THE FUTURE OF FIXED INCOME

Weekly Bond Bulletin

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Divergent paths for high yield corporates

As an increasing number of high yield corporates run into trouble we question whether the rise in corporate distress is a signal for more caution, or if lower rated credits now look more attractive at improved valuations.

Fundamentals:

Anyone reading the financial news headlines of late would be forgiven for thinking that the UK high street has been fraught with troubles. This year, we've already witnessed the collapse of Jamie's Italian, Thomas Cook and New Look, while more recently the debt-laden dining chain Pizza Express has been in discussions with creditors in a bid to prevent bankruptcy. However, these tales of corporate distress haven't been limited just to the UK. In the US, the energy sector has come under pressure, accounting for roughly half of the defaults suffered in the US high yield market over the past 12 months. Although high yield default rates remain benign, standing at just 2.52% in the US and 1.77% in Europe at the end of September, the number of distressed credits has been on the rise. Leverage among high yield corporates is still at fairly manageable levels and interest coverage ratios remain high. But with funding costs at such low levels, it is worth keeping a watchful eye on those credits that could turn out to be the next ones to get tagged.

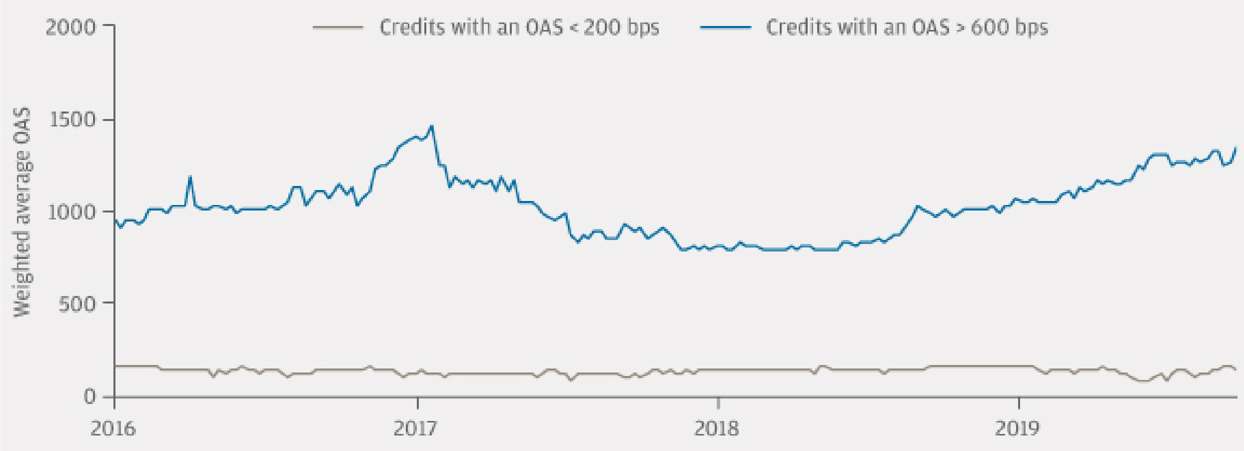
Quantitative valuations:

Despite the increase in distressed credits this year, high yield performance has been strong overall, posting returns of 11.42%. However, these returns have not been broad based and divergence has picked up. In general, tight credits have become tighter and wide credits have drifted wider. This aversion to low credit quality explains why, in the US, CCC rated bonds look set to underperform BB rated bonds by the largest margin on record outside of a recession. So far this year, CCC bonds have returned just 5.81% compared to 13.57% for BB credits. A similar trend has been seen in Europe, where the ratio between single-B and BB spreads has moved from 1.8x to 2.2x. While European BB spreads may look tight at 238 basis points (bps), and single-B spreads may look to offer better value at 527bps, in our view there is room for this divergence to continue, especially as the European Central Bank's corporate sector purchase programme 2.0 has not yet commenced. (All data as of 22 October 2019).

Technicals:

Technical conditions remain strong in the high yield market. In fact, if it wasn't for the supportive technical backdrop, spreads would probably be drifting wider. Retail fund flows have been mixed, with USD 1,405 million of flows into US high yield and EUR 359 million of flows out of European high yield in the month to date. However, with 23% of the global bond market negative yielding, unconstrained and institutional investors (who are not captured in retail fund flows) continue to look to high yield for income. Further support also comes from a shrinking market, with more rising stars leaving the market than are being replaced by fallen angels, while net new debt issuance remains negative after coupons. (All data as of 18 October 2019).

European high yield credits on a diverging path



Source: ICE BofA Merrill Lynch Euro Developed Markets Non-Financial High Yield Constrained Index (HECM); data as of 22 October 2019. OAS = option-adjusted spread.

What does this mean for fixed income investors?

While default rates are yet to rise all that much, there are increasing signs of stress among some high yield corporates. Easy financing conditions, a benign maturity wall and deteriorating covenants may prevent default rates from surging any time soon, but in the face of a divergence in spreads between higher and lower rated credits, investors must ask whether they are staring at a value trap. On the whole, portfolio positioning appears to be defensive, so a broad based rally could turn out to be the pain trade. Nevertheless, in our view a continued prudent approach to credit selection remains imperative and we believe the status quo of divergent paths is likely to prevail for a while longer.

About the Bond Bulletin

Each week J.P. Morgan Asset Management's Global Fixed Income, Currency and Commodities group reviews key issues for bond investors through the lens of its common Fundamental, Quantitative Valuation and Technical (FQT) research framework.

Our common research language based on Fundamental, Quantitative Valuation and Technical analysis provides a framework for comparing research across fixed income sectors and allows for the global integration of investment ideas.

Fundamental factors include macroeconomic data (such as growth and inflation) as well as corporate health figures (such as default rates, earnings and leverage metrics)

Quantitative valuations is a measure of the extent to which a sector or security is rich or cheap (on both an absolute basis as well as versus history and relative to other sectors)

Technical factors are primarily supply and demand dynamics (issuance and flows), as well as investor positioning and momentum

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