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High Yield: Finding Value in a Landscape Rife with Risk

BARINGS INSIGHTS

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Concerns surrounding COVID-19, lower oil prices and a global recession have weighed heavily on markets—including global high yield bonds and leveraged loans. While value opportunities are emerging, the landscape is punctuated with risks that must be carefully navigated.

The fallout from the coronavirus is already causing economic deterioration, and will likely continue to weigh heavily on consumer sentiment as countries across the globe adapt to the new reality of travel bans, closed schools and working from home. High yield has felt the full effects of this in recent weeks, as bond and loan spreads have widened past levels experienced during the European sovereign debt crisis (2011), the commodity crisis (2016) and the volatile period in the fourth quarter of 2018. While spreads today aren't quite at the wides seen during the global financial crisis, the trajectory and pace at which asset prices have moved in recent weeks is certainly reminiscent of that period.

Also evocative of the financial crisis, the selloff we've seen recently is less a result of changes to the underlying credit fundamentals of corporate issuers, at this time, than of an exogenous or unforeseen shock—in 2008, the bankruptcy of Lehman Brothers; today, the global pandemic. That said, the length and severity of the pandemic is a still a big unknown, and the longer it plays out, the more fundamental deterioration we would expect to see. With that in mind, we continue to closely monitor and reevaluate our views on an ongoing basis and as conditions dictate.

Looking at the markets today, while we would expect fundamentals to weaken, we believe current spreads—anywhere from roughly 600–1150 bps over the base rate—may at this time be overcompensating for the real risk to corporate earnings. While defaults are likely to rise, particularly in more troubled sectors, we think they will remain largely manageable and in easily identifiable areas. With regard to corporate earnings, we expect a majority of issuers may be poised for a relatively sharp recovery from the pandemic itself, once supply lines open back up and companies return to more recognizably normal trading. We also believe investors will act rationally to bridge the extreme nature of the event, providing liquidity support where necessary to help companies through the disruption. In addition, many of the companies in this space have positioned their maturity walls well following the high levels of recent refinancing activity. This, together with the low base rate environment, should help mitigate the impact of subsequent economic weakness.

Given the decline in oil prices and the economic impact of the virus, the likelihood of a large wave of fallen angels—credits that fall from the lowest IG rating to a high high-yield rating—has increased significantly in recent weeks, evidenced by the recent downgrade of Ford. In fact, J.P. Morgan estimates that as much as $215 billion of debt (or almost 4% of the investment grade index) could be downgraded in 2020, which would be a record. We expect this could put technical pressure on parts of the high yield market as buyers look to sell out of certain issuers to make room for the new issuers that fall into the market. Somewhat counterintuitively, however, the rise in fallen angels could work in high yield investors' favor over the long term if the composition of the high yield market itself begins to tilt to higher-quality, more liquid issuers that still offer yields—and potential total returns—more akin to what would traditionally be expected in high yield.

FIGURE 1: Spread Widening Has Historically Been Followed By Periods Of Strong Performance

	Global Financial Crisis		European Sovereign Debt Crisis		Commodity Crisis		4Q 2018		3/31/2020
Market	Spread Wides	12 Month Total Return	Spread Wides	12 Month Total Return	Spread Wides	12 Month Total Return	Spread Wides	12 Month Total Return	Current Spread
European BB High Yield[1]	1566 bps (12/11/2008)	65.4%	801 bps (10/04/2011)	26.2%	505 bps (02/11/2016)	14.9%	398 bps (12/11/2018)	14.4%	582 bps
European B High Yield[2]	2604 bps (11/24/2008)	90.1%	1193 bps (10/04/2011)	33.4%	772 bps (01/20/2016)	17.8%	740 bps (12/11/2018)	13.6%	1150 bps
European Loans[3]	1987 bps (12/18/2008)	48.1%	901 bps (10/06/2011)	10.6%	584 bps (03/01/2016)	9.5%	458 bps (12/31/2018)	7.5%	998 bps
U.S. BB High Yield[4]	1444 bps (12/16/2008)	54.4%	683 bps (10/04/2011)	20.3%	582 bps (02/11/2016)	19.4%	363 bps (12/27/2018)	16.3%	641 bps
U.S. B High Yield[5]	2084 bps (11/21/2008)	56.8%	923 bps (10/04/2011)	21.3%	900 bps (02/11/2016)	25.9%	579 bps (12/27/2018)	15.0%	957 bps
U.S. Loans[6]	1859 bps (12/16/2008)	45.4%	757 bps (08/26/2011)	10.7%	700 bps (02/16/2016)	12.5%	552 bps (12/28/2018)	8.2%	974 bps

12 month total return is from spread wides.
PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS.
1. SOURCE: ICE BAML BB European Currency High Yield Index (HP10), Hedged to USD.
2. SOURCE: ICE BAML B European Currency High Yield Index (HP20), Hedged to USD.
3. SOURCE: Credit Suisse Western European Leverage Loan Index (Non-USD denominated), Hedged to USD.
4. SOURCE: ICE BAML BB U.S. High Yield Index (H0A1), Hedged to USD.
5. SOURCE: ICE BAML B U.S. High Yield Index (H0A2), Hedged to USD.
6. SOURCE: Credit Suisse Leverage Loan Index, Hedged to USD.

Some Industries More Vulnerable Than Others

The effects of COVID-19 are not (and will not be) uniform, with some industries and companies more vulnerable than others. While this is being reflected in the market to some degree, everything is down notably, which we do not believe to be indicative of overall fundamentals or potential recoveries. For instance, there are a number of higher-quality companies that are trading down significantly despite being largely sound from a fundamental perspective and unlikely to experience a massive disruption to earnings. Food manufacturers, cable providers and packaging companies, for example, seem to be operating more or less as usual—and in some cases may even be benefitting from stronger sales during this period. We believe these businesses are also likely to experience the quickest recoveries once this event is behind us—something the market does not appear to be pricing in.

There are also many companies that are facing short-term challenges but remain well positioned longer-term. While these businesses may require liquidity to move through this short-term pain, they were on solid footing coming into this event and will likely emerge in decent shape afterward. Cinema businesses, travel companies and sports franchises (like Formula 1 Racing) are examples. Though negatively affected in the short-term by social distancing trends and, in a growing number of cases, mandated (temporary) closures, these sectors and companies could see a sharp recovery in demand on the back of the pandemic.

It's not surprising that industries incurring a direct blow from the pandemic have been hardest-hit. Energy, which has been under pressure for the last several years, is a prime example. In addition to the pandemic, the sector is under tremendous pressure from the decline in oil prices, and it's not out of the question that we could see a steep rise in defaults going forward. The challenges will likely be felt most acutely in the U.S. high yield bond market, where energy makes up roughly 10% of the market. In the senior secured bond and European high yield markets, for comparison, the impact should be much less material as energy makes up roughly 5% and 3% of those markets, respectively.[1]

Retail is another—comprising many highly levered businesses already facing secular challenges, the industry is now confronting the very real prospect of stores being shut down for weeks or months at a time. This doesn't mean there isn't value to be found in these sectors on a selective basis—but in many cases, these industries and companies will be hit harder, and take longer to recover. For this reason, and outside of select opportunities, we think these areas look less appealing today on a risk/return basis.

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1. Source: Bank of America Merrill Lynch. As of March 13, 2020.

How High Can Defaults Go?

It's extremely difficult to say with any accuracy how high defaults may ultimately go. Broadly speaking—and keeping in mind that the longevity and severity of the virus remain to be seen—we believe there are two categories of defaults likely to occur.

The first is composed of good businesses that may only go into default as a result of this specific event. While these companies may switch off coupons and/or request liquidity support—either from debt or equity investors—we believe that the support will be forthcoming. As a result, we think there is a good chance those businesses will ultimately bounce back in the aftermath of the epidemic, resulting in only minimal losses.

The second category comprises companies that were perceived to be high risk prior to the pandemic—such as those that were trading at stressed or distressed levels at the end of last year. A simple analysis of companies trading below dollar (or Euro) prices at key breakpoints **(FIGURE 2)** provides a rough indication of the percentage of the market that falls into this category. These companies, in our view, may have already been headed for balance sheet restructurings—though this event will likely accelerate those restructurings. Here, we would expect to see recoveries more in line with market precedent over the medium term. Challenges will certainly be amplified in the short-term, particularly if these restructurings occur while equity market valuations are still depressed. However, we believe there is a strong possibility that value will bounce back over time.

FIGURE 2: Credits Trading At Stressed Or Distressed Levels At Year-End 2019

	80 and Below	85 and Below	90 and Below
U.S. Loan Market	2.9%	5.5%	8.6%
European Loan Market	1.0%	1.8%	5.5%
U.S. High Yield Bond Market	3.6%	4.4%	6.4%
European High Yield Bond Market	2.0%	2.8%	4.3%

SOURCES: Barings, Credit Suisse and ICE Index Platform. Representative indices for each market include Credit Suisse Leveraged Loan Index, Credit Suisse Western European Leveraged Loan Index, ICE BofA U.S. Non-Financial High Yield Constrained Index and ICE BofA European. Currency Non-Financial 3% Constrained Index. FOR ILLUSTRATIVE PURPOSES ONLY.

Indeed, while defaults do entail a potential loss of principal, there are typically opportunities to recover a portion of that through a restructuring process. Although past recovery rates do not indicate future results, factoring in long-term recovery rates of 50% for unsecured high yield bonds—very close to the long-term average recovery rate—suggests spreads of roughly 900 bps imply a market-wide default rate of roughly 18%—far in excess of the roughly 10% we saw during the global financial crisis. But as suggested above, this scenario may be overly pessimistic for the market as a whole.

Lessons From History

The COVID-19 crisis may tip the global economy into recession, but it is notable that mild recessions have not necessarily been bad environments for credit markets in the past. The majority of high yield issuers have the flexibility to continue to service their debt through a period of economic weakness, especially if that period proves to be somewhat mild and temporary.

While this crisis should not be taken lightly, especially given the immense and tragic toll it is taking around the world, it is worth reiterating that financial markets have a history of overreacting to headlines—both the negative and the positive—and a tendency to exhibit short-term pricing inefficiency during periods of dislocation or volatility.

In the years since the financial crisis, there have been a number of risk-on/risk-off periods in response to macroeconomic and geopolitical factors. Lasting anywhere from a few weeks to several months, these dips in the market have often been followed by periods of recovery and gains. Indeed, almost without exception, the credit markets tend to have a lower drawdown than their equity counterparts during such periods, while also having a much quicker recovery **(FIGURES 3, 4)**.

High yield spreads saw extreme widening during the 2008 financial crisis, and significant drawdowns across the board—all markets exhibited peak-to-trough declines of 30% or more. Within a year, the markets had largely recovered, and all went on to deliver 12-month total returns in excess of 40%. The bond and loan markets declined again during the European sovereign debt crisis in 2011, with spreads widening materially, though not to the levels seen during the GFC. The European bond and loan markets, perhaps unsurprisingly, were hit hardest. Notably, the markets went on to rally the following year, with European single-B bonds delivering 12-month returns of roughly 33%.

The energy and commodity shock in 2015 paints a similar picture. High yield took a negative turn as oil prices fell, and spreads—particularly on U.S. bonds and loans—widened. Less than six months later, the market rallied, generating positive returns across the board. Most recently, in the fourth quarter of 2018, headline-induced turbulence caused bonds and loan spreads to widen—in excess of what was experienced during the post-GFC period. Within two months, the markets experienced a swift rebound, and delivered very strong performance on the year.

While every crisis is different, we have been in similar situations before—and we know that ultimately, times of crisis can also yield significant opportunity if navigated carefully.

FIGURE 3: Max Drawdown During Historical Periods Of Volatility

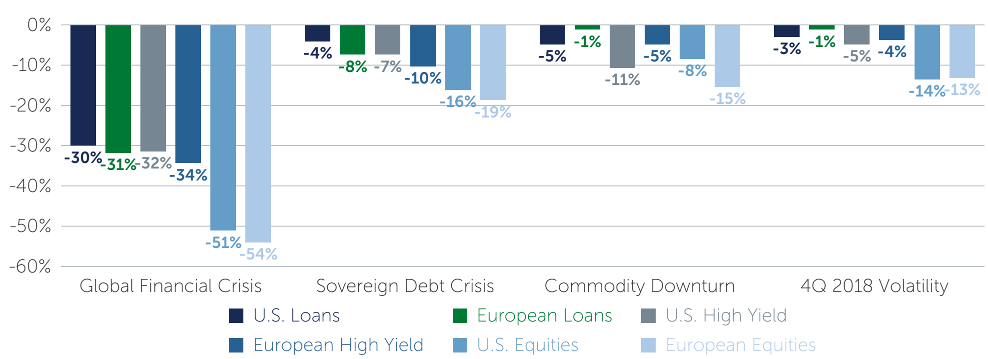
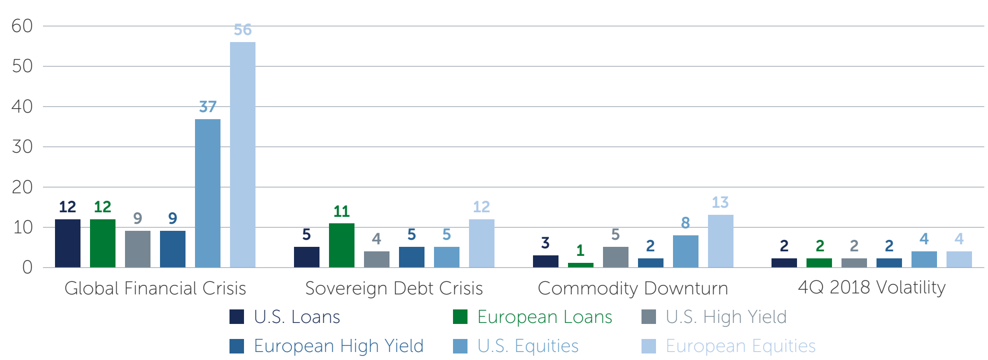


FIGURE 4: Number Of Months To Recover After Drawdown



SOURCES (FIGURES 3, 4): Credit Suisse Leveraged Loan Index, Credit Suisse Western European Leveraged Loan Index (non-USD, hedged to EUR), ICE BofA U.S. Non-Financial High Yield Constrained Index, ICE BofA European Currency Non-Financial High Yield 3% Constrained Index (hedged to EUR), S&P 500 Index and STOXX Europe 600 Index.

Not the Time to Time the Markets

History has proven that it is almost impossible for investors to "time the markets" in high yield. Rather, what has tended to work over the long run is a flexible approach, whereby managers shift allocations between bonds and loans (and across geographies) as prices decouple from fundamentals and relative value emerges.

As we look across the markets today, in addition to the opportunities we see in traditional high yield bond and loan markets, opportunities are also beginning to appear in less trafficked, below investment-grade credit. Distressed debt, for instance, presents an interesting opportunity—and the global pandemic may just be the trigger that investors have awaited for deploying more capital into these strategies. While we believe opportunities may be plentiful in the next cycle, there are a number of challenges in this space. For this reason, casting a wide net that covers a variety of deal types, sizes, asset classes and geographies is likely to be critical for investors aiming to generate alpha.

Collateralized loan obligations (CLOs), too, offer an interesting opportunity. While there are certainly some concerns around the asset class, we believe it tends to be somewhat misunderstood, and the benefits overlooked. In particular, CLOs can offer an opportunity to pick up meaningful incremental yield relative to traditional bonds and loans, with the added benefits of diversification and enhanced structural protection. Though not without risk—one concern today, for instance, is the potential for challenges on the back of recent loan market weakness—the asset class has also delivered solid risk-adjusted returns, and low relative defaults, over time.

The long-term impacts of the coronavirus and related economic slowdown are impossible to quantify at this stage. Things may very well get worse before getting better and investors will undoubtedly be forced to grapple not only with volatile markets, but also with continued negative headlines reflecting the reality of this extremely challenging time for all. That said, opportunities are emerging, and given the extent that market prices have fallen, investors do not need to take on extreme levels of risk to earn potentially attractive returns. In higher-rated parts of the high yield bond and loan universe, and in areas like distressed debt and CLOs, the long-term risk-reward picture has become particularly compelling—but investors must stay vigilant.

Markets, as mentioned, are impossible to time. But if the past is any indication, a steadfast focus on fundamentals and bottom-up, credit-by-credit analysis can help identify issuers with the potential to thrive beyond today's events—and this crisis, ultimately, may prove to be a significant opportunity for value creation.

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