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High Yield | Leveraged Credit

Finding attractive total returns in the low(est) yield world

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London & Boston - The world is awash in stimulus. U.S. GDP estimates for 2021/22 are consistently being revised upwards with every check that Congress writes. Expectations for Treasury yields and inflation are rising. Cyclicals are leading the rebound, and the expectation is that this trend will continue. Where do you invest in credit in this environment?

Reduce duration and reach for yield?

That consensus view seems to suggest high yield corporates. Sure, economic sensitivity is high and the asset class *duration* — that's, the sensitivity of high yield bond prices to changes in interest rates — 's relatively low. But what yield? The average yield of the ICE BofA U.S. High Yield Index is at a record low, under 4%. The average yields on BBs, single-Bs, CCCs... again, all at record lows. Finally, almost 75% of the high yield market is trading to a call, *limiting positive convexity*. That technical jargon basically means that there is little room for further price improvement in most high yield bonds.

Does this sound like the time to reach for beta? We don't think so. In our opinion, gaining broad high yield exposure through passively managed vehicles or actively managed funds that traditionally rely on beta to outperform wouldn't be the most prudent course of action.

Identifying idiosyncratic opportunities through individual credit selection

However, that doesn't mean the opportunity in high yield has been lost. We still see prospects in high yield to capitalize on idiosyncratic opportunities and to outperform though individual credit selection.

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The corporate fundamentals of high yield issuers are expected to improve in 2021, and this improvement has been recognized by the nationally recognized statistical rating organizations (NRSROs). January marked the first month in nearly a year that the upgrade-to-downgrade ratio for the high yield market was positive.

Much of this anticipated improvement is baked into current valuations, but not in all situations. Identifying individual credits where the anticipated credit improvement is not fully captured at current trading levels takes experience, a discerning eye and, perhaps, even a bit of a contrarian view at times.

There are four areas where we believe we can unlock additional value this year: rising stars, reopening trades, stressed first lien loans and consolidation targets.

Rising stars

While we saw a tidal wave of investment grade debt downgraded to high yield last

year, we think some of those credits will not stay in the high yield market for long. And for several high yield issuers that were on the path to investment grade prior to the pandemic, the goal remains achievable. We have identified opportunities in the automotive, healthcare and utilities sectors, among others. Some are in fallen angels that were rated investment grade before COVID-19.

Many of these fallen angels have non-callable or *bullet* bonds, which is an atypical structure for high yield issuers. In these situations, the most positive convexity is found in the long end of the credit curve and in the non-callable or bullet bonds. That's right: you have to reach for spread duration here if you want convexity.

Reopening trades

Several opportunities still exist in the harder hit sectors from the pandemic - such as restaurants, gaming, cruises and movie theaters. We found credits that have more than adequate liquidity to bridge to a normal environment, business models with a reason to exist on the other side, and the ability to grow into their balance sheets over time. For these issuers, creditors are still earning excess spread to own the securities.

Stressed first lien loans

There wasn't a lot of love in 2020 for leveraged loans from falling interest rates, which resulted from the easing of monetary policy. That created an arbitrage opportunity between the loans and bonds of certain issuers who issue both. Given the strong retail inflows into the loan asset class recently, some of those opportunities proved fleeting — but not all. The risk/reward to swap from unsecured bonds into first lien loans remains attractive in certain capital structures. This allows us to increase downside protection and reduce duration without giving up yield.

Consolidation targets

We expect to see a considerable increase in M&A this year. In particular, we are already witnessing consolidation activity in the energy sector, where investment grade issuers can benefit from acquiring smaller producers with high quality acreage. Producers with less exposure to federal land — and those concentrated in basins less affected by transportation constrictions or other political and regulatory headwinds — are becoming even more attractive in the current environment.

Bottom line: In short, we get it. Headline yields in our market won't knock anyone's socks off. That said, we do still firmly believe that there remains opportunity for attractive relative returns in high yield. We just have to work for it.

With contributions from Will Reardon, Institutional Portfolio Manager, High Yield.

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