COVID-19 has shaken up high yield and put opportunities on the table for insurers

The asset class is accustomed to volatility, but the uneven impact of the virus means fundamental credit analysis is more important than ever

Highlights

- Spreads: Levels remain elevated, but have more recently narrowed, with intervention from central banks providing a reassuring backstop
- Defaults: The hard stop in parts of the economy will lead to defaults, however flexibility in refinancing will help weather the storm
- Credit selection: The arrival of former investment-grade names into the high yield universe will have a material effect on the market and provide select opportunities
- Future prospects: Expectations for future returns should be tempered by the uncertainty of global economies and further spikes in virus transmission in the coming months
- Increasing yield for insurers: When optimising yield against capital considerations, exposure to specific sections of the market can be more attractive than others

As the COVID-19 pandemic cast its shadow over our economies, the high yield debt market saw considerable changes of its own – not least the glut of downgrades bringing formerly investment-grade (IG) names into the sector. There are, however, signs of resilience and opportunities for insurers to increase yield in a capital-efficient manner.

Two fundamental aspects of the high yield (HY) market have given issuers a chance to weather the storm. First, HY companies tend to 'term-out' debt – habitually moving shorter-term arrangements to longer-term. Second, firms typically have a degree of flexibility from revolving credit facilities (RCFs) which allow them to access cash, up to a predetermined limit, at any time. In short there is no widespread and sudden refinancing requirement on the horizon, and those issuers with debt payments due have access to liquidity. In a sector used to stressful conditions, companies are well-placed to get through this crisis.

That said, the effects of the pandemic are inevitable. Global lockdowns of populations have seen activity slump – in some cases to near-zero and for month after month. It has been particularly dramatic for the likes of retailers, restaurants and airlines where consumer demand evaporated. In high yield, the energy sector, and particularly US oil, has been one of the hardest hit.

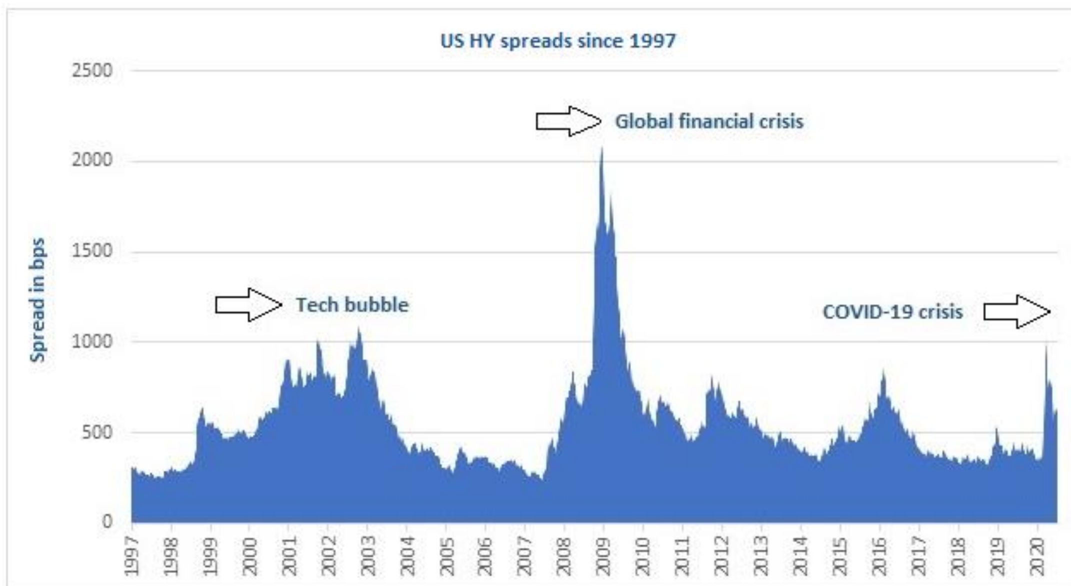
Bridging the gap

However, this market volatility has led to potential opportunities for investors. Spreads have narrowed from their peak, but remain well above pre-crisis levels, which we believe may still offer good value for insurers. As of 19 August, spreads in Europe were 459 basis points (bps), in the US 525bps and globally 540bps[1]. This is tighter than the peak in March but still about

[1] Source: Inter Continental Exchange 19 August 2020

150+bps wider than the start of the year. The spreads we have seen are almost equivalent to the tech crash in 2002, and the only period with dramatically wider spreads was the global financial crisis where they briefly hit 2,000bps in US HY (see Figure 1 below). We believe that the swift action and the sheer scale of monetary and fiscal policy announced to combat the coronavirus around the world – and the willingness to do more in future – has helped to avoid this outcome.

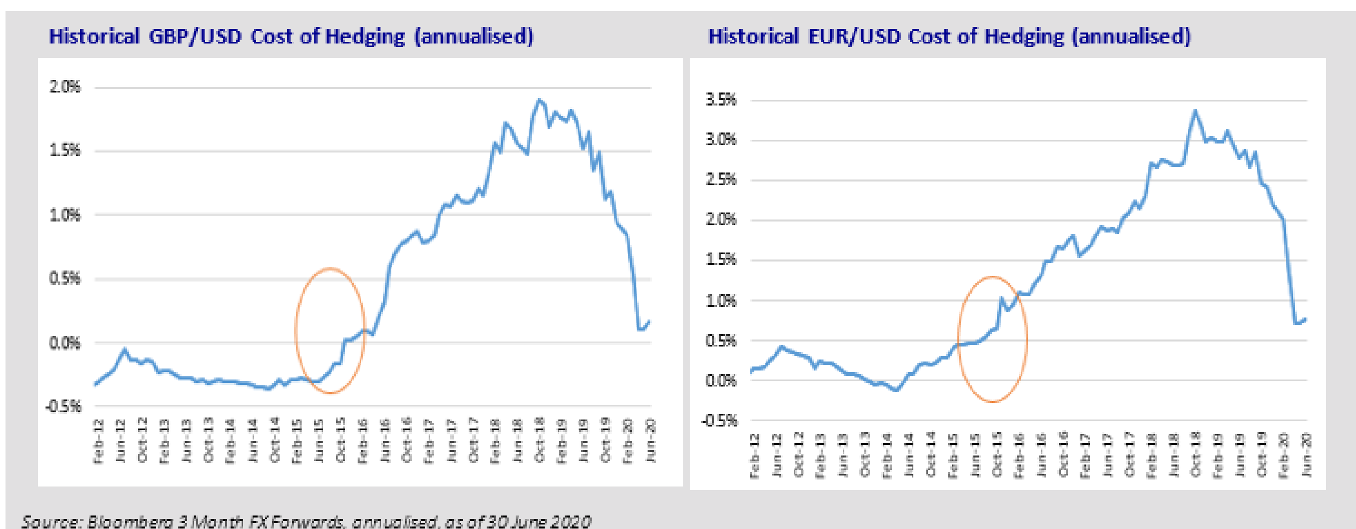
Figure 1: COVID-19 HY spreads are dwarfed by those seen in 2008/2009



Source: Inter Continental Exchange, US High Yield Spreads (H0A0) as at 10 July 2020

US names still dominate, accounting for more than half of the global high yield market. For UK and continental European insurers looking to access the US market, it is also worth noting the impact on potential yield (in local currency) of the hedging costs (see Figure 2). After historical highs in late 2018 which were significantly impacting that yield that investors received, effective zero rates from the Federal Reserve mean currency hedging costs are now at lows not seen since 2015. This means that US high yield looks very attractive even after accounting for the effect of hedging costs.

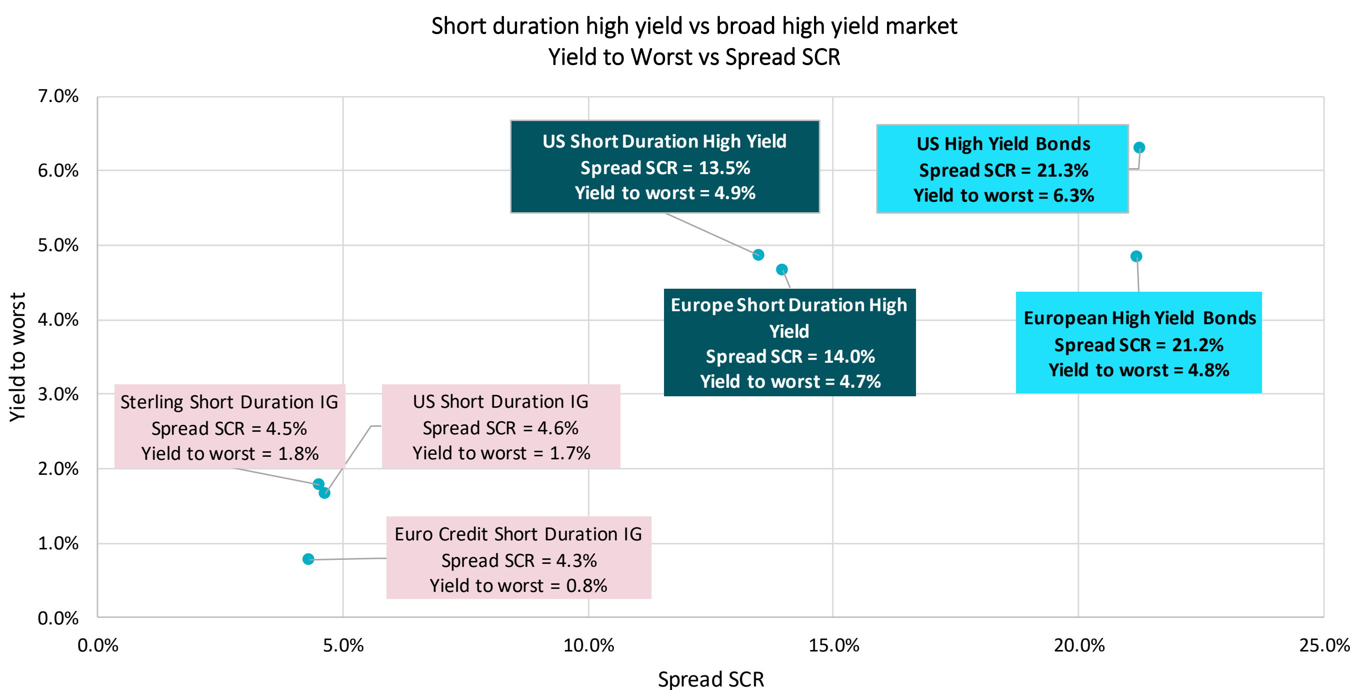
Figure 2: UK investors benefit from lowest hedging costs since 2015



Source: Bloomberg 3 Month FX Forwards, annualised, as of 30 June 2020

Short duration high yield bonds form a subset of the broad high yield universe, and one that we believe offers an excellent opportunity for insurers. There is clearer visibility over an issuer's cashflows in the short term, which can provide greater certainty over its abtility to meet the debt obligations for a short duration bond, and so offer less risk. These shorter duration bonds also benefit from a greater "pull to par" effect than the broad market average, and as such may provide a more defensive entry point for insurers. From a capital perspective, these bonds can also provide an attractive way to increase yield while limiting solvency capital requirements (SCR). In an insurer's context, overall return on capital (RoC) when compared to investment grade of similar maturity can be very attractive, in addition to the broad advantages of HY diversification away from IG.

Figure 3: Shorter duration high yield bonds may provide an even more attractive entry point for insurers



Source: Past performance is not a guide to future returns. Spread SCRs are estimated by AXA Investment Managers and based on UBS Delta's interpretation of standard formula spread risk sub-module methodology. The Spread SCRs calculated for the range of AXA IM funds are indicative only and should not be relied on for any purpose. Data shown as at June 2020. Representative portfolios: US SD - AXA WF US Credit Short Duration IG; Sterling SD - AXA Sterling Credit Short Duration Bond; Euro SD - AXA WF Euro Credit Short Duration; US SDHY – AXA IM FIIS US Short Duration High Yield; Europe SDHY – AXA IM FIIS Europe Short Duration High Yield; US HY - AXA WF US High Yield Bonds; European HY - AXA WF European High Yield Bonds.

Avoiding defaults

Despite the extensive support from central banks and governments, defaults are likely to rise in the global HY space. We think a first wave will continue over the next few months, with a second possible as we move through 2021 when the effect of stimulus and intervention wanes and when the true impact of the outbreak is clear. This doesn't rob the HY sector of its appeal, but it does emphasise the importance of credit selection to avoid the most vulnerable names. We expect an overall default rate of 5-8% in US HY this year.

The demand picture in HY has been strangely mixed, with liquidity holding up well at the more distressed end of the market which offers attractive entry points. There are also those issuers who were well shielded from the virus, and even somewith a positive crisis story to tell such as those in healthcare. Some of these less-impacted companies are trading not far below where they traded before, but there may also be value here as the default risk remains low.

There is a middle group, however, where visibility about prospects is relatively low, liquidity has been weaker and prices suffered early in the crisis. The potential for both risk and value is perhaps highest here in our view. As such, we believe it is for these issuers that good credit analysis will be able to add the most value, although it may take time to position portfolios.

Scrutiny for fallen angels

Within these groups, across and within sectors, the effects of the pandemic have been uneven. Balance sheet liquidity has always been a key part of our credit research process, but it is particularly relevant now to determine which individual companies may have trouble bridging to the other side of this crisis, in both a base case and a more stressed scenario where lockdowns persist for some time. We have been reviewing individual holdings for short-term liquidity needs in both scenarios, while our analysis is adapting to factor in the unique characteristics of national intervention and support measures.

This issuer-by-issuer approach applies equally to the influx of so-called fallen angels from the IG segment into HY.There has been a sharp increase in the number of names downgraded in the wake of the pandemic, as the dollar volume of global fallen angels hit $268bn for March-June[1]. This ongoing effect of the crisis is having a material impact on the size and structure of the HY market and could bring selective buying opportunities as the market adapts, although we believe there is need to be selective when considering these fallen angels, especially in weaker sectors. Value is possible due to forced sellers, but fundamental analysis and valuation remain the starting points for any individual trade.

In an unprecedented crisis, markets have inevitably been rattled. However as volatility softens, attention should turn to the value on offer. We can see good reason to selectively take exposure to high yield and when doing so, consider short-duration strategies as a potentially more attractive entry point for insurers.

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[1] Inter Continental Exchange