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European high yield credit: strategy update

Fixed Income | Q1 2020

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While European High Yield (EHY) credit market returns were significantly negative and spreads materially wider by the end of the first quarter, market valuations are now much more attractive than at the start of the year. We entered 2020 conservatively positioned in our EHY portfolios, and as we revisit valuations and the policy response to Covid-19 we are maintaining our defensive positioning while looking to switch to higher quality credits and add to credits that we previously thought expensive but which now look attractive.

Q1 market review

The likelihood of economic recession in many developed markets, following the Covid-19-related economic shutdown and isolation measures, met with rising risk aversion and market illiquidity to force yields and credit spreads significantly wider, reaching levels not seen since 2011/12.

Dislocation was evident in the differing performance of markets. The US dollar high yield market led spreads wider, rising more than 600bps to almost 1,100bps at its peak. As the market moved into a complete sell mode environment, we saw that often better names were being sold more aggressively than lower quality names, as the selling was very much liquidity driven. This helped to accelerate the fall in bond prices, while ETFs experienced net asset value (NAV) discounts of up to 8%.

It was a very one-sided environment with actual bids often being below screen prices. Trading was possible but with a liquidity premium. At the same time, the trading of any size was difficult with trade executions taking much longer than in normal market conditions. This was not specifically a high yield problem as the environment was the same for investment grade, especially for shorter-dated maturities.

At a sector level, industries hit the hardest included more cyclical areas of the market such as autos and energy, as well as transport and leisure and non-food retail. Relatively better performance was evident in those with less exposure to the cycle such as healthcare, utilities and telecoms.

Though market liquidity continues to be challenged, and while overall trading remains dislocated, there has been some improvement in the later part of March. With central bank support from the European Central Bank, the Bank of England and the US Federal Reserve, and the large government fiscal responses, the situation improved with better liquidity for better names. As the market became more rational it started to distinguish between better, more defensive names versus weaker, more cyclical names – and better names outperformed.

There are also some early signs that better quality names seem to find a two-way market more easily. Selling is now relatively easier but buying is more difficult with some names being up several points. However, more cyclical or weaker names continue to be very difficult to sell. On the new issuance front, unlike in the investment grade market, this has come to a halt.

We continue to be in this second wave of relative market improvement and are seeing large dispersions between better and worse names, with good names trading at a significant premium and lower quality names trading much less so or even at a significant discount.

Activity and outlook

EHY spreads are around 0.6 standard deviations wide of the long run (20-year) average, from around flat at the end of 2019.

The substantial monetary and fiscal policy measures announced will help ameliorate the significant – though temporary – interruption to economic output and employment. More specifically, much of the policy response is targeted at keeping the credit channel open. Policymakers want to avoid an economic shock turning into a financial crisis. Policies such as the US Federal Reserve directly buying investment grade corporate bonds are designed with credit spreads in mind and should help to stabilise the overall credit market, as already has started to take place.

Credit ratings agencies have been quick to act, and the likelihood of further downward rating action will hang over the market for the next few months. There has been much talk recently regarding “Fallen Angels”. Since the start of the year in the European space there have already been €30 billion and £3.5 billion of Fallen Angels, more than 2018 and 2019 combined, and already around 10% of the outstanding EHY market. Credit rating downgrades have accelerated as the ramifications from the Covid-19 shock continues and governments, globally, scramble to implement monetary and fiscal policies to stem the deterioration.

JP Morgan, in its most recent release, targets potentially €100 billion or 4.3% of the investment grade universe falling into the EHY space. With the current EHY universe entailing €350 billion in notional and €300 billion in market value, should this be realised it will increase the EHY universe by almost 30% with the risk of causing digestion issues for the relatively small EHY market. The effects of downgrades are being seen presently, for example in Ford. These effects are wide-spread and expected to continue. A number of these Fallen Angels have relatively strong fundamentals and we would see them as opportunities for investments. In summary, at present we feel spreads offer material compensation for rising credit risk.

Since the start of the year our EHY strategy has been, and continues to be, defensively positioned with a moderately underweight market beta (while maintaining a level of liquidity), and maintains on a sector basis an underweight in cyclicals such as autos, transportation and basic industries, while being overweight in healthcare (eg, IQVIA), technology (SFR and Netflix), media and financial services.

High-quality over low-quality bonds was one of our investment themes going into 2020, and we would re-emphasise that theme. Low-quality bonds will be challenged by higher default rates in cyclical sectors, especially those related to the crude oil situation and global containment (for example, energy, transport and autos). Given market dislocations, we are looking where possible to improve the overall credit quality of the strategy, switching into higher quality credits with a focus on BB and senior rated paper.

We are also looking to add some Fallen Angels and higher-rated credit after the recent price blow out given the indiscriminate selling experienced by the market in March. We feel we are being well compensated with potential returns for investment risk taken. Notably at current spread levels, markets are compensating investors at many multiples of the worst historic default experience.

Performance summary

Broadly speaking, our EHY strategy has performed well over the first quarter of 2020 for the reasons documented above.

Note: all data Bloomberg as at 31 March 2020, unless otherwise specified.