



High Yield Bonds Continue to Offer Value

Opportunities remain despite recent spread tightening.

August 2020

KEY INSIGHTS

- Despite spread tightening, there is still value in the high yield bond market—although the nature of the opportunity set has changed.
- There are opportunities to invest in companies in sectors that have been hit hard by the coronavirus, but which have the cash flow to emerge stronger.
- Car parts manufacturers and casinos could be among the firms to rebound strongly.

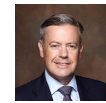
After widening dramatically at the height of the coronavirus market sell-off in the spring, high yield bond spreads have narrowed again in response to aggressive government stimulus packages and improving economic data. The question is: Given that valuations have recovered, is there still value in the high yield market?

We believe there is, but we also acknowledge that the nature of the opportunity in the high yield market has changed. Although credit spreads have yet to recover their pre-coronavirus levels and therefore have room to rally further, this may not occur for a while yet, and when it does, it will be much less dramatic than the tightening of the past few months. The great buying opportunity that arose when high yield bonds sold off aggressively in the early days of the coronavirus shock has passed.

Instead, we expect a period of slowly improving conditions as life gradually returns to normal in most countries. Further outbreaks of the coronavirus are likely, but these will probably result in localized lockdowns rather than the countrywide restrictions imposed during the first wave—and will therefore be significantly less damaging to the global economy. A vaccine may become widely available early next year, but even if it does not, we believe that governments and health authorities will have the tools to deal with new outbreaks without resorting to draconian measures. In this environment, spreads may hover around current levels, with pockets of volatility, for some time to come—meaning that carry is still available.

Automakers and Casinos Could Be Set to Bounce Back

An improving economic environment is not a risk-free one, however. Large numbers of high yield issuers have been hit very hard by the coronavirus

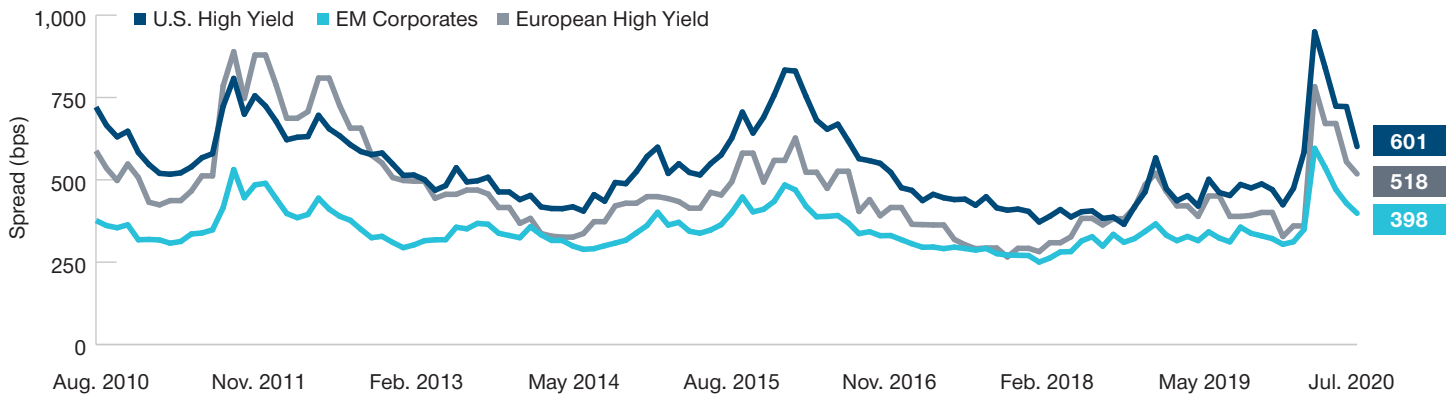


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Spreads Are Wider Than Before Pandemic

U.S., European, and emerging market (EM) spreads over time



As of July 31, 2020.

European High Yield represented by the ICE BofA European Currency High Yield Constrained Excluding Subordinated Financials Index; U.S. High Yield represented by the J.P. Morgan Domestic High Yield Index; EM Corporates represented by the J.P. Morgan CEMBI Broad Diversified Index.

Sources: J.P. Morgan (see Additional Disclosure) and Bank of America Merrill Lynch.

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shock, and some will never recover. Based on an in-depth analysis of the balance sheets of all the companies we follow, we are anticipating a default rate of 9% for the U.S. high yield market in 2020 and around 5% for the European high yield market. These estimates are roughly in line with the default rates predicted by most sell-side analysts, although they are considerably lower than the 12.2% and 6.1% default rates predicted by ratings agency Moody's.¹

Assuming we are correct in anticipating a slowly improving economic environment, which high yield sectors offer the most potential? Defensive sectors such as packaging and cable have delivered strong performance during the crisis and will probably continue to perform relatively well, albeit not to the same degree as before. Instead, the next phase of the recovery will most likely be led by companies in sectors that have been hit hard by the coronavirus and are currently trading at a significant discount, but which have the cash flow to weather the storm and emerge stronger.

The automotive sector, for example, has been severely impacted by the coronavirus because of forced factory closures, its dependence on discretionary spending, and the collapse of some of its key markets, particularly in Asia. Ratings agencies have downgraded billions of dollars' worth of debt owed by automakers, and the sector continues to face steep challenges—but it also offers significant potential upside. In particular, manufacturers of auto parts such as seats and other interior features are trading very cheaply and appear in a good position to recover strongly. All cars require interior parts, so these firms have good prospects regardless of the extent to which electric cars disrupt the market.

While online gaming companies have performed well during the coronavirus pandemic, physical gaming companies such as casinos have been forced to close and are trading very cheaply. There may be an opportunity to invest in casino firms that have enough liquidity to survive for at least two years and reap the benefits as lockdowns are eased.

¹ The discrepancy is partly explained by differences in methodology. While Moody's places a lot of emphasis on the amount of leverage a firm takes on, we prefer to assess a company's ability to survive by examining its balance sheet and cash flow. Many highly leveraged firms in industries that face severe sales slowdowns have been downgraded by Moody's and other ratings agencies.

“...the next phase of the recovery will most likely be led by companies in sectors that have been hit hard by the coronavirus...”

The services sector in general is very broad and diverse and has a number of attractive and idiosyncratic companies with the potential for considerable upside.

Fallen Angels Have Deepened the Opportunity Set

It is not just a matter of identifying the sectors with the potential to rebound, however; it is also important to identify the likely winners and losers within those sectors. A firm with a weak balance sheet and poor cash flow is unlikely to survive a steep, industrywide fall in demand, particularly if it lacks the ability to raise new capital. Another company in the same sector that has a stronger balance sheet and better cash flow may be able to weather the storm and emerge stronger on the other side. We do not believe that the amount of leverage a company has is particularly important in determining its ability to survive a crisis. What ultimately matters is its ability to meet its coupons and interest payments until its revenues recover.

Identifying such companies will be the key to successfully navigating the high yield bond market in the period ahead. For those who can, there will

be plenty of opportunities available. Ratings agencies are likely to continue downgrading large quantities of BBB bonds to high yield, depending on the path of the economic recovery. Automakers, leisure, restaurants, hotels, airlines, and retail firms will bear the brunt of this. Among these fallen angels will be some multibillion-dollar companies whose business models remain robust and whose liquidity will enable them to survive until demand picks up again. There are also many smaller, long-standing high yield issuers whose prospects were steadily improving before the coronavirus crisis and will continue to do so afterward.

Although spreads have tightened, we believe that the additional spread offered by BB bonds over BBB rated debt adequately compensates investors for the additional credit risk. What's more, if we are correct in our view that any future outbreaks of the virus are likely to be met with only localized lockdowns, the high yield bond market is likely to benefit as consumers slowly resume their former spending habits and a number of badly hit sectors begin to recover.

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