Volatility Creates High Yield Opportunity

A Discussion with Artisan Partners Credit Team portfolio manager Bryan C. Krug, CFA

PORTFOLIO MANAGER
Viewpoints

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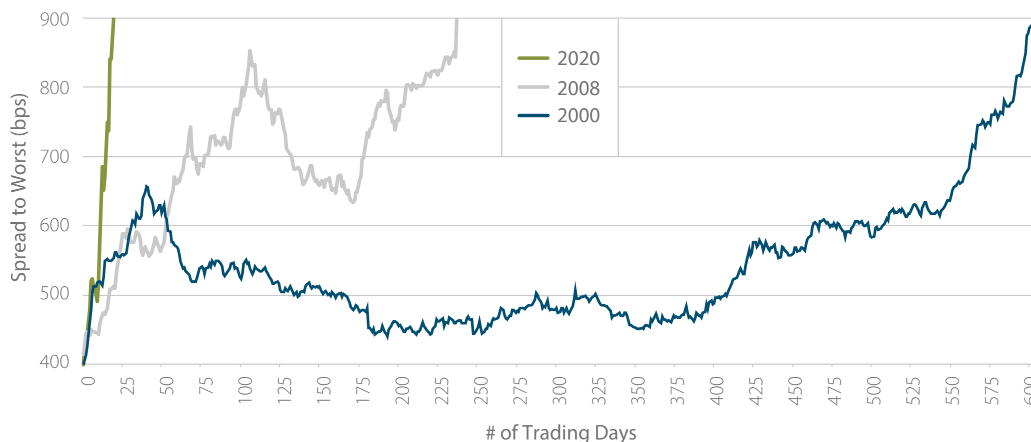
Can you discuss the impact coronavirus has had on the high yield credit markets?

Escalating concern around the containment of COVID-19 and its impact on global economic growth has sparked an aggressive turn in risk sentiment over the last few weeks. The selloff in noninvestment grade markets has been unprecedented in terms of speed and severity. The repricing of risk has resulted in high yield spreads moving from under 400bps to more than 900bps in just 4 weeks (Exhibit 1). For context, it took 11 months during the 2008 recession for spreads to cross the same threshold, and more than 28 months during the 2000 downturn.

Intensifying the decline were Saudi Arabia's and Russia's decisions to flood the oil market with supply in a bid to exert maximum pressure on marginal and high-cost producers. This supply shock combined with the negative demand surprise has pushed oil prices down over 60% from late-January highs. High yield energy credits—which account for about 10% of the ICE BofAML High Yield Index—have violently widened from already-distressed levels and have moved past 2016 extremes. The declines in high yield energy have dwarfed all other industries, with YTD returns of -40% for the E&P and oilfield services spaces. While energy represents a much smaller portion of the high yield index relative to the 2015-2016 downturn, it has contributed more than a third of the asset class's YTD decline.

Exhibit 1: Spread-Widening Events—# Trading Days from 400bps to 900bps



Source: ICE BofAML. As of 18 March 2020. **Past performance is not a reliable indicator of future results.** High yield spreads are represented by the ICE BofAML US High Yield Index. Spreads are calculated on spread-to-worst basis. Spread-to-worst is a bond's yield-to-worst minus the yield-to-worst of a similar duration Treasury security.

Can you give us a sense of your positioning going into this downturn?

Given low all-in yields and cyclically tight valuations, we entered the year with an underweight to BB-rated bonds. As a surrogate for high-quality credit risk, we've preferred an allocation to leveraged loans. This positioning has served us well, as loans have held up relatively better than high yield bonds during the recent volatility.

We've also maintained an underweight to energy for more than a year. This has left our portfolio better positioned to withstand a prolonged price war between Saudi Arabia and the rest of the world. With prices under $30/bbl, most US shale producers are going to face a sharp decline in profitability and constrained access to capital markets, meaning more financial distress and a pickup in defaults.

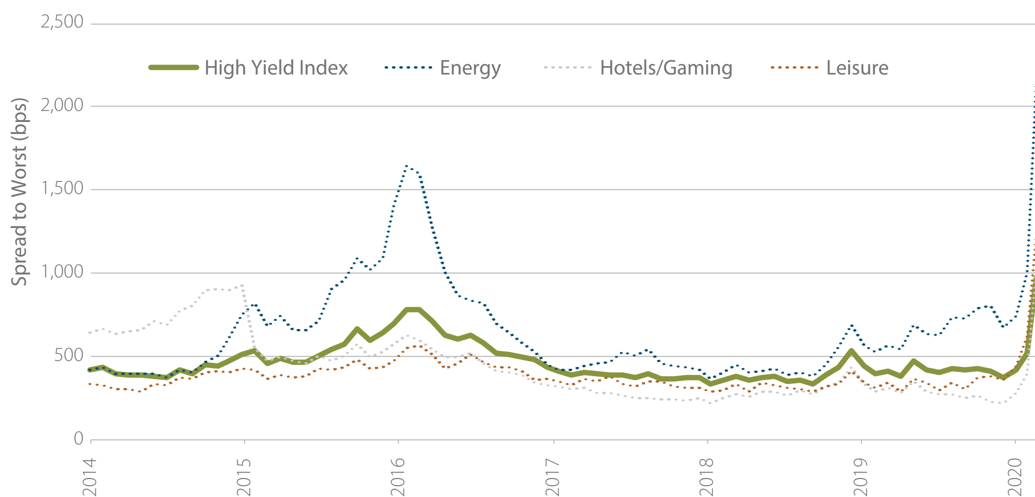
Finally, we've held an underweight to the largest benchmark names in favor of more idiosyncratic opportunities. The securities from the largest capital structures have been among the easiest securities to unload during this recent selloff and have been disproportionately impacted by dynamics of liquid exchanged-traded funds.

Where are you looking for opportunities amid the volatility?

The material repricing of risk has left us no shortage of interesting opportunities. Areas with even loose ties to leisure, travel and hospitality have been decimated by what could be a period of unprecedent demand destruction. Airlines and hotels have all seen their borrowing costs increase exponentially as investors begin pricing in worst case scenarios in the face of a near-standstill in travel activity. While a material earnings shock is likely for the next couple quarters, we expect the damage to be transitory and credit impairment unlikely for most companies. In general, many of these issuers tend to have higher-rated credit profiles, sufficient access to capital, and enough levers to pull to sustain their capital structure for a couple quarters of severe revenue declines.

Stress hasn't been limited to high yield issuers, either. Talk of fallen angels is increasing as headlines of virus-related disruptions worsen. Valuations for some of the most leveraged BBB issuers have moved well into high yield territory and, should ratings downgrade pressure occur, would introduce new supply to the high yield market from forced sellers. For most formerly IG-rated companies, outside of a severe economic downturn, fundamental deterioration is generally manageable. These companies typically have sufficient flexibility—and motivated management teams—to regain their investment-grade status. The emergence of fallen angels should provide attractive relative value opportunities for high yield buyers, as technical selling pressures often drive prices to overshoot their intrinsic value to the downside.

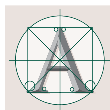
Exhibit 2: Credit Spreads for the ICE BofAML High Yield Index and Select High Yield Sectors



Source: ICE BofAML. As of 18 March 2020. **Past performance is not a reliable indicator of future results.** High yield spreads are represented by the ICE BofAML US High Yield Index. High yield index: ICE BofAML US High Yield Index. Energy, Hotels/Gaming and Leisure are sectors within the ICE BofAML US High Yield Index.

Is now a good time to consider allocating to high yield credit?

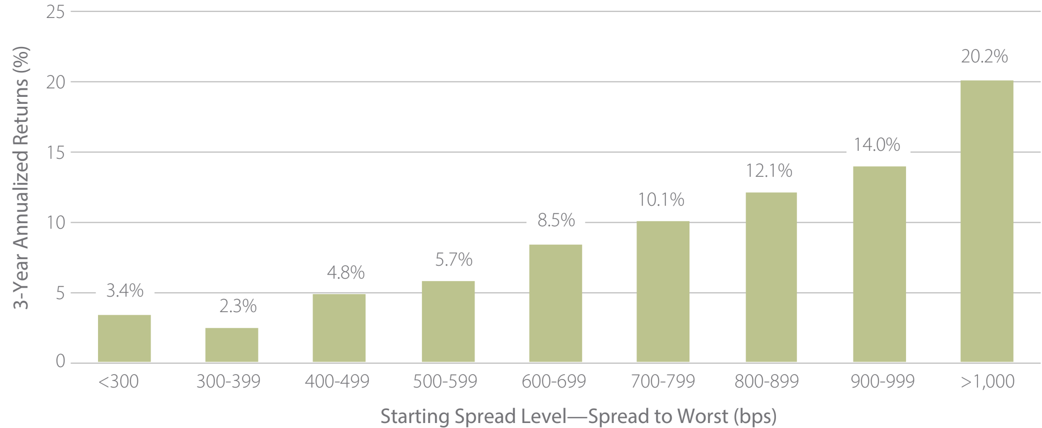
We believe the aggressive repricing has created sufficient compensation for the wide range of outcomes that could unfold over the coming quarters. Today's pattern of steep declines followed by rapid recovery makes it even more important to maintain a long-term mindset. Risk is unwinding at record speed, and its possible spreads could continue to widen from here, but current valuations have tended to offer attractive entry points for investors with longer time horizons. While an imperfect proxy, starting spread levels can provide a good guide for future return potential.



Though past performance is not indicative of future performance, since 1996, when spreads have exceeded 900bps, the ICE BofAML US High Yield Index has generated positive forward 3-year returns, averaging 14% annually over the subsequent 36 months (Exhibit 3).

In short, there is a lot of uncertainty, but we believe the opportunity set is the most attractive it has been in several years. Having managed through several cycles before, we know times like these require us to be discriminating and disciplined in our decision making. With an approach consciously designed to exploit market dislocations, we will use volatility to be a selective liquidity-provider during periods of stress. Our experience gives us confidence in our goal of generating successful investment outcomes for our clients and we believe our portfolio is well tailored to thrive in this uncertain environment.

Exhibit 3: Three-Year Average Annualized Returns by Starting Spread Level



Source: ICE BofAML US High Yield Index. **Past performance is not a reliable indicator of future results.** Annualized returns presented were calculated using monthly spread to worst measured in basis points for the ICE BofAML US High Yield Index for the period December 31, 1996 to February 29, 2020. Spreads are based on month-end values.

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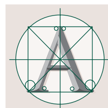
A R T I S A N  P A R T N E R S