Chart Focus: USD High Yield in COVID-19 – Why the Complacency?

BLUEALPHA INVESTMENT MANAGEMENT

Corporate bonds are a good reflection of economic stress because people demand a higher yield in times of economic stress. Saying that, over the course of the COVID-19 pandemic – arguably the largest market shock since the Great Depression, and certainly since 2008/09, market risk in certain assets has been relatively subdued in comparison to previous crises.

Figure 1 plots the spread of the US Domestic High Yield Bond Index. By 'high yield' we are talking about companies that are rated just outside of investment grade. So, using Moody's ratings, it would typically be companies rated Ba3, B1 and B2. Currently the Index comprises about 2,100 companies with an average maturity of 6 years. Given the length of the chart – with data going back to 2000 – you can see the effects of all three of the most recent US recessions: a small recession in 2001; the large recession of 2008/09 triggered by the US housing market collapse, and of course 2020 which was set off by COVID-19.

Figure 1: US Domestic High Yield Bond Index Spread

Source: Bloomberg

Instead of assessing absolute yield of the Index, we use the spread to US treasuries with a similar duration because there has been a dramatic fall in inflation over the last 30 years, together with a large fall in short interest rates. As we mentioned, the index has a maturity of 6.1 but a duration of the index is just over 4. Duration differs from maturity in that maturity is when the principal of the bond falls due. Duration is the point in time at which a bond's total payments balance (a zero-coupon bond's maturity and duration are the same; the higher the coupon the lower the duration). Figure 2 details recession characteristics of the Index vs. the 10-year average.

Figure 2: US Domestic High Yield Bond Index Characteristics

	2001	2009	2020	Last 10 Year Avg.	Current
Yield (%)	14.1	22.9	11.4	6.5	4.2
Spread to US Gov (%)	10.2	19.6	10.9	4.8	3.6
Duration	4.6	4.3	4.3	4.2	3.6
Default Rate (%)	8.2	11.0	6.1	2.8	6.4

Source: Bloomberg

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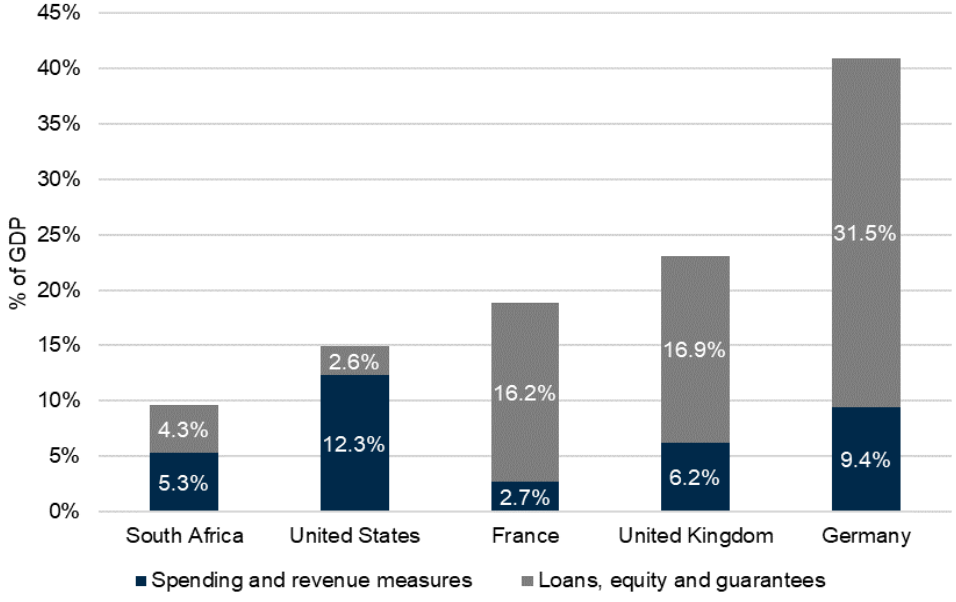
What is most noticeable in the data is that according to the corporate bond market, the 2020 recession is mild compared to both previous recessions in 2008/09 and 2001. Even default rates are subdued. So, despite all the chaos created by COVID-19, US companies are supposedly doing just fine.

Can this be right? Well, there are three things at play to explain this seeming anomaly. Firstly, we are looking at high yield and not C-rated bonds (the picture looks very different in very risky company debt). Secondly and most importantly, governments have provided an enormous amount of both monetary and fiscal support – through liquidity (lower rates) and government loans and guarantees respectively. This support has been massive relative to prior recessions. Figure 3 details government responses across 6 countries, including South Africa during 2020.

Figure 3: Fiscal Response to COVID-19



Source: JP Morgan Research

We did not get this fiscal response in 2008 /09, it was mainly liquidity. Also, what the loans and guarantees have done is encourage banks to reschedule existing loans with corporate customers, as well as encourage equity investors to inject more capital into businesses that would otherwise have been on the brink. Good examples include both Singapore Airlines and Carnival Cruises. As seen in figure 4 below, Carnival Cruises' perceived risk – despite being exceptionally hard hit by the pandemic – has decreased significantly.

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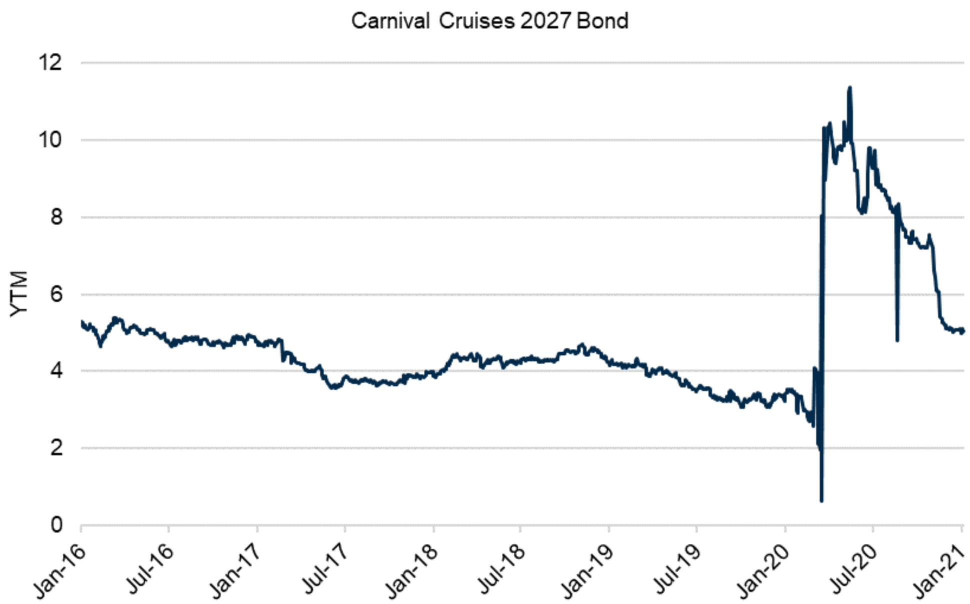
Figure 4: Carnival Cruises Yield to Maturity



Source: Bloomberg

The third difference is that households entered this recession with very little debt. In fact, measured as a percentage of disposable personal income, it was the lowest in 40 years. Of course, some of this has to do with the persistently low interest rates of the past decade. Government assistance during COVID-19 has helped this number temporarily fall further.

We are left with a situation where we know that at some point, fiscal support will be withdrawn, which could turn into a head wind. So far, we have yet to see a major economy do this, but it suggests that we should not be complacent about 2021. A lot will depend on how quickly the world can get back on its feet. Although Carnival Cruises got a big injection of capital in 2020, they might not be as successful if they have to ask for more money in 6 months' time. That fact holds for many businesses in similar circumstances.