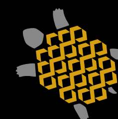
GLOBAL HIGH YIELD NEWSLETTER

Economic Lockdown

First Quarter 2020

SHENKMAN



As the world capitulated to the impact of COVID-19 - few in the field of science - let alone finance, were truly equipped to opine with confidence on the path of the virus, the severity and length of the economic downturn.

Comparisons to history are a natural tendency when dramatic events occur, but the current era already has a plethora of unique features from past recessionary periods. First, central bank and government programs were rapidly introduced, especially in the US. Second, advances and penetration in technology are massively evident in the ability of many business to work from home and for people to order essential items during a lockdown. Third, capital markets reopened rapidly, including high yield bond new issuance (something that was not seen in 2008). Thus far high yield bond offerings have primarily been coming with secured structures, coupons higher than market averages and shorter than average maturities.

While the decline in prices during March dominated the quarter, it is important to put this dramatic period in context as the resiliency shown matters. The ICE BofA Developed Markets High Yield Constrained Index (HYDC, the "Index") posted a dramatic rally from its lows on March 23rd. The period from March 24th through April 15th saw the Index gain +13.6%. If compared to monthly returns, it would have been the best performing month in the history of the Index by about +250 bps with the spread on the Index at 737 bps (286 bps over the five year historical average).

Exhibit 1: Benchmark performance

USD Hedged	ICE BofA Developed Markets High Yield Constrained Index (HYDC)
Q1 2020	-12.07%
Q4 2019	+2.61%
Q3 2019	+1.43%
Q2 2019	+2.75%

Source: ICE Data Indices

A relief program designed to get cash into the economy faster

The initial central bank actions in early March improved the liquidity, but as the month progressed it became clear that markets were focused on the economic costs of shutting down the vast majority of the global economy. Once fiscal support safety-net programs appeared to be in place, this led to a rapid tightening in credit market spreads from late March into April.

We view the US programs to be much more extensive and broader reaching than most other programs in the developed markets. Increased government disbursements are typical in a recession; in this case, it is coming very early in the "cycle". So while this program is clearly a relief program and not a stimulus, it should get into the economy earlier in the cycle and faster than we have seen in the past. However, unlike many programs in the past, and certainly different from straight stimulus, much of the success of this program will depend on how well these companies utilize the funds.

Globally, we have seen a lower interest rate environment. In addition to the rate cuts in the US, the Fed is dramatically increasing its balance sheet holdings and the fiscal support programs will increase the US deficit. This will likely keep Treasury interest rates low for some time. For investors, this may ring in a very different period having not operated for many years in an environment where there is a fiscally and economically activist government, other than tax cuts.

The Federal Reserve recognizes the leveraged debt markets

The high yield and cross-over markets got a significant boost in April in the US when the Fed expanded its balance sheet programs, providing new financing and potential purchasing of selected Fallen Angel credits (i.e. credits downgraded from investment grade to high yield) and high yield ETFs. While the actual impact of these programs can be debated, the recognition by the central bank of the importance of these markets to the economy, and employment in particular, is a definite positive for leveraged credit. Additionally, even if actual purchases are modest compared to market size, putting these mechanisms in place now will help the central banks respond rapidly if needed.

The energy sector is in crisis while higher quality credits outperform

On top of the virus, a price war developed in oil which has resulted in about a 60% drop in the price per barrel of oil. Energy sectors were the worst performing during the quarter. However, away from these sectors, the other weakest were not the typical "deep cyclicals" that often get hurt in a recessionary environment but were those that were directly impacted by the virus and quarantines such as Gaming and Leisure and Entertainment. Sectors such as Cable, Food & Beverage and Technology were the best performing sectors.

Not surprisingly, the better quality portions of the market outperformed in the quarter with BB rated bonds outperforming the balance of the market. With its large energy exposure, CCC's posted the weakest returns of the rating categories. Bank loans performed better than the broad global high yield Index as well. One of the stand-out segments in leveraged finance was the shorter duration portion of the markets, as bonds with a duration of 0-2 years outperformed, even in a period of rapidly declining government interest rates.

During the quarter, the U.S. dollar denominated markets appeared more volatile than the European currency denominated markets based on their respective indexes. Although, by quarter end, and then through mid-April, the U.S. dollar market ended up outperforming. This was occurring in the context of significant volatility in exchange rates among the G-10 currencies.

Default expectations and "Fallen Knives"

Expectations for defaults have increased dramatically, though it is difficult to predict if it will reach the high end of historical levels. The length of the economic shutdown is likely the largest factor in where default figures end-up, although some industries that are not typically recession-sensitive may feel the impacts for years. It is worth noting that entering this crisis the global high yield bond market had higher average credit quality and more industry diversity than in the 2001, 2008 and 2011 economic downturns.

The sudden shutdown of the economy, the lingering impacts on select industries and the curve of the virus may be counter-balanced against the fact that thus far access to financing for many companies is available. In the US, an exceptional number of programs to assist liquidity are being made available through the government. Further, many of the most likely defaults are already being priced into the security prices - so from a market value sense, if one bought the entire market today, the impact on returns of defaults would likely be less than a headline default rate implies.

One major factor that will likely shift default numbers is the sheer number of Fallen Angels. While the number of these Fallen Angels has been particularly low in the last few years (approximately $16 billion in 2019), year-to-date through mid-April the estimated figure is US$150 billion in the corporate bond markets. This will not only impact the denominator in any default study, but some portion of these downgrades may prove to be "falling knives," that not only get downgraded but eventually default and increase the denominator.

These Fallen Angels are already reshaping the below investment grade market. They are shifting industry sector weightings, average ratings, maturities and duration in benchmarks. Additionally, the timing of these credits leaving and entering the indexes may vary as well, as one major index family chose to suspend their own protocols in April about inclusion of new bonds in their index.

These Fallen Angels will help diversify the high yield bond markets significantly and will increase the need for credit selection. We believe that for investors with a longer time horizon and access to research that can differentiate between the quality of downgraded credits, this period of Fallen Angels should create some good investment opportunities.

Final thoughts

The correction this month was not just extreme, but exceptionally rapid as the whole market repriced. Credit selection made a material difference during this sell-off. In the future, to make a significant difference in performance it will likely require careful analysis of corporate liquidity and business prospects and a disciplined investment approach that can look past mark-to-market levels.

Even after the curve of the virus starts to turn downward and with relatively broad and rapid government responses relative to other recessionary cycles, the economic impacts of COVID-19 will be felt for some time. This will likely keep both volatility and return dispersion high. We believe that there will be significant opportunities to rotate into various industries and asset classes as the lockdowns hopefully unwind, and the differences in this economic recovery start to reveal themselves.

The central bank actions have dramatically lowered returns on the government and government related low risk investments. As market fears normalize, income focused investors will likely once again need to seek higher yielding parts of the credit market. This may even escalate more than in the past, as corporate dividend investment strategies may come under pressure from dividend cuts.

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