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FIXED INCOME

High Yield: The Power of Flexibility in Volatile Times

BARINGS INSIGHTS

The journey back to normalcy will likely be punctuated with stops and starts. But opportunities will emerge—and being in a position to capture the upside is key.

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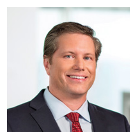

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High yield has regained much ground since the significant selloff in mid-March. But uncertainty remains, and volatility is likely a given going forward—particularly amid fears of a second wave of coronavirus cases. Just as the pandemic and related economic slowdown have been more severe for some industries than others, the pace of recovery will be far from uniform.

Sectors like travel and leisure, entertainment, retail and aerospace have been particularly hard-hit by social distancing trends and mandated closures, as companies have seen revenue decline sharply, in some cases to zero. Many of the companies in these industries have traded down significantly, despite being on solid footing heading into the crisis. However, while this has been an extremely challenging environment, there are select companies across these sectors that look stable from a fundamental perspective and now offer significant upside—as they appear to be well-positioned longer term and could see a strong recovery in demand when the pandemic finally recedes.

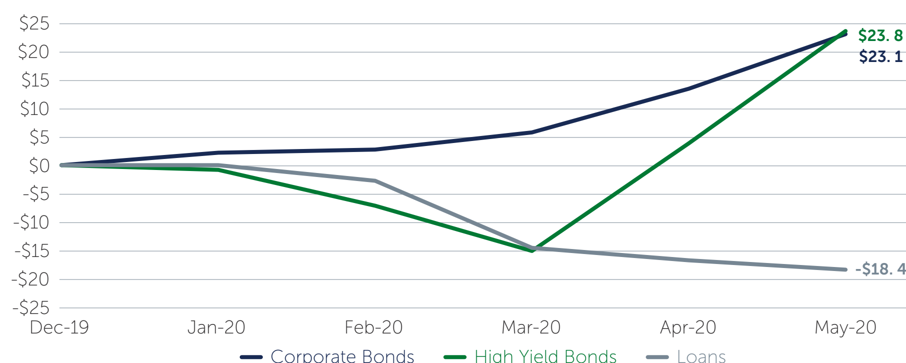
There will likely be different ways to access the opportunity as these industries begin to recover, driven in part by technical distortions—such as we have seen across loans and CLOs—as well as by the varying pace of reopening and recovery across geographies.

Loans

In late March, the U.S. Federal Reserve announced that it would begin to buy so-called fallen angel credits—or those recently downgraded from the lowest investment grade status to high yield—as well as shares in high yield ETFs. More recently, the central bank announced that it will also buy individual corporate bonds in the U.S. In response, U.S. high yield bond funds experienced notable inflows both in April—$13.9 billion—and in May—$15.3 billion, the second largest monthly inflow on record.[1]

Outside of a few marginally positive weeks, net flows for loans, which were excluded from the Fed's announcement, remained negative. Exacerbating this, and in a continuation of the last 12-18 months, expectations of lower interest rates have perpetuated some investors' shift away from loans and into fixed rate assets. CLO issuance has also remained relatively muted compared to history, partially because the pricing of liabilities has made the economics of CLO transactions (the arbitrage) more difficult.

FIGURE 1: YTD Estimated Net Fund Flows ($B)



SOURCE: Barings, Morningstar Direct. As of May 31, 2020.

1. Source: J.P. Morgan. As of April 30; May 31, 2020.

The combination of these technical factors has slowed the recovery of the loan asset class, leaving what we believe to be material upside potential for many loans, particularly those issued by lower-rated companies and in more challenged sectors. And there are signs that the technical picture is beginning to improve: CLO buyers have been slowly returning to the loan market via new CLO issuance, which combined with the lack of primary supply in the loan market, could provide a strong technical tailwind for loans—even before any improvement in the 'real economy' is priced into fundamentals. While some companies will inevitably default going forward, most should be able to continue to meet their debt obligations and will eventually see their trading levels normalize, or move back closer to par.

CLOs

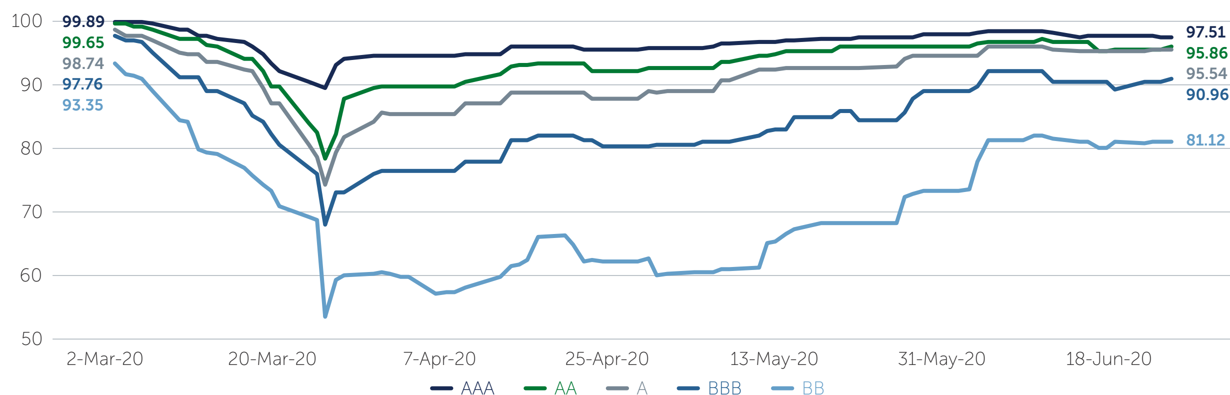
When it comes to below investment grade credit, there are also advantages to looking across less trafficked asset classes like CLOs. While CLOs function somewhat differently than the more traditional high yield bond and loan markets, they can offer attractive value, particularly for investors willing to take longer-term positions.

Through the recent bouts of volatility, we have continued to see examples where prices have decoupled from fundamentals, offering opportunities to capture value. For example, BB CLO tranches experienced strong selling pressure during the March volatility, leaving them trading at heavily discounted prices—below what fundamentals would suggest and at levels that appeared to overcompensate for potential defaults. This created what we viewed as a compelling opportunity to invest in high-quality deals at attractive prices—although the window for capturing this upside has begun to diminish as investors have become more comfortable investing in lower-rated parts of the capital structure, particularly considering how this segment of the market has rebounded in previous selloffs.

Indeed, the market has rallied back in recent weeks—partly a result of the liquidity that entered the market following the Fed's announcement, but also helped by improving forecasts around defaults and downgrades, as well as potential cash flow diversions. As evidence of this, the CLOIE BB index was up 23% in the month of May and is up roughly 11% as of June 26. That said, prices remain depressed compared to the period immediately preceding the COVID selloff and are expected to recover further over time.

Despite the recent rally, we continue to see long-term value in BB tranches, particularly given the potential illiquidity and complexity premium versus more traditional high yield bonds and loans. CLOs can also provide an effective way to access the loan market. CLOs are the largest buyers of loans, and they are actively managed—and CLO managers remain active buyers in both the primary and secondary markets even during periods of limited loan issuance. This puts managers in a position to take advantage of potentially attractive relative value opportunities as they emerge. However, not all CLO managers are created equal, and manager selection is paramount.

FIGURE 2: JPM CLOIE Tranche Prices



SOURCE: J.P. Morgan. As of June 25, 2020.

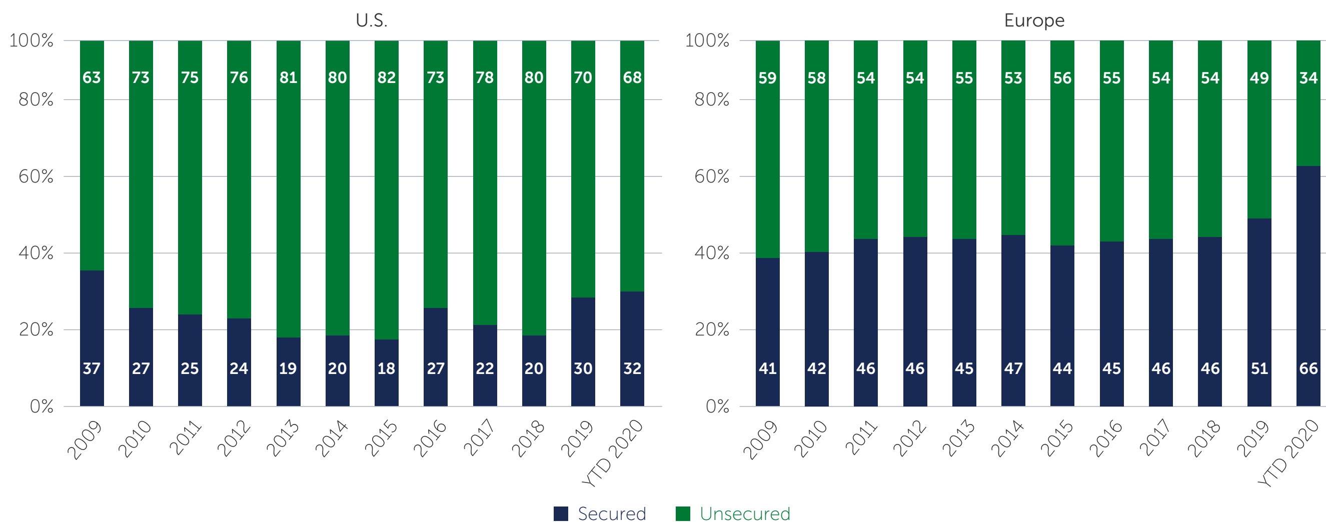
Cross-Border Relative Value

From a geographical perspective, as the U.S. and Europe open their economies at different paces and central banks provide varying levels of stimulus, relative value will likely shift across the two regions, presenting opportunities for investors who can straddle both geographies efficiently. In particular, actively managed strategies that invest across these markets should be well-positioned to capitalize on unique opportunities in individual credits or segments of the market that arise as a result of external influence.

The Fed's bond-buying program exemplifies this: in addition to providing a strong tailwind to the U.S. high yield bond market, which did not extend to European high yield, the Fed's announcement opened the door for U.S. high yield issuers to come back to the market. European high yield issuance, on the other hand, has been slower to recover. As a result, we believe the U.S. market looks slightly more attractive on balance, as the window for primary issuance is open and providing investors with opportunities to put capital to work at attractive valuations.

The increase in fallen angel credits—or those recently downgraded from the lowest investment grade status to high yield—has also created opportunities in the U.S. market. Since the onset of COVID, roughly $200 billion of debt has been downgraded from investment grade to high yield, including well-known companies like Ford and Occidental Petroleum.[2] Fallen angel credits can, in our view, create an opportunity for high yield investors to invest in higher-quality, more liquid issuers with yields—and potential total returns—more akin to what would traditionally be expected in high yield. Looking ahead, we expect additional downgrades, even as the economy recovers.

FIGURE 3: High Yield New Issuance



SOURCE: S&P LCD. As of May 31, 2020.

Within the U.S., we see better value in select, high-quality companies in the harder-hit sectors mentioned above, which we believe are well-positioned to experience strong recoveries on the back of the pandemic. In many cases, these companies have been able to successfully refinance themselves or access additional capital, although investors are understandably asking for better

2. Source: J.P. Morgan.

"While the corporate credit markets tend to be highly correlated over the long term and exhibit similar risk/return profiles, they are driven by different factors that, historically, have caused them to outperform or underperform one another at different times"

economics and controls. Indeed, senior secured lending, in particular, is proving popular among the markets' buyer base—and we have seen a significant rise in secured bond issuance in the U.S. in recent weeks. Given today's heightened volatility, senior secured bonds offer a number of potential benefits worth considering—while not recession-proof, they are higher in the capital structure than unsecured bonds, which means they can offer investors greater protection from principal loss in the event that market default rates spike.

It is worth mentioning that while the U.S. market has benefitted recently from the technical factors mentioned above, the European market has performed strongly over time. In fact, European bonds or loans have outperformed their U.S. counterparts in seven of the last eight years, despite what was perceived to be a healthier economic environment in the U.S.[3] Going forward, pockets of relative value will very likely emerge across the region as the economy recovers—and a global strategy can put investors in a position to capitalize on the resulting opportunity.

Accessing the Opportunity

Indeed, while the corporate credit markets tend to be highly correlated over the long term and exhibit similar risk/return profiles, they are driven by different factors that have caused them to outperform or underperform one another at different times—a dynamic that tends to be exacerbated during periods of volatility and uncertainty. It can be very difficult to time investment decisions around short-term market movements, and technical drivers such as we're currently seeing in some areas of high yield can recede as quickly as they appear. For this reason, we believe the ability to look across geographies and asset classes to uncover relative value in high yield is as critical as ever.

Risks abound, certainly, and the universal challenges facing businesses as a result of COVID and widespread shelter-in-place orders should not be underestimated. But opportunities will emerge as the economy gradually improves—and a multi credit approach, in helping facilitate the timely capture of evolving relative value opportunities, can help position investors to capture the upside as the market recovers.

3. Source: BAML; Credit Suisse. As of December 31, 2019.

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