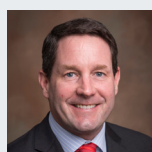
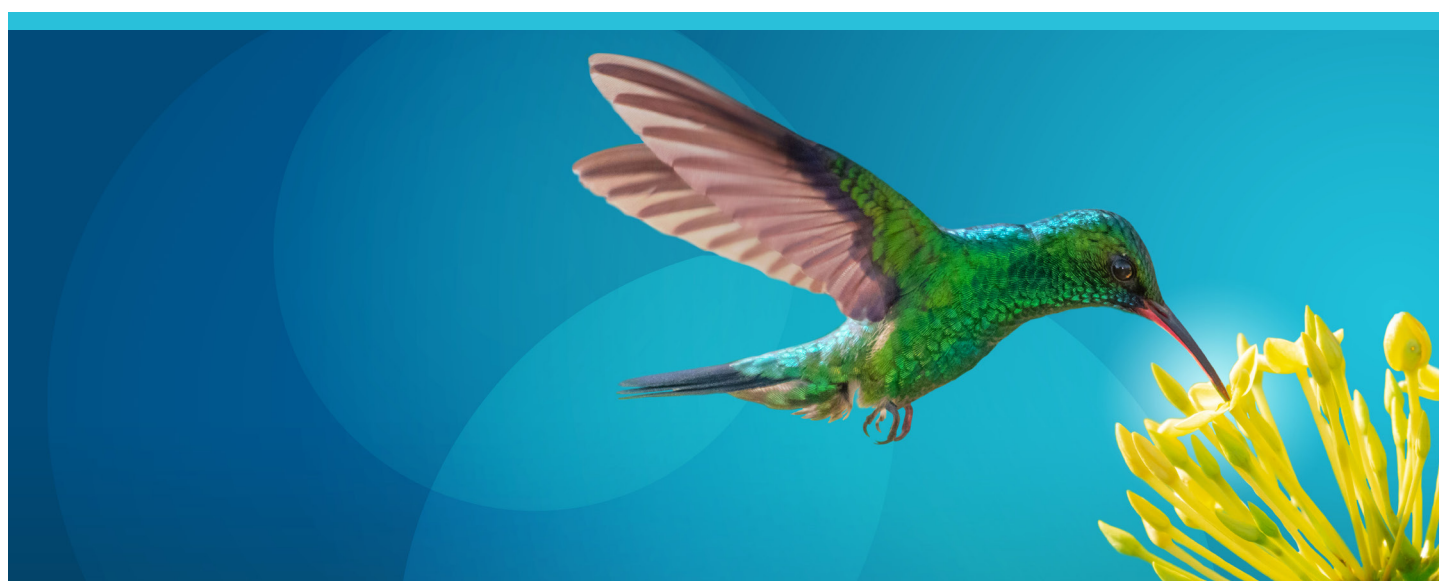




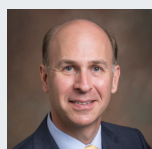
Credit Outlook

COVID-19 has transformed the US high yield opportunity set



Kevin Loome

Portfolio Manager,
US High Yield Strategy



Gregor Dannacher

Portfolio Specialist

Downgrades and defaults have had a major impact on the asset class

Record volumes of credit downgrades and a sharp spike in defaults have reconfigured the US high yield bond market in the wake of the coronavirus. This has presented a compelling opportunity to invest in quality companies that are well-placed to rebound strongly as the market recovery continues – but it has also created a tumultuous investment environment in which credit risk is set to remain elevated in the near term.

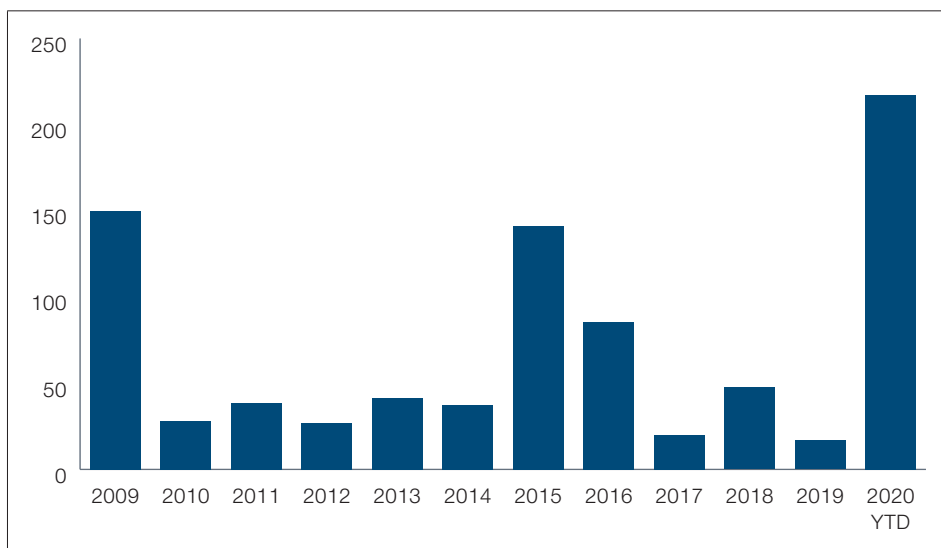
The scale of US 'fallen angel' downgrades (companies losing investment-grade status) over the past three quarters has been unprecedented. Before the pandemic, BB-rated names comprised around 49% of the ICE BoA US High Yield Constrained Index; now, the figure is closer to 56%. This mirrors a global trend: according to S&P Global Ratings, worldwide fallen angel debt is set to reach a record high of US\$640 billion in 2020. The previous record was US\$486.86 billion in 2005.

The surge in the number of fallen angels is a consequence of companies taking financial risks before the coronavirus, and then taking massive blows to corporate profitability once the pandemic struck. When the downgraded companies are large, this can have an immediate impact on high yield benchmarks. For example, when Ford was stripped of its investment grade status in March, US\$36 billion of the carmaker's debt tumbled into the high yield market. The downgrades of other major names, including Kraft Heinz, Macy's and Occidental Petroleum, have brought further billions of dollars of formerly investment grade debt into the high yield space. As a result of these downgrades, high yield benchmarks now have more BB-rated debt, higher overall duration (interest-rate exposure) and a much bigger overall market size.

Defaults, too, have risen. According to Moody's Investors Service, the trailing 12-month US high yield default rate in August was 8.7% – up from 3.2% in August 2019. For comparison, following the global financial crisis the default rate spiked at 14.7%, which remains an all-time record. Many of this year's defaults have occurred in the energy sector, which has been hit hard by the collapse in crude oil prices amid a global slump in energy demand since March. The impact of these defaults has been amplified by the fact that recovery rates in the energy sector – which accounts for about 13% of the US high yield market – have also been substantially below historic norms.

Fallen angel debt set to reach record levels in 2020

US high yield had taken in US \$217bn of investment grade debt by the end of the third quarter



As at 30 September 2020.

Sources: J.P. Morgan, Moody's Investor Service, S&P.

Liquidity key in an uncertain world

Most of the industries that have taken the brunt of the impact from the coronavirus will recover. When restrictions on everyday life are eased, it is likely that people will want to return to restaurants, hotels, casinos, theatres and eventually (possibly) cruise liners. However, it is impossible to predict when this will happen because the path of virus – and therefore the likelihood of further lockdowns – is unknown. It is therefore imperative to identify the companies most likely to make it through the current period and emerge stronger on the other side.

When seeking to identify such companies, we focus primarily on asset coverage and liquidity, the latter of which has been a major issue for firms since coronavirus struck. In a typical year, only a low-to-mid-teen percentage of the proceeds of new bond issuance will be allocated to general corporate purposes, but this year the figure has been around 26%. In other words, companies have been raising money to create excess liquidity as they face these

uncertainties. The firms most likely to rebound strongly from the current crisis will be those in hard-hit sectors that retain enough cash on their balance sheets to withstand any further spikes in the virus, and whose business models remain robust.

Energy and healthcare sectors braced for November elections

The firms that do survive will need to navigate some tough challenges along the way. As long as the prospect of further outbreaks of coronavirus remains and an effective vaccine is unavailable, US corporates face the risk of major disruptions to their supply chains if lockdowns are reimposed. At the same time, however, the overwhelmingly domestic focus of the US high yield sector (only around 12% of issuers are from outside of the US, and the bulk of those are from Europe) provides investors in the asset class with a degree of insulation from overseas event risks.

Other risks are closer to home. If Democrat candidate Joe Biden wins November's presidential election, a significant refocusing

of government policy in some areas is likely. For example, energy producers – the biggest issuers of high yield bonds – may find their activities restricted by Biden's US\$1.7 trillion climate change plan, with its commitment to significantly escalate the use of renewable energy in the transport, electricity and building sectors. This would be a meaningful departure from the status quo – Trump's energy plan focuses on expanding drilling for oil and gas on federal lands and offshore, and includes no commitment to reversing climate change.

The healthcare sector will also be affected by the outcome of the election. If President Trump wins a second term, he will continue his quest seeking to dismantle Barack Obama's Affordable Care Act (ACA), which would benefit US-based drug makers and large insurers. The healthcare sector comprises just over 9% of the US high yield market, with hospitals and healthcare facilities making up around 4% of the total market – and it is this latter subsector that would be hit particularly hard if the ACA was repealed given that around 20 million would-be uninsured Americans have been receiving 'covered' hospital visits under the ACA.

By contrast, Biden has pledged to expand and strengthen the ACA, which would pose a challenge for US pharmaceutical firms by lowering the barrier to entry for foreign drug makers. Biden's pledge to offer Americans a new public health insurance option is unlikely to be welcomed by the larger existing insurers, but his commitment to increase coronavirus testing and promote novel therapies will likely benefit biotech firms and equipment makers.

It is worth noting that it is not just the outcome of the presidential race that will determine policy during the next administration; the results of the two congressional elections will also be very influential. For example, a Democrat clean sweep of the Senate and House of Representatives as well as the presidency would provide Biden with a clear mandate to deliver a more radical set of policies, including higher corporate tax rates. This would be considerably more difficult to achieve in the event of a Senate/House split.

Yield does not come for free

Although the great buying opportunity that arose when high yield bonds sold off aggressively at the beginning of the coronavirus crisis has passed, the US high yield bond market continues to offer some very strong opportunities. Low rates mean that investors are having to dip lower down the credit spectrum to find any real yield, and the US high yield market offers that potential. Inflows into US high yield have been at almost record levels despite the rise in defaults, which implies the market is very forward-looking. Overall, the US high yield market currently offers a strong income opportunity and a moderate total return opportunity.

Market inefficiency and default risk remain and highlights the importance of using an active approach to the high yield asset class – yield does not come for free, particularly in the current environment. The key to navigating the next 12 months or so will therefore be to earn income and avoid making credit mistakes. Active management and bottom-up security selection will be essential to achieving this.

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