Flash- La Française High Yield Market Update

Written on
14 | 04 | 2020

COVID-19 ASSESSMENT

To date, the number of people who tested positive for Covid-19 is close to 2 million and the death toll exceeds 120,000 worldwide. Social distancing measures seem to be bearing fruit with a slowdown in the spread of the virus in Europe and even in the United States, which is becoming the most affected country. The situation in some emerging countries is still concerning as Turkey, India and Brazil could see a rapid increase in new cases and deaths. Europe and the United States are now examining strategies to lift lockdown restrictions, and it seems that resuming normal activities will take months, if not quarters.

WHAT COULD BE THE ECONOMIC CONSEQUENCES OF THIS HEALTH CRISIS?

The assessment is made even more difficult by the nature of this unprecedented shock as well as governments' inability to put a timetable on the loosening of restrictions. As confinement extends, the predictions regarding the severity of the recession worsen. For 2020, the IMF average growth forecasts stand at -3% globally, -7.5% in Europe, and -3.2% in the United States. For 2021, it anticipates global growth to reach +4.7% in Europe and in the United States, and +5.8% globally[1].

The world will undoubtedly enter a severe recession. Social welfare systems along with political decisions will affect the degree to which public debts will absorb the shock, but households and firms will not be spared.

CENTRAL BANKS

Central banks are going beyond the actions taken throughout previous crises. Spectacular measures have notably been initiated by the Fed, which has increased its secondary market corporate credit facility. The initial investment of $ 20 billion in primary and secondary markets was thus increased to $ 75 billion.

- Bonds rated BBB- / Baa3 as of March 22, 2020 and whose ratings have been downgraded to BB- / Ba3 are now eligible for purchases by the Fed.

- High Yield ETFs, which were initially excluded, are now eligible if the fund's objective is to gain exposure to the US High Yield bond markets. This announcement, albeit not eliminating the risks of default of fragile American companies (B and CCC), remains very positive for the credit market as it alleviates the major risk of deterioration of BBB ("fallen angels") issuers and will limit the probability of a global increase in default rates.

THE HIGH YIELD MARKET IS UNDER PRESSURE

Risky assets are severely penalized by the current crisis and in particular the High Yield market which is very dependent on macroeconomic data and on issuers' solvency. Spreads on the global HY index[2] have widened by more than 400 bps since the beginning of February. The emerging and US High Yield markets were more significantly impacted, with spreads widening by 430 bps and 550 bps respectively. Furthermore, the lowest rated issuers (B and below) were naturally more affected, with spreads widening by more than 500 bps for the "B" segment vs 380 bps for the "BB" segment.

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[1] Source: IMF, April 2020.
[2] BofAML, April 2020
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The inversion of the curves, along with the expected rise in default rates, also accentuated the underperformance of short-term bonds compared to long-term issues. This inversion of the curves also applies to BB and Investment Grade issuers.

The Fed's recent pledge to buy high yield bonds led to a substantial increase in valuations.

DEFAUTS WILL OCCUR... OPPORTUNITIES WILL ARISE

Default rates have for now been contained, but are expected to increase

Default rates will inevitably increase in the medium term versus the current level of 2%[3]. The real question is, to which extent?

From our point of view, the rise in defaults will not be as drastic and homogeneous as anticipated by rating agencies. The most pessimistic predictions anticipate an increase in overall defaults to 18% over the next 12 months[4]. We believe that the rise in default rates will be more moderate as companies' refinancing needs are lower than they were during previous crises (2001 and 2008)[5], especially in Europe, and as the accommodative measures conducted by governments and central banks have been faster and more targeted than in previous crises. This observation must however be nuanced depending on geographical zones[4]

Thus, by geographic area:

-We believe that emerging countries (which currently have the lowest default rate, below 1%) will be the most impacted (particularly Latin America and the Middle East), given the weight of the energy sector in these regions, the budgetary imbalances and the significant refinancing needs in dollars, the cost of which has significantly increased.

- We believe that the US High Yield market will also be impacted due to its exposure to the energy and cyclical consumption sectors.

- The European market should be less affected as a result of its lower exposure to the energy, leisure and travel sectors (5%).

- In general, large issuers in Europe and the United States should benefit from the accommodative measures conducted by governments and central banks (see above), which should limit financial contagion and prevent a severe increase in defaults in these 2 areas.

Capturing market opportunities

The liquidity problems which amplified the downward spiral in financial markets, along with the likely wave of downgrades of Investment Grade rated companies to High Yield ("Fallen Angel") which is starting to affect the technical factors by bringing additional flows to the High yield market (the 1st quarter of 2020 experienced the largest volume of "fallen angels" ever recorded) create interesting opportunities, in particular on high quality European and American issuers.

[3] BofAML, March 2020
[4] S&P and Moody's, March 2020
[5] BofAML, March 2020

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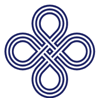

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