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Staying defensive in the junk bond market

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For some, the idea of the "junk bond" market might conjure up thoughts of bold risk-taking where portfolio managers make big bets on troubled companies in an effort to earn outsized returns. In reality, seasoned high yield investors understand that the key to achieving outperformance in the world of below-investment grade corporate debt largely involves avoiding losers rather than picking winners.

In the uncertain world of the coronavirus, even with several vaccines on the way, avoiding excess risk is more important than ever. As a result, one might assume that relatively higher quality issuers would trade at a premium over those with lower quality balance sheets as investors vie to own the highest quality assets. Surprisingly, however, today higher quality assets arguably look cheap when compared with riskier issuers relative to historical averages. Consequently, and given the context, having a defensive mindset within high yield makes more sense than ever. Luckily, for investors looking to play it safe, the opportunity set in the high yield market is greater than ever and likely growing.

CREDIT: CONTROLLING THE DOWNSIDE IS KEY

Some say that credit investors see risks before equity investors. Whether that's true is open to debate, but the mentality of a credit investor is certainly different from an equity investor despite both making bets on individual companies. When an equity investor buys a stock, their downside is "limited" to 100%. Yet, as any early investor in many of today's large-cap technology stocks knows, there can be more than 100% upside if you make the right calls! However, with high yield bonds (and senior loans), the sky is hardly the limit. Instead,

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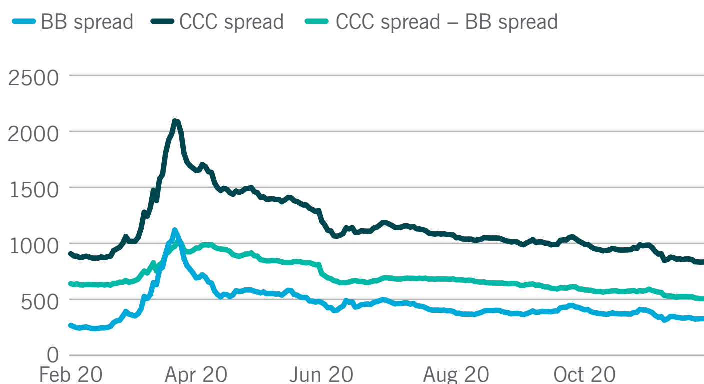
risks are generally asymmetric to the downside, so controlling default losses and deteriorating credit situations is key to long-term outperformance. This is not to say that there may not be situations where higher risk issuers represent good investments as their valuations more than reflect this risk. Furthermore, there may be environments (unlike today) where general risk taking is better rewarded. That's why active management is key as opportunities in the high yield market can shift over time. Today, however, the risk and return opportunity seems most apparent within relatively better quality issuers.

Comparing risk premiums

There are a few ways to analyze how well investors are being compensated for risk. Figure 1 shows spreads in the BB market, spreads in the CCC market and the line in the middle is the difference between the two (which represents the extra spread an investor gets paid to move from BB to CCC).

Figure 1: Investors are not being compensated for moving down the risk spectrum in high yield



Source: Credit Suisse Plus. As of 30 Nov 2020.

Not surprisingly, from late February through the end of March as the spread of the coronavirus rattled the market — and investors quickly lost their appetite for risk — the extra compensation for owning CCC relative to BB skyrocketed from roughly 630 basis points (bps) in mid-February to 1000bps by 23 March. Since then, however, that number has more than normalized. Today, the spread between CCC and BB is 506 bps,[1] which is meaningfully less than the 630 bps level occurring in the weeks leading up to the market selloff on 20 February. That should be fairly surprising that today investors are being compensated less to move from BB to CCC relative to pre-coronavirus levels.

Another way to compare spreads is to look at them as ratios. This is particularly helpful over longer periods of time because it accounts for the magnitude of the differences. For example, if the spread of BB-rated bonds was 300 bps and the spread of CCC-rated bonds was 400 bps, the simple difference is 100 bps. Yet if BB-rated bonds carried a spread of 900 bps and the spread of CCC was 1000 bps then the 100 bps differential would contextually be much less meaningful in a wider spread environment. The spread ratio tries to capture that, but is not without its own limitations.

Looking at the spread ratio is particularly helpful given how dramatically risk-free rates and spreads have moved around the last several years. Figure 2 shows the ratio of CCC spreads to BB spreads (CCC/BB), which has experienced some volatility over the last year but recently settled in at a level of around 2.5x, meaning that CCC investors stand to earn 2.5 times the amount of spread relative to BB investors. For context, the average spread ratio since 2015 has been just under 3x. Over that time, the spread ratio was higher than it is today in nearly 90% of daily observations.

Figure 2: Spread ratio has declined below recent averages, despite elevated uncertainty

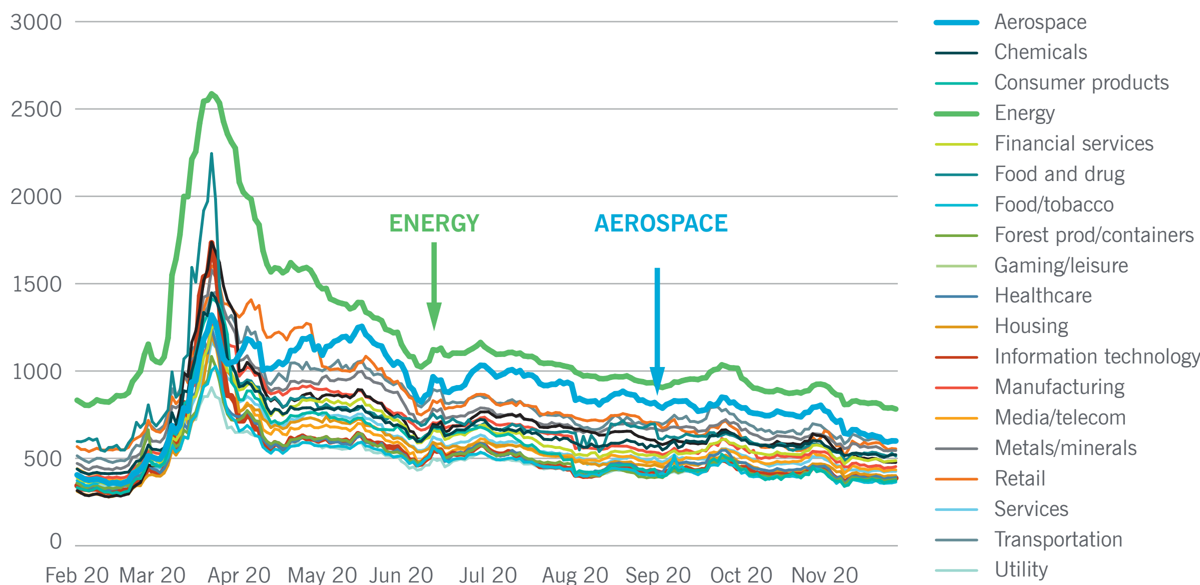
CCC spread divided by BB spread

Source: Credit Suisse Plus. As of 30 Nov 2020.

What's driving down risk premiums in high yield to some of the lowest levels they've been in five years, especially in the midst of a global pandemic? Some interrelated factors include: low interest rates, Fed stimulus and a recalibration of risk and return. Some have said that "the Fed can create liquidity, but they can't create solvency." For individual issuers, many of whom have recently issued short-term debt to buy liquidity, the future remains very uncertain. The risk is very real and yet it doesn't appear priced into lower quality assets.

Looking across industries yields a similar conclusion as depicted in the ratings-driven analysis shown in Figures 1 and 2. Spreads have converged across industries as the market doesn't seem to be necessarily distinguishing between them as much as one might expect. Looking at Figure 3, the cluster on the right looks very similar to cluster on the left (with the exception of Aerospace, which has widened out substantially versus February levels). Given the fundamental impact of coronavirus, it's surprising that we are not seeing more dispersion across industries.

Figure 3: Spreads across most industries have converged again



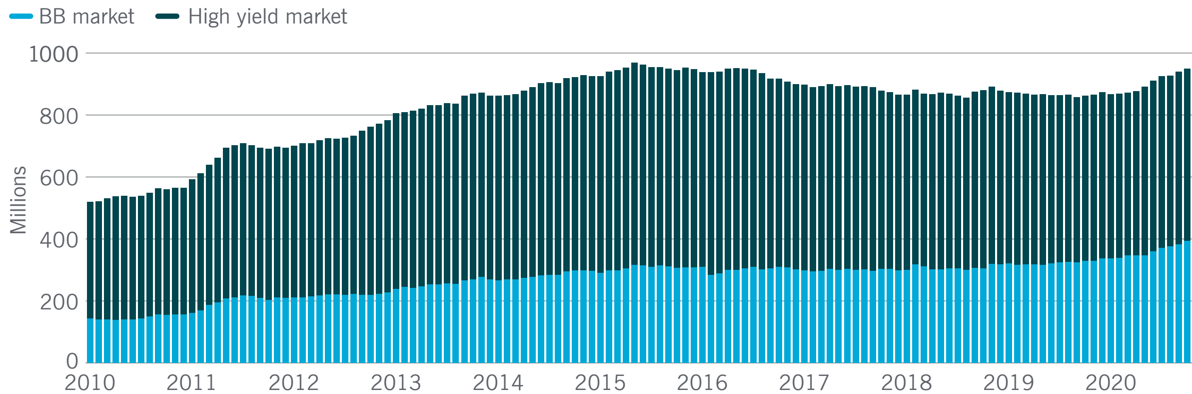
Source: Credit Suisse Plus. As of 30 Nov 2020.

"HIGH QUALITY" JUNK BONDS, A GROWING UNIVERSE

Fortunately, there's great news for high yield investors who are more interested in staying out of trouble right now versus extending risk. Indeed, for the defensive-minded high yield investor, the investment universe is as large as it's ever been. And with a large BBB market sitting above high yield, the universe could potentially grow if investment-grade bonds are downgraded into the high yield market should the U.S. economy struggle over the next several years.

Unlike the senior loan and investment grade corporate markets, where lower quality debt has ballooned in recent years, the high yield market has actually gone in the opposite direction. As far back as 2010, BB-rated bonds comprised less than 30% of the overall high yield market. Today, that number has grown to 44% as the high yield market itself has also grown (Figure 4). Putting that into dollar terms, the BB universe has grown by 250% since 2010 from $160 billion to nearly $400 billion today. And that number could continue to grow.

Figure 4: The BB market has grown

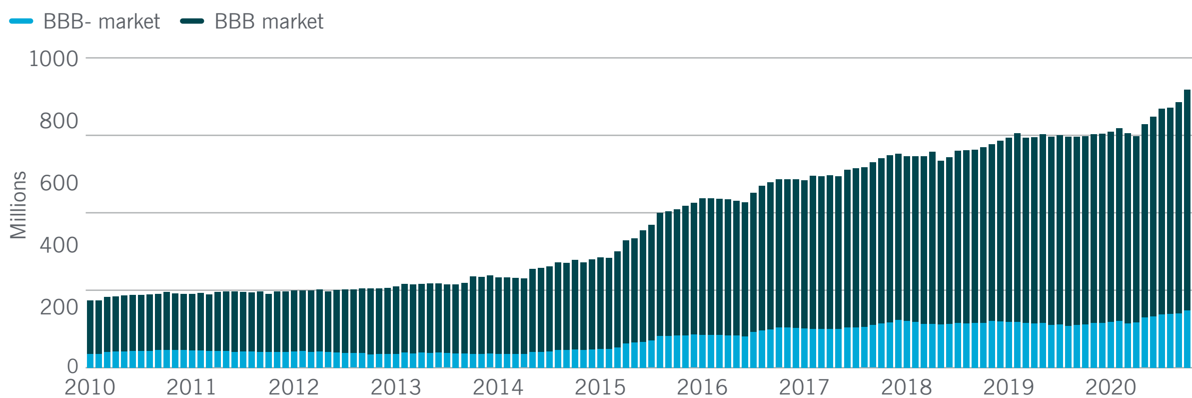


Source: Credit Suisse Plus. As of 30 Nov 2020.

The growth of the BBB market —the lowest ratings bucket before a credit moves from investment grade to junk status — has garnered much attention. Standing at $1.5 trillion, the BBB market is actually larger than the entire high yield market combined. And the BBB-market, which is the lowest notch before moving to high yield, stands at over $400 billion (Figure 5).

The growth of the BBB market has been cited as a risk for high yield investors as it has the potential to cause an oversupply were there to be systemic downgrades. However, the more likely result is that the high yield market is fed more higher quality, high yield paper over time, giving defensive-minded investors a better mix of assets from which to choose.

Figure 5: The size of the BBB market has grown exponentially



Source: Credit Suisse Plus. As of 30 Nov 2020.

Senior secured debt is also a structure that has become more popular within the high yield market recently (Figure 6). This type of debt is secured by some form of a lien on the issuer's assets, a feature found within most corporate loans and also additive to the defensive investor's universe. It's important to mention that the issuance of senior secured debt has recently been most prevalent within companies seeking to raise liquidity in response to the coronavirus, especially in sectors that are more negatively impacted by the pandemic. In fact, despite having a "safer" structural profile, senior secured debt currently trades with a higher spread than unsecured debt. However, over time there will no doubt be winners and losers that emerge.

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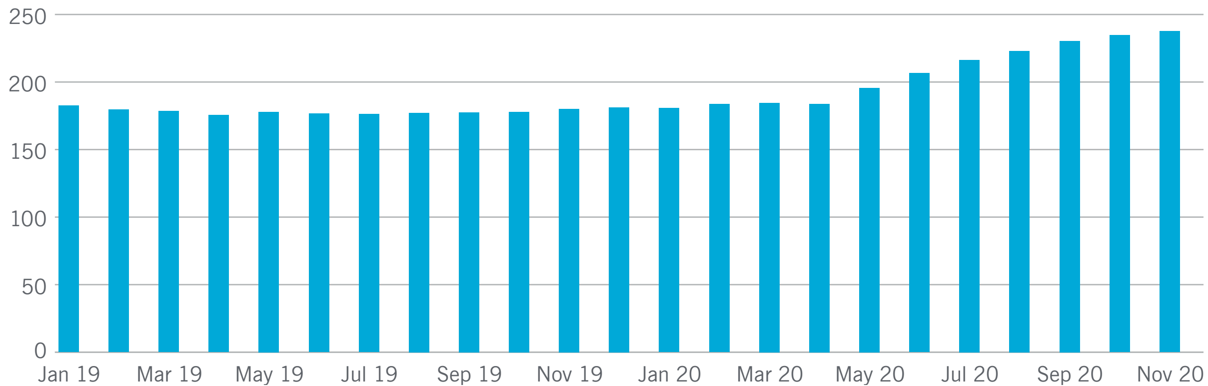
Figure 6: Issuance of senior secured debt has been increasing

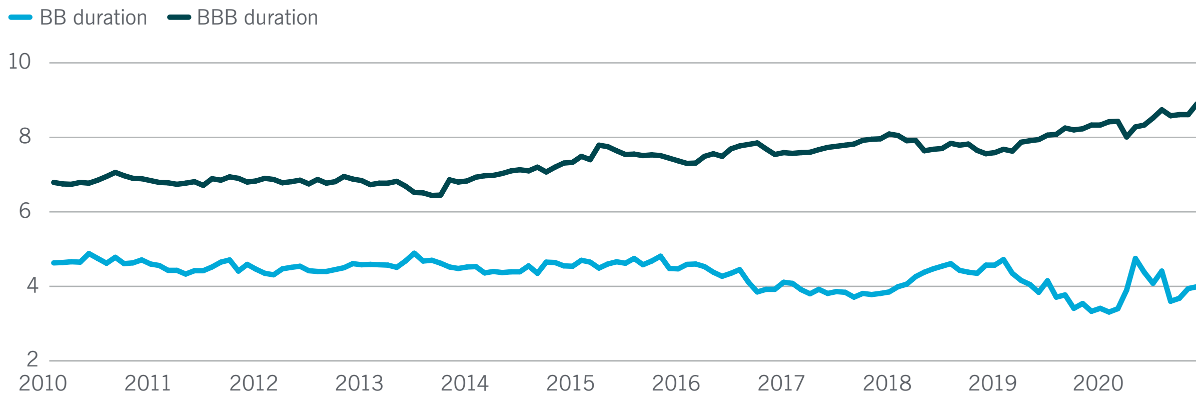


Source: Credit Suisse Plus. As of 30 Nov 2020.

LOWER LEVELS OF DURATION RISK MAKE HIGH YIELD APPEALING

Until further notice, high yield investors should undoubtedly be more concerned with credit risk versus rate risk (as they typically are). However, high yield does have a bit of interest-rate sensitivity, and rates have come into focus again recently. Even within BB (a more rate sensitive high yield), duration risk is at roughly the lowest levels in 10 years, as shown in Figure 7, which contrasts with the one-rung higher BBB market where duration has actually extended recently.

Figure 7: High yield investors have less duration risk today, while investment grade investors have more



Source: Credit Suisse Plus. As of 30 Nov 2020.

CONTINUED UNCERTAINTY MAY BROADEN THE HIGH YIELD INVESTMENT UNIVERSE

With relatively tight spreads, uncertainty around the coronavirus, and risk premiums fairly narrow, investors in high yield today should go back to basics by avoiding downside risk rather than looking for upside potential. While there is some opportunity today in high yield, it's largely about collecting your coupon and getting back your principal. This is a typical framework for a high yield investor, even in a world without the coronavirus. However, the uncertainty around the pandemic only adds to the need to focus on downside. Luckily, for high yield investors today looking to maintain a healthy portfolio, there is a surprisingly large menu of choices.

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For more information, please visit nuveen.com.

1 As of 30 November 2020.

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A word on risk

Investing involves risk; loss of principle is possible. There is no assurance that downside protection will be achieved.

Credit risk may be heightened for the portfolios that invest a substantial portion of their assets in "high yield" debt or loans with low credit ratings. These securities, while generally offering higher yields than investment-grade debt with similar maturities, involve greater risks, including the possibility of interest deferral, default or bankruptcy, and are regarded as predominantly speculative with respect to the issuer's capacity to pay dividends or interest and repay principal. Companies that issue high yield debt or loans tend to be highly leveraged and thus are more susceptible to the risks of interest deferral, default and/or bankruptcy.

Securities of below investment grade quality are regarded as having predominately speculative characteristics with respect to capacity to pay interest and repay principal, and are commonly referred to as junk bonds. Issuers of high yield securities may be highly leveraged and may have fewer methods of financing available. The prices of these lower grade securities are typically more sensitive to negative developments, such as a decline in the issuer's revenues or a general economic downturn, than are the prices of higher grade securities. The secondary market for high yield securities may not be as liquid as the secondary market for more highly rated securities, a factor which may have an adverse effect on a portfolio's ability to dispose of a particular security. There are fewer dealers in the market for high yield securities than for investment grade obligations. The prices quoted by different dealers may vary significantly and the spread between the bid and ask price is generally much larger than for higher quality instruments. Under adverse market or economic conditions, the secondary market for high yield securities could contract further, independent of any specific adverse changes in the condition of a particular issuer, and these instruments may become illiquid. As a result, a portfolio could find it more difficult to sell these securities or may be able to sell the securities only at prices lower than if such securities were widely traded.

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