



THREE QUESTIONS ON CREDIT: HIGH YIELD FEATURING BRIAN KENNEDY

HOW IS THE HIGH YIELD MARKET HOLDING UP?

The high yield (HY) market was down sharply in March by about 11.5% (Bloomberg Barclays US Corporate High Yield Index). On March 23, HY spreads peaked at 1100 basis points and almost half of the securities within the ICE BofAML High Yield Index were trading at spreads north of 1000 basis points, which is a valuation level HY investors have historically considered “distressed.” The last time the distressed ratio was that high was in early 2009, following the global financial crisis. We are experiencing a major bifurcation within credit quality buckets, with many BB companies holding their value while many lower-rated CCC bonds are being priced for default. Low interest rates have left US dollar prices on many bonds higher than one would expect at this point, despite the violent selloff.

We are also witnessing vast downgrades from investment grade to HY. There was a record \$92.8 billion (Barclays US High Yield Corporate update, 4/1/2020) in fallen angels¹ in March, and we are expecting more in the coming months. Fallen angels have historically represented great value and return potential. High yield spreads rarely trade at the levels we are seeing today; historically speaking, they tend not to stay at these levels for very long.

WHAT SECTORS ARE MOST IMPACTED?

The energy industry is one of the biggest contributors to extreme sector valuations. The spread on the energy portion of the Bloomberg Barclays US Corporate High Yield Index peaked on March 20 at 2310 basis points, more than double that of the overall index. Beyond the COVID-19 crisis, oil and gas have suffered due to ongoing disagreement between OPEC and Russia. Despite this weekend’s historic crude oil production cuts, global demand will likely continue to suffer, resulting in the potential for many oil storage facilities to reach capacity in the coming weeks. While this appears to be a short-term panacea, the supply cuts do not address today’s bigger issue in oil: a sudden and notable drop in global demand.

Other impacted industries include retailers, transportation, gaming and aerospace & defense, most of which are currently trading near distressed levels. Value is resetting at an unprecedented speed in the HY market.

WHAT’S YOUR OUTLOOK FOR DEFAULTS?

We are anticipating a severe drop in both National Income and Product Accounts (NIPA) and S&P 500 profits in the second and third quarters of 2020—perhaps 30% or more. Monetary and fiscal stimulus are set to cushion the blow but revenues, profits and cash flow could be largely hampered. HY spreads are currently forecasting a significant rise in default rates over the next 12 months. We currently anticipate a substantial rise in the HY default rate over the next 12 months, to approximately 7%-10%.

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Endnotes

¹ A bond that was initially given an investment grade credit rating but has been downgraded to junk bond status.

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Market conditions are extremely fluid and change frequently.

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