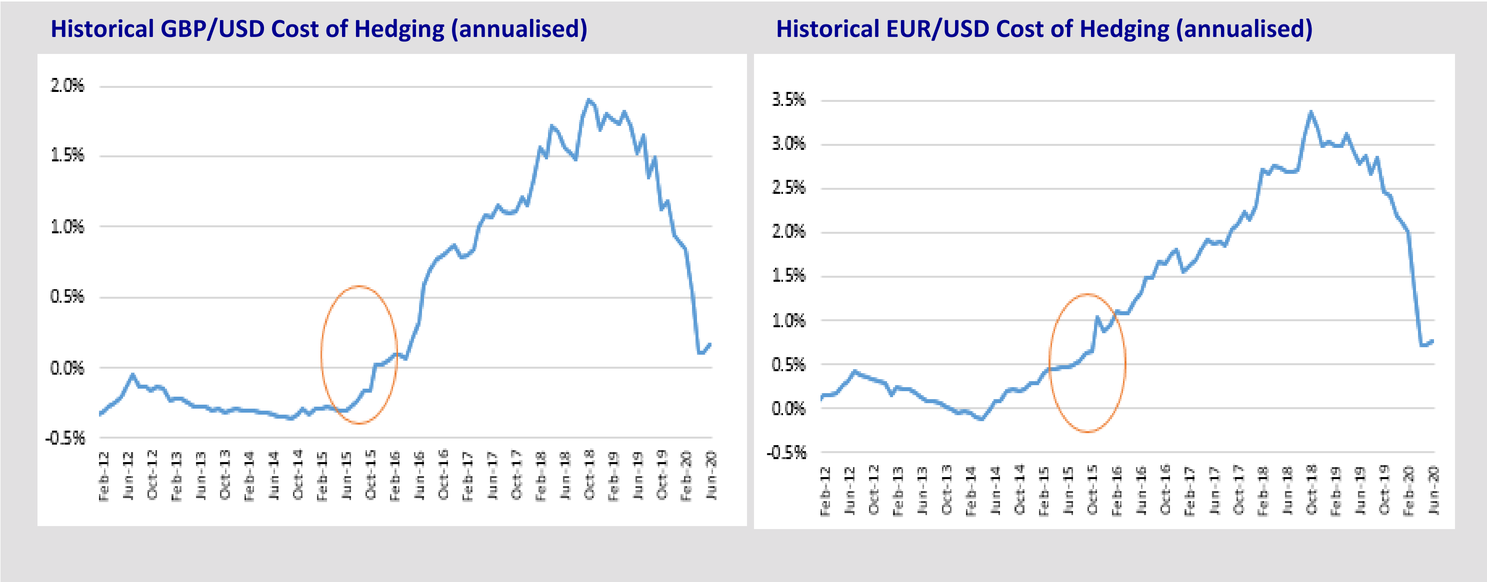
That said, damage is inevitable. The hard stop in parts of the economy has seen activity slump – in some cases to near-zero and for month after month. It has been dramatic for retailers, restaurants, airlines and many more. In high yield, the energy sector, and particularly US oil, has taken some of the hardest hits.

Bridging the gap

Spreads have narrowed from their peak, but remain well above pre-crisis levels, which we think offers good value for UK insurers and pension schemes. As of 22 July spreads in Europe were 483 basis points (bps), in the US 533bps and globally 559bps[1]. This is tighter than the peak in March (by 383bps, 554bps and 535bps respectively) but still about 200 wider than the start of the year. US issues still dominate – accounting for more than half of the global high yield market. For UK and European investors looking to access the US market, it is worth noting that hedging costs (see Figure 1) have tumbled. After historical highs in late 2018, effective zero rates from the Federal Reserve mean currency hedging costs are now at lows not seen since 2015.

[1] Source: Inter Continental Exchange 22 July 2020

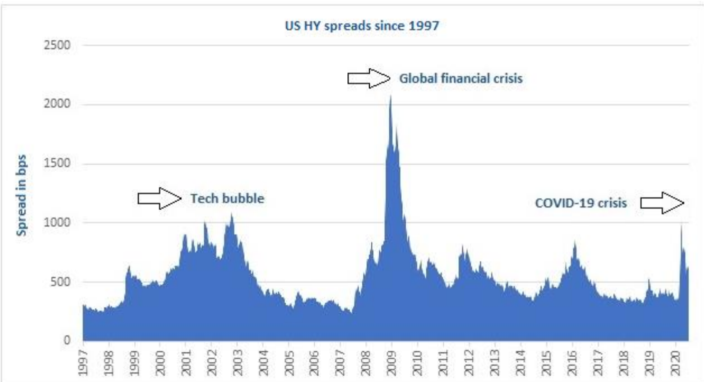
Figure 1: UK investors benefit from lowest hedging costs since 2015



Source: Bloomberg 3 Month FX Forwards, annualised, as of 30 June 2020

The spreads we have seen are almost equivalent to the tech crash in 2002. The only period with dramatically wider spreads was the global financial crisis where they briefly hit 2,000 bps in US HY (see Figure 2). We believe that the swift action and the sheer scale of monetary and fiscal policy announced to combat the coronavirus around the world – and the willingness to do more in future – has helped to avoid this outcome.

Figure 2: COVID-19 HY spreads are dwarfed by those seen in 2008/2009



Source: Inter Continental Exchange, US High Yield Spreads (H0A0) as at 10 July 2020

Avoiding defaults

Defaults will rise in the global HY space. We think a first wave will continue over the next few months, with a second possible as we move through 2021, when the effect of stimulus and intervention wanes, and when the true impact of the outbreak is more clear. This doesn't rob the HY sector of its appeal, but it does mean that care is needed when taking advantage of these market conditions. We expect an overall default rate of 5-8% in US HY this year.

The demand picture in HY has been a curious beast, with liquidity holding up well at the more distressed end of the market, and among issuers who were well shielded from the virus impact or which even have a positive crisis story to tell (such as in healthcare). In the latter group, some companies are trading not far below where they traded before, but there may well be reasonable value here as the default risk remains low.

In the middle group, however, where visibility about prospects is relatively low, liquidity has been weaker and prices suffered early in the crisis. That means the potential for both risk and value is perhaps highest here, in our view. And it is here, too, that good credit analysis will be able to add the most value, although it may take time to position portfolios.

Within these groups, across sectors and within sectors the effects of the pandemic have been uneven. Balance sheet liquidity has always been a key part of our credit research tools, but it is particularly relevant now to determine which individual companies may have trouble bridging to the other side of this crisis in both a base case and a more stressed case where lockdowns persist or return. We have been reviewing individual holdings for short-term liquidity needs in both scenarios, while our analysis is adapting daily to factor in the unique characteristics of national intervention and support measures.

This issuer-by-issuer approach applies equally to the influx of so-called fallen angels from the IG segment into HY – the dollar volume of fallen angels hit a record $91.5bn in March. This ongoing effect of the crisis is having a material impact on the size and structure of the HY market and will bring buying opportunities as the market adapts. We believe there should be no blind rush to snap up fallen angels, especially in weaker sectors. Value is possible because there may be forced sellers and the companies concerned may be larger and more resilient. However, fundamental analysis and valuation remains the starting point for any individual trade.

In an unprecedented crisis, barely a decade from the last one, markets have rightly been rattled. But as volatility softens, attention should turn to the value on offer. We can see good reason to increase duration and risk positioning, where appropriate, while controlling risk for more stressed situations that may arise. History suggests that entry into the HY market at these sorts of spreads has a good probability of a strong return over a one-year view providing good opportunites for UK pension schemes.

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