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ASSET MANAGEMENT

# High Yield Credit in Crisis: What's next for corporate bond markets?

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Junk bonds roared into the headlines this week, with talk of fund liquidations and suspended redemptions triggering a panic selloff on Friday and Monday that rocked global risk markets. Many are wondering if this is a sign of things to come as the Fed looks set to raise rates for the first time in almost a decade on Wednesday.

US High Yield markets are on track for their worst year since 2008, when index returns were in the region of -17%. If the year finished today, investors look set for 2015 returns in the region of -6%, with most of that loss coming in the last six weeks and in particular the last few days. In between, from 2009-2014, investors enjoyed average annual returns of almost 11%, for a compound return over those 6 years of 86%. So for those willing to tolerate a negative year every now and then, high yield bonds can offer attractive returns.

However, there is good reason to be cautious about High Yield markets in the next few years. Default rates have remained persistently low as zero-interest rate policies (ZIRP) around the world have driven fixed income yields to historic lows. The ongoing search for yield has led to tighter spreads and weaker covenants (contractual obligations on the part of the issuer designed to protect bond investors). Now as rates begin to normalize and the economic cycle shows signs of maturing, lending standards are being tightened. It is reasonable to expect a rise in default rates, particularly from the energy and mining sectors which have been hit hard by an extended period of low commodity prices.

High Yield investors are compensated via coupons for a number of financial risks, of which default risk (the risk a borrower

becomes insolvent and is unable to repay) is just one. Other risks include liquidity (the risk an investor would not be able to sell bonds at a reasonable price if they wanted to), and negative convexity (the risk that the borrower can redeem early if the bond value goes up, or extend if the bond value starts to fall.)

The total compensation for these risks is typically measured as the *Excess Spread* over a comparable portfolio of 'risk free' government bonds. The Excess Spread for High Yield bonds in both Canada and the US has been widening steadily in the second half of 2015, from roughly 500bp in May to over 700bp in December. As investors demand a wider spread for High Yield, bond prices fall, causing valuation losses in most portfolios.

So at 700bp are investors being adequately compensated? It all depends on your view of whether default rates will rise materially in 2016, and whether there is adequate liquidity in the market. The "run" on high yield which led to a 5% drop in recent weeks is primarily a concern over the latter, as lower prices lead to investor redemptions which lead to forced liquidation which leads to lower prices, etc. It can become a vicious circle which can persist for a few weeks or months, as we saw in 2008 when US High Yield prices fell 35% between May and December, and again during the Greek debt crisis in 2011 when prices fell 11% between May and October. Investors have to be prepared to weather these periods of dislocation if they want to reap the long term rewards of High Yield.

My view is that the compensation at these levels is reasonable, since I expect default rates to rise in 2016 but not to extreme levels (High Yield default rates historically fall to 2% during periods of expansion and peak near 10% during downturns). I would expect to see default rates to rise from 2% currently to around 4% in 2016, with most defaults coming from the commodities sector. The liquidation issues we have seen in the headlines this week have actually been fairly isolated; **Third Avenue** was known to have a concentrated portfolio of distressed debt. When the market realized the fund was facing forced liquidation, the bids for its holdings evaporated which led to the suspension of redemptions. The other name in the press, **Lucidus**, was able to liquidate *before* announcing its closure to the market; hence there should be no lingering concerns about selling pressure. No doubt there will be other Third Avenues in the months to come, but I do not expect it to

become systemic. Once "fast money" is out of the way and selling pressure abates, I would expect a rebound in prices sometime early in 2016. However, that does not mean returns will be exceptional for high yield, and I could envisage low-to-mid single digit returns for the year.

As the US Federal Reserve withdraws stimulus from the markets and allows interest rates to drift higher over the next few years, it is reasonable to expect that liquidity-runs and periods of negative returns may become more frequent. And as the press has rightly pointed out, price swings can become more violent, as the overall market size has grown tremendously relative to the risk tolerance of traditional market makers; the trading desks at investment banks. When everyone wants to sell, these dealers just don't have the capacity to buy the way they did a decade ago.

Which begs the question, do you *need* to take that kind of risk to generate reasonable returns in your portfolio? *Volatility*, the measure of price risk in different asset classes, historically runs at about 7% for High Yield, compared to 12% for equities. Another asset class to consider is Investment Grade credit. Here, volatility is typically 2%; liquidity is much better than in High Yield, and default rates typically remain below 1% throughout the economic cycle. Investment Grade fund managers have been able to generate consistent returns in recent years without the drama of stocks or junk bonds. Despite widening spreads, Canadian investment grade funds such as our Lawrence Park Credit Strategies fund look set to deliver positive returns in the region of 3-4% in 2015, while domestic stocks and high yield bond returns will be negative. And like High Yield, the excess spread of the investment grade sector has improved in recent months, which offers potential

for higher returns in 2016. Is it any wonder then that institutional investors such as pension funds and insurance companies devote a significant component of their portfolios to Investment Grade credit, while High Yield tends to be primarily owned by individual investors?

As ever, it comes down to your tolerance for risk.

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