First State Investments

HIGH YIELD CREDIT – WHERE TO FROM HERE?

Declining cash rates and investors' healthy appetite for risk saw high yield credit spreads fall sharply in 2019, resulting in favourable returns from the asset class.

In this update, Matt Philo and Jason Epstein, Co-Heads of High Yield, outline some of the factors that might affect sentiment in the months ahead and consider whether high yield credit can make further progress in the remainder of 2020.

Do you think high yield spreads can tighten in the rest of this year?

Well, that's certainly an interesting question at the moment. High yield spreads can always move lower (driving total return to the upside), but it's equally important to acknowledge the extent of the moves made last year. As a reminder, high yield credit spreads narrowed from +539 bps at the start of January 2019 to +372 bps by the end of December. That was a real tailwind for the performance of high yield funds. Some of our flagship US high yield products returned 16+% over the year. While another year of double-digit returns is not our base case, we continue to view the high yield market as attractive in absolute terms. It also offers solid relative value in any fixed income allocation/line-up, mainly due to the followings:

- Relatively high income (5.62% yield to worst at the end of January 2020);
- Relatively low interest rate sensitivity; and
- We only own credits that fit our stringent investment process, offering us spreads that overcompensate for every credit's annual default risk (spreads were +403 bps at the end of January 2020).

As recently as 2018, spreads for the high yield index got as low as +327 bps and credit cycle peaks tend to be even tighter, towards +250 bps. Therefore, there's scope to go lower. Even with limited spread compression, the high yield market could experience 7-8% total returns this year.

Why is that, what factors are supportive of current valuations?

Importantly, corporate earnings in the US remain quite resilient overall. We'll see how Q4 2019 earnings stack up as companies announce them over the next month or two, but profitability was pretty strong earlier in 2019, despite a moderation in the pace of overall GDP growth. Relatively low interest rates enable most companies to comfortably service their debt repayment obligations and refinance higher coupon debt at lower interest rates. Additionally, we have seen an uptick in the quality of the high yield bond universe over the past five years, as many weaker credits found the most attractive lending terms in the leveraged loan and private credit markets rather than the high yield bond market. Against this backdrop, default rates in the sector are expected to remain low.

More broadly, the potential income on offer from high yield credit – that's the current spread plus the yield from US Treasuries – seems likely to remain attractive relative to fixed income alternatives. With cash rates so low and unlikely to increase any time soon, we believe high yield credit will remain appealing to income-hungry investors. Capital appreciation resulting from further spread narrowing is a reasonable expectation with all factors remaining stable.

Are we likely to see periods of volatility during the year?

We certainly wouldn't be surprised to see pockets of weakness during the year as investors' risk appetite waxes and wanes – indeed we already saw some of that in January. With the US and China agreeing to a trade deal and with Brexit progressing, geopolitical risk appears to have diminished a little. But they're always there just beneath the surface, ready to flare up at any time. And remember we have the US Presidential Election in November, which might start to affect sentiment more broadly as we move through the year.

Other external drivers can affect the market too. Just look at how volatile the oil price has been over the past couple of years, for example. That affected sentiment and saw valuations move quite sharply in some areas.

At the end of the day, investors should always expect some volatility – particularly in risk assets like high yield credit. That said, volatility isn't something we worry about because our investment process forces us to be somewhat contrarian. In fact, we're comfortable with some degree of volatility since we expect to be underweight credit risk relative to the benchmark index and our peers. As such, we welcome the resulting opportunities to increase exposure to favoured issuers at attractive valuations.

While we do think we'll see another year of positive returns in 2020, there's certainly no complacency in the team. We drive one another to remain focused on the downside, always. We're trying to deliver favourable total returns to investors, but always have one eye on capital preservation too; that's the beauty of our investment process. With that in mind, there's an emphasis on ongoing issuer monitoring as well as initial issuer selection.

OK, so how are First State Investments' High Yield portfolios currently positioned?

We believe the funds are all sufficiently diversified, for a start. A high degree of diversification is important when investing in credit in our view, to ensure unanticipated defaults do not have an outsized influence on performance outcomes. Sector exposures are largely a by-product of bottom-up issuer selection, but concentrations are monitored and managed within sensible limits. Again, that's primarily to mitigate default risk in particular areas of the market.

Our investment process is quite formulaic in that issuers have to pass a number of predetermined criteria to be considered for investment. The over-riding emphasis is on value for risk – every issuer we invest in must offer a potential income return that we believe more than compensates for the risk we're taking on. More specifically, we have strict 'margin of safety' hurdles that must be met for all potential portfolio constituents. Especially in high yield, minimising defaults is a critical part of maximising investment returns over time.

Matt Philo & Jason Epstein
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