High-Yield Bonds: The Canary isn't Choking

March 2020

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- High-yield markets are showing some signs of stress, but to date they have remained orderly and manageable.
- While there have been losses in absolute terms and relative to U.S. Treasury's, performance has otherwise been fairly strong given significant declines in many capital markets.
- Performance has varied widely by sector with energy and leisure faring poorly while telecommunications and healthcare have held up.
- We have not made any significant changes to our high-yield portfolios and caution investors that rash decisions made in response to short-term market gyrations often generate poor long-term results.

High-yield bonds are often thought of as the "canary in the coal mine" because trouble in high-yield markets can sometimes be an early warning signal for other asset classes. By most measures, high-yield bonds had held up fairly well only falling about 2% year-to-date through March 6. But as was the case with essentially all risk assets, losses in high-yield bonds accelerated dramatically on March 9. Although the high-yield canaries aren't singing right now, they aren't choking either.

Liquidity

Liquidity—which is generally lower for high yield than investment grade—has deteriorated, but not to the point where it has caused real issues. There is no new issuance this month and quotes are wide. Many high-yield funds, SEI included, appear to have cash to cover rising outflows. Exchange-traded funds and credit-default swaps have also been a source of funding for outflows, limiting the need to sell actual bonds. While these are all signs of stress, high-yield markets are still orderly and manageable. Outflows would really have to ramp up from here for our portfolios to become forced sellers.

Performance has been Diverse

High-yield market performance has varied widely by sector, with energy suffering from reduced oil demand and a fierce battle for market share between Saudi Arabia and Russia, at the expense of prices.

Unsurprisingly, leisure has also fared poorly in a world of COVID-19-related quarantines and travel bans.

Conversely, telecommunications and healthcare (which are two larger high-yield sectors) along with bank loans (which are above bonds in the capital structure, and typically BB rated floating-rate instruments) have fared much better. This dynamic may persist for a bit.

Commodities Spotlight

Most commodities are highly correlated with economic growth so it's no surprise they have slumped as COVID-19 takes a toll on global growth prospects. Oil prices have declined more than most commodities as Saudi Arabia and Russia have engaged in a battle for market share at the expense of supporting prices. Crude oil prices plunged dramatically from March 6 to March 9 and having seemingly settled in the low $30's for now.

In our view, this level is unsustainable. We believe Saudi Arabia and Russia need prices around $70 and $50, respectively, to break even fiscally. Meanwhile, the higher cost U.S. shale producers are not likely to be able to sustain themselves for a prolonged period with prices this low.

While none of the major oil producers can tolerate this price level long term, they can continue to pump over the short-to-medium term. The energy sector is a significant sector in U.S. high-yield markets and it will likely remain challenged until oil prices rise. The longer prices remain subdued the greater the chances of individual defaults or downgrades in the energy sector.

High-yield spreads have moved considerably wider this year, some of which is deserved—particularly in the case of energy, where default risk has certainly risen. In other sectors, the spread widening has been more a case of "guilt by association." We continue to cautiously look for opportunities, keeping in mind the lower levels of liquidity in high-yield markets and the potential for significant outflows if investors begin to panic.

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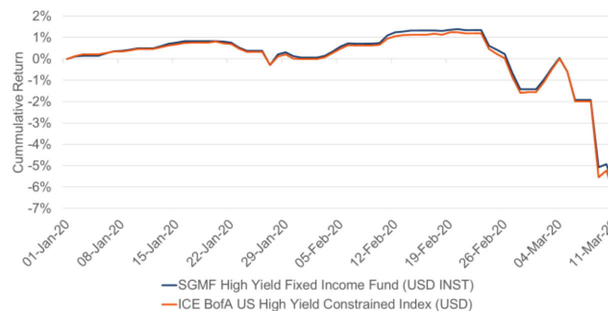
Defaults and Downgrades

Defaults have been near historically low levels so there is certainly room for them to rise in a time of stress. There may be more “fallen angel” opportunities than usual if we see a number of downgrades of BBB rated securities. Sectors that are the most performance challenged right now, notably energy, are the most at risk for defaults and downgrades. Managers have indicated that they are looking to add risk, particularly in affected areas, when it makes sense.

Positioning and Outlook

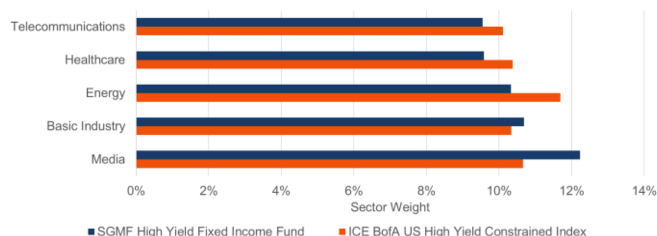
We have not made any significant positioning changes to our high-yield portfolios. The bulk of assets, as always, are in higher rated B and BB rated issuers. Portfolios are diversified across sectors without taking major sectors bets, while allowing managers to focus on individual credit selection. Energy will likely remain challenged until oil prices normalise, but other sectors should fare better. We believe this dislocation may provide a buying opportunity to selectively add risk and remind investors that rash decisions to hastily sell based on short-term performance challenges often generate poor long-term results.

Exhibit 1: Total Year-to-Date Return



Source: SEI’s IMU Data Portal, as at 11 March 2020
Past performance is not a reliable indicator of future results.

Exhibit 2: Top Sector Allocations



Source: SEI’s IMU Data Portal, as at 29 February 2020

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