Flash High-yield

Written on
25| 06 | 2020

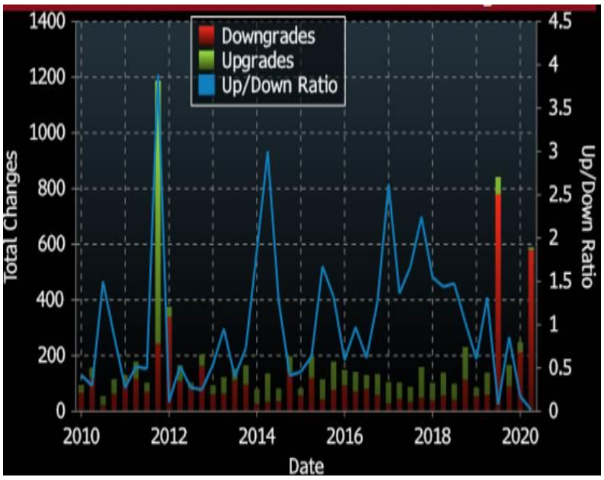
An exceptional rebound

Following a historic fall, both in terms of duration and magnitude, an equally exceptional rebound has been observed on the markets.

While this rebound initially disconcerted many investors because of its decorrelation with the real economy, it is now well explained and understood.

Two months ago, we were in a situation where the rating agencies, which had been largely criticized for the slow adjustment of their ratings in the wake of the 2008 crisis, took the opposite stance and massively downgraded companies in record time and without any distinction.

Rating Drift Europe



Source : Bloomberg, 25/06/2020

Rating Drift US

Source : Bloomberg, 25/06/20

Rating agencies assessed the impact of the crisis on business fundamentals before central banks and governments announced their accommodative measures.

As a result, rating agencies, and part of the market, anticipated an extremely large number of upcoming defaults. For example, in March, S&P Global Ratings stated that the default rate for high-yield bonds was heading towards 10% over the next 12 months, more than triple the 3.1% rate that was recorded at the end of 2019. Similarly, Fitch Ratings[1] forecasted a 17% default rate for the US energy sector.

Over the last month, however, markets have been able to refine this analysis and recognize that the picture has fundamentally changed. This exceptional situation has had an equally exceptional response, never observed throughout previous crises:

- Central Banks, which had taken four years to react to the 2008 crisis, injected substantial amounts of liquidity into financial markets to contain the situation.
- Governments put aside public deficit concerns to help national companies and preserve employment.
- At the same time, the month of May, which was particularly eventful with a large number of high-yield companies releasing their Q1 results, gave investors a little more insight into the

[1] Source: Bloomberg, March 2020

situation of the second quarter and reassured them about the financial health of many high-yield companies.

Our estimates on default rates are significantly lower:

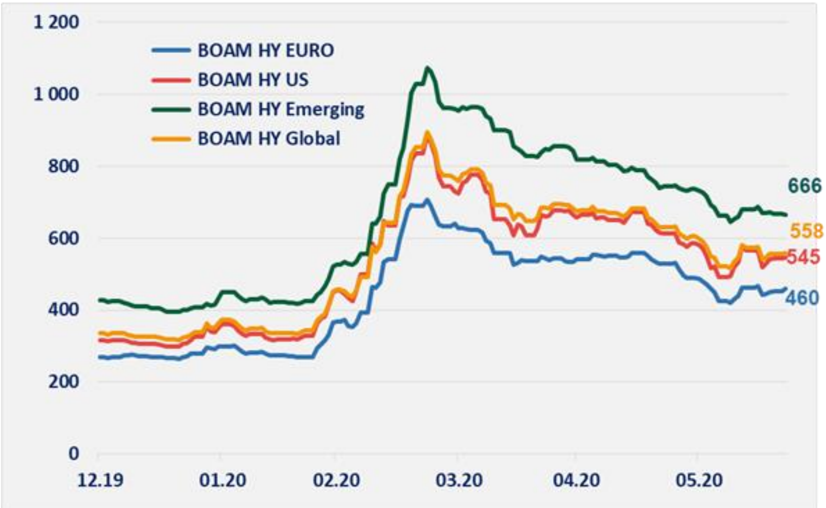
- Euro High-Yield :
  - Base scenario: 4.6%,
  - Negative Scenario: 6%
- US High-Yield:
  - Base scenario: 7.3%,
  - Negative scenario: 10.5%

It should be noted that our estimates are made taking into account the weight of defaulted bonds relative to the number of issues overall in order to get a better understanding of the health of the high-yield market and better represent current risks. Agencies, however, communicate their default rate as the number of issuers in default in relation to the number of issuers overall, de facto overestimating defaults on the market.

Valuations supported by accommodative measures

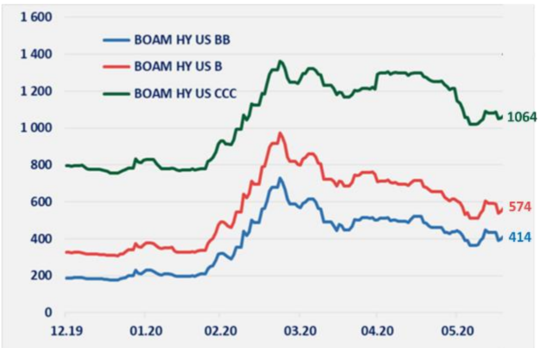
The massive support of Central Banks and governments to prevent this sanitary crisis from turning into an economic crisis is today a decisive element on the High-Yield market. As a result of these measures, flows are gradually returning to the asset class, and this support is beginning to be reflected in the valuations of High-Yield bonds as presented below.

High-Yield spread by geographic area

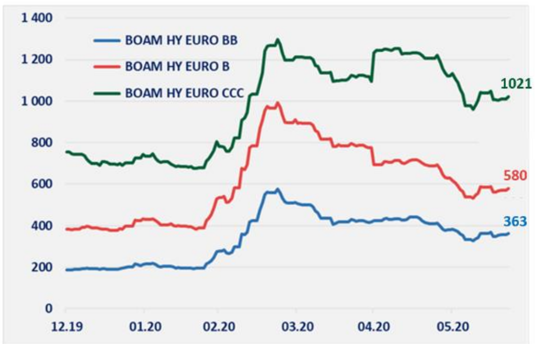


Source: BoAM/ML, Bloomberg, data as at 23/06/2020

US High-Yield spread by rating



Euro Zone High-Yield Spread by rating



Countries that have full monetary and fiscal policy autonomy will see their economies recover more rapidly. We believe that the rebound will thus be more significant in the United States than in Europe, because of approaching November 2020 elections, which should urge the incumbent candidate (D. Trump) to accelerate the recovery plan to deal with the spectacular rise in unemployment and social inequalities. The recovery in the United States, and more particularly in the US High-Yield market, will be facilitated by the Fed's buyback of "fallen angels" and High-Yield ETFs; which the European Central Bank has not done.

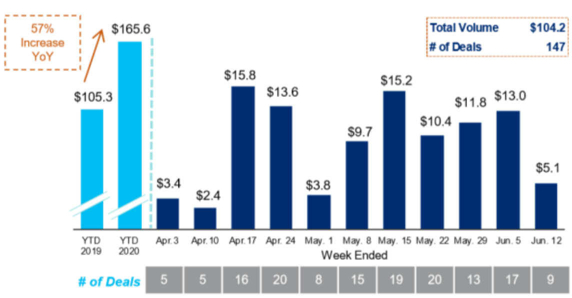
The cost of the post-crisis period with a decline in growth and an increase in public debt will be significant in Europe, particularly in peripheral countries with fragile political situations (Italy for instance). The initiatives of the ECB and of the European Commission (recovery plan, etc.) are unprecedented in this respect and are a step towards greater European integration.

We do not expect a substantial increase in default rates

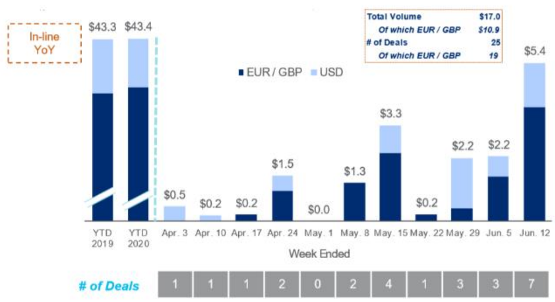
The world has experienced or is experiencing the most serious economic crisis since 1929, but paradoxically we consider that this will not result in a severe increase in the number of defaults as it did in 2001 (22% default rate) and in 2008 (15% default rate) because of the expected recovery of the world economy (the first elements of which are beginning to materialize in China and the USA) given deconfinement and, above all, the rapid and massive support of Central Banks and governments.

We believe that the default rate projections of ratings agencies for 2020 and 2021 are exaggerated and do not sufficiently take into account the improving financing conditions which have enabled many issuers to refinance themselves and significantly improve their liquidity. The volume of bond issuance has reached an all-time high of more than $1,000 billion since the beginning of the year[2].
In the High-Yield space, the US market has been very dynamic, with a 57% increase in issuances compared to last year, unlike in the European market, which has remained less dynamic but is expected to accelerate by summer.

US High-Yield issuances



EMEA High-Yield issuances



Source : Citi, data as at June 2020

If the recovery scenario is in a "U" shape (our base case scenario), rating agencies will probably lower their High-Yield default projections (factors that are starting to be gradually integrated by the market).

We do not think there will be a massive wave of defaults on energy issuers in the US. The energy sector is certainly marked by a rather dramatic and unprecedented drop in prices, but the rise in defaults will mainly be on small players and emerging markets. The United States will never give up its energy independence and the Republicans will not abandon the industry. The main losers from the fall in the price of oil are emerging countries that depend heavily on commodities and suffer from large external deficits (Middle Eastern countries and Latin America). Small U.S. producers will disappear, but this will not result in an increase in defaults as significant as initially anticipated. The market is gradually integrating this factor as evidenced by the significant decline in the "distressed ratio" of energy companies in the United States which has dropped from 80% in March to less than 15% currently[3].

[2] Source: Bloomberg, June 2020
[3] Source: Bank of America, June 2020

Convictions on the High-Yield Investment strategy

- Geographically:
  - We favor the United States and Core Europe, and remain cautious regarding emerging and peripheral countries
  - Emerging country fundamentals appear weakened due to the current crisis and their heavy dependence on commodities (including oil). Also, they do not benefit from the same central bank support as in the US and Europe.
  - Peripheral countries are expected to suffer from a significant decline in growth and an important increase in public debt. Political risk also weighs heavily.
- Ratings:
  - We favor large US issuers (notably fallen angels) that offer attractive risk premiums compared to European issuers, especially with the significant drop in hedging costs that should persist over time thanks to the Fed's expansionary monetary policy.
- Sectors:
  - We remain cautious regarding cyclical securities rated « B » and « CCC » and favor "benchmark" issuers over smaller issuers with low liquidity.

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