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Fixed Income Strategy

December 2019

Global High Yield 2020: Squeezing water from a stone

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Summary

- Supported by low refinancing risks, low default rates and a low yield environment, global high yield (HY) bonds have enjoyed outsized returns in 2019. Looking forward we remain constructive on HY markets, as downside risks have been reduced. This is consistent with our relatively optimistic outlook for the New Year.
- However, expectations for HY bond performance in 2020 should be moderated. We expect US HY bonds to generate returns between 4-5%, with CCC-rated debt underperforming. We expect similar performance in US bank loans where "all-in yields" above 6% are attractive, with lower price volatility. This can create attractive risk-adjusted returns, relative to other markets.
- In Europe, we expect euro-denominated HY bonds to return between 2-3% in 2020, as European Central Bank bond purchases supports spreads. However, lower absolute bond yields offer less support if core rates rise, as we expect. We expect slightly better returns in Euro bank loans, where carry opportunities are higher.
- UK and Asia HY markets also offer attractive opportunities, where spreads and yields are higher and have the scope for tightening. Average sterling-denominated HY bonds yield 5.5%, while Asia HY yields are near 8.5%. Of course, both markets come with heightened risks around Brexit and rising US/China trade tensions.

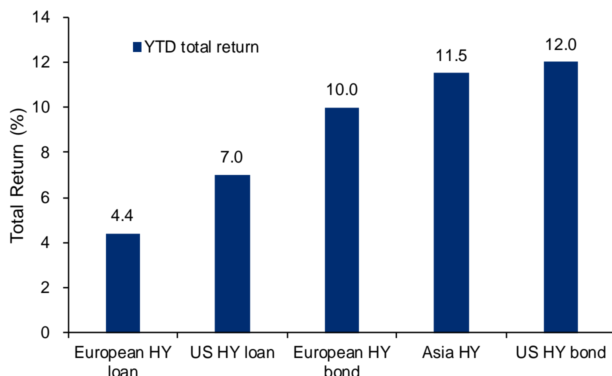
2019 performance

Global high yield bonds (HY) enjoyed outsized returns in 2019, generating gains of 11% (unhedged to US dollars). US markets outperformed the global benchmark, producing 12.5% returns. European HY marked 10% gains, its best annual return since 2013. While Asia HY bonds split the difference, with US dollar benchmarks rising 11.2% **(Fig. 1)**.

2019 performance also reflected an "up-in-quality" bias, with BB-rated issuers outperforming lower quality bonds **(Fig. 2)**. With investment-grade (IG) corporate yields falling to a 6-year low, investors reaching for yield helped fuel a 14% return in BB's. At the same time, pure HY managers looking to reduce risk amid rising macro fears raised portfolio quality into higher rated HY bonds.

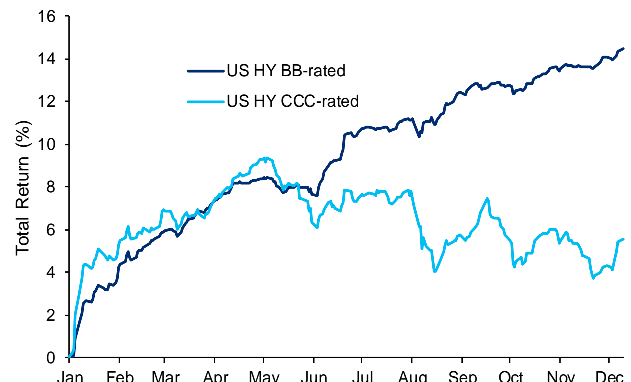
Consequently, these trends led to underperformance in low quality HY, with CCC-rated bonds returning 4%. This is first time on record that CCC-rated issuers have underperformed while the broader HY market produced returns greater than 5%. Besides large idiosyncratic credit events, oil price volatility heavily contributed, with energy-related CCC-rated issuers losing 10%.

Figure 1. Year-to-date performance of global HY markets



Source: Bloomberg Barclays Indices as of December 11, 2019

Figure 2. High quality HY bonds have outperformed



Source: Bloomberg Barclays Indices as of December 11, 2019

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To be fair, the sell-off in risk assets that occurred late December 2018 set the stage for a robust year in global HY bond markets. Indeed, a large majority of 2019 performance transpired over the first several months of the year. Between January and April, HY bond benchmarks produced 70% of 2019 full year performance. Subsequently, HY indices managed a more modest return for the remainder of this year **(Fig. 3)**.

The starting point for 2019 was just as meaningful for HY bank loan returns, both in the US and Europe. However, not to its advantage. Considering HY loan markets held up relatively better than bonds during the December 2018 sell-off, there was less scope for a bounce. Negative convexity also constrains returns, with banks loans perpetually callable by the issuer. In other words, as loan valuations improve, issuers are encouraged to refinance terms at levels that are more attractive. This keeps prices from moving much beyond $100 and why HY *bonds* tend to outperform HY *loans* during periods of improving risk appetites.

Still, US HY bank loans managed to produce a steady 7.0% return year-to-date, despite significant retail outflows and Federal Reserve rate cuts (bank loans pay floating-rate coupons). Similar to HY bonds, higher quality HY bank loans outperformed, with BB's gaining 8.5%. In Europe, bank loans markets suffered relatively more from lower yields, lower interest returns and idiosyncratic credit events, resulting in a disappointing 4.4% YTD gain.

Figure 3. YTD HY bond returns were largely front-loaded

Source: Bloomberg Barclays Indices as of December 11, 2019.

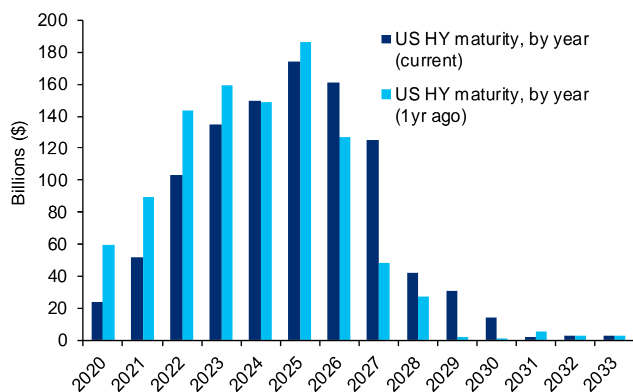
Looking ahead to 2020

We remain constructive on global HY markets for 2020, as downside risks have been reduced. This is consistent with our modestly optimistic outlook for the New Year. In our view, recession probabilities have lessened, with the US Fed and ECB easing policy. Growth over the coming year also has the potential to exceed expectations, with a rebound in manufacturing likely.

In the case of the ECB, asset purchases restarted in 2019, with the central bank buying €20 billion in bonds per month. This includes sovereigns and IG non-financial euro corporate bonds. In our view, this creates a supportive technical environment, as the net supply of available bonds for private investor's decreases.

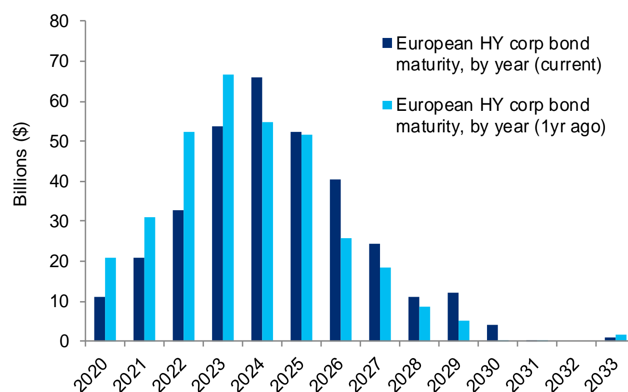
The low global yield environment and improvement in risk appetites also provides HY issuers with an easier path to refinance existing debt. Though issuance had picked up year-over-year, 70% of total new issue volume was to refinance maturing bonds or existing maturities. As a result, less than 3% of the US and European HY markets are expected to mature in 2020, which is 50% less when compared to one year ago **(Figures 4 & 5)**.

Figure 4. US HY bond maturity distribution by year



Source: FTSE Russell Indices, Bloomberg as of December 11, 2019

Figure 5. European HY bond maturity distribution by year



Source: FTSE Russell Indices, Bloomberg as of December 11, 2019

Defaults rates

Low refinancing risks also supports a low global default rate, currently 2.3% (source: S&P). The US HY default rate is higher at 3.0%, though excluding the energy sector, drops to 2.0%. The European HY default rate is lower at 2.1%, though the region has little exposure to energy. HY bank loan default rates are even lower than HY bonds, with the US near 1.5% and Europe at 0.5%.

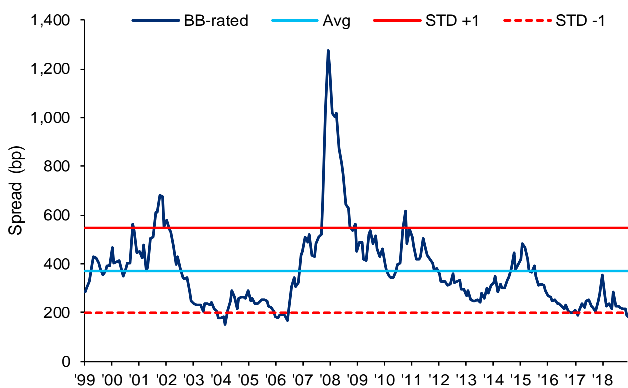
That said, it is still possible we could see the US default rate rise modestly in 2020, as distressed situations (or bonds priced below $60) have increased 25% year-over-year. However, we find these particular situations largely idiosyncratic and unlikely to have a broader impact. Therefore, we expect default rates to remain well below historical averages.

Valuations

While fundamentals and technicals in HY bond markets offer some optimism, current valuations do not get us overly excited. US HY bond index spreads of +350 basis points (bp) are near its 2-year average, and 100bp through its 10-year average. It is notable to point out that already expensive US HY bond valuations include CCC-rated debt. If we exclude the lowest-quality US HY bonds, index spreads tighten by an additional 100bp to +260bp.

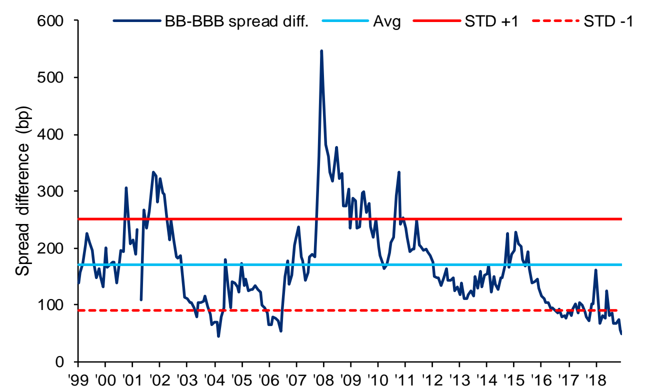
BB-rated US HY bonds are the most over-valued, in our view. Average spreads of +180bp are at their tightest levels since 2007. The BB/BBB spread differential has also narrowed to 50bp, which is the lowest we have seen since 2005 **(Figures 6 & 7)**.

Figure 6. US BB-rated spreads are well below averages



Source: Bloomberg Barclays Indices as of December 11, 2019

Figure 7. BB/BBB spread differentials are narrow

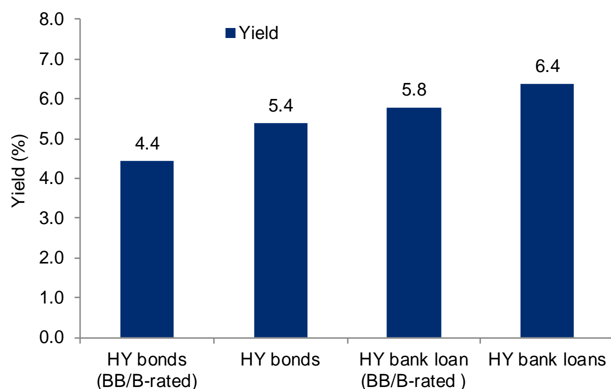


Source: Bloomberg Barclays Indices as of December 11, 2019

European HY benchmark spreads are even tighter at +300bp. However, euro benchmarks are higher in credit quality, with a lower percentage of CCC-rated debt and 50% rated BB (vs. 40% in US HY). High quality HY euro spreads are also wider than what is found in the US, with BBs at +230bp versus +180bp in US. However, wider euro spreads are based off negative sovereign rates, resulting in lower absolute yields of 2.0%.

Bank loan valuations are more attractive, as lower bank funding rates has induced wider spreads. Though Fed rate cuts has pushed 1-month US LIBOR down to 1.75%, US HY loan spreads have widened to 460bp. This has created an all-in yield of 6.4%, or 100bp higher than US HY bonds **(Fig. 8)**. In Europe, the demand for yield has tightened loan spreads, though levels remain elevated above 400bp. This also creates an opportunity when compared to lower yielding euro HY bonds.

Figure 8. US bank loan yields above those in HY bonds



Source: Bloomberg Barclays Indices, S&P as of December 11, 2019.

Return expectations for 2020

With yields low and spreads tight, HY bond return expectations for 2020 should be moderated. Our base-case scenario for the coming year includes no further escalation in the US/China trade war and a bounce-back in global manufacturing. Negative interest rate policies and ECB bond purchases are expected to persist throughout the year, creating positive technical support and a heightened demand for yield within the region and globally.

As fundamentals improve, we would expect long-term Treasury yields to rise. However, improving risk appetites should fuel tighter spreads. With default rates moving slightly higher, we would expect US HY bonds to generate returns between 4 - 5%, with CCC-rated debt underperforming.

We expect HY bank loans to generate similar returns, despite the limitations of price upside (negative convexity). All-in yields near 6% are attractive, in our view. More important, HY loans are likely to hold up relatively better in the event of broader risk aversion, which creates a more attractive risk-adjusted return profile.

In the Eurozone, the stabilization in macro fundamentals should also weigh on core rates, with 10-year Bunds possibly moving back towards zero. Alongside ECB bond purchases, spreads have the scope to tighten. However, low absolute yields offer less support as rates rise. Therefore, we expect returns in euro HY bonds around 2.0%. Slightly better expected in euro bank loans.

Implementation and relative value

In the US, BB-rated HY bonds are trading at expensive levels. As a result, B-rated issuers looks relatively more attractive. The spread difference between BBs and B's are roughly 160bp, near its widest level since 2016. Moving down in quality does require a higher degree of selectivity, as higher beta issuers hold a larger share of the B-rated market (i.e., energy and communications). We would avoid CCC-rated debt altogether.

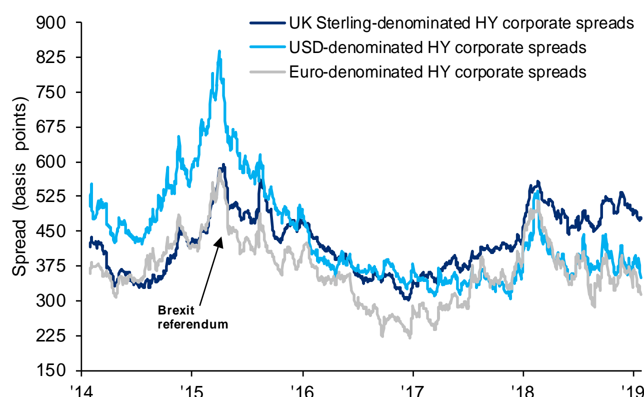
We favor US HY bank loans over bonds, as loan yields are higher and price volatility is lower. The overall quality of the loan market has moved lower and more risky CLO issuance has increased. This keeps our bias favoring higher quality issuers.

More attractive opportunities can be found in the UK, where probabilities of a "no deal" Brexit have fallen significantly (see our October 2019 report on UK corporates). Upon a Brexit deal, we would expect sterling-denominated spreads to tighten and compress versus European and US HY issuers **(Fig. 9)**.

To be fair, liquidity in UK HY is relatively weaker. At the same time, sector concentrations should be considered. For example, cyclicals make up 30% of the UK HY benchmarks. However, we believe this could provide an even larger boost to benchmark performance upon a Brexit deal. Especially if we get a global manufacturing rebound over the coming year, which we expect.

Asia (USD) HY bonds have lagged versus their US counterparts since early 2018. The weakness can be attributable to a number of factors including trade wars and rising default rates in the region. With spreads above 700bp, we see scope for spread narrowing, particularly in the Chinese property sector **(Fig. 10)**. As noted in the November 2018 Asia Strategist, we see a cyclical rebound in China taking place. If US/China trade wars ease and Chinese policy makers continue to support the economy, this could bode well for risk assets and the property sector more broadly

Figure 9. UK HY bond spreads are wide to US and Europe



Source: Bloomberg Barclays Indices as of December 11, 2019

Figure 10. China HY may benefit from policy easing

Source: Bloomberg Barclays Indices, JP Morgan as of December 11, 2019

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