Allianz Research

High yield: have the tourists left?

High carry and higher spreads before a U-turn in 2023

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EXECUTIVE SUMMARY

- The tide has turned for high yield credit. Since mid-April, high yield credit has entered a new decompressing regime characterized by a structural increase in risk premium, with market participants pricing in tightening financial conditions, still elevated geopolitical risk, uncertainty around the future inflation path, a deteriorating growth outlook and increased pressures on corporate balance sheets. Liquidity is also deteriorating: US corporate bond failed trades are now higher than during the initial Covid-19 outbreak, which is consistent with a recessionary/crisis-like environment. However, there is still no clear sign of an upcoming market breakdown.
- The aggregate quality of high yield credit remains relatively strong, with leverage, interest coverage, liquidity and profitability ratios remaining close to their highest levels in decades. This signals that strong cash balances may be able to provide a decent cushion for the asset class at an aggregated level in the mid to long-term. Yet, a timid increase in broad default rates is to be expected.
- Our macro-driven spread decomposition warns about short-term risks but depicts a stabilizing mid-term picture. The possibility of a further economic deterioration paired with the expected tightening in financial conditions and the elevated probability of additional volatility spikes should not provide any strong spread compressing effect in the short run. By year end and into 2023, the combination of declining equity volatility, the loosening of financial conditions and an economic reacceleration should start compressing high yield corporate credit spreads.
- In our baseline scenario, we expect corporate HY spreads to remain under pressure for the rest of the year with some decompression episodes in the pipeline. In this scenario, we expect the combination of a more dovish policy stance, a better-than-expected economic performance and higher-than-expected corporate resilience to keep spreads close to 500 and 525 for USD and EUR HY credit for the end of 2022 (vs 496 and 591bps for US and EUR HY currently) and to compress to 400 and 425 in 2023. However, if we hit our adverse scenario, we would expect high yield corporate spreads to widen to levels last seen during the onset of the Covid-19 crisis as higher policy rates and inflation will lead to a sharp repricing in defaults and rising credit risk. This initial widening will quickly revert in 2023 as easing monetary policy and fiscal support will kick in again.

High yield credit remains under pressure.

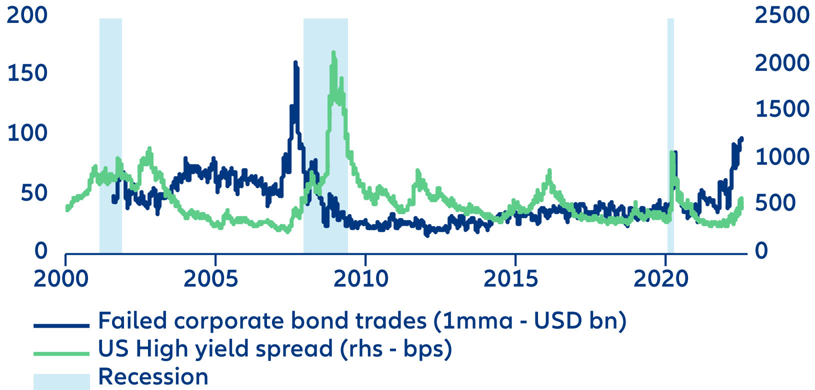
The tide has turned in credit markets, especially for the high yield (HY) segment. After widening only moderately until mid-April, despite the historically high rates sell-off, spreads have notably widened (US: +125bps and EUR: +180bps) compared to their respective long-term rates. Market participants have started discounting rising concerns about corporates' debt-repayment capacity in a recessionary environment (Figure 1). This "new" corporate credit regime is likely to last until the end of the year as the further tightening of financial conditions, especially with the start of quantitative tightening (QT), still elevated geopolitical risk and the uncertainty over the future inflation path and its consequences on growth and corporate margins will keep the asset class in check. Against this backdrop, the prospects of slower demand, as well as the persistent pressure on cost inflation and supply chains, will continue to fuel an elevated dispersion at a single company and sector level, possibly underpinning the performance of the broader market towards year-end.

Figure 1: US and EUR high yield option-adjusted spreads (bps)

Sources: Refinitiv Datastream, BofA; Allianz Research

An eagle eye approach to the asset class reveals decent resilience but the market microstructure is showing some signs of increasing stress. At a time when high yield investors are recursively pricing in a worse-than-expected outlook, some market piping fissures are becoming bigger. These are relevant as they could rapidly affect price discovery and lead to a rapid repricing of the liquidity premium embedded in high yield spreads. One of the most notable market fissures is the increasing number of failed US corporate bond trades, which is now higher than the level reached during the initial Covid-19 outbreak. This metric tends to indicate a recessionary/crisis-like environment (Figure 2).

Figure 2: US Corporate bond failed trades (1mma – USD Bn)

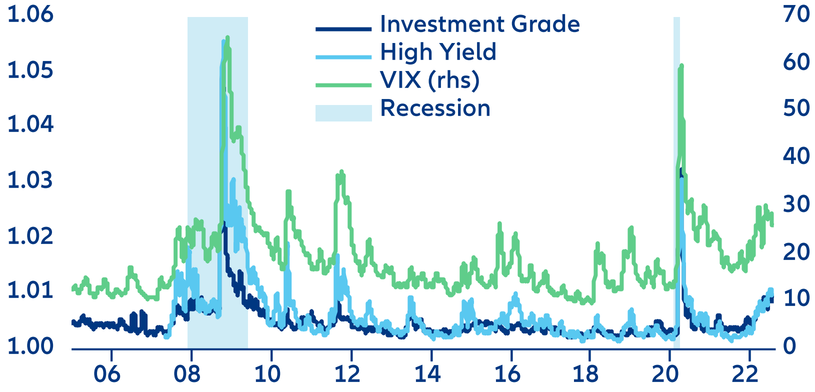


Sources: Refinitiv Datastream; Allianz Research

At the same time, the intra-day volatility, as measured by the high/low intra-day range, has also increased (Figure 3), showing that corporate credit is not fully isolated from the current high market volatility regime. Additionally, and digging into exchange-traded fund (ETF) markets, the divergence between Net Asset Value (NAVs) and benchmark indices is also slowly widening, showing that market liquidity is deteriorating.

Nonetheless, and despite the liquidity deterioration, there are no clear signs of an upcoming broad market breakdown yet.

Figure 3: US Corporate credit intra-day high - low ratio vs equity volatility (1mma)



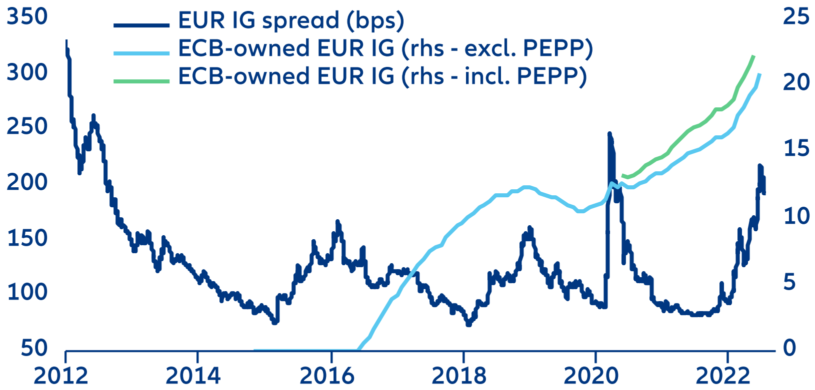
Sources: Refinitiv Datastream; Allianz Research
Note: The High to Low ratio is proxied using one of the largest US IG and HY corporate ETFs

Most of the upcoming tightening in financial conditions has already been priced in.

During the second part of the year, corporate market liquidity will be again put to the test as the gradual withdrawal of central banks, an inelastic demand market participant, will leave the existing liquidity pool at the mercy of switches in market sentiment.

The exit from Quantitative Easing (QE) during a time of weakening demand is having a decompression effect on spreads. Focusing on the Eurozone, and with the end of the Corporate Sector Purchase Programme (CSPP), market decompressing forces will remain high. Even if HY credit has never been part of the eligible universe, the pass-through effect of a "whatever it takes" approach has tended to increase risk appetite, leading to inflows into riskier asset classes (i.e. high yield credit). Part of this effect has already been discounted, as shown by the larger widening in EUR spreads vis-a-vis their USD counterparts. Besides the worse macroeconomic projections for the Eurozone, this also reflects a less supportive EUR market environment. Due to the traditional link between EUR sovereign spreads and EUR credit, the ECB's commitment to tackle fragmentation risks should help avert a Eurozone crisis-like scenario, but it will not spare some larger-than-average volatility spikes (Figure 4).

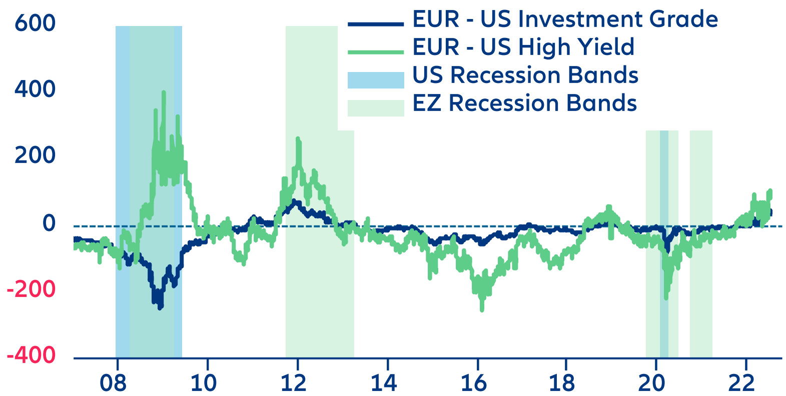
Figure 4: ECB ownership of IG EUR corporate credit (bps - % total market)



Sources: Refinitiv Datastream; BofA; Allianz Research
Note: EUR corporate market proxied using BofA corporate indices

The current spread differential between EUR and USD HY corporate markets looks slightly overdone as it seems to have already priced in most, and even too much, of the policy rate divergence. EUR credit seems oversold compared to US credit and could provide some additional pick up[1]. However, the current uncertainty due to the war in Ukraine and the threat of a gas "black-out" weighs on credit risk sentiment and could lead to decompression episodes towards the end of the year (Figure 5).

Figure 5: EUR vs USD corporate credit spread differential (bps)



Sources: Refinitiv Datastream; BofA; Allianz Research

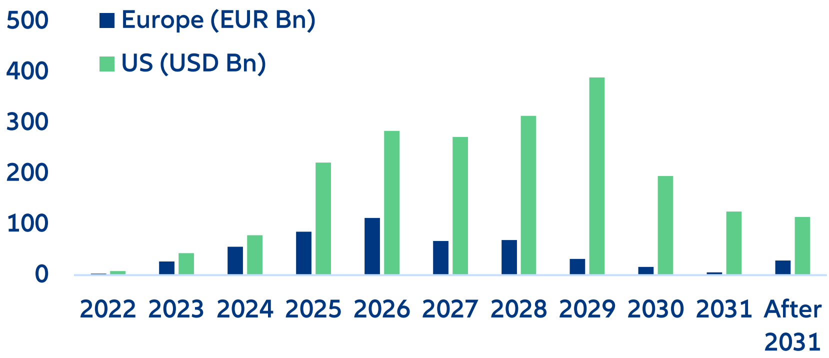
Fundamentals look strong but could quickly deteriorate.

Looking at the high yield debt maturity profile during the next 10 years, we find that high yield companies have successfully managed to extend the duration of their debt, pushing any refinancing issues due to the expected increase in short-term rates to 2025 and 2026. Because

[1] It is important to mention, that, currently, when doing a country comparison, using the spread over swap rather than the spread over sovereign is warranted. As an example, and since the divergence between the EUR swap and the German bund is at a record high due to the German bund scarcity and flight-to-safety premium, the EUR HY spread over the bund (587bps) is around 70 to 80bps higher than the spread over swap (500bps) depicting an overall worse credit risk repricing. This effect is larger in EUR Investment grade credit (190bps vs 105bps).

of this, and leaving aside the direct effect on high yield bond-market pricing, the expected increase in short-term yields should not have a major impact on corporates' refinancing costs, making HY credit more immune than expected (Figure 6).

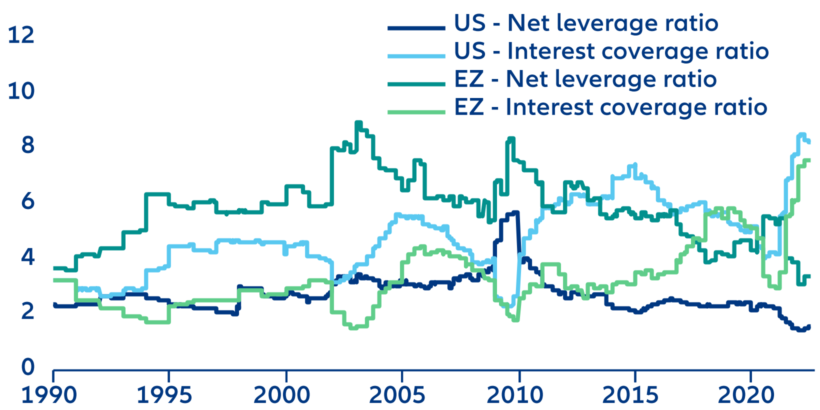
Figure 6: EUR and USD high yield credit debt maturity profile*



Sources: Refinitiv Eikon; Allianz Research
**excluding perpetual bonds*

The aggregate quality of high yield credit remains strong and tilted towards BB or one notch below investment grade. At the same time, most debt indicators such as the leverage, coverage, liquidity and profitability ratios remain close to their highest levels in decades, signaling that the strong cash balances collected in the past two years should provide a decent cushion at an aggregated level and in the short to mid-term. To put the resilience into numbers, and assuming a constant interest expense for simplification purposes, both the US and Eurozone EBIT would have to drop by more than -35%, from current levels to get interest-coverage ratios back to long-term average values (Figure 7).

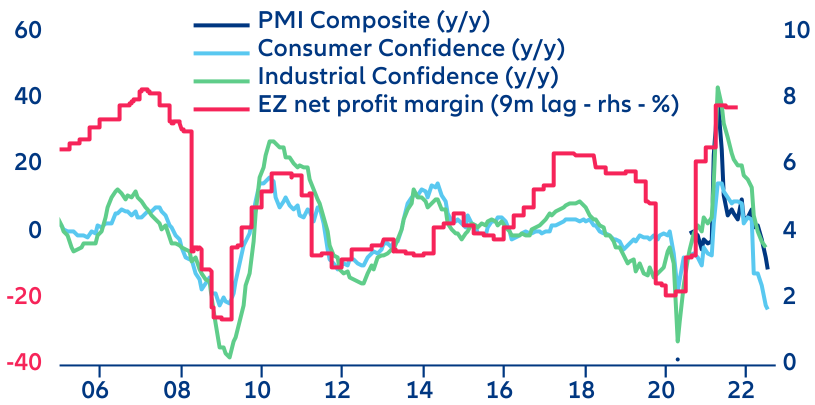
Figure 7: US and Eurozone net leverage and interest coverage ratios



Sources: Refinitiv Datastream; Worldscope; Allianz Research

But even if fundamentals and debt-servicing ratios are historically high, the future resilience of corporate balance sheets will soon be put to the test. The record downside earnings revisions and the continuing decline in consumer and industrial confidence indicate that corporates' top and bottom lines will remain under pressure in the near future, which could lead to a rapid deterioration of fundamentals and debt-servicing ratios. The relationship between confidence and margins indicates that EUR corporate margins could fall by as much as 4-6pps to 4-2% within the next nine months, which would implicitly push interest coverage ratios slightly below their long-term average. Such a drop could trigger a sizeable repricing of the high yield credit risk premium (Figure 8).

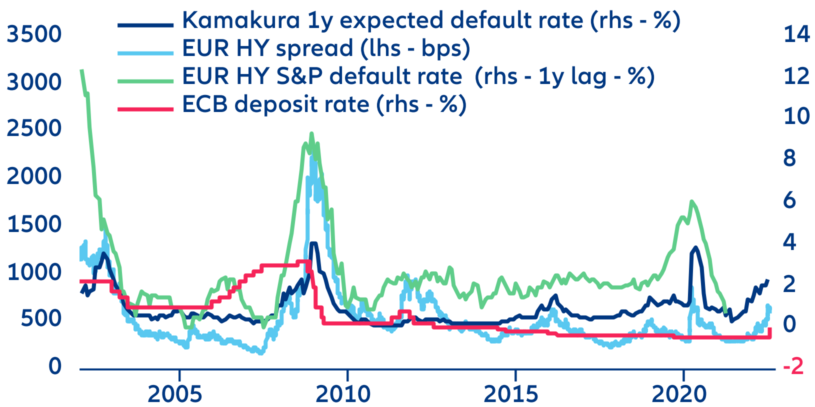
Figure 8: Eurozone net profit margins (y/y)



Sources: Refinitiv Datastream; Worldscope; Allianz Research

In this context, we expect an increase in default rates at a single company level, especially since the 2020-2021 rate was extremely low. At an aggregated level, and taking market, fundamental and technical metrics into account, we expect a timid increase in broad default rates. This is confirmed by the recent increase in the Kamakura 1y ahead probability of default index[2], which shows that the combination of current financial ratios, stock prices and macro-economic factors points towards an increase in default rates. Despite the expected acceleration in defaults, the 1y ahead default rate expectation is still much lower than the one experienced during the dotcom bubble, the global financial crisis and Covid-19, confirming that corporate credit is expected to be more resilient this time (Figure 9).

Figure 9: Kamakura's 1y ahead default rate and EUR corporate spread



Sources: Refinitiv Datastream; S&P; Kamakura; Allianz Research

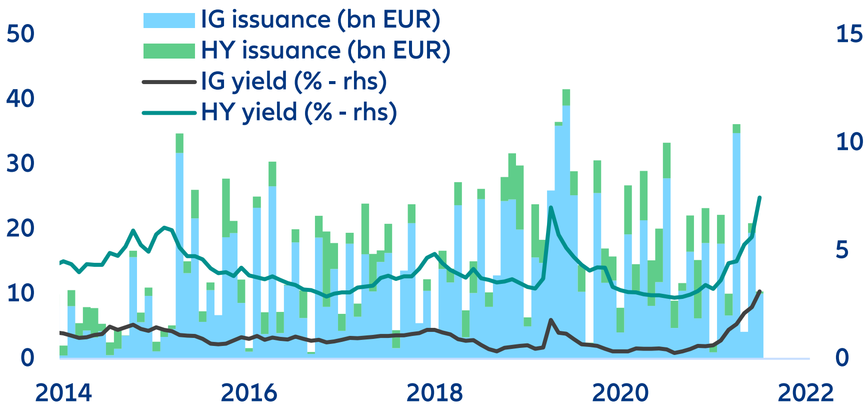
[2] The Kamakura Troubled Company Index® measures the percentage of 40,500 public firms in 76 countries that have an annualized one-month default risk of over one percent. The average index value since January 1990 is 14.53%. Since November 2015, the Kamakura index has used the annualized one-month default probability produced by the KRIS version 6.0 Jarrow-Chava reduced form default probability model, a formula that bases default predictions on a sophisticated combination of financial ratios, stock price history and macro-economic factors.

Primary markets to remain dry for as long as uncertainty fails to abate.

The lack of issuance, the rush out from asset class tourists and the relatively cheap valuations should help stabilize spreads. With risk appetite having structurally declined since November 2021, and especially since the Ukraine war started, USD HY and EUR HY bond funds have experienced cumulative net outflows of around 10-12% of the beginning of the year's Assets Under Management (AuM)[3]. Looking closer at the sell-off, it seems that a lot of asset class tourists have exited, leaving a more robust and stable investor base. Additionally, and against the muted appetite for HY credit, the limited supply has also been a key stabilizer for the market.

Moving forward, however, the asset class will need some more structural investors looking for high carry to sustain and stabilize the market further. To put things into perspective, the HY issuance for both EUR and USD credit has been less than 80% of that of the past two years. The increased uncertainty, deteriorating economic prospects, tightening financial conditions and large cash positions should continue to keep HY issuance volumes extremely muted, thus supporting corporate spreads as the additional amount of bonds used for price determination will be limited. Taking all that into account and acknowledging the probable "oversold" label attached to high yield credit, the combination of higher yields and healthier valuations could still trigger a timid increase in investment appetite for the asset class towards year end. However, and despite the relative attractiveness of high yield, the risk-return attractiveness competition will be fierce and probably sided towards sovereign debt as higher long-term yields will weigh on demand for risky assets (Figure 10).

Figure 10: EUR corporate credit issuance vs credit spreads (bn EUR - bps)



Sources: Refinitiv Datastream; FINIM; Allianz Research

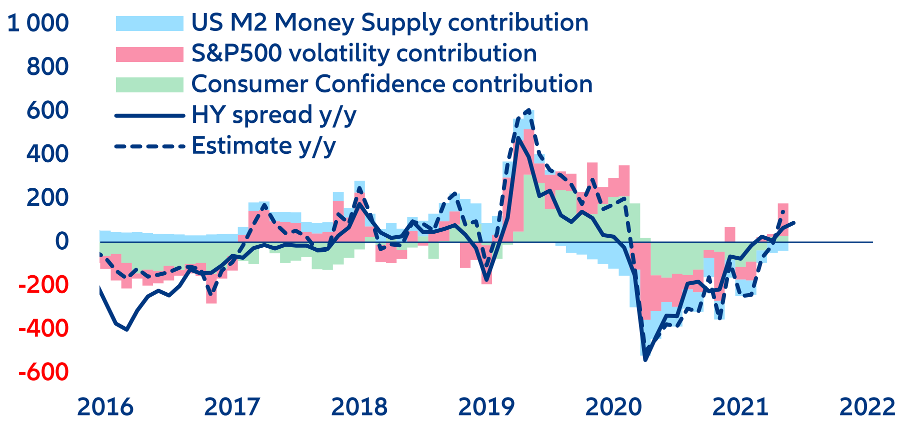
Risks to outweigh potential returns until year-end.

Our macro-driven spread decomposition warns about short-term risks but depicts a stabilizing mid-term picture. Our decomposition methodology shows that a combination of declining economic sentiment, a gradual slowdown in money velocity and a substantial spike in equity volatility are to be blamed for the HY spread widening seen of late. This market conundrum brings some headwinds and tailwinds. Starting with the headwinds, the possibility of a further economic deterioration paired with the expected tightening in financial conditions and the elevated probability of additional volatility spikes should not provide any strong spread containing or compressing effect in the short-run, and for as long as uncertainty fails to abate. This means that in the short-run, headwinds will, most probably, outweigh tailwinds. On the other hand, by year end and into 2023, the "how low can it go" bias will most probably kick in. Most metrics will start to revert to non-crisis levels with the combination of declining equity

[3] *Computed using Mutual Funds and ETFs; Eikon Refinitiv Flows.*

volatility, loosening financial conditions and an economic reacceleration adding some compression effects to corporate credit spreads and thus exposing some interesting entry points (Figure 11).

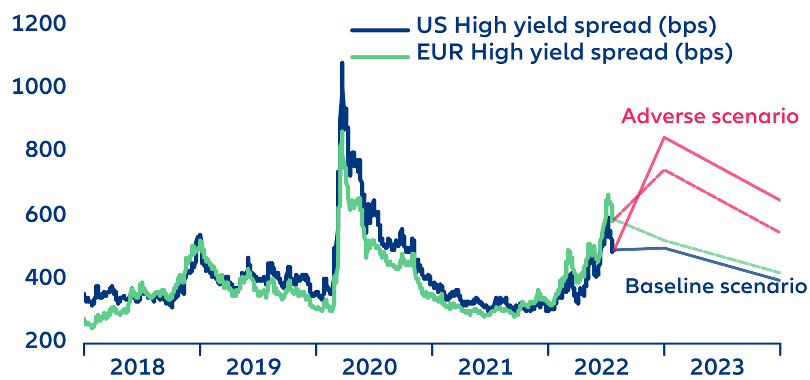
Figure 11: US HY credit spread decomposition (y/y – bps)



Sources: Refinitiv Datastream; Allianz Research

In our baseline scenario, we expect corporate HY spreads to remain under pressure for the rest of the year with some decompression episodes in the pipeline. In this scenario, we expect the combination of a more dovish policy stance, a better-than-expected economic performance and higher-than-expected corporate resilience to keep USD and EUR HY credit spreads close to 500 and 525 for the end of 2022 (vs 496 and 591bps for US and EUR HY currently), followed by a compression to 400 and 425 in 2023, respectively. However, if our adverse scenario[4] materializes, we would expect high yield corporate spreads to widen to levels last seen during the onset of the Covid-19 crisis as higher policy rates and inflation will lead to a sharp repricing in defaults and rising credit risk. This initial widening will quickly revert in 2023 as easing monetary policy and fiscal support will kick in again. Aggregating the scenarios in an expected value format, the scenario-weighted expectation for US and EUR HY spreads would be around 625bps in 2022 and 500 bps in 2023 (Figure 12).

Figure 12: HY credit spread projections (bps)



Source: Refinitiv Datastream; BofA; Allianz Research

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[4] *See our Q2 Macroeconomic and Capital Markets scenario report (link).*
[5] *Internal Model, Diversified incl. VA before PHP, as of Q4 2021.*

These assessments are, as always, subject to the disclaimer provided below.

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