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US high yield: market volatility update

US High Yield | 25 March 2020

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Markets including high yield remain unsettled as the difficulties of forecasting this unprecedented pandemic and the associated individual, company and government responses continue to develop. The purpose of this update is to provide some context on what is happening in US high yield and to frame a few things that we expect going forward.

Market returns

Losses accelerated over the past week in high yield and overall financial markets. Over the first two weeks in March, the weakest returns seemed to be in companies that would be more directly impacted by COVID-19. This past week, the selling was more indiscriminate with even higher quality companies trading down meaningfully and with widened bid/ask spreads. This was in part due to investors raising cash by selling credits that have held up better, and also the reality that the impact of all the shutdown activity will be broad and negatively impact most companies. As a reference, five of the six worst total return days on record in the asset class have occurred in the past two weeks, and the return of US high yield so far in March is worse than any month during the 2008 financial crisis.

Figure 1: US high yield returns

	Week of 20/3	MTD	YTD	1 Year
US High yield*	-10.55%	-17.44%	-18.71%	-13.00%
BB	-9.74%	-15.62%	-16.53%	-9.57%
BB	-10.86%	-18.36%	-19.99%	-14.49%
CCC	-12.74%	-23.35%	-25.43%	-24.06%
Energy	-16.92%	-38.32%	-43.84%	-44.99%

Source: Columbia Threadneedle Investments, as at 20 March 2020. *ICE BofA US High Yield Cash Pay Constrained Index.

Liquidity

In the US high yield bond market, earlier in the month liquidity was challenging but the market was functioning, albeit with larger bid/ask spreads. As a point of reference, high yield CDX (which can be a proxy for the high yield market), typically trades with a bid/ask of around 8/100 of a point. Two weeks ago, that increased to ½ to ¾ points. Towards the end of this past week, liquidity worsened noticeably. CDX spreads remain wide – at times up to 1 point. On Thursday (19 March) and Friday (20 March), we observed some higher quality bonds with around 3-point bid/ask spreads, and even greater spreads on some of the high beta credits. The issue is being exacerbated by traders working from home, making it difficult to transact. Additionally, it appears that inventories at the broker/dealers has gone from around $5 billion to essentially flat, but there are some challenges that persist in sourcing that data. Price discovery is the norm and we still see several price discrepancies in certain credits between the various index providers.

Benchmark performance could diverge even further as the Intercontinental Exchange (ICE BofA benchmark provider) is currently surveying users as to whether they should skip the normal month end rebalancing at the end of March, which would keep fallen angels out of high yield at least until May and keep defaulted securities in the benchmark for another month. Our investment grade and mortgage-backed securities portfolio managers are reporting similar trading liquidity issues in those markets.

Credit rating downgrades

The agencies have already begun to downgrade credits, primarily in energy and other sectors directly impacted by COVID-19. S&P revised its 2020 oil price deck down to $25/bbl even though the futures market is pricing $30+ in for the second half of 2020 and nearly $35/bbl for 2021. We expect the trend of energy and overall downgrades to continue.

In the past, we have highlighted that CCC-rated bonds as a percentage of the benchmark were near 10-year lows; that is still the case given their severe price depreciation. However, approximately 21% of the credits in the broad benchmark have a B3 or B- rating from at least one credit rating agency and we expect to see an increase in the number of CCC-rated credits.

Fallen angels

Previously, we had expected fallen angel activity to be moderate. With oil at depressed prices and a dramatic economic slowdown, we no longer expect that to be the case. We have seen estimates of potentially $200 billion in downgrades and that does not strike us as unrealistic. For reference, the US high yield market is currently around $1.3 trillion of face value. According to Bank of America, approximately $250 billion in high grade bonds currently trade wider than high yield BB-rated credits.

Ford 10-year bonds are currently trading at a spread of approximately +1,100bps, which is over 300bps wider than high yield BBs, indicating the market has priced in a high likelihood of a downgrade. This is notable as Ford would represent more than 2% of the high yield market in non-capped indices. This downgrade activity has already begun, as Occidental Petroleum (OXY, c.$31 billion of index eligible debt) and Cenovus Energy (CVECN, c.$4.7 billion of index eligible bonds) were recently downgraded into high yield from investment grade.

Energy

The decision by Saudi Arabia to materially increase oil production after a sustained period of cutbacks was surprising and led to a dramatic fall in oil prices. It is one thing to increase supply, it is another to do that in the midst of one of the largest demand shocks in history.

As a result of this move, high yield energy bonds have traded down dramatically, particularly in Energy – Exploration & Production and Oil Field Services, while Gas Distribution (Midstream) has held up better on a relative basis. Most energy companies in high yield and investment grade cannot survive if prices are sustained at these low levels. The key questions are the duration of this low-price environment and the timing for an eventual increase in demand.

In 2015-2016 when prices dropped significantly after OPEC did not cut, US oil production was at around 9.6 million bbls/day and dropped to some 8.5 million bbls/day within 12 months - an 11% decline. We expect an even faster drop over the next 12 months from current US oil production of around 13 million bbls/day for several reasons. First, most of the increased US production was from shale, which has a higher decline rate; second, producers were better hedged during that period, which sustained capex; third, many companies were still delineating their acreage and the capex was committed and; finally, some of the best acreage was drilled to manage through the downturn. Since the Saudi announcement, there has been a swift response to capex with several large companies announcing cuts. A 15% decline in 12 months, based on the announced spending cuts, would reduce US production by a healthy 2 million bbls/day.

The midstream companies will have to deal with the impending declines in production. One tool we expect to be utilized is dividend reductions, as many midstream companies maintain significant dividends. This activity has already begun, as Targa announced a 90% cut to its dividend, which will keep $700+ million in cash with the company – we expect others in the sector to follow suit. Absent a change in policy by Saudi Arabia, we do not expect a significant oil price increase near term. As domestic production drops and demand returns, we expect prices to improve; however, a return to the $50 range of recent years is unlikely anytime soon. In the meantime, inventories will build rapidly. If the price recovery takes longer than expected, there may be little differentiation of credits within energy as many/most are likely to fail.

Portfolio positioning / changes

While valuations have widened, positioning has not changed significantly. We entered this period with a higher quality energy portfolio and a greater weight in consumer related sectors, as the strength of the US consumer was one of the highlights of the US economy. While we have highlighted some of the issues in Energy, the anticipated increases in US unemployment has negatively impacted security prices in consumer-related sectors in the near term.

The liquidity issues and dramatic price declines in Energy have led to little portfolio trading in that sector, including no purchases. As we anticipate eventual commodity price improvement from the US supply reductions and improved demand environment, relative to current levels, as the COVID-19 impact lessens over time, we would anticipate the markets to once again differentiate (at least to some degree) between higher and lower quality Energy issuers.

Outside of Energy, we have been more active taking advantage of perceived price dislocations as the market seeks liquidity in individual bonds, but total activity has been modest. It has been difficult to reduce positions in sectors directly impacted by COVID-19, and generally buying has been easier than selling. We recognize “picking the bottom” during extreme market volatility is nearly impossible, and we have preferred to take a more modest approach to incrementally add to credits, which we believe offer attractive risk-adjusted return profiles, while maintaining liquidity to add more exposure should the market continue to weaken. The duration of dormant economic activity from the COVID-19 shutdowns is uncertain, as is the period of economic weakness which will follow. We are focusing on credits that have sufficient liquidity and/or cost flexibility to get through an extended period of economic dormancy, and asset coverage through the capital structure even at recessionary earnings levels. Some examples of recent purchases include companies in the Food & Beverage industry, Healthcare sector and a few smaller purchases in credits that are directly impacted by the virus such as Aramark and Hilton.