Global High Yield: Value Opportunity for Long-Term Investors

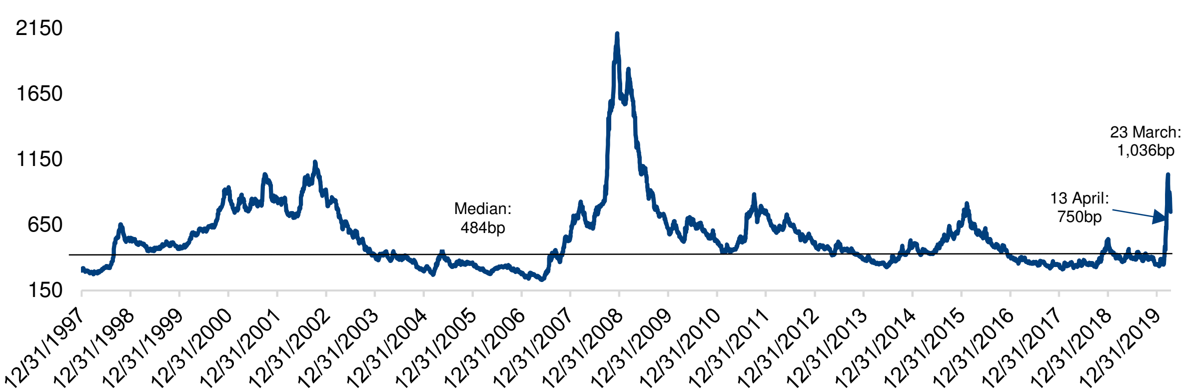
High yield valuations are at levels not seen since the Global Financial Crisis (GFC) as a result of the demand shock from the COVID-19 outbreak. We do not claim to have visibility on the depth and duration of the current downturn. However, what we can see is the price we pay for an asset and history shows that forward returns are positive when buying at current prices/spreads.

Key takeaways:

- **Recent market volatility has led to a historic rise in global high yield spreads not seen since the financial crisis.**
- **History shows that as U.S. high yield spreads breach 900bp, forward returns have been positive in all instances. According to JPM[1], the median annualized return over the next 12, 24, and 36 months for high yield as spreads cross 900bp is 36.9%, 25.5%, and 20.8%.**
- **Further, the global high yield market sharply outperformed global equities in the initial recovery phase coming out of the GFC.**
- **The high yield market is much more fundamentally sound than it has been in previous cycles.**
- **Downgrades from IG corporates into the high yield universe will be the biggest theme in 2020, however, this should continue to elevate the overall quality of the high yield universe and will result in dislocations borne from forced selling IG mandates. We believe the new supply will be adequately absorbed by high yield investors.**

Risk assets have experienced significant volatility this year as a result of the COVID-19 outbreak and the subsequent shutdown. High yield bonds, in particular, have experienced material declines this year as risk-off sentiment has roiled the market. Global high yield spreads, which had rallied in the back half of 2019 and started the year near post-crisis lows, have experienced one of the most pronounced periods of widening on record. Global high yield spreads are nearly 400bp wider to year-end 2019 levels, at over 700bp after reaching a low of 333bp in mid-January. Needless to say, the speed and severity of this spike in volatility has been unprecedented.

Chart 1: Global High Yield Option-Adjusted Spreads



Source: ICE BofAML Developed Markets High Yield Constrained Index, as of 13 April 2020

With spreads where they are, and given what we believe to be a fundamentally stronger environment for credit than in past cycles, we believe this presents an attractive entry point into the asset class. According to JPM[1], the median annualized return over the next 12, 24, and 36 months for U.S. high yield (a majority of the developed index) as spreads cross 900bp is 36.9%, 25.5%, and 20.8%. With a horizon of a year or more, the U.S. high yield market has generated only positive returns in 25 examples as spreads cross 900bp. With global rates where they are, we believe the continued investor search for yield will eventually look towards credit at a discount, as valuations today are unprecedented outside the depths of the financial crisis.

Chart 2: U.S. High Yield Historical Performance as Spreads Breach 900bp

	1yr	2yr	3yr	4yr	5yr
Average	34.7%	24.6%	19.6%	16.7%	15.3%
Median	36.9%	25.5%	20.8%	17.1%	16.6%
High	61.4%	36.9%	25.9%	23.5%	20.5%
Low	0.5%	4.9%	11.8%	11.0%	9.7%
Positive	25	25	25	25	25
Negative	0	0	0	0	0

Source: JPM, 25 March 2020

The story resonates the same in the global developed high yield market. Spreads within the ICE BofAML Developed Markets High Yield Constrained Index approached two standard deviations above the long-term average on 23 March 2020 (1,036bp). Within the global high yield market, instances in which spreads reached two standard deviations above the mean resulted in strongly positive performance over all of the same time periods. As such, we believe that current spreads offer attractive entry points into the global high yield asset class.

Additionally, resilience is one of the hallmarks of the asset class. On a historical basis, there has never been an instance of two straight years of negative performance. Global high yield bonds tend to bounce back in a strong manner following periods of sharp underperformance (Chart 3).

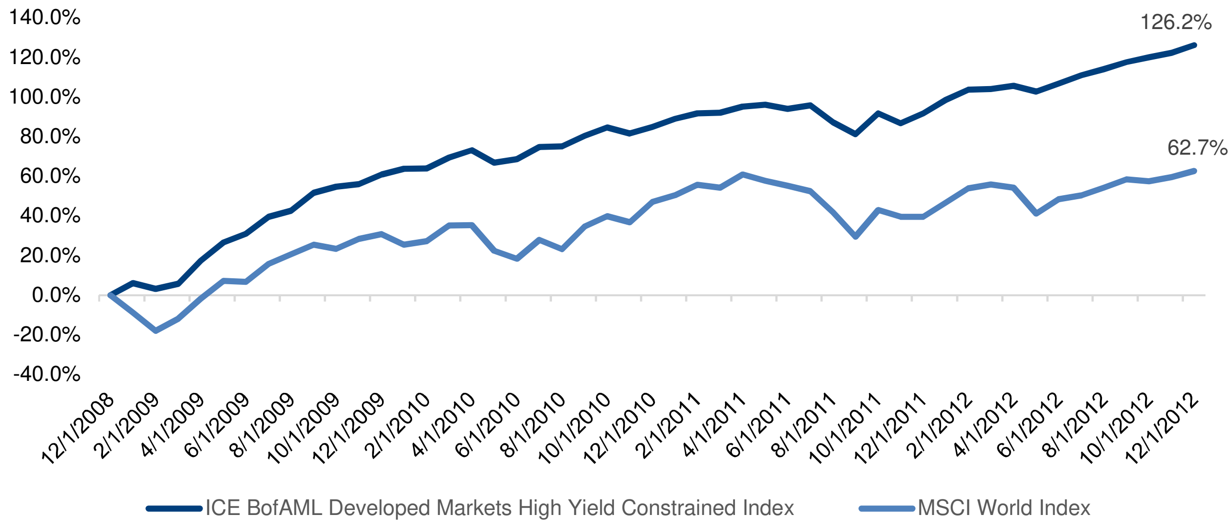
Chart 3: Global High Yield: Positive Performance following Negative Years

Negative Return Year	Return	Following Year Performance
2018	-2.58%	13.83%
2015	-3.09%	15.50%
2008	-26.40%	60.85%
2002	-1.04%	28.21%
2000	-5.55%	3.52%

Source: ICE BofAML Developed Markets High Yield Constrained Index

Even more, while global high yield bonds suffered during the GFC, the asset class outperformed global equities on both an absolute and risk-adjusted basis coming out of the crisis. Global high yield returns in 2009 were 60.85% while global equities returned 30.79%. Total returns were over double in the four-year period following the crisis, at 126.2% versus 62.7% (Chart 4), respectively, a further testament to the relative resiliency of the asset class following periods of volatility.

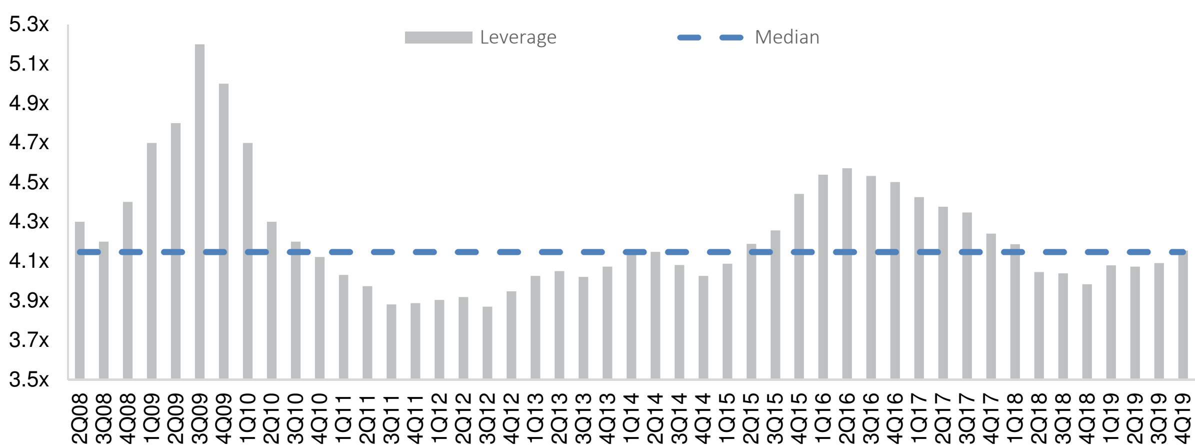
Chart 4: Global High Yield Outperformance vs. Global Equities in the Initial GFC Recovery Phase



Source: ICE BofAML Developed Markets High Yield Constrained Index; MSCI World Index. Four year cumulative performance (2009-2012)

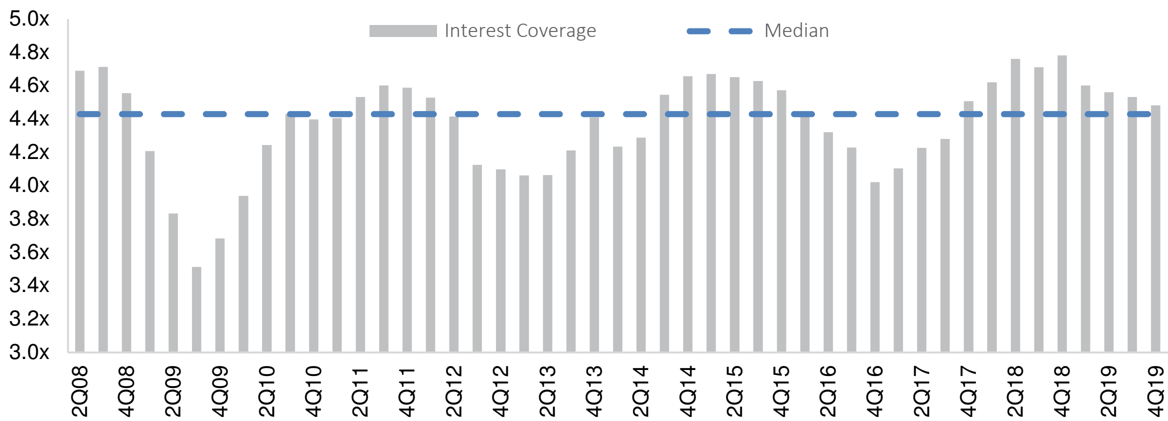
While there is investor concern surrounding the health of the leveraged credit market, and high yield in particular, we believe that this market environment is much healthier than that of past cycles. Unlike 2008, which was driven by a liquidity squeeze and excess leverage in the system, we are experiencing a demand shock, driven by a health crisis and a cessation of normal day activities. Underlying fundamentals for the high yield space are in much better shape than they were in 2007/2008 as well. The U.S. high yield market, the largest component of the global high yield index, has enjoyed strong earnings, improving balance sheets (Charts 5 & 6), and a vast improvement of overall quality for the index since the financial crisis. That said, we acknowledge that current market dynamics will likely put pressure on credit fundamentals going forward.

Chart 5: U.S. High Yield Leverage



Source: JPM, as of 4Q19

Chart 6: U.S. High Yield Interest Coverage



Source: JPM, as of 4Q19

Issuance, a leading indicator for the health of the high yield market, has been much higher quality in recent years for U.S. high yield as well (Chart 7). In fact, several years of positive earnings and more disciplined financings in the fixed, U.S. high yield market has resulted in a higher quality cohort than in previous years.

Chart 7: Higher Quality Issuance vs. 2007

High Yield Issuance	Avg. 2006-2007	Avg. 2015-2019
Acquisition Finance/LBO	48%	22%
Lower-Rated	29%	13%
PIK/Toggle/Deferred	10%	0%

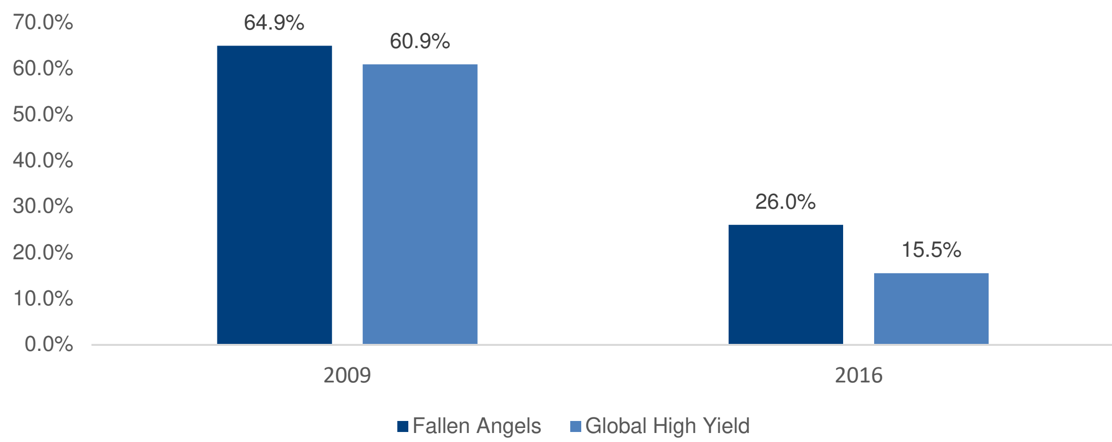
Source: JPM, 18 March 2020

Today, BB-rated debt accounts for 56.3% of the overall global high yield index while CCCs are at 9.1%, a much higher quality mix than we saw ten years ago.

We believe we will see a wave of downgrades from IG corporates but think that this will ultimately expand and continue to elevate the overall quality of the high yield universe. Rating agencies have been reacting quickly to increasing pressure on the BBB segment, as we have already seen downgrades of IG companies into high yield, also known as fallen angels, in recent months and we believe this is creating exceptional opportunities for returns and alpha. Several estimates are predicting around $200-$300B of fallen angels in 2020, and could exceed this range if the duration of this crisis is longer, compared against $1.26T in existing high yield outstanding. Numerous large household names have already been downgraded to high yield, such as Kraft Foods, Ford, Occidental, and Delta. The question is whether the high yield market can absorb these downgrades. It is our view that while there may be some periods of indigestion, particularly if we see the higher estimates of potential downgrades, we believe the high yield market will welcome the new supply, especially those names that may be enduring cyclical or capital deployment challenges as opposed to liquidity-driven or structural. Moreover, we believe the U.S. Federal Reserve (Fed) corporate support program, which recently expanded its criteria to include fallen angels and high yield ETFs, will further provide support for this segment. We believe this presents an attractive opportunity to invest in quality companies with tremendous financial flexibility trading at attractive valuations given potential dislocations borne from forced selling IG mandates.

- According to Barclay's research, larger-cap fallen angels typically widen out 200-300bp more than the overall IG index in the six month period prior to being downgraded to high yield.
- In fact, these fallen angels tend to enter the high yield market at a wider spread levels than existing BB issuers – on average, around 150bp wider.
- As a result, fallen angels tend to outperform once they are downgraded versus the broader high yield universe (Chart 8)

Chart 8: Fallen Angel Outperformance during Periods of Heavy Downgrades



Source: ICE BofAML Fallen Angels Index; ICE BofAML Developed Markets High Yield Constrained Index

Overall, we believe that fallen angels will be a source of attractive total return and alpha for high yield managers in coming weeks and months. Finally, we believe that the overall global high yield index will become slightly higher in quality, even after making assumptions about downgrades down the stack of the high yield universe, with a greater percentage of the overall high yield opportunity set residing in BBs.

While underlying fundamentals remain healthy, in our view, the depth and duration of this crisis is unclear and we do not have the visibility on when there will be normalization. The focus is on the growth rate in the number of infections, mortality rate, and our healthcare system's ability to absorb the afflicted. Further, at current spread levels, the implied default rate is between 9-10% (7% excl. energy). The duration of this crisis will largely dictate the number of defaults in both directions. At the same time, there has been some extraordinary monetary and fiscal stimulus measures that we believe may help alleviate some of the economic pressures, both on a corporate and consumer level. We believe this is a prime environment for active management and a strong bottom-up fundamental approach given the forecasted rise in defaults, underlying market dislocations, and the high level of uncertainty in the short-term direction of the market.

Footnotes

[1]*Source: JPM, 25 March 2020*

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