Unprecedented High Yield bond market behaviour on the threshold of a probable economic recession

12 July 2022

In a market environment affected by inflation and recessionary risks, the High Yield asset class stands out due to its robust fundamentals and favourable technical factors.

According to Swiss Life Asset Managers, which recently invited its investors to a presentation on credit, the economic data points to a likely technical recession, continued inflationary pressures and a strong rise in interest rates driven by monetary tightening by the central banks, led by the US Federal Reserve.

Swiss Life Asset Managers' macroeconomic scenario projects a moderate recession between 2023 and 2025. *"In the US, we expect a short-lived recession due to the negative effects of monetary tightening on wealth production, not a credit or banking system crisis. In Europe, we lean towards a cyclical recovery in 2023 due to the easing of supply issues, followed by a surge in recessionary risks due to a delayed response from the ECB compared to the Fed."* explains Edouard Faure, Head High Yield Portfolio Management at Swiss Life Asset Managers. Inflationary pressures in the US, which initially originated in the commodity sector, have spread to services.

No spread slippage or High Yield volatility spike

This expected growth shock is already in evidence on the bond markets, as evidenced by the inversion of US sovereign yield curves for 2- and 10-year securities. *"This is a precursor to the growth shocks as already seen at the end of the 1980s, in 2000, 2006 and 2019,"* states Edouard Faure. However, in contrast to previous reversals, the High Yield bond segment has reacted better than the investment grade since the start of the year, including for lower quality securities, rated "CCC". Counter-intuitive, this situation is thus unprecedented. *"This can be explained not only by the fact that High Yield credit is less sensitive to rising interest rates than the investment grade category, but also by market sentiment: investors seem to have confidence in the fundamentals of High Yield companies,"* he adds. However, the impact of rising interest rates on High Yield securities must be factored in, as *"the former especially affects the longer durations. Hence the need to approach the asset class with active maturity and credit risk management."*

At this stage, the widening of High Yield credit spreads does not anticipate a major recession: it has moved from around 350 basis points to just over 470 since 2021, when it jumped from around 250 to over 800 in 2006-2007, on the eve of the great recession[i]. *"We also note that the increase in equity market volatility in recent months has not led to a High Yield volatility spike. The spread widening has remained measured,"* affirms Edouard Faure.

Issuers with strong fundamentals

On various criteria, High Yield issuers are characterised by their robust fundamentals. *"Overall, these companies were very cautious during the COVID-19 crisis. They deleveraged markedly and improved their credit ratios, which are now stronger than before the health crisis and at historically satisfactory levels,"* says Emmanuel Jourdan, credit analyst at Swiss Life Asset Managers France.

The pandemic has led managers to adopt a conservative stance on financial policy, providing a substantial liquidity buffer coming out of the health crisis. Improvements in the debt ratio were made across all ratings, especially for the lowest rated issuers, driven by their lower cash consumption.
"This restoration cycle has helped to improve interest coverage ratios and bolsters investor confidence in the ability of High Yield issuers to honour their debts" explains Emmanuel Jourdan. On the other hand, in terms of results, the median EBITDA margins of High Yield issuers are currently at record levels, over 16%[ii], which gives flexibility in the face of the inflationary trend that is beginning to be felt after the events at the start of the year.

Attractive yields and risk premia in Europe

From a technical point of view, the yields of the High Yield sub-fund are currently attractive at almost 7% on the European market. Apart from the Covid-19 crisis, such levels are unprecedented since the sovereign debt crisis. We are now above the levels of early 2016 when the oil price fell to USD 25 per barrel. *"Yields and risk premia are now higher in Europe, due to the proximity to the Russian-Ukrainian conflict and the rise in energy prices, which represent a significant cost for European issuers. On the other hand, it benefits the exploration and production of shale oil and gas, very important in the US High Yield market. At the same level of risk, we favour European 'B' ratings, which are more attractive than their American peers, with a premium loading close to 150 basis points, twice the spread of the past ten years,"* observes Florent Rouget de Conigliano, High Yield Portfolio Manager at Swiss Life Asset Managers.

On the primary market, issuers have been reluctant to reach out to creditors so far this year. The first half of the year saw the lowest level of primary issues since the onset of the sovereign debt crisis more than a decade ago.

"The behaviour of issuers is above all linked to the increase in refinancing costs in the wake of the rise in sovereign yields and risk premia, but also a legacy of their prudence during the health crisis, which prompted them to prioritise liquidity," concludes Florent Rouget de Conigliano.

Indeed, while Moody's expects default rates in the US and Europe to rise slightly, from 1.3% and 1.7% respectively in April 2022, to 3.3% and 2.9% in April 2023, these levels remain contained[iii]. *"In Europe, ECB monetary policy remains less restrictive than that of the Fed in the United States, which rules out a priori any risk of a surge in default rates, far from the scenario of 2008-2009 when they reached 13%. In the US and Europe, based on current risk premia, the markets anticipate a limited rise in default rates"* confirms Romy Kruger, Credit Analyst at Swiss Life Asset Managers.

Finally, the High Yield team of Swiss Life Asset Managers France does not foresee any short-term maturity wall facing the High Yield sub-fund. Only 8% of European High Yield bonds will have to be refinanced by the end of 2023 and under 20% by the end of 2024. Given the relatively low level of maturities in the short to medium term, the average coupon will progress gradually and it will take until the end of 2025 for the average coupon of the "BB" and "B" ratings to increase by 1 point[iv].

"All of these fundamental and technical factors clearly support the asset class, which offers robust performances and harbours investment opportunities. We are convinced that there is good 'momentum' now to start building positions in High Yield credit," concludes Edouard Faure.

[i] *Source: Bloomberg Morgan Stanley Research*

[ii] *Source: Bloomberg Morgan Stanley Research, S&P Capital IQ*

[iii] *Source: Moody's*

[iv] *Source: J.P. Morgan*

Media relations

Marie CARADEC - +33 (0)1 40 15 22 04 – marie.caradec@swisslife-am.com

Swiss Life Asset Managers France FARGO

Yohann HENDRICE - + 33 (0)6 16 83 28 89 – yhendrice@fargo.agency

Yohan ABRIEL - + 33 6 16 83 88 17 – yabriel@fargo.agency

Aliaksei KASYANENKA - + 33 (0)6 46 60 00 98 – akasyanenka@fargo.agency

www.swisslife-am.com

About Swiss Life Asset Managers

Swiss Life Asset Managers has more than 165 years' experience managing the Swiss Life Group's assets. This close link with insurance underpins its investment philosophy, the main objectives of which are to take a responsible approach to risks and to act each day in its clients' best interests. Swiss Life Asset Managers also offers this proven approach to third-party clients in Switzerland, France, Germany, Luxembourg, the UK and the Nordics.

As at 31 December 2021, Swiss Life Asset Managers managed EUR 266.3 billion in assets for the Swiss Life Group, with more than EUR 99.1 billion in assets under management on behalf of third-party clients. Swiss Life Asset Managers is a leading real estate manager in Europe[1]. Of the EUR 266.3 billion in assets under management, EUR 84 billion are invested in real estate. In addition, Swiss Life Asset Managers manages EUR 27.8 billion of real estate assets jointly with Livit. Thus, as at 31 December 2021, Swiss Life Asset Managers managed EUR 111.8 billion in real estate assets.

The clients of Swiss Life Asset Managers benefit from the commitment and expertise of more than 2 500 employees in Europe.

1 INREV Fund Manager Survey 2021 (based on AuM as at 31 December 2020)
Swiss Life Asset Managers, data from 31 December 2021

A self-determined life

Swiss Life enables people to lead a self-determined life and look to the future with confidence. This is also the goal of Swiss Life Asset Managers: we think long-term and act responsibly. With our expertise and experience, we develop future-oriented savings and investment solutions. We support our clients in achieving their long-term investment goals so that they, in turn, can take into account the needs of their clients and build a self-determined financial future.