FIXED INCOME

High Yield: A Time to be Nimble

BARINGS CONVERSATIONS

This piece was adapted from an interview with Martin Horne. The full audio podcast can be found *here.**

In this Q&A, Martin Horne, Barings' Head of Global Public Fixed Income, discusses the state of high yield markets amid a late-cycle environment, and why it's critical to be nimble and selective in order to capture points of relative value.

*Full podcast URL: https://www.barings.com/viewpoints/high-yield-rates-recessions-and-relative-value

From your perspective, where are we today when it comes to high yield, and how is that affected by interest rates? What are you seeing on the ground today?

At this point, it is undeniable that we are in a late-cycle environment. Interest rates are a reflection of where the global economy is heading—and central banks have shifted into easing mode. As a result, we've seen very stereotypical outflows from variable rate products like loans; we're already seeing global yield compression; and there's more or less global agreement that we're in a low-growth environment. There are $15 trillion of negative yield bonds in the marketplace, which poses a significant technical and adds to the global search for yield—as investors have to be invested somewhere.[1] In many cases, that means moving downstream from investment grade to high yield.

Despite recession-focused rhetoric from market commentators and politicians, which has contributed to erratic equity market movements, the behavior of corporate issuers suggests that we are heading for something much more measured. Similar to the recession in the 1990s, it appears that any movement downward will likely be very gradual. Credit markets tend to fare well in mild recessions, too. Spreads often stay wide, and defaults have tended to stay manageable. Credit-focused managers should be able to identify and circumnavigate the opportunity set, and do well for their investors as we move further ahead. Additionally, because the end of the cycle has been a topic of discussion for so long now, we've seen a gradual shift in the way corporates have positioned themselves. Finance directors and CEOs, for instance, have adjusted their return on capital assumptions, CapEx deployment processes, and inventory level expectations—all of which means corporations should be better prepared to absorb what's coming. That said, selectivity will be critical; it is not a time to be index tracking.

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We've seen somewhat of a bifurcation in the high yield markets, with some underperformance of the riskiest credits, mainly those that are CCC rated. What's your take on the rating agency actions and the default picture today?

We're still in a situation where, if you look at long-term historical default averages, we're below them in both U.S. and European loans—at 2.3% and 2.5%, respectively—and bonds—at 2.8% and 1.6%, respectively.[2] Defaults will inevitably creep upward—but if you look at where they're occurring in the U.S., it's almost exclusively within the energy and retail sectors, and within cyclical industries. Our expectation is that while defaults will likely rise, they will do so in a very manageable way. Rating agencies are hearing the same narrative, but after having been burned in the GFC, are being more front-footed this time around—by increasing downgrades in industries that are likely to suffer in declining economic environments. This produces a very predictable technical reaction in the marketplace, and should create an opportunity in lower-rated assets. Markets overreact to both the downside and the upside—and taking advantage of those situations will require the ability to be nimble and selective over the near- to medium-term.

1. Source. Bloomberg. As of September 30, 2019.
2. Source: Credit Suisse. As of September 30, 2019.

"Never assume that credit markets are logical. They're not—and we aim to be flexible and nimble in order to move where the opportunity presents itself."

In terms of performance, what have you seen across the "core four" high yield asset classes—U.S. and European loans and bonds—on a year-to-date (YTD) basis? Does anything stand out to you as offering particularly good relative value?

In terms of bonds, the U.S. market has exceeded low double digit returns YTD, and the European market appears to be heading that way. With respect to loans, both the U.S. and European markets have delivered returns that are about half of that. Fixed rate spreads have compressed, whereas falling interest rates have driven nearly a year of retail outflows in floating rate loans—contributing to their relative underperformance this year, and helping drive bond prices higher. Given where we are in the cycle, this is a very typical market reaction. If spreads in one sub-asset class get too wide, you should see them correct after a period of time, particularly in an environment where investors are trying to find points of relative value.

The markets seem to be moving toward those value points in a significantly faster way than they have in the past, which means opportunities will likely appear and fade quickly. So, it's critical to be nimble in asset allocation—which is one reason we are such big advocates of a multi-credit approach.

All things being equal—if spreads tighten a little, and there are no distinct points of value across the high yield universe—are loans, in theory, more defensive?

Typically, when the financial markets sell off, loans are one of the least correlated asset classes, making them innately more defensive. A great example was in 2018, when there were few financial markets that provided any positive returns at all—and yet, the loan market did. This is partly due to the floating rate nature of the asset class, and partly due to the fact that loans are secured by assets. Bonds are likely to pay more over time because they're fixed rate and unsecured, meaning they're not as high up in the capital structure. But investors need diversification; it's important to have an asset allocation mix to help dampen correlation and volatility. And during a big market sell-off, loans will often hold up—therefore enabling investors to shift capital around in a less penal way. That's one of the most important attributes of the asset class.

Looking outside of the core four asset classes, at some opportunities that are "beyond the index" in high yield—primarily at strategies like collateralized loan obligations (CLOs), distressed debt and emerging market (EM) corporate debt—where are you seeing value today?

As part of a high yield allocation, all three of those asset classes add potential diversification and incremental yield—assuming they're executed by an experienced team with an eye toward risk management. CLOs and distressed debt, in particular, often fall into the alternatives bucket—which typically encapsulates lesser-known asset classes that are not traded in large volumes. CLO liabilities, in particular, offer considerably more value than their corporate equivalent. For example, a BB rated liability in the CLO market can pay 300–500 basis points (bps) more than an equivalent BB rated corporate issue. But generally speaking, it's not a market that is well understood, despite the fact that it held up well during the Lehman's crisis in 2008–09. So, that's an asset class that we think is particularly attractive and absolutely fitting for a multi-strategy product.

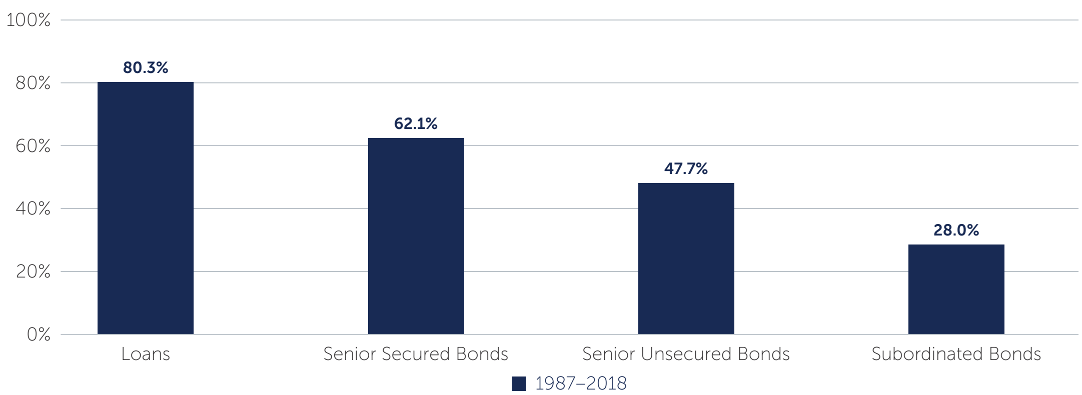
In terms of EM corporate debt, the lines between EMs and developed markets (DMs) are becoming increasingly blurred—which means that a lot of the characteristics seen in EM corporate debt today resemble those of high yield DMs. In fact, a significant portion of EM corporate debt is found in DM indexes today, because many of the issuers are large businesses that issue on a global basis. In many cases, EM corporate debt is given a high yield rating because of the sovereign in which it's domiciled, rather than its actual balance sheet. While this is not an asset class to index track—because its domains are so different—it is certainly an asset class that can offer diversification and yield-pick up.

On the topic of security, can you discuss the attraction of the global senior secured bond market, particularly in this late-cycle environment?

In a weak economic environment—or at least one that's lost some degree of strength—secured assets can pose many benefits. Global senior secured bonds are a lesser known subset of high yield—with collateral backing and capital structure seniority—which means senior secured bondholders are some of the first to get paid in the event of default. It is not unusual for the valuation of the issuing company to be double the size of the senior secured debt—thus making senior secured bonds compelling assets to hold amid concerns of an economic recession.

We typically see more secured products in the single-B rated category, as opposed to the BB rated category. But when entering a recession, we would almost always prefer to be invested in a single-B secured bond as opposed to a BB unsecured bond. This is primarily because rating agencies take the probability of default into consideration when valuing a security, but not the probability of recovery—and senior secured bonds have historically offered higher recovery rates than unsecured bonds **(FIGURE 1)**.

FIGURE 1: Moody's Global Average Corporate Debt Recovery Rates Measured by Ultimate Recoveries



SOURCE: Moody's Corporate Default & Recovery Rates. As of March 31, 2019.

As you consider the next 12 months, what is your overall philosophy on the best way to navigate high yield?

Looking ahead, there are a few key tenets we adhere to in our approach. First, we never assume that credit markets are logical. They're not—and we aim to be flexible and nimble in order to move where the opportunity presents itself. Those points of yield may be fleeting, but they will definitely be there. Second, we are prepared to make contrarian calls. Political risks in the U.S. have become elevated as we approach an election—and that's going to be a theme for another 12 months, at minimum. Industries like health care will likely get batted around in the process. The bottom line is that we are definitely in an asset selection period of time. It's not a time to be index tracking. Rigorous, bottom-up credit selection—as opposed to macro calls—will be absolutely critical to navigating the asset class successfully as we move forward.

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