Four Phases of Credit Crisis Present Risks and Opportunities

Seeking promising value, including fallen angels, in phase three.

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KEY INSIGHTS

- Despite the current crisis being triggered by a pandemic, we think credit will follow the four phases of crisis that it has in previous severe downturns.
- In the first phase of a credit crisis, market participants evaluate the extent of the shock. In the second phase, some high yield investors sell to raise cash.
- In the third phase, our managers strive to find credits with the potential to generate total returns in the fourth phase, when sentiment abruptly recovers.

The coronavirus pandemic has triggered an economic crisis that has created significant pressures across financial markets, including credit. Economic growth estimates have been ratcheted lower due to the enormity of the impacts of the virus and the simultaneous oil price pressures. In addition, liquidity across fixed income markets has been extremely challenged in recent weeks. Markets have seen and endured crises before; however, the depth and velocity of the current downturn is somewhat unprecedented.

While the global outbreak may be unique in having precipitated the crisis, we think credit markets will follow the four broad phases of crisis through recovery, as they have in previous severe downturns. Currently, selling is indiscriminate in credit markets as investors look for ways to redeem for cash or to shift their asset allocation toward equities. As corporate credit market activity begins to stabilize, our portfolio managers can selectively take on targeted risk to potentially generate strong total returns over the next couple of years. This can be an ideal environment for active credit managers, who can strive to buy strong credits at dislocated prices while passive funds may be forced to sell at unattractive prices.

Phase One: Evaluating Extent of Shock

In the first phase of a credit crisis, market participants evaluate the extent of the shock and sell corporate credit in rough proportion to the perceived risk. Although there is still much uncertainty about the ultimate progression and impact of the coronavirus pandemic, credit spreads[1] on the J.P. Morgan Global High Yield Index had widened more than 700 basis points[2] for the year through March 20 as investors priced in a global recession.

[1] Credit spreads measure the additional yield that investors demand for holding a bond with credit risk over a similar-maturity, high-quality government security.
[2] A basis point is 0.01 percentage points.

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Saudi Arabia's early March decision to slash oil prices and boost production triggered an even sharper sell-off in energy-related corporate debt. Energy-related issuers accounted for about 15% of U.S. high yield benchmarks. Energy spreads widened about 300 basis points on March 9 alone, the first trading day after the announcement from Saudi Arabia, and exceeded 2,300 basis points by March 20.

Phase Two: Managing Liquidity

In the second phase of a credit crisis, some investors in high yield portfolios sell to raise cash—which can exacerbate the selling pressure from the first phase. T. Rowe Price manages its high yield portfolios (and all fixed income strategies) to have a cash buffer and minimal exposure to illiquid assets such as private debt, which should allow portfolio managers to meet cash demands without selling positions that could be attractive long-term holdings. We regularly stress-test portfolios to simulate severe downturns and determine the size of cash buffers.

Phase Three: Search for Long-Term Opportunities

In the third broad phase, T. Rowe Price portfolio managers strive to find credit positions with the potential to generate attractive longer-term total returns. Portfolio managers collaborate closely with the firm's team of global credit analysts, who are sector specialists, to search for bonds trading at dislocated prices that do not reflect their fundamentals.

This crisis may provide more opportunities than usual in the energy sector, which has been buffeted by the double "black swan" of the coronavirus epidemic and Saudi Arabia's decision to supply more oil as the virus has reduced demand. Although we expect many defaults and restructurings for weaker energy credits, we also anticipate a wave of "fallen angels"—bonds that are downgraded into the high yield universe from investment grade. Institutional investors that can only hold debt with investment-grade credit ratings will be forced to sell these bonds, potentially creating attractive opportunities for dedicated noninvestment-grade investors. Our energy credit analysts have been closely collaborating with T. Rowe Price's energy sector equity analysts to evaluate opportunities to strive to generate total return in the next several years.

Phase Four: Abrupt Spread Tightening

The fourth phase of a credit crisis—the point where spreads abruptly move tighter as sentiment recovers—is the most difficult to forecast. Because it is nearly impossible to pinpoint the exact time when sentiment bottoms out and spreads begin to narrow, we strive to identify opportunities in phase three, when markets are still dislocated. That said, when high yield spreads reach 800 basis points, investors have historically been rewarded over the next 12–24 months—with spreads over 1,000 basis points as of March 20, the asset class may be well positioned over the medium to longer term.[3]

We often think of high yield market participants as either "tourists" or "permanent residents." Tourists are those who have the flexibility to invest across a wide range of asset classes and likely do not specialize in analyzing the noninvestment-grade market and its issuers. On the other hand, permanent residents are dedicated high yield investors who can identify pricing dislocations. A high yield sell-off of the magnitude we have witnessed due to the coronavirus crisis and oil supply shock often scares tourists out of the market, creating attractive longer-term opportunities for permanent residents.

[3] Based on data from January 1986–February 2020. High yield spreads were measured using historical monthly spread to worst values and there were 42 instances where spreads reached 800 basis points or more. High yield is represented by the JPMorgan Domestic High Yield Index; prior to 1/31/95, the Credit Suisse High Yield Index was used. We then measured subsequent annualized returns of the index over 1 and 2 year periods Indices cannot be invested into directly.

With central banks having implemented various measures to address liquidity problems, we are monitoring global efforts to boost fiscal stimulus to help offset the economic effects of the coronavirus pandemic. Governments around the world have started to work toward approving aggressive fiscal stimulus plans, but political issues may delay the process and trigger more market volatility.

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