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»High Yield Bonds: Outlook for 2021

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HY outlook 2021: Ingredients for positive returns are in place, but upside is limited

Executive summary

- **The global pandemic** will continue to define H1 2021, whereby any setbacks are likely to cause volatility.
- **Valuations** are already pricing in a fairly positive scenario regarding the recovery of the global economy after the pandemic. However, we believe there is room for further spread tightening.
- **Default rates** will likely fall towards historical averages in the absence of any major setback in the progress towards eliminating Covid-19.
- **Key risks** include the development of vaccines and their distribution, and specifically any setbacks to the success of the endeavor, as well as the ever volatile energy sector.

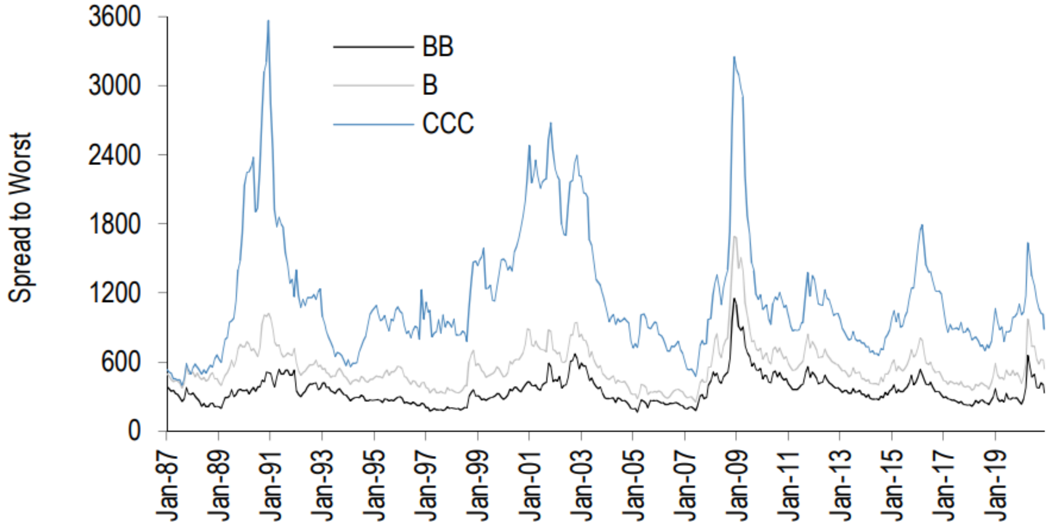
We expected 2020 to be a tough year to generate significant returns (for non-USD investors). Why?

- **Concern – US elections:** The outcome of the US election had the potential to negatively affect large segments of the high yield market, including energy and healthcare if the Democrats won majorities in both houses of Congress plus the presidency.
  Reaction: Even though the US election was to some extent overshadowed by the ongoing pandemic and rising case counts coming into autumn, it was – as many had suspected – a very close election, with the democratic nominee Joe Biden winning the presidency. However, the Democrats could not secure both houses of Congress (at least not yet).
  Impact: The split outcome led to a rebound in energy companies, as any aggressive regulations proposed by the Democrats could be blocked by the Republicans. While this boosted our absolute performance, it did not help from a relative perspective as we were underweight energy.

- **Concern – Trade:** We believed that the outcome of the trade negotiations between the US and China (and to a more limited extent with other countries) was likely to have a significant effect on market sentiment and also the growth outlook. Investors generally believed in a positive outcome, so the risk was skewed to the downside if an agreement had not come to fruition.
  Reaction: Trade negotiation took the back seat with the outbreak of the Covid-19 pandemic shutting down substantial parts of the global economy during the first wave in spring.
  Impact: No direct impact from trade negotiations.

- **Valuations:** We viewed valuations as relatively tight apart from energy and CCCs, and were concerned that any slowdown in the global economy would lead to a meaningful widening.
  Reaction: We of course did not envision that a global pandemic would lead to a global economic slowdown of this magnitude. Consequently, spreads widened to a level across all ratings not seen since 2016. However, we also saw one of the fastest recoveries in history (Chart 1).
  Impact: We underperformed at the very beginning as we owned very liquid bonds, which were sold first, but as the downturn continued we generated significant outperformance. We also reduced risk further at the start of the downturn, which proved positive. However, we did not add enough risk as policy makers took unprecedented action, resulting in some underperformance. This was especially the case in the energy sector, where the weighting also increased significantly due to Fallen Angels, but we were still underweight despite increasing our weighting.

Chart 1: Spread to worst by rating



Source J.P. Morgan, November 2020

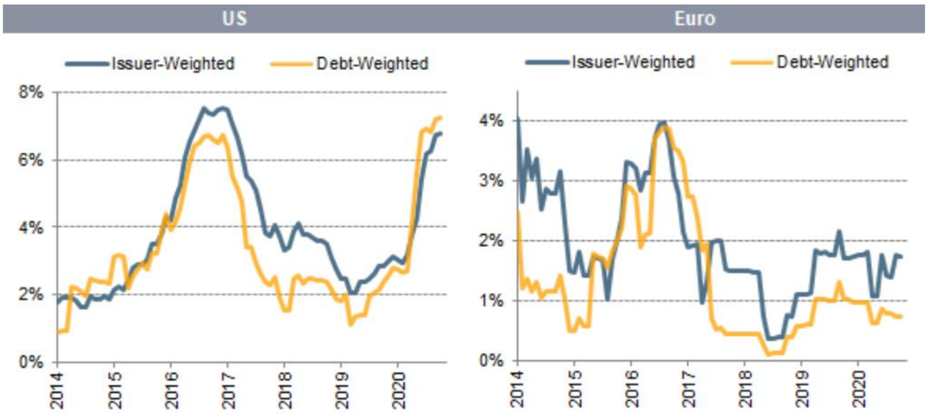
— **European vs US high yield:** We viewed European high yield as fairly valued versus US high yield, with B-rated credits more attractive in Europe, while BB-rated credits offered better value in the US.
Reaction: European high yield underperformed its US counterpart arguably due to less rate cushioning coming into crisis.
Impact: We were overweight European high yield, which was detrimental to our relative performance.

Chart 2: EUR ex USD high yield spreads

Source BofA Merrill Lynch Global Research

— **Default rates:** We expected default rates to be modestly higher in 2020 (2.5–3.5%) versus 2019 but to remain at or below long-term historical averages.
Reaction: The exogenous shock of the sudden economic slowdown due to the pandemic led to a spike in default rates. Especially, in the US we reached default rates as high as the levels seen in 2016. The bulk of the defaults in the US were energy companies, which were already under stress given unsustainably low oil prices for many producers.
Impact: The impact on our performance was limited as we avoided most of the severely stressed companies.

Chart 3: High yield LTM default rates



Source CreditSights

— **Technicals:** We expected a neutral technical picture with supply not meaningfully different from 2019. However, many companies had additional capital needs due to the pandemic, and gross supply hit a record of over USD 400bn in primary market transactions. Net supply was further heightened by record migration from investment grade to high yield.

We expect 2021 to be a year of low single-digit returns following the pandemic and an unprecedented recovery in high yield bonds.

— **Global pandemic:** The speed and efficiency of the roll-out of vaccines and any potential flare-ups in infection rates along the way will paint the picture for the first half of the year. Any positive news above expectations will likely benefit the most impacted sectors during the pandemic, such as leisure, travel and transportation. Especially for the first half of 2021, we would expect continued support from fiscal and monetary policy to dampen volatility, and absent setbacks in the battle against Covid-19 or any new unexpected crisis, we would expect spreads to tighten. We are anticipating a return to a more "normal" world in the second half of the year. As that normalization occurs, a risk remains that the pandemic has changed or sped up changes in certain industries (e.g. retail) and that those industries come under renewed pressure as the extraordinary policy support also lessens.

— **Energy**: The current level in oil prices will likely persist, despite any expansion in the global economy post the pandemic. Even if the demand for oil should increase initially, we believe that the pandemic has accelerated the shift away from fossil fuels. This should cap the demand for oil and its derivatives, making it difficult for oil prices to rise significantly above current levels. Also due to ESG considerations, including fears of stranded assets, many of these companies will face greater difficulty in accessing capital markets. The new US administration will likely further propose policies that will not be positive for the energy industry, either from the supply or the demand perspective. Consequently, many higher cost producers will not be able to survive as a going concern in their current form. This may lead to increased M&A or persistent high defaults in this sector. Natural gas prices will likely remain volatile but potentially have better underlying support than oil prices.

— **Valuations**: After the tremendous spread widening in March, valuations are already approaching near pre-pandemic levels. However, the receding tail risk from the pandemic and a reach for yield given the persisting low interest environment should lead to further spread tightening in our opinion in 2021. We prefer B’s over CCC as we think the compression in CCC has already been very substantial and we think B’s offer the best risk-reward in the event we are wrong about the improvement in credit quality and normalization of the world in 2021. BB’s may gain additional support from high grade investors as they reach down the rating spectrum for yield enhancement.

— **European vs US high yield**: We have a slight preference for European high yield going into the new year. In our opinion, European high yield has slightly more room in terms of spread compression after the pandemic compared to the US. It is also tilted to higher quality and less commodity exposure, especially energy.

— **Default rates**: We would expect default rates to decrease relative to the high level caused by the pandemic, and move closer to their long-term average of around 4%. However, we believe they will not decline meaningfully below long-term averages for some time as companies may struggle with their capital structures coming out of the pandemic. This is especially true for the energy sector, which also suffers from persistent low energy prices.

— **Technicals**: Our expectation is that both gross and net supply will be lower. As many companies had additional capital needs due to the pandemic, gross supply hit a record of over USD 400bn in primary market transactions. We believe the issuance in 2021 will not reach a similar level. Net supply was further heightened by record migration from investment grade to high yield. While we expect net supply also to be positive we believe it will be lower. 2020 also saw a significant shift by debtors from loans into issuing bonds to satisfy their capital needs, which we would not expect to repeat in 2021. Nonetheless, although lower than 2020, we expect supply to still be robust in 2021.

Conclusion

Overall, we still expect high yield to generate positive returns in 2021. However, the combination of prevailing low interest rates, already tighter spreads close to historical averages, and concerns about capital structures after the pandemic of certain segments of the market (especially energy, retail and leisure), make us believe that 2021 will be a year of low single-digit returns for high yield. At the same time, we would expect volatility to be contained given continued monetary and fiscal stimulus unless a severe setback in Covid-19 would materialize.

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