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Global High Yield Whitepaper

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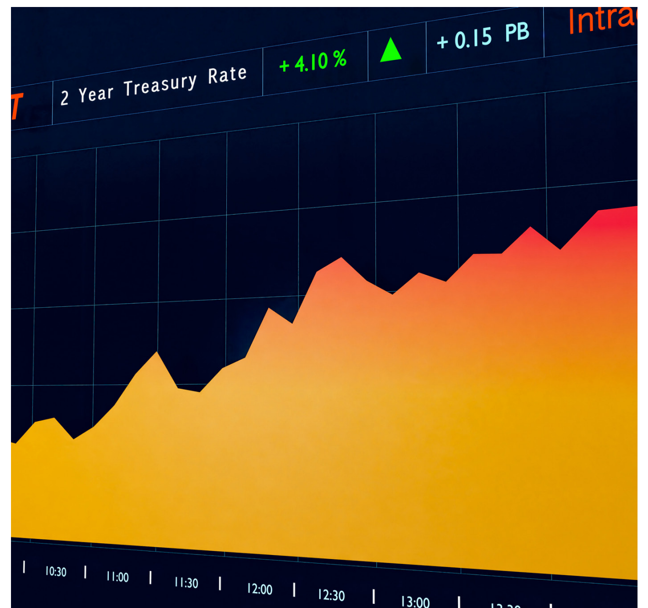

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Welcome to CAMRADATA's Global High Yield Whitepaper

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In an economic environment rocked by inflation, war and the overspill of a pandemic, there is often little appetite for risk.

Flows out of high yield funds over the past year, according to Lipper, have shown investors' caution towards the asset class, but the US Federal Reserve raising interest rates may have done it a favour by constraining supply.[1]

Yet expected default rates have been on the rise in recent months, according to rating agency Fitch. In April, it cited the collapse of Silicon Valley Bank as a catalyst for it raising its estimate to between 3-3.5% over 2023, up from the 2.5-3.% it predicted in October.[2]

However, these estimated defaults are lower than the agency's historical average of 3.6%, despite a backdrop of US political wranglings about its debt ceiling.

This may explain why spreads above fixed income instruments further down the risk curve are relatively narrow, despite the looming threat of recession in some major global economies.

But with an asset class that is buffeted more than most in the field of fixed income by external factors, how should investors be assessing it within a portfolio?

[1] https://lipperalpha.refinitiv.com/2023/04/high-yield-corporate-debt-funds-attract-inflows-as-high-yield-bond-issuance-increases/#

[2] https://www.fitchratings.com/research/corporate-finance/us-hy-default-rate-inches-higher-diamond-sports-default-looming-14-02-2023#:~:text=We%20forecast%20HY%20defaults%20will,out%20of%20the%20TTM%20period.

Global High Yield Roundtable

The CAMRADATA Global High Yield Roundtable took place in London in May 2023

Navigating high-yield debt through economic storms

High-yield debt has felt the impact of global economic malaise and high inflation over the past year, though the returns available are piquing investors' interest once more.

Defaults may be on the rise, but countering that is the huge range of investment options available within the asset class. So, what is the outlook for high yield and, importantly given the economic slowdown, for recoveries from these securities? Which looks more attractive – sovereign or corporate high yield – and how does the pressing issue of sustainability play out in the space?

CAMRADATA invited a panel of senior investment specialists to weigh up the opportunities and challenges of this asset class. Panellists on the roundtable came from a wide range of backgrounds, serving both institutions and private clients in developed and emerging markets. From their divergent standpoints, they shared their contrasting client views about high yield's appeal.

Artemis' Fixed Income Portfolio Manager Jack Holmes was upbeat. "Definitely the conversations we've had recently are more positive on fixed income more broadly but within that high yield," he said. "We have clients that had stepped away from fixed income and been very low duration for the last decade [now] re-evaluating the space.

"A lot has come from investors re-evaluating equity exposure and still wanting to have some upside without the same level of downside. The other factor is that many investors have had to hunt for alternative sources of yield over the last five years and there is a bit of a relief switching from something like private credit or something more exotic, to something that's a bit easier to understand and to communicate to the end client."

Chris Sawyer, Head of the European High Yield Investments Group at Barings, noted, "What we've seen this year is people accept the world is different – it is likely to stay different. We're not a believer in rate cuts this year or in inflation being under control and a lot of investors are coming round to that. So, this high-yield, higher-for- longer environment is one we should all get used to.

"In credit generally there is a little bit of something for everybody. If your focus is on liability matching, you probably want to look more at high yield or investment grade – if you need income, you've got loans, which are currently offering a high single digit running/income yield given their floating rate nature and the move in base rates. Once you understand the credit risk in each market, there's some pretty good value to be had."

> *"With our larger family clients, we're often the most liquid part of their strategy. That's something we're always quite focused on. The concept of risk and credit/fixed interest has been thrown into a whole different dynamic over the last 12 months."*

Lane Clark & Peacock LLP (LCP) Senior Consultant and Head of Liquid Credit, Nick Cooney said, "The past year or so has been difficult, with de-risking and more con-strained liquidity budgets, but high yield is now looking more attractive. So, investors are moving away from some of the private assets they were previously allocating to and looking at these liquid asset within the high yield again."

WTW Global Head of Credit Research Kate Hollis, noted that high yield is a permanent fixture in the "return-seeking bucket" of defined benefit portfolios but she added, "Some countries are constrained by local regulations. In the UK, in particular, the charge cap makes it difficult to buy high yield in DC portfolios."

However, Oakglen Wealth's Nick Davis, Investment Director – UK, said he is concerned about the liquidity constraints associated with high yield.

"We are slightly more cautious about liquidity in fixed-income markets full stop and we think spreads are still relatively narrow over government bonds to justify that liquidity risk."

"With our larger family clients, we're often the most liquid part of their strategy. That's something we're always quite focused on. The concept of risk and credit/fixed interest has been thrown into a whole different dynamic over the last 12 months."

Giving a Middle Eastern perspective, Habib Investment Limited Head of Investment Advisory, Sandeep Jadwani, noted that investors in the region were more naturally attuned to high yield.

"The investment ideology is typically driven by a high disposable income and higher expenses, which make investors usually high risk by nature. They need to get that extra return by increasing the risk. We typically make our clients aware that the high-yield space is interesting

as it's not as interest-rate sensitive as Treasuries or IG, but is driven by the underlying sentiment and balance sheet of the particular corporate or sovereign."

By contrast, among the Italian retail clients at Mediolanum, fund analyst Paul Tsavalas noted a "tug of war with the safeness and familiarity of investing in BTPs [Italian government bonds]. We are trying to highlight that asset classes such as the high yield market are a prudent way to diversify exposure away from BTPs while not forgoing an attractive yield."

Role of high yield

WTW's Hollis noted that high yield can add some useful duration to portfolios as well as return, while LCP's Cooney described it as a helpful middle ground in terms of risk and return between other fixed income and equities.

"The evidence suggests it has done well over longer periods and looking forwards, it is likely to do better than it has done in more recent times when we've had a low interest-rate environment," he said.

Oakglen's Davis was a dissenting voice. He feels the underlying assets behind corporate high yield – equities – are overpriced. History, he suggested, points to caution.

"Back in 2008, everyone said, 'Run from equities,' and everyone piled into high yield. Hang on, you are not prepared to invest in this company but you are prepared to lend them your money? That's quite a crazy decision."

Countering that view, Barings' Sawyer noted that high-yield spreads had almost doubled from 2007/8 to close to 500 today.

> ***"Panellists pondered the question of whether the fixed-income universe has caught up with the rapidly widening investment horizons of even the least sophisticated of investors."***

"Equity markets seem to be a one-way bet on rate cuts. With high yield, you are talking about lending to a company, generally speaking, at less than 50% loan to value for a three-to-four-year period where you get money back as long as the company doesn't go bust. It is a very different risk profile and much more in favour of the investor."

Both WTW's Hollis and Artemis' Holmes noted that covenants afforded protection not available to equity investors. Holmes also pointed to the asset class' greater bounce-back potential compared with equities.

In the credit crisis "high yield fully recovered from the trough within nine months – equities took almost five years. Over the long term you get a very good risk-adjusted return from high yield. That hasn't played out in last five years because of this very low-rate environment. But we're clearly out of it," he said.

Mediolanum's Tsavalas also noted the relative resilience of high yield.

"If we talk about the potential recovery rates when we do have these bad events, this is something this asset class can offer as opposed to equity, when you just lose all your capital."

Roundtable panellists discussed the image problem that has dogged high yield, including the unhelpful "junk bond" moniker. LCP's Cooney suggested comparing high-yield managers with the benchmark has contributed to high yield's dubious reputation, while WTW's Hollis said that investors harbouring the notion that fixed income is "proxy cash" are not doing the asset class any favours.

In fact, panellists noted that high yield is as diverse as the companies or entities behind it. Barings' Sawyer cited such behemoths as Telecom Italia, Virgin Media, Netflix and Formula One Motor Racing among the established, household names issuing high-yield debt in recent years.

Emerging market high yield

If high yield is already widely perceived as risky, what happens when you add emerging markets to the mix?

Habib Investment Limited's Jadwani said, "This boils down to the reach and understanding of ground-level reality – apart from the numbers we would typically see or the cash flow coming through, and the age and legacy of the company, we look at how systemically important that credit is to the country where it is based."

In the case of oil companies, where the risk is driven by geopolitics, "we are on the ground and we understand what an Adnoc is doing, what Oman Oil is doing," he added. "We know that as sovereign and systemically important entities, they won't default."

Artemis' Holmes was among panellists eschewing emerging market high yield.

"It is a different skillset. To my mind, it requires deep knowledge to understand the political system and how the company is integrated within that – and fundamentally we don't think we have any edge there to be able to do that. We therefore focus on developed market high yield, where our edge lies."

Panellists pondered the question of whether the fixed-income universe has caught up with the rapidly widening investment horizons of even the least sophisticated of investors.

WTW's Hollis said, "The fixed income universe has expanded enormously but the price is liquidity. Some of this newer stuff is complex but all of it is of limited liquidity compared to equities. That is the problem. When people decide they want to get out they either find they can't or they get hit with a walloping ADL [anti-dilution levy], or a swing. It's been exacerbated by certain fund managers providing daily liquidity on portfolios that are anything but, for marketing reasons."

Artemis' Holmes added, "The point about liquidity is misunderstood by most of the market – it goes back to the issue of people viewing things as single units."

"Maybe it's a simplistic way of approaching the market but it feels like there is a misunderstanding. 'I have my daily liquidity on my agency MBS portfolio, so why can't I get it on my subprime car loan portfolio?' Those are two radically different asset classes and we probably need to

be better in terms of communicating that to clients. "

High yield and sustainability

Sustainability is a major preoccupation for equity investors, though panellists were divided about the influence their high-yield counterparts can exert. They also noted that ESG was a nuanced arena and something of a minefield with 'environmental' and 'social' mandates often conflicting, for example, where a developing-world mine closure would put thousands out of work.

ESG risk abounds in certain industries, such as coal, tobacco, and gaming, panellists noted. However, in high yield, ESG as a risk factor is often overlooked.

Artemis' Holmes said, "There are businesses that have fundamental risks associated with them that, despite high yield's theoretical fundamental focus on risk, is totally ignored.

"To my mind, that's analysis that needs to be done by an analyst that is individually covering the stock. It can't be outsourced to an ESG specialist or a rating agency."

WTW's Hollis was among the more optimistic of panellists about high-yield investors' ability to encourage good ESG habits.

"There are chunks of high yield that have no public equity, so the only room for engagement is through borrowing. "

Even private equity, not typically regarded as prioritising ethical niceties, has an incentive to listen to concerns about sustainability in order to refinance, she added.

"Engagement is water on stone. You're not going to engage with someone where they suddenly say, 'I've seen the light and I am going to change my whole business model.' But if you make it difficult for them not to change their business model, or their attitude, or their data provision, or whatever it might be, it will change."

Even in the US, where 'bifurcated' concerns about fossil fuels and diversity sometimes work in opposition to each other, companies are answerable to global investors, so need an ESG strategy, she added.

Barings' Sawyer added that private equity also needs to have its ESG ducks in a row when it comes to ultimate exits via IPOs.

"They cannot execute on that in most markets unless they have a fully thought-through ESG policy.

Otherwise, the monetisation of their investment is more challenging."

When it comes to ESG considerations, panellists rued a serious lack of reliable data.

Artemis' Holmes said, "As investors we always value having a number and we sometimes forget that having the wrong number is worse than having no number."

Giving an emerging market perspective from Dubai, Habib Investment Limited's Jadwani said, "If ESG compromises on the return substantially, investors don't want to get into ESG, primarily due to little or no knowledge, though with COP28 coming to the UAE there is a lot of buzz around it."

Oakglen Wealth's Davis noted that from a private client perspective, there is a huge diversity of views but warned of the impact of ESG on investment returns by reducing the available investment universe.

He added, "The governance factor is the key thing. If you have good governance the E and the S piece will probably follow with it. "

Artemis' Holmes was cautious on elements in the claims of some green bonds, particularly in the US, even though, he said, they tend to issue at lower spreads than non-green bonds and trade better.

"My fundamental issue is that unless there is an incredibly clear narrative around 'This is being used for X purpose, which will have Y outcome', and it is very easy to measure, I would regard a green bond as just any other bond in that capital structure."

Panellists also discussed the appeal of sovereign high yield . Habib Investment has significant exposure to GCC sovereign high yield, particularly of oil-exporting nations, said Jadwani.

He added, "Egypt stands out as a sovereign. The spreads are fantastic, the risk-reward profile is good, however, needs to be aligned with investor risk profile. We are very comfortable with GCC sovereign high yield, more than corporates."

However, LCP's Cooney felt that sovereign high yield requires "a different skillset. It's more macro, rate-driven, top-down rather than bottom up."

With economic uncertainty prevailing and the cost of capital high, recovery prospects for when things go awry is a burning question for high-yield investors. Panellists were generally sanguine.

Barings' Sawyer said, "There are going to be some good-quality businesses that are going to default over next five years simply because of 10% cost of capital. In those businesses, we are going to see some very good recoveries. There will be other companies that will go bang and recoveries will be poor."

However, he added, "It's not the high-yield market of 2000, or 2005, where we're really talking about small and medium-sized businesses in growth mode. It's very

different now with large, established market leading businesses issuing high-yield debt.

That scale, size, and reason-to-exist could help underpin a reasonable recovery rate."

"Our base case is that defaults will remain manageable, call it 3 [percent], maybe 4. You are talking about anywhere between 100 and 200 basis points of credit losses in a single year."

Artemis' Holmes added, "Now the cost of debt is higher among treasurers, there is an incentive towards paying down debt. That's a tailwind in terms of credit."

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Three Reasons Why the Fixed Income Environment May Be Better Than You Think

"Perhaps counterintuitively, an environment where credit is less available could work in favor of investors in credit markets—both public and private."

While there are a number of risks creating volatility and unease across the market, there are also reasons to believe that today's fixed income markets offer a range of compelling opportunities.

Recession worries, inflation and tighter credit conditions are impacting fixed income investors, stoking fears of wider credit spreads and an imminent wave of defaults. While the volatility and general unease cannot be dismissed, investors in public debt markets may benefit from taking a step back and assessing the overall level of risk-reward on offer. In our view, and despite the prevailing negativity, investors are likely to find that fixed income currently offers a range of compelling opportunities. Here are three reasons why that is the case:

1. The Long-Anticipated Downturn

Starting in late 2021 as inflationary pressures mounted and major central banks' rate hiking cycles subsequently began, consensus has seen a recession as imminent. While certain countries such as Germany have technically already entered a recession, other major economies such as the U.S. may not follow until later in 2023 or early 2024—arguably making it one of the most widely anticipated downturns in recent history. That has given companies considerable time to prepare and there is little sense of foreboding among corporate management, who are managing costs closely and keeping inventory levels low. Many companies have also reduced leverage levels and proactively increased the maturity profile of their debt. For example, U.S. high yield companies' net leverage declined to 3.4x at the end of last year, from 3.7x a year ago, while interest coverage ratios increased to 5.9x from 4.8x during the same period.[1]

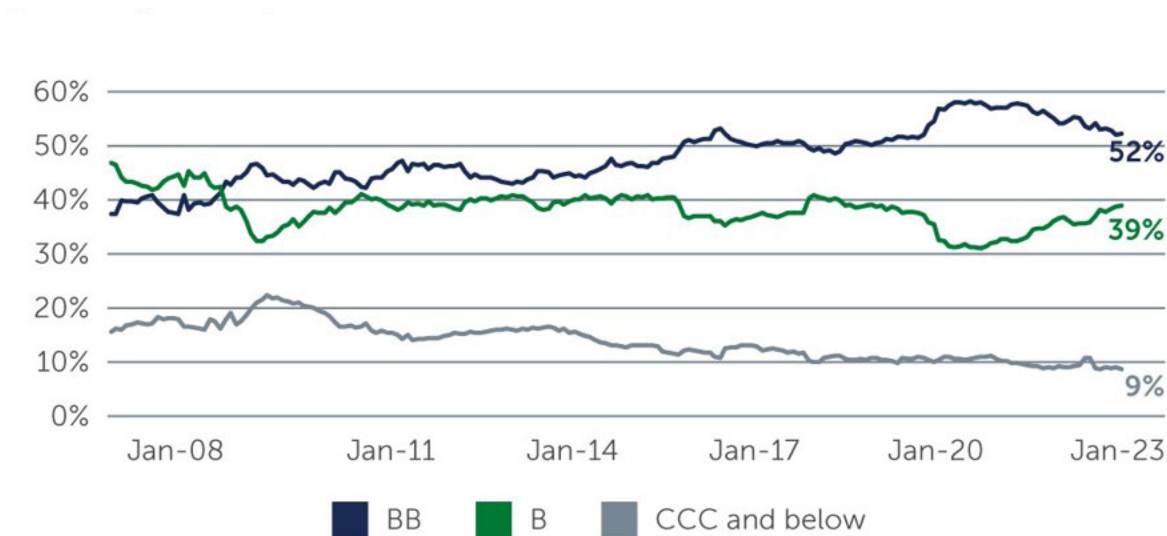
As a result, any earnings decline that occurs as growth slows is likely to be orderly, while default rates could be lower than in previous downturns. Indeed, high yield issuers are in a stronger financial position to ride out a challenging period than they were pre-pandemic, while the credit quality of the global high yield bond market has also improved considerably since the global financial crisis—BB issuers now comprise 52% of developed markets high yield, while single-B companies make up 39% (Figure 1).

Author:

Martin Horne
Global Head of Public Assets

[1] Source: JP Morgan. As of December 31, 2022

Figure 1: A Higher-Quality Market



Source: Bank of America. As of March 31, 2023.

While a recession will undoubtedly trigger some decline in credit quality, unemployment remains at record low levels and hundreds of thousands of jobs remain unfilled. If consumers stay employed, strong demand could continue in many sectors of the economy—which suggests that a downturn may be less severe than some forecasters expect.

2. Dislocations Create Opportunities

While the recent spate of banking problems is more a result of declining market values for high-quality bank assets than of lax lending standards, banks will undoubtedly move more cautiously going forward by making credit less available and more expensive. This is causing concern among public fixed income investors because a lower propensity by banks to lend could trigger liquidity problems for borrowers in public markets. But those fears may be overblown.

Perhaps counterintuitively, an environment where credit is less available could work in favor of investors in credit markets—both public and private. Opportunities to finance healthy companies that would otherwise have tapped banks are likely to increase and with the supply/demand dynamics moving in favor of lenders, investors can expect to earn not only attractive yields but do so with added structural protections. In essence, providing capital when capital is scarce can be an attractive source of returns for investors willing to take smart credit risk—even into a downturn.

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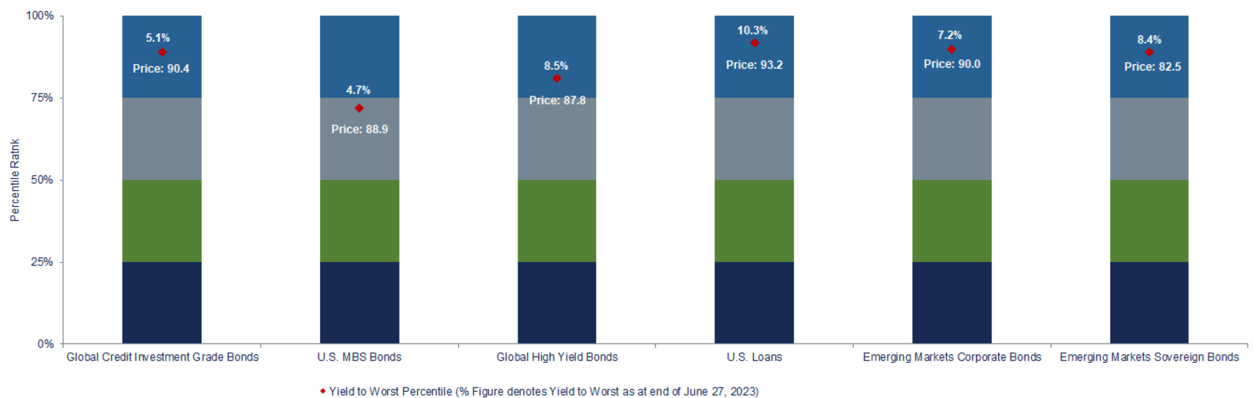
3. Yields Offer a Considerable "Margin of Safety"

While we acknowledge that uncertainty will persist and volatility is likely to remain high, a lot is already reflected in the price. Outside the depths of the pandemic, yields across most fixed income assets are at levels not seen since the global financial crisis and at which investors have historically generated attractive total returns (Figure 2). Trying to precisely time the right entry and exit points is extremely difficult, but fixed income offers the potential for higher and more dependable absolute returns than many other asset classes.

Figure 2: Yields Across Most Fixed Income Asset Classes Are in the 80th-90th Percentile Vs. the Last 20 Years



Source: Bank of America Merrill Lynch, Credit Suisse, Bloomberg, J.P. Morgan. As of June 27, 2023, 2023. ICE BofA Non-Financial Developed Markets High Yield Constrained Index (HNDC), Credit Suisse Leveraged Loan Index, Bloomberg Global Aggregate Credit Total Return Index, Bloomberg US MBS Fixed Rate Total Return Index, JP Morgan CEMBI Broad Diversified Index and JP Morgan EMBI Global Diversified Index. PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS.

At Barings, we advocate for patient investing and diversification in helping our clients solve for challenges ranging from income generation to liability matching. Fortunately, there are more choices today than ever before to help achieve this—from corporate and sovereign bonds (both high yield and investment grade) across developed and emerging markets, to floating-rate loans, collateralized loan obligations (CLOs) and various flavors of asset-backed securities. Indeed, the investment universe is broad and deep.

In managing fixed income portfolios through the ups and downs of many past economic cycles, our team has found that markets generally overreact both to the upside and downside. For savvy investors, intent on finding both absolute and relative value through deep credit analysis, environments like the one we face today can therefore offer some of the best long-term opportunities for total returns.

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