IS IT PRIME TIME FOR CREDIT?

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CREDIT MARKETS ARE MOVING FAST. SINCE THE END OF 2019, CORPORATE BOND SPREADS HAVE SOARED FROM 330 TO 1100 BASIS POINTS IN HIGH YIELD (HY), AND FROM 94 TO 373 BASIS POINTS IN INVESTMENT GRADE (IG).[1]

COVID-19 has crippled the global economy, and it's unclear exactly when economic and market activity will return to business as usual. The uncertainty has markets reeling.

But, periods of maximum uncertainty often make the most attractive entry points. Why?

1. **Market valuations typically overreact during periods of high uncertainty,** discounting much more pain than will likely materialize. As uncertainty fades, prices often come roaring back.
2. **Recoveries have yielded outsized returns;** holding and adding to credit allocations through downturns has been rewarded handsomely in the past.
3. **Security-specific opportunities open up**. Fear, forced selling and other factors create dispersions that credit pickers can potentially capitalize on.

Here's more detail on each point.

1. Markets Overreact

- Credit spreads have historically been far more volatile than realized defaults. Over roughly the past 20 years, 12-month high yield defaults have a standard deviation of 3.3% versus 12.7% for 12-month high yield returns.[2]
- The current crisis may become another example of this decoupling. So far, this crisis represents the third-worst HY drawdown and second-worst IG drawdown on record.[3] A glass-half-full perspective says we are in a statistical tail; movements of this magnitude are historically rare. For a glass-half-empty perspective, if you think this crisis will be worse than the global financial crisis, then markets may only be partway there.

BLOOMBERG BARCLAYS US CORPORATE HIGH YIELD INDEX - TOP 10 DRAWDOWNS

RANK	EVENT	PEAK	TROUGH	LENGTH (MONTHS)	DRAWDOWN (TOTAL RET %)
1	GLOBAL FINANCIAL CRISIS	Jun-07	Nov-08	18	-33.3
2	1990 RECESSION	Aug-90	Oct-90	3	-17.2
3	**COVID-19 PANDEMIC**	**Feb-20**	**Mar-20**	**2**	**-15.3**
4	WORLDCOM	Mar-01	Jul-02	17	-12.0
5	ENERGY CRISIS	Jun-15	Jan-16	8	-9.7
6	TECH BUBBLE BURST	May-99	Nov-00	19	-8.9
7	SAVINGS & LOAN CRISIS	Sep-89	Feb-90	6	-8.0
8	US DEBT CEILING DEBACLE	Aug-11	Sep-11	2	-7.1
9	LONG-TERM CAPITAL MGMT PANIC	Aug-98	Oct-98	3	-7.0
10	BLACK MONDAY	Apr-87	Oct-87	7	-6.9

Source: Bloomberg Barclays, Loomis Sayles calculations. July 1, 1983, through March 23, 2020.

BLOOMBERG BARCLAYS US CORPORATE BOND INDEX - TOP 10 DRAWDOWNS

RANK	EVENT	PEAK	TROUGH	LENGTH (MONTHS)	DRAWDOWN (TOTAL RET%)
1	GLOBAL FINANCIAL CRISIS	Mar-08	Oct-08	8	-15.4
2	**COVID-19 PANDEMIC**	**Mar-20**	**Mar-20**	**1**	**-9.3**
3	CONTINENTAL ILLINOIS BANK FAIL	Feb-84	May-84	4	-6.9
4	FED RATE HIKE SURPRISE	Feb-94	Jun-94	5	-6.8
5	BLACK MONDAY	Mar-87	Sep-87	7	-6.2
6	FED "TAPER TANTRUM"	May-13	Jun-13	2	-5.0
7	IRAQ WAR/SARS	Jun-03	Jul-03	2	-4.6
8	RISING RATES	Feb-96	May-96	4	-4.2
9	RISING RATES	Feb-99	Aug-99	7	-4.0
10	CHINA TRADE/RECESSION FEARS	Jan-18	Nov-18	11	-3.9

Source: Bloomberg Barclays, Loomis Sayles calculations. July 1, 1983, through March 23, 2020.

WE ARE IN THE GLASS-HALF-FULL CAMP

- There is unprecedented global fiscal and monetary stimulus aimed at keeping this economic downturn as shallow and short as possible. Major central banks and governments are committed. Moral hazard isn't a factor this crisis, and policymakers are all-in on the decision to lend support. Even if the recovery is long, fixed income investors may be able to compound attractive yields during the process. The yield cushion can act as a buffer if prices are volatile during the recovery or if the process is protracted.
- Selectivity is key, however. Credit downgrades have started to rise, as have default expectations. The size of the BBB debt universe was at all-time highs prior to this crisis, roughly tripling to $2.6 trillion[4] over the past decade. We may see a wave of downgrades to HY. Heading into this crisis, leverage and other raw credit metrics were weak relative to history. But companies used low interest rates to term out their debt. Interest coverage and cash positions on balance sheets were generally strong. Issuers with sufficient liquidity (balance sheet cash, credit lines, access to debt markets) are best-positioned to come through the downturn. IG and certain HY companies can also tap central banks' corporate liquidity programs. Attractive returns have the potential to accrue to investors who deeply understand issuer credit fundamentals as well as the details and reach of recently announced stimulus programs.

2. Recoveries Yield Outsized Returns

- Looking back at past drawdowns, forward returns have often been positive and outsized.

BLOOMBERG BARCLAYS US CORPORATE HIGH YIELD INDEX - FORWARD RETURNS

						SUBSEQUENT PERFORMANCE (TOTAL RETURN%)				
RANK	EVENT	PEAK	TROUGH	LENGTH (MONTHS)	DRAWDOWN (TOTAL RET %)	1 YEAR	2 YEAR	3 YEAR	4 YEAR	5 YEAR
1	GLOBAL FINANCIAL CRISIS	Jun-07	Nov-08	18	-33.3	65.0	92.6	100.6	134.8	154.8
2	1990 RECESSION	Aug-90	Oct-90	3	-17.2	48.7	71.3	102.0	104.5	136.5
3	**COVID-19 PANDEMIC**	**Feb-20**	**Mar-20**	**2**	**-15.3**	**??**	**??**	**??**	**??**	**??**
4	WORLDCOM	Mar-01	Jul-02	17	-12.0	27.0	43.6	59.7	66.2	77.0
5	ENERGY CRISIS	Jun-15	Jan-16	8	-9.7	20.8	28.7	31.0	43.3	21.3
6	TECH BUBBLE	May-99	Nov-00	19	-8.9	7.8	4.3	33.4	49.4	54.5
7	S&L CRISIS	Sep-89	Feb-90	6	-8.0	7.5	46.3	67.2	90.5	94.0
8	US DEBT CEILING	Aug-11	Sep-11	2	-7.1	19.4	27.9	37.1	32.4	49.3
9	LTCM PANIC	Aug-98	Oct-98	3	-7.0	4.3	2.7	2.5	-3.1	29.6
10	BLACK MONDAY	Apr-87	Oct-87	7	-6.9	17.3	19.6	4.2	55.0	78.6
					Average Period Return	9.4	19.7	30.3	41.3	53.2

Source: Bloomberg Barclays, Loomis Sayles calculations. July 1, 1983, through March 23, 2020.

BLOOMBERG BARCLAYS US CORPORATE BOND INDEX - FORWARD RETURNS

						SUBSEQUENT PERFORMANCE (TOTAL RETURN%)				
RANK	EVENT	PEAK	TROUGH	LENGTH (MONTHS)	DRAWDOWN (TOTAL RET%)	1 YEAR	2 YEAR	3 YEAR	4 YEAR	5 YEAR
1	GLOBAL FINANCIAL CRISIS	Mar-08	Oct-08	8	-15.4	31.1	46.3	55.3	71.1	68.7
2	**COVID-19 PANDEMIC**	**Mar-20**	**Mar-20**	**1**	**-9.3**	**??**	**??**	**??**	**??**	**??**
3	CONT'L ILLINOIS BANK	Feb-84	May-84	4	-6.9	35.5	62.6	73.7	86.4	109.4
4	FED HIKE SURPRISE	Feb-94	Jun-94	5	-6.8	15.1	21.0	31.7	46.6	49.4
5	BLACK MONDAY	Mar-87	Sep-87	7	-6.2	15.0	28.6	36.5	59.8	82.5
6	FED "TAPER TANTRUM"	May-13	Jun-13	2	-5.0	7.7	8.5	17.2	19.8	18.8
7	IRAQ WAR/SARS	Jun-03	Jul-03	2	-4.6	6.1	12.2	12.4	18.5	20.8
8	RISING RATES	Feb-96	May-96	4	-4.2	8.8	22.0	25.9	25.9	43.9
9	RISING RATES	Feb-99	Aug-99	7	-4.0	6.4	21.0	27.3	39.2	49.9
10	CHINA TRADE / RECESSION FEARS	Jan-18	Nov-18	11	-3.9	15.9	9.3	9.3	9.3	9.3
					Average Period Return	8.1	16.6	25.4	34.7	44.8

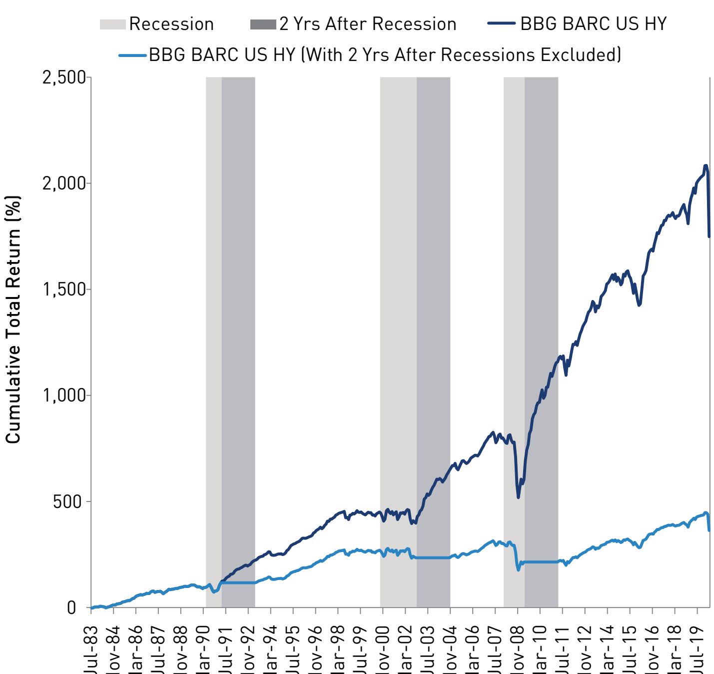
Source: Bloomberg Barclays, Loomis Sayles calculations. July 1, 1983, through March 23, 2020.

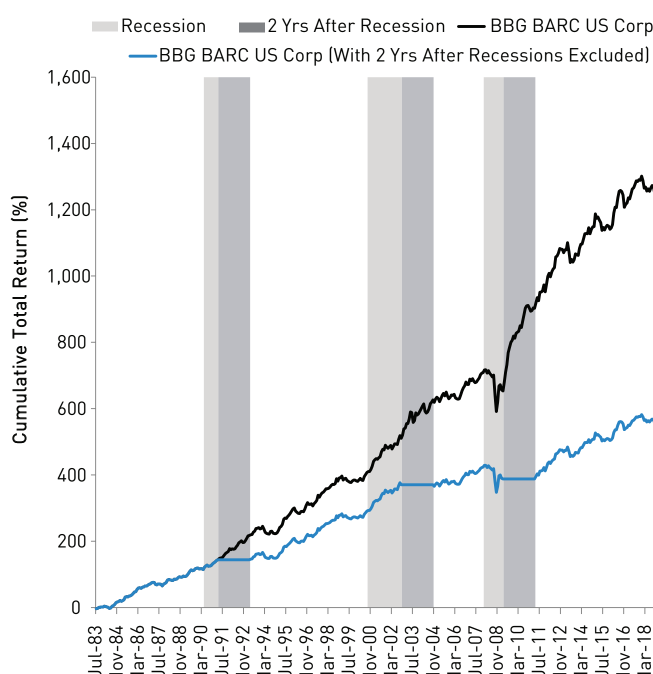
- Historically, sitting on the sidelines through downturns and early recoveries has come at a high opportunity cost. To see how critical these periods can be to total return, consider the exhibits below. An investor who was not in the market for the two-year period after recessions would have earned significantly less than one who was.

PARTICIPATION IN RECOVERY: CRITICAL TO LONG-TERM PERFORMANCE

	CONTINUOUS INVESTING[5] 7/1/83-12/31/19		EXCLUDING 2 YEARS AFTER RECESSIONS 7/1/83-12/31/19	
	CUMULATIVE RETURN	ANNUALIZED RETURN	CUMULATIVE RETURN	ANNUALIZED RETURN
BBG BARC US HY	2,083%	8.8%	447%	5.7%
BBG BARC US CORP	1,465%	7.8%	661%	7.0%

Source: Bloomberg Barclays, Loomis Sayles calculations.

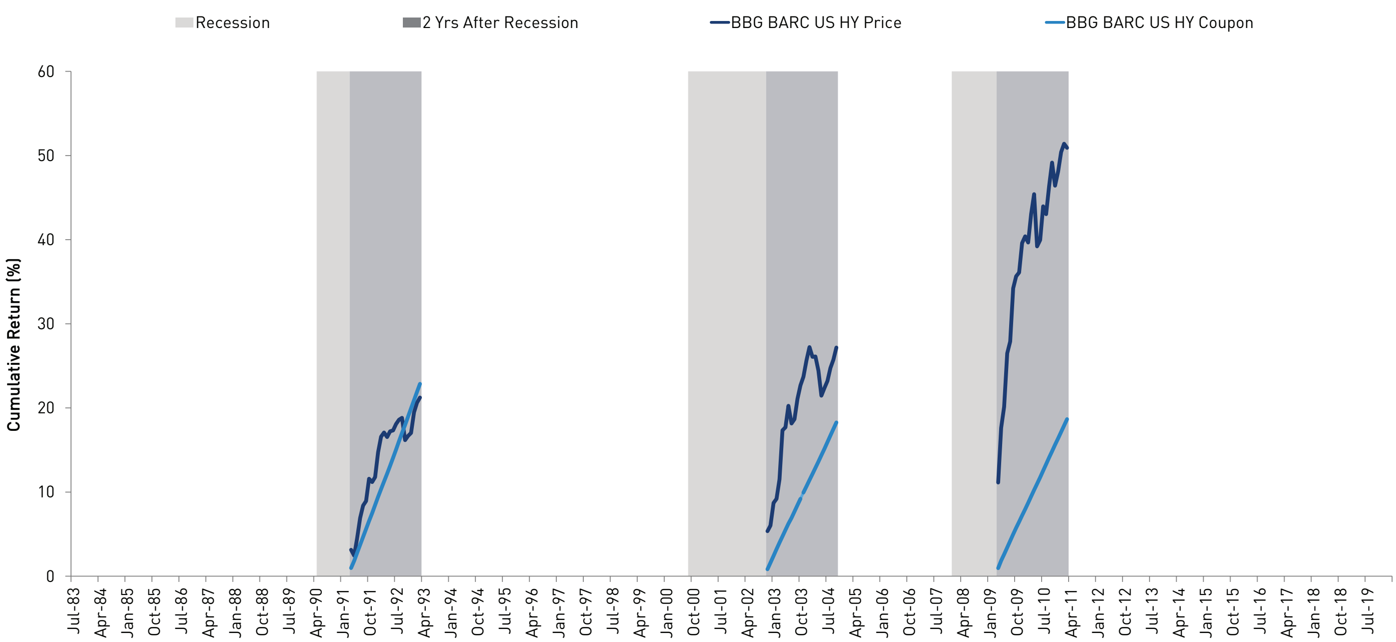




Source: Bloomberg Barclays, Loomis Sayles calculations. July 1, 1983, through March 23, 2020.

- Why are recoveries so critical? The early days of recovery set up twin tailwinds for bonds: a largely positive price-appreciation trend and yield advantage. Together, they make these periods a sweet spot for credit. Trying to precisely time the bottom could mean missing part of this recovery. And as market liquidity improves and risk appetite recovers, it can become more difficult for investors to obtain the bond allocations they want.

TWIN TAILWINDS: POWERFUL COMBINATION OF PRICE APPRECIATION AND HIGHER INCOME



Source: Bloomberg Barclays, Loomis Sayles calculations. July 1, 1983, through March 23, 2020.

3. Security-Specific Opportunities Open Up

- Market overreactions can be even more pronounced at the individual company level than they are at the aggregate index level. Fallen angels[6] are a prime example of this phenomenon. This segment of the market is subject to institutional constraints and guideline-driven forced selling, which inflate the risk premium associated with many bonds.
- We welcome these opportunities and strive to capitalize on them. Credit spreads were very compressed prior to this sharp economic and market downturn. Investors were clamoring for yield and assuming outsized risks to get it in some cases. As of December 2019, the difference in option-adjusted spread between top-quartile and bottom-quartile bonds was only 70 basis points in IG and 300 basis points in HY. Fast-forward to March 23, 2020, and the difference had grown to 175 basis points in IG and 800 basis points in HY, as shown below.

PERCENTILES BASED ON OAS LEVELS

	INVESTMENT GRADE OAS		HIGH YIELD OAS	
	12/31/19	3/23/20	12/31/19	3/23/20
TOP QUARTILE	122	430	465	1,470
MEDIAN	86	327	237	929
BOTTOM QUARTILE	53	257	155	680
TOP QUARTILE - BOTTOM QUARTILE	69	173	310	790

Source: Bloomberg Barclays.

Better Credit Investing Opportunities

Credit spreads will almost certainly continue to fluctuate and could go wider from here. But we believe this environment is creating better credit investing opportunities than we have seen in some time. We are looking through the volatility, studying economic indicators and corporate fundamentals, and carefully selecting entry points to create long-term portfolio value and strong future performance potential.

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Endnotes

[1] *Source: Bloomberg Barclays US Corporate High Yield Index and Bloomberg Barclays US Corporate Bond Index spread levels at December 31, 2019, and March 23, 2020. March 23, 2020, represents peak spread level of current crisis as of publication date (April 8, 2020).*

[2] *Based on annual standard deviation of Bloomberg Barclays US High Yield Corporate Index 12-month return and 12-month change of Moody's US high yield default rate; data from January 1, 2001, to February 1, 2020.*

[3] *Drawdown measures the percent peak-to-trough decline for an investment before a new peak is attained. July 1, 1983, the inception date of the Bloomberg Barclays US Corporate High Yield Index, was selected to give the analysis a common track record.*

[4] *Source: Bloomberg Barclays; BBB debt outstanding as of 12/31/2020.*

[5] *You cannot invest directly in an index. This example is for illustrative purposes only.*

[6] *A bond that initially had an investment grade rating but has since been reduced to high yield.*

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