

» *High Yield Bonds: Outlook for 2020*

High Yield Portfolio Management Team
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HY outlook 2020: Margin for error increasingly thin

Executive summary

- **Reduced USD hedging costs** provide less of a headwind for non-USD investors.
- **Valuations** are already pricing in a fairly positive economic scenario, with the energy sector being a wildcard.
- **Default rates** will likely rise slightly to around 2.5-3.5% in 2020 absent a significant economic downturn.
- **Key risks** include trade negotiations with China, US elections, a more uncertain economic outlook, and the ever volatile energy sector.

We expected returns in 2019 to be much lower than they turned out. Why?

- **Concern:** Rising interest rates were expected to create a headwind, especially higher up the rating scale, while solid economic growth should support CCCs.
- **Reaction:** Instead, the Fed cut interest rates and Bund yields did not rise, which gave a tailwind to higher-quality, longer-duration credits within the high yield segment. CCCs underperformed significantly, in part due to energy, but the remainder of the CCC-space was also weaker than the broad market as growth concerns remained (see chart 1).
- **Impact:** The weakness in CCC-related credit helped our performance but our conviction in higher interest rates meant we were not ideally positioned for the rally in long-dated BB-credit.

Chart 1: US HY total returns by rating category



Source: Bloomberg, Bloomberg Barclays Indices, Barclays Research

— **Concern:** Energy ended 2018 on a very weak note, with energy prices falling precipitously in Q4 2018 against a very uncertain outlook (see chart 2).

Reaction: Although oil prices rebounded in 2019 versus Q4 2018, and have averaged around USD 55 per barrel, the energy sector has experienced significant weakness throughout 2019 as investor doubts persisted about the sustainability of higher prices and the ability of issuers to refinance debt.

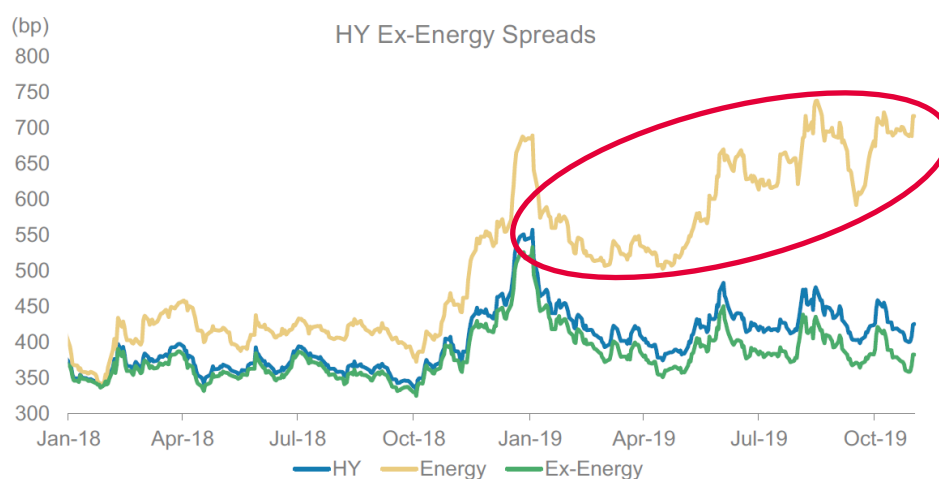
Impact: Although we correctly believed that energy prices would rise in 2019, the performance of the energy sector did not reflect that development, negatively affecting our relative performance in 2019.

Chart 2: WTI oil price development



Source Bloomberg, November 2019

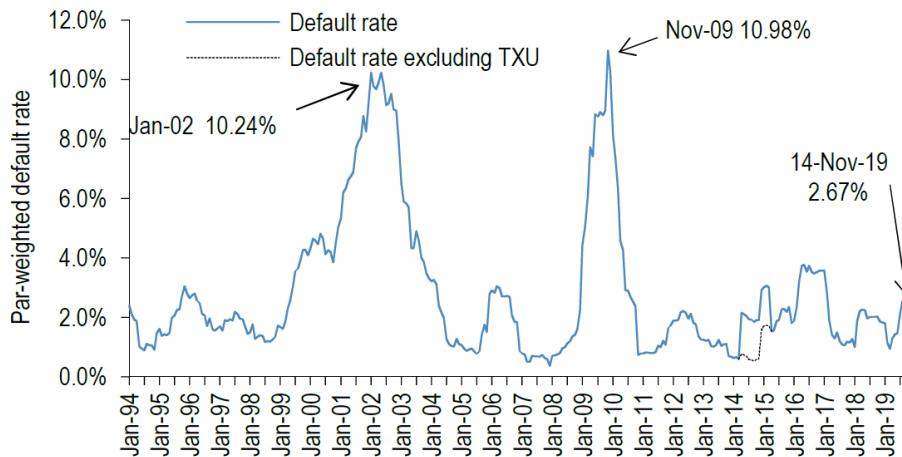
Chart 3: US HY spread development



Source Morgan Stanley Research, FTSE Fixed Income LLC

- **Default rates:** We expected default rates to be in the 2-3% range, which proved to be accurate.

Chart 4: US HY default rate (LTM default rate based on par amount)



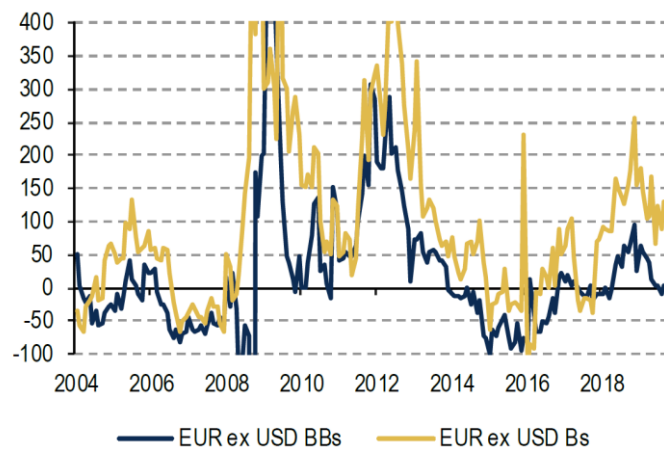
Source JP Morgan, note: excludes distressed exchanges

- **Technical:** We expected market technicals to be generally supportive with less new issuance in 2019 than 2018 (in part due to greater resiliency in leveraged loans, although we expected bonds to outperform leveraged loans). In contrast, issuance has ended up much greater in 2019 than 2018 due to weakness in leveraged loans (loans have underperformed bonds to a large extent).
- We saw **valuations** to be generally “fair”, although spreads ended up tightening around 100 basis points in 2019.

In contrast to 2019, we expect 2020 will be a tough year to generate significant returns (for non-USD investors).

- **US elections:** The outcome of the US election has the potential to negatively affect large segments of the high yield market, including energy and healthcare, especially if a candidate like Senator Warren were to win and the Democrats won majorities in both houses of Congress.
- **Trade:** The outcome of the trade negotiations between the US and China (and to a more limited extent with other countries) is likely to have a significant effect on market sentiment and also the growth outlook. Investors generally believe in a positive outcome, so the risk is skewed to the downside if an agreement does not come to fruition.
- **Valuations:** Aside from energy and CCCs, valuations do not leave much room for spread tightening, and we see a higher probability of widening than tightening in 2020. In fact, should it appear that the economy is likely to fall into recession, we would expect spreads to show meaningful weakness. On that basis, we remain cautious on CCCs. Energy could deliver strong returns if investors become convinced that the risk of a collapse in energy prices is very limited. Lower USD hedging costs should provide some uplift, however, versus 2019.
- **European vs US high yield:** We view European high yield as fairly valued versus US high yield, with B-rated credits more attractive in Europe, while BB-rated credits offer better value in the US. However, European B-rated credits are relatively less attractive than at the beginning of 2019 (see chart 5).

Chart 5: EUR ex USD high yield spreads



Source: BofA Merrill Lynch Global Research

- **Default rates:** We expect default rates to be modestly higher in 2020 (2.5–3.5%) versus 2019 but such levels remain at or below long-term historical averages.
- **Technicals:** We expect a neutral technical picture with supply not meaningfully different from 2019. Due to more challenging valuations, flows into the asset class will probably be less than in 2019 (although investors will likely continue to face difficulty in finding alternatives). Finally, should it persist, the weakness in the loan market witnessed in 2019 could have a negative spillover effect on the bond market.

Conclusion

Overall, although we still expect high yield to generate positive returns in 2020, the combination of prevailing low interest rates, tighter spreads, and persisting concerns about certain segments of the market (especially CCCs and energy), make 2020 a year in high yield where the return profile has a more negative skew than most years.

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