State of the high yield market: Four questions for the rest of the year

Fixed Income

August 2020

IN BRIEF

- The speed and magnitude of the sell-off and subsequent rally in the high yield market has been unprecedented—reflecting the nature of the Covid-19 outbreak and the massive fiscal and monetary response that the crisis has sparked.
- After the intense volatility experienced so far in 2020, we look at the main questions on the minds of high yield investors as they position for the remainder of the year.

1. How has high yield[1] performed so far?

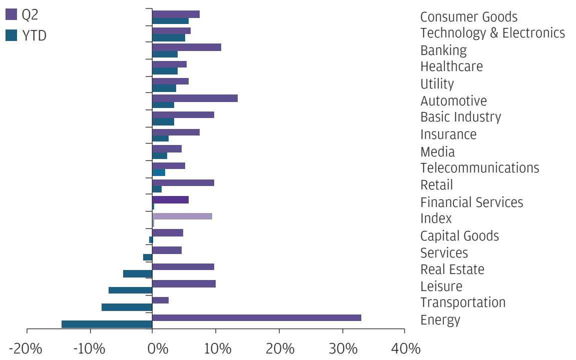
To say that the last seven months have been turbulent for high yield valuations would be an understatement. Spreads rose from the low-to-mid 300 basis points (bps) area at the start of the year to peak in late March at ~1,100 bps for US high yield and ~900 bps for European high yield—the widest levels since the global financial crisis. Since the March sell-off, both markets have rallied, with spreads settling in the low 500s. US and European high yield have delivered a year-to-date (YTD) total return[2] of -0.33% and -3.76% respectively (the US market has returned a better performance primarily due to the rally in US Treasury rates).

The unprecedented speed and extent of the initial sell-off, and the subsequent rally, is proving categorically distinct from past crises. Thanks to decisive monetary and fiscal action globally, this is perhaps the first recession in history that has experienced coincident credit growth.

As markets began to anticipate the gradual reopening of economies following the Covid-19 lockdowns, it should not come as a surprise to see that the sectors worst affected by the virus outbreak were the best performers in the second quarter—for example, energy in the US and leisure in Europe (see **EXHIBIT 1**).

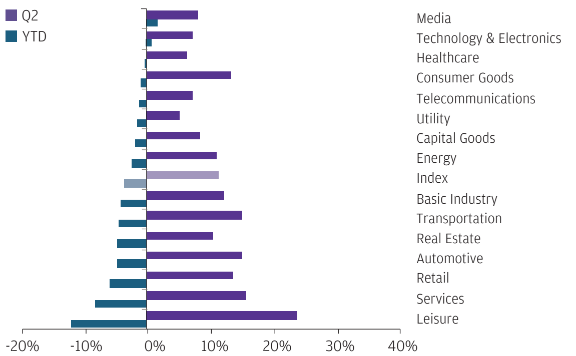
EXHIBIT 1: HARDEST HIT SECTORS HAVE BEEN THE BEST PERFORMERS IN Q2

2020 Sector Total Returns for US high yield



Source: Bloomberg. ICE BofA US High Yield Constrained Index (HUC0). Data as of 05 August 2020.

2020 Sector Total Returns for European high yield



Source: Bloomberg. ICE BofA Euro Developed Markets Non-Financial High Yield Constrained Index (HECM). Data as of 05 August 2020.

Past performance is not a reliable indicator for current and future results.

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[1] High yield market refers to US and European high yield markets only.
[2] For US High Yield, the benchmark used as reference is ICE BofA US High Yield Constrained Index (HUC0). For European High Yield, the benchmark used as reference is ICE BofA Euro Developed Markets Non-Financial High Yield Constrained Index (HECM).

2. Where might valuations go from here?

Coming into 2020, we thought valuations looked expensive, with low yields and narrow spreads leaving less room for spread tightening and carry to contribute to total returns. Fast forward to today, and the prospect for outsized near-term returns still feel limited given the strength of the rebound in second-quarter valuations since spreads peaked on 23 March.

We believe that for the next few months high yield spreads will trade between 150bps wider and 75bps tighter compared to current levels. This outlook would imply that high yield will generate carry-type returns, which—on a relative value basis compared to competing asset classes—remains attractive. For context, yield-to-worst levels for US and European high yield are 5.5% and 4.4% respectively[3].

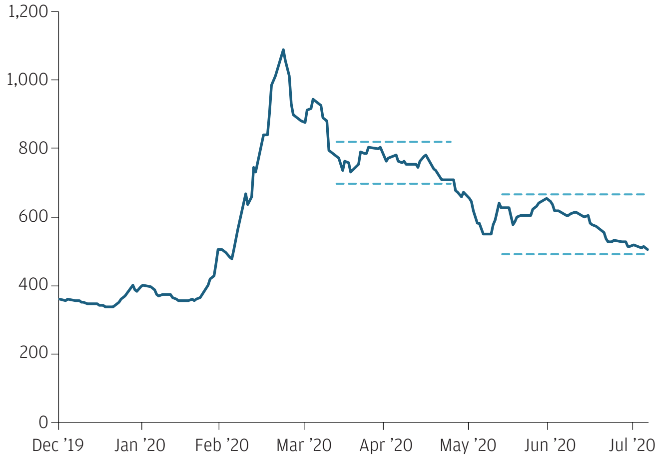
The market is looking for the next catalyst to propel spreads higher or lower. As the initial enthusiasm for the re-opening of economies wanes and re-infection rates rise again, a risk-off tone could transpire in the next few months. There are any number of factors that could contribute to a retracement including US trade rhetoric, the US elections and disappointing third-quarter earnings. Any spread widening could provide attractive pockets of opportunity to add risk, as it is our base case that the fragility of post-Covid economies will keep central banks vigilant and responsive to any signs of market risk aversion (see **EXHIBIT 2**).

However, we are wary that high yield markets may be growing complacent to the various long-term structural impacts that certain businesses will face because of Covid-19. As a consequence, the mismatch between current valuations and fundamental reality is increasing. For example, valuations within the leisure sector, specifically gaming and hotels do not seem to be discounting the longer-term consequences of persistent travel restrictions and potential future lockdowns. Somewhat paradoxically, these specific sectoral concerns are mitigated by low borrowing costs that continue to enable all but the most distressed borrowers to access high yield credit near record low costs.

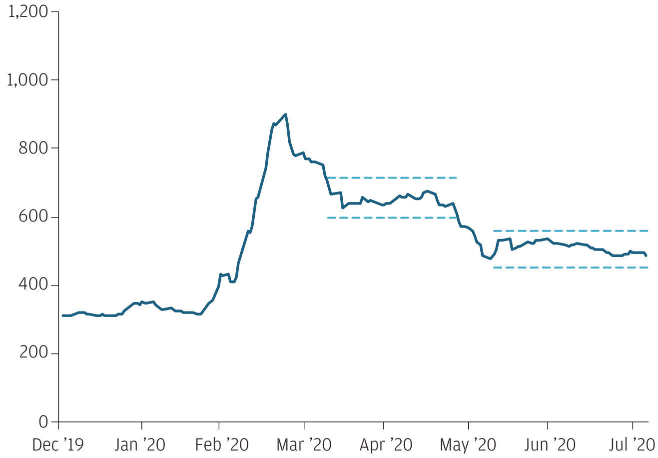
Even if unprecedented monetary and economic stimulus has lowered the default rate, there will still be an opportunity to enhance high yield returns through careful credit selection. Furthermore, it is worth considering that spread levels at current valuations provide more attractive prospects for long-term excess returns than they did at the start of the year.

EXHIBIT 2: SPREADS REQUIRING THE NEXT CATALYST TO MOVE LOWER

US high yield Option Adjusted Spread (bps) YTD



European high yield Option Adjusted Spread (bps) YTD



Source: Bloomberg, ICE BofA. Data as of 05 August 2020. EHY: ICE BofA Euro Developed Markets Non-Financial High Yield Constrained Index (HECM), USHY: ICE BofA US High Yield Constrained Index (HUC0).

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[3] For US High Yield, the benchmark used as reference is ICE BofA US High Yield Constrained Index (HUC0). For European High Yield, the benchmark used as reference is ICE BofA Euro Developed Markets Non-Financial High Yield Constrained Index (HECM).

3. What is the current state of high yield fundamentals?

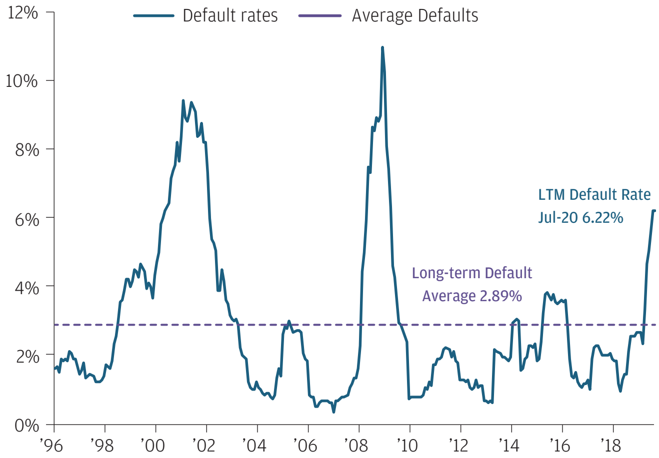
Fundamentals within the high yield market have never felt so uncertain. While the global financial crisis was a true financial crisis in every sense, non-financial corporate health remained in decent shape and most sectors experienced a v-shaped recovery. This is not the case with the current Covid-19 crisis, although the magnitude, speed and co-ordination of the response by central banks and governments is unprecedented.

This monetary and fiscal response has been the main support for fundamentals and has allowed companies to access capital to meet immediate liquidity needs. Funding corporate liquidity could help to reduce the near-term trajectory for defaults, but also requires companies to take on additional borrowing in a weaker economic environment. Our full-year 2020 default rate expectations are 7%-9% for US high yield and 2%-4% for European high yield (see **EXHIBIT 3**). While this is an improvement on our earlier forecasts, we think it is plausible that mid-to-high single-digit default rates will persist for longer than they did in the aftermath of the global financial crisis.

Finally, as we move deep into the second-quarter earnings season it is hard for us to get excited about announcements that beat expectations, given expectations were very low to begin with. Perhaps a more effective data point is chief executive confidence, with a recent McKinsey poll[4] of more than 2,000 global executives revealing that "in North America and in developing markets, executives have become less hopeful about their countries' economies". We think that the fourth quarter might be the clearest picture of what the new post-Covid world looks like.

EXHIBIT 3: DEFAULTS ARE SET TO RISE

US high yield default rates



Source: J.P. Morgan Asset Management and Moody's Investor Services. Default rates are par-weight. Data from December 1996 to 31 July 2020. 12m rolling monthly data.

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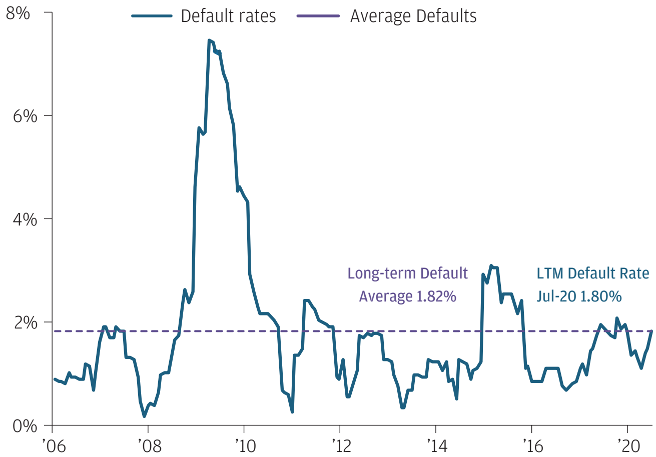
European high yield default rates



Source: J.P. Morgan IB, Markit. Data from February 2005 to 31 July 2020. The calculation universe is based on par value percentage of the EUR and GBP HY Non-Financials Corporate bond universe. Defaults include missed coupon payments, restructuring and distressed exchanges.

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4 COVID-19 and the great reset: Briefing note #16, July 30, 2020

4. Will technicals continue to be the strongest driver of valuations?

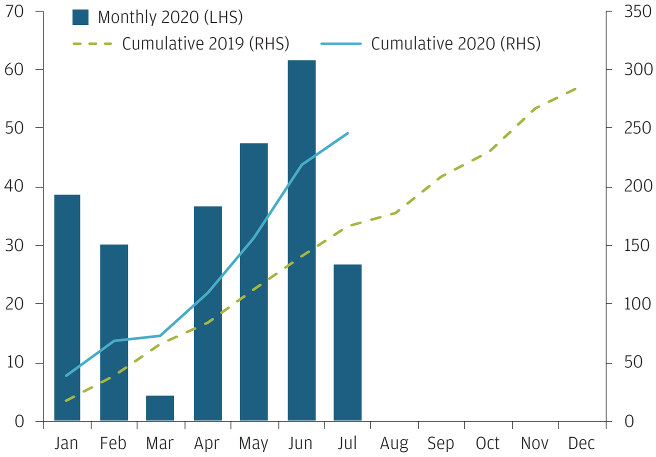
Fiscal and monetary support has greatly diminished tail risks in the high yield market. It has helped to reopen primary markets and, since the end of March, we have experienced record issuance levels. Year on year, US high yield and European high yield gross issuance is up 47% and 25% respectively (see **EXHIBIT 4**). Specific to the US market, June new issuance reached the largest ever monthly level. We expect primary activity to continue as companies look to repay corporate revolver draws and refinance upcoming maturities.

In the US, supply of this magnitude (and factoring in fallen angels[5] as well) would have almost surely weighed on secondary valuations had it not been for such strong market demand. US high yield inflows have been immense since 25 March, with mutual funds receiving net inflows totaling ~$56 billion. The pace of US inflows may slow down, but in an environment where fixed income yields are staggeringly low, the demand for higher yielding assets should persist. In Europe, even though demand has been more tentative, there is renewed optimism for European assets on the back of Europe's €750 billion recovery fund and the region's overall response to the Covid-19 crisis.

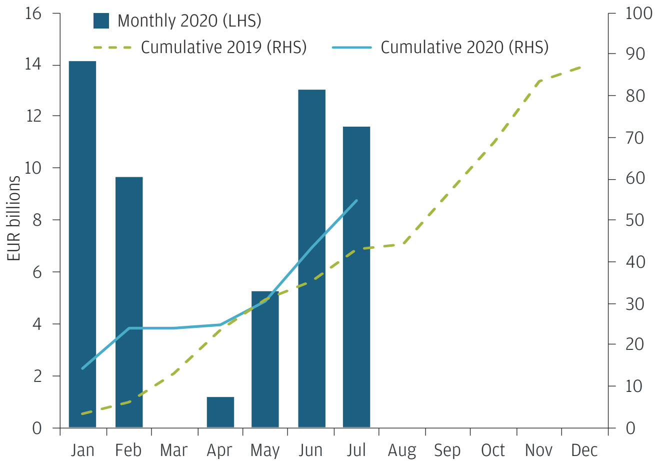
As investors deploy these vast sums of cash, we have to ask ourselves whether market participants are buying high yield credit because they want to, or because they have to due to the fear of missing out. While history has taught us to not bet against central banks, at some point asset prices and fundamentals will matter more. The 1.4 trillion[6] dollar question is when?

EXHIBIT 4: PRIMARY ISSUANCE HAS PICKED UP SIGNIFICANTLY SINCE MARCH

US high yield bond volume (USD billions)



European high yield bond volume



Source: J.P. Morgan IB. Data as at 31 July 2020.

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[5] Fallen Angels - A term given to companies that lose their investment grade rating
[6] Size of the US high yield market as of 31st July 2020.

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