

Global high yield bonds continued to offer value

► **Mike Della Vedova explores where the high yield opportunities remain, despite recent spread tightening**

After widening dramatically at the height of the coronavirus market sell-off in the spring, high yield bond spreads have narrowed again in response to aggressive government stimulus packages and improving economic data. The question is: given that valuations have recovered, is there still value in the high yield market?

We believe there is, but we also acknowledge that the nature of the opportunity in the high yield market has changed. Although credit spreads have yet to recover to their pre-coronavirus levels and therefore have room to rally further, this may not occur for a while

yet and, when it does, it is likely to be much less dramatic than the tightening of the past few months. The great buying opportunity that arose when high yield bonds sold off aggressively in the early days of the coronavirus shock has passed.

Instead, we expect a period of slowly improving conditions as life gradually returns to normal in most countries. Further outbreaks of the coronavirus are likely, but these will probably result in localised lockdowns rather than the country-wide restrictions imposed during the first wave – and will therefore be significantly less damaging to the global economy. A vaccine may become

widely available early next year, but even if it does not, we believe that governments and health authorities will have the tools to deal with new outbreaks without resorting to draconian measures. In this environment, spreads may hover around current levels, with pockets of volatility, for some time to come – meaning that attractive income is still available.

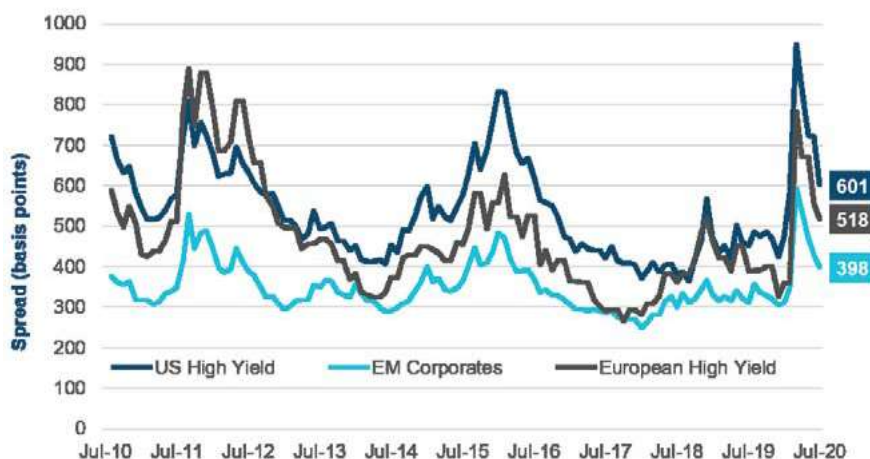
Automakers and casinos could be set to bounce back

An improving economic environment is not a risk-free one, however. Large numbers of high yield issuers have been hit very hard by the coronavirus shock and some will never recover. Based on an in-depth analysis of the balance sheets of all the companies we follow, we are anticipating a default rate of 9 per cent for the US high yield market in 2020, and around 5 per cent for the European high yield market. Although they are lower than the 12.2 per cent and 6.1 per cent default rates respectively predicted by rating agency Moody's¹.

Assuming we are correct in anticipating a slowly improving economic environment, which high yield sectors offer the most potential in our view? Defensive sectors such as packaging and cable have delivered strong performance during the crisis and we think it will probably continue to perform relatively well, albeit not to the same degree as before. Instead, we think the next phase of the recovery will most likely be led by companies in sectors that have been hit hard by coronavirus and are currently trading at a significant discount, but which have the cashflow to weather the storm and emerge stronger.

The automotive sector, for example, has been severely impacted by the coronavirus because of forced factory closures, its dependence on discretionary spending and the collapse of some of its key markets, particularly in Asia. Rating agencies have downgraded billions of dollars' worth of debt owed by automakers and the sector continues

Spreads are wider than before pandemic



As of July 31, 2020

Past performance is not a reliable indicator of future performance.

European High Yield—ICE BofA European Currency High Yield Constrained Excluding Subordinated Financials Index; US High Yield—J.P. Morgan Domestic High Yield Index; EM Corporates—J.P. Morgan CEMBI Broad Diversified Index. Source: J.P. Morgan & Bank of America/Merrill Lynch

to face steep challenges, but it also offers significant potential upside. In particular, manufacturers of auto parts such as seats and other interior features are trading at significant discount and appear in a good position to recover strongly. All cars require interior parts, so these firms have good prospects regardless of the extent to which electric cars disrupt the market.

While online gaming companies have performed well during the coronavirus pandemic, physical gaming companies such as casinos have been forced to close and are trading at significant discount. There may be an opportunity to invest in casino firms that have enough liquidity to survive for at least two years and reap the benefits as lockdowns are eased. The services sector in general is broad and diverse, and has a number of attractive and idiosyncratic companies with the potential for considerable upside in our view.

Fallen angels have deepened the opportunity set

It is not just a matter of identifying the sectors with the potential to rebound, however; it is also important to identify

the likely winners and losers within those sectors. A firm with a weak balance sheet and poor cash flow is unlikely to survive a steep, industry-wide fall in demand, particularly if it lacks the ability to raise new capital. Another company in the same sector that has a stronger balance sheet and better cashflow may be able to weather the storm and emerge stronger the other side. We do not believe that the amount of leverage a company has is particularly important in determining its ability to survive a crisis; what ultimately matters is its ability to meet its coupons and interest payments until its revenues recover.

Identifying such companies will be the key to successfully navigating the high yield bond market in the period ahead. For those who can, there will be plenty of opportunities available. Rating agencies are likely to continue downgrading large quantities of BBB bonds to high yield, depending on the path of the economic recovery. Automakers, leisure, restaurants, hotels, airlines and retail firms will bear the brunt of this. Among these fallen angels will be some multibillion-dollar

companies whose business models remain robust and whose liquidity will enable them to survive until demand picks up again. There are also many smaller, long-standing high yield issuers whose prospects were steadily improving before the coronavirus crisis and will continue to do so afterwards.

Although spreads have tightened, we believe that the additional spread offered by BB bonds over BBB-rated debt adequately compensates investors for the additional credit risk. What's more, if we are correct in our view that any future outbreaks of the virus are likely to be met with only localised lockdowns, the high yield bond market is likely to benefit as consumers slowly resume their former spending habits and a number of badly-hit sectors begin to recover.



Written by T Rowe Price portfolio manager, Mike Della Vedova

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¹ The discrepancy is partly explained by differences in methodology. While Moody's places a lot of emphasis on the amount of leverage a firm takes on, we prefer to assess a company's ability to survive by examining its balance sheet and cash flow. Many highly leveraged firms in industries that face severe sales slowdowns have been downgraded by Moody's and other rating agencies.

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