BlueBay
Asset Management

High yield credit – valuations and returns from a historical perspective

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23 March 2020

- The exogenous shock to the global economy of the coronavirus pandemic is the catalyst for a violent and painful re-pricing of growth-sensitive risk assets. Until the virus is brought under control and the path to recovery from recession is visible, it seems extreme volatility will continue to characterise financial markets and weigh on risky assets.

- Extraordinary uncertainty, volatility and the dash for cash currently overwhelm valuations and fundamentals as the principal drivers of asset prices. Nonetheless, from a historical perspective, high yield credit spreads and bond prices are at levels that are typically associated with subsequent positive investment returns.

- Governments and central banks are almost daily announcing further extraordinary policy interventions to limit the permanent economic damage from measures to contain COVID-19. If successful, the increase in corporate defaults will, in our opinion, be less than from prior recessions and the subsequent economic recovery and rebound in asset prices more rapid.

- Our estimates suggest that credit spreads imply annual default rates of around 13% and 11% for US (ex-energy) and euro high yield bonds – broadly comparable to the peak annual default rates in the global financial crisis.

The sell-off in growth-sensitive risk assets and volatility seen in financial markets since late February is unprecedented in its pace and magnitude. Financial markets continue to be roiled by the economic and financial implications of the COVID-19 pandemic and efforts to contain its spread and the loss of life.

The world's major economies are on the brink of recession, the depth and duration of which is highly uncertain. With investors collectively trying to reduce risk in their portfolios, illiquidity and dislocation currently characterise credit and financial markets more generally.

In our view, credit markets will only stabilise once investors are able to size the quantum of default risk and the transfer of risk to those able and willing to bear it has largely been completed.

Credit fundamentals and valuations are currently overwhelmed by volatility across markets, including in core government bonds and commodity prices, as well as the premium placed on liquidity by investors. But from a historical perspective, high yield valuations are currently at levels that are associated with a positive skew in terms of subsequent investment returns.

Once investors gain confidence that the spread of the virus is contained and the path of economic recovery is in sight, we believe valuations and fundamentals will again become key drivers of asset performance.

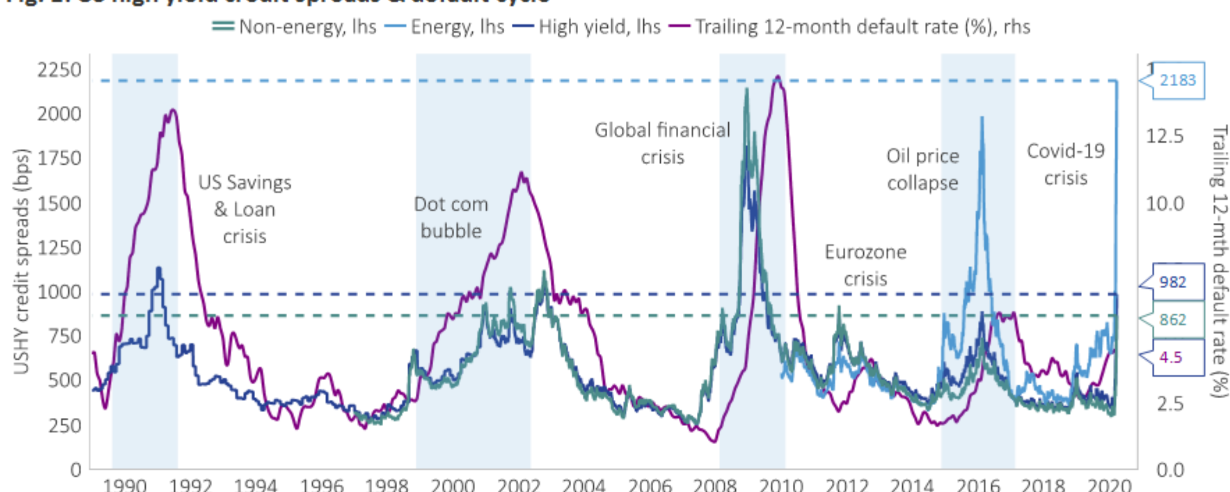
The speed and volatility of the re-pricing of credit, in our opinion underscores that the primary driver is exogeneous – COVID-19 spread and the collapse in oil prices – rather than an unwind of excessive leverage and financial imbalances that characterised previous crises, including the global financial crisis in 2008-09.

If governments and central banks are successful in containing the permanent economic damage from the pandemic, as they are focused on doing with the extraordinary policy measures so far announced, the economic recovery and rebound in markets should be faster than in previous recessions and default cycles.

High yield spreads and implied default rates

Investors demand an additional yield or credit spread on corporate credit over 'risk-free' government bonds to compensate for the expected losses from business defaults and the greater uncertainty and volatility of returns. The credit spreads on high yield (sub-investment grade rated) corporate debt subject to the greatest risk of default are currently near historic wides. But in contrast to previous crises, the pace of the move wider can be measured in a few weeks, rather than several months.

Fig. 1: US high yield credit spreads & default cycle



Source: BofAML ICE US High Yield index (H0A0); US High Yield excluding energy, metals & mining (HXNM); US High Yield energy (H0EN); shaded blue columns denote Moody's default cycle indicator marking consequative quarter increases in the trailing 12-month default rate above the long-term average (4.3%); latest data at 20 March 2020

The volatility, dislocations and liquidity premium across markets inevitably renders tentative any analysis of 'what is priced', in terms of default rates in the global high yield market. With that caveat, Figure 2 illustrates that credit spreads are currently wider than the expected loss (after default and recovery value) implied by the worst five-year cumulative default rate (using S&P default rates since 1981).

The dramatic widening in credit spreads on US high yield energy debt reflects the additional shock of the halving in global oil prices over the last month. High yield energy spreads are wider than in 2015-16 when oil prices collapsed and the default rate amongst energy issuers rose to 24% according to BofAML data – a level that we think is likely to be matched over the coming year.

Investors also fear that the US high yield market may have to absorb a surge in the debt of investment-grade companies downgraded to sub-investment grade – so-called 'fallen angels'.

Companies rated in the lowest 'BBB' rating bucket of investment-grade have some USD3 trillion of outstanding debt. In a severe wave of rating downgrades, as much as USD200-250 billion could fall into the USD1.2 trillion high yield bond category.

Fallen-angel risk is an additional source of uncertainty for credit investors but, in our view, it will be manageable and broadly in line with past credit cycles when viewed as a percentage of the high yield market, based on S&P Global Market Intelligence data.

Fig. 2: Table of US & Euro high yield spreads vs expected losses

	Latest	Spread implied 5yr default prob for given recovery rate:			Actual 5yr default rate			Required spread for default (40% recovery):		Current spread vs required spread	
Rating	Current spread	0%	20%	40%	Worst	Average	Rating	Worst	Average	Worst	Average
BB	781	32.3%	38.6%	47.8%	17.3%	8.2%	BB	228	103	553	678
B	1025	40.1%	47.3%	57.4%	38.4%	19.7%	B	581	263	443	761
CCC	1812	59.6%	67.8%	77.9%	72.5%	51.5%	CCC	1,549	868	263	944
USHY	1013	39.7%	46.9%	57.0%	30.9%	17.2%	USHY	444	226	569	786
BB	651	27.8%	33.4%	41.9%	27.3%	5.4%	BB	383	67	269	585
B	651	27.8%	33.4%	41.9%	47.6%	14.2%	B	776	184	-124	467
CCC	1812	59.6%	67.8%	77.9%	75.0%	40.2%	CCC	1,664	617	149	1,195
EHY	889	35.9%	42.6%	52.3%	38.8%	12.0%	EHY	589	153	300	736

Note: S&P average and worst cumulative 5-year default rate, 1983-2017

Source: Credit spreads by rating from Bloomberg Barclays High Yield and Investment grade indices; S&P; and BlueBay Asset Management calculations; spreads at 19 March 2020

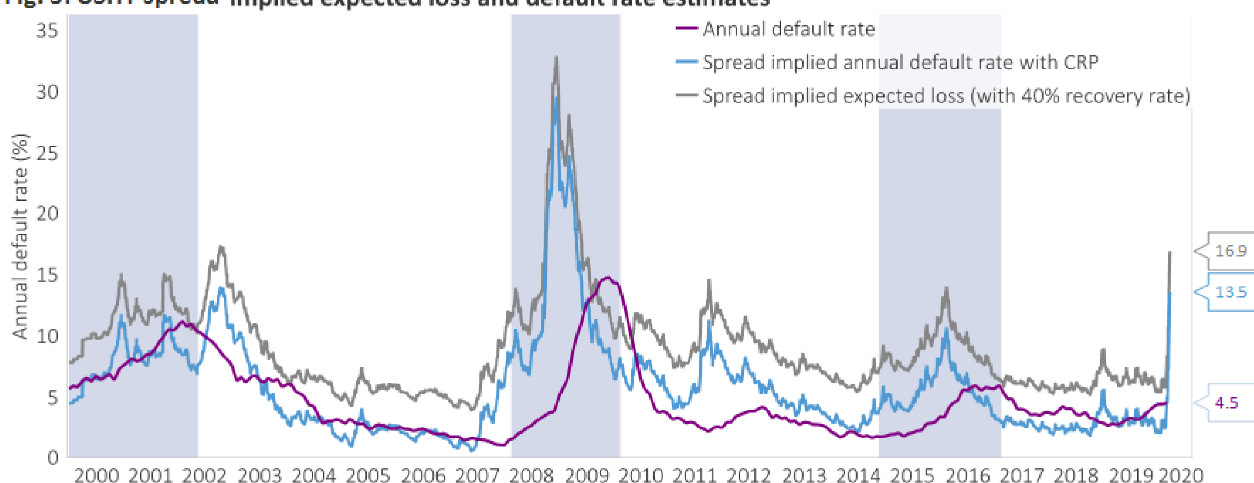
Credit spreads, however, also incorporate an additional 'credit risk premium' investors demand as compensation over and above the expected loss (recovery after default) that varies meaningfully over time. On average, the credit risk premium (CRP) for US high yield (USHY) is around 250 basis points (bps) (also used as the CRP for Euro high yield).

In low-volatility environments with stable forward expectations for default rates the CRP is low, while during the global financial and eurozone crises it is estimated to have been in excess of 1000bps.

Using the average CRP, the implied one-year forward default rate is 13% and 11% respectively for USHY and Euro high yield (EHY) – close to the actual annual default rate associated with the global financial crisis (see Fig. 3 below).

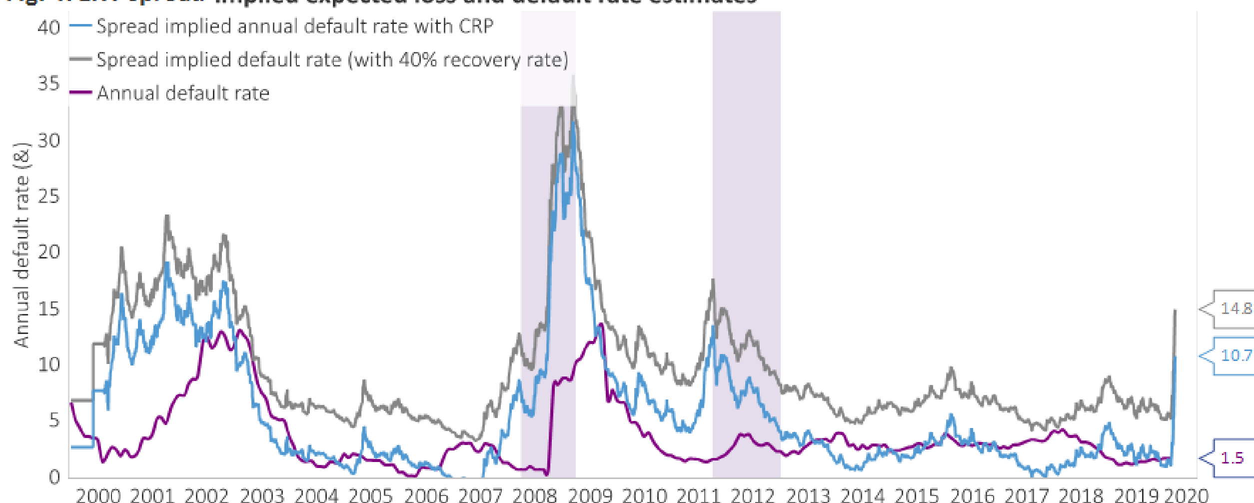
While acknowledging the huge uncertainty that characterises the near-term outlook for the global economy, our current assessment is that fiscal support and liquidity measures directed towards households and companies will contain the default rate below the level seen during the global financial crisis.

Fig. 3: USHY spread-implied expected loss and default rate estimates



Note: CRP is credit risk premium - spread in excess of that required to compensate for expected losses (default X recovery rate) - and assumed to be 250bps.
Source: Bloomberg Barclays US High Yield index; shaded blue columns denote Moody's default cycle indcator marking consequative quarter increases in the trailing 12-month default rate above the long-term average (4.3%); latest data at 20 March 2020

Fig. 4: EHY spread-implied expected loss and default rate estimates



Note: CRP is credit risk premium - spread in excess of that required to compensate for expected losses (default X recovery rate) - and assumed to be 250bps.
Bloomberg Barclays Euro High Yield index; shaded purple columns denote CEPR-dated Eurozone recessions; latest data at 20 March 2020

Valuations and subsequent returns

History shows, not surprisingly, that the wider the credit spread and lower the bond price, the higher the potential returns to investors over subsequent time periods. Fig. 5 and 6 reports the total returns on the Bloomberg Barclays US High Yield ex-energy and Euro high yield bond indices in the one, two and three years after the spread on the index exceeded 800bps (energy is excluded because of the extreme widening in energy credit spreads skews the overall spread on the broader US high yield index).

The 'hit rate' is the percentage of positive annualised returns in the periods following a starting point of spreads greater than 800bps. For instance, the credit spread on the USHY ex-energy index has been greater than 800bps in only 31 months in its 26-years of history. The annualised 3-year total return has always been positive, i.e. the hit rate is 100%.

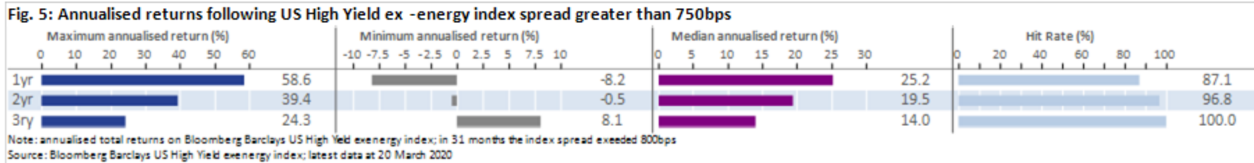


Fig. 5: Annualised returns following US High Yield ex -energy index spread greater than 750bps

	Maximum annualised return (%)	Minimum annualised return (%)	Median annualised return (%)	Hit Rate (%)
1yr	58.6	-8.2	25.2	87.1
2yr	39.4	-0.5	19.5	96.8
3ry	24.3	8.1	14.0	100.0

Note: annualised total returns on Bloomberg Barclays US High Yield exenergy index; in 31 months the index spread exeeded 800bps
Source: Bloomberg Barclays US High Yield exenergy index; latest data at 20 March 2020

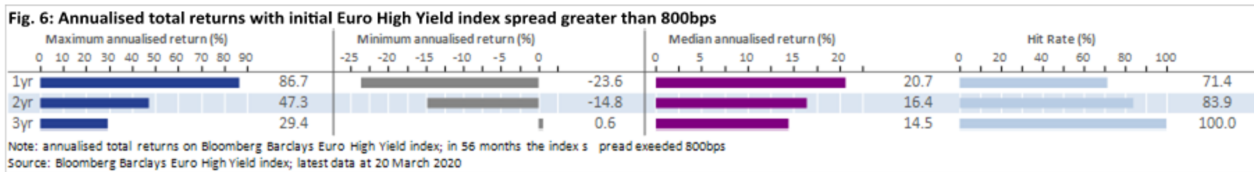


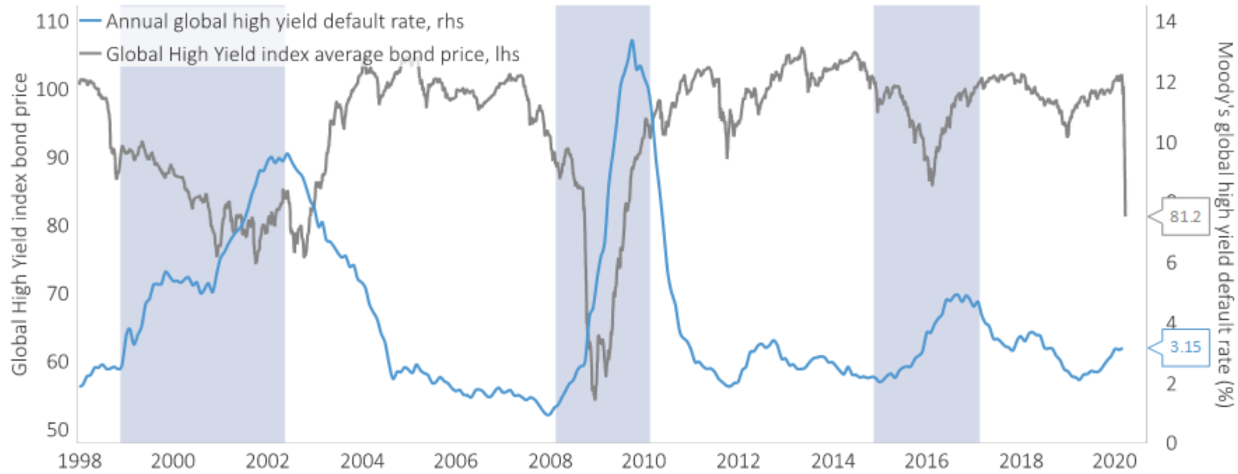
Fig. 6: Annualised total returns with initial Euro High Yield index spread greater than 800bps

	Maximum annualised return (%)	Minimum annualised return (%)	Median annualised return (%)	Hit Rate (%)
1yr	86.7	-23.6	20.7	71.4
2yr	47.3	-14.8	16.4	83.9
3yr	29.4	0.6	14.5	100.0

Note: annualised total returns on Bloomberg Barclays Euro High Yield index; in 56 months the index s pread exeeded 800bps
Source: Bloomberg Barclays Euro High Yield index; latest data at 20 March 2020

The average price of bonds in the global high yield index has fallen by an eye-watering 20+ percentage points since its high on 20 February, based on BofAML Global High Yield Constrained Index data. At 81 cents, the index bond price is at a level only witnessed during prior recessions and default cycles, although prices dropped as low as mid-50s at the height of the global financial crisis.

Fig. 7: BofAML Global High Yield Constrained Bond index price



Note: haded blue columns denote Moody's default cycle indicator marking consequative quarter increases in the trailing 12-month default rate above the long-term average (4.3%)
Source: BofAML Global High Yield Constrained index average bond price, latest data at 20 March 2020;Moody's global high yield trailing 12-month default rate, latest monthly data February 2020

Annualised total returns over a 3-year horizon on the global high yield index are positive in every episode since its inception in 1998, when the average (index-weighted) initial bond price was in the 80c-85c bucket (see Fig. 8). The annualised 3-year return on the global high yield index was positive even when the average bond price subsequently fell sharply in the aftermath of the Lehman Brothers bankruptcy.

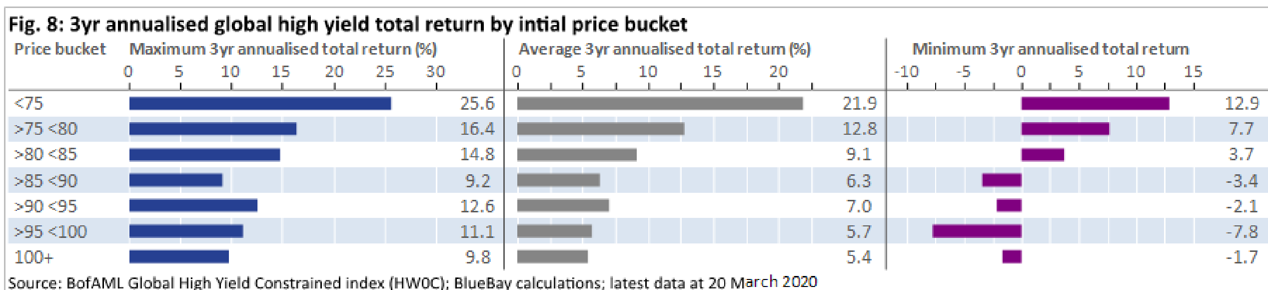


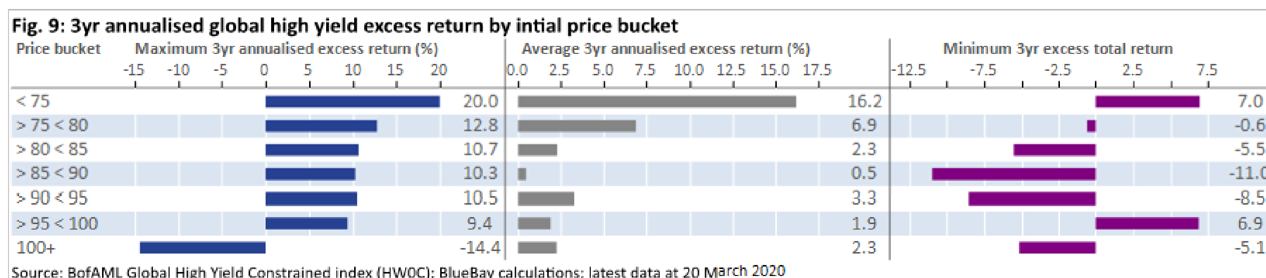
Fig. 8: 3yr annualised global high yield total return by intial price bucket

Price bucket	Maximum 3yr annualised total return (%)	Average 3yr annualised total return (%)	Minimum 3yr annualised total return
<75	25.6	21.9	12.9
>75 <80	16.4	12.8	7.7
>80 <85	14.8	9.1	3.7
>85 <90	9.2	6.3	-3.4
>90 <95	12.6	7.0	-2.1
>95 <100	11.1	5.7	-7.8
100+	9.8	5.4	-1.7

Source: BofAML Global High Yield Constrained index (HW0C); BlueBay calculations; latest data at 20 March 2020

Total returns include gains and losses from shifts in similar maturity government bond prices/yields.

Focusing solely on credit excess returns, i.e. the return in excess of that on risk-free bonds, the average annual excess return over a 3-year investment horizon when the average bond price falls in the 80c -85c bucket is 2.3% and there have been episodes when excess returns have been negative even with a low initial starting price. The profile of excess returns, however, improves meaningfully once the average bond price in the global high yield bond index is less than 80c, just below the current price of 81c.



Summary

The coronavirus pandemic is first and foremost a global health crisis that the policy authorities and citizens are rightly focused on addressing to minimise the deaths and illness that it tragically brings.

But the pandemic and the efforts to minimise its impact on health also constitutes a major negative exogenous negative shock to the global economy and financial markets. The surge in volatility across financial markets reflects the uncertainties regarding the duration and severity of the economic downturn and the associated rise in default risk.

In our view, credit spreads at current levels fully compensate investors for the likely surge in corporate default rates that we believe will be contained below the levels associated with the global financial crisis by the extraordinary support measures currently being in put in place by governments and central banks.

Timing the lows of a sell-off is notoriously difficult and until the pandemic is effectively contained and the return to more normal economic activity is in sight, volatility will continue and ‘cheap’ assets could get cheaper. But at current valuations, the future return profile for high yield credit is, in our view, skewed favourably for investors.

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