INSIGHTS

MIRABAUD ASSET MANAGEMENT

If the UK were a high yield bond, how would it rank?

EXPLORING OPPORTUNITIES IN GLOBAL HIGH YIELD

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WHEN WE ANALYSE HIGH YIELD CREDITS, ONE OF THE FIRST QUESTIONS WE ASK OURSELVES IS: ARE MANAGEMENT INTERESTS ALIGNED WITH BONDHOLDERS, OR SHAREHOLDERS?

Government chaos would send it sliding down the ratings spectrum, but fortunately, prospects across the real credit landscape are more interesting.

If the UK were a corporate bond, with the government representing the management team, it would be trading significantly wide to ratings peers due to considerable concern regarding governance and strategic direction.

When we analyse high yield credits, one of the first questions we ask ourselves is: are management interests aligned with bondholders, or shareholders? Indeed, when looking at any credit, you want to see consistency of management and for your interests to be aligned.

Given the current UK government is so new, with a rotating cast of prime ministers and chancellors (at the time of writing, we're at a count of two and four respectively so far this year), we can't take a 30-year, five year, or even one year view on how it's going to act and what impact it's decisions will have on the credit quality of the country.

The government have also tried to focus on short-term priorities – helping people through the winter and getting ready for the next election – but the market has pushed back to try and force some responsible long-term planning to take place.

Turning to the real high yield credit landscape, sentiment on the economic outlook is very bearish, but valuations may have already moved sufficiently to compensate for the slowdown to come. Investors are concerned that spreads haven't moved to price in a full recessionary scenario, but a key thing to remember about high yield it's that it's a 'yield' asset class – it's made up of rate and spread.

Today, we have a yield of 9.81% on the ICE BAML Global High Yield Index (USD Hedged as at 19 October). Aside from during the global financial crisis, the index has only spent a handful of days in 10%+ territory.

So, do we think the market is going to sell off and stay above 10% for a significant period? I'd say no, this seems unlikely. If we do move into a recessionary environment, spreads will rise, but these will be offset by falling government rates, and you'll be collecting a healthy coupon.

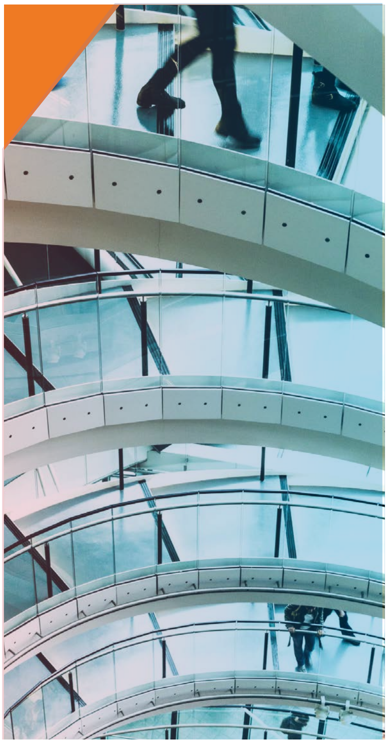
While we're facing a lot of uncertainty and it's impossible to predict what the remainder of 2022 will deliver, excluding a financial crisis-style event, high yield bonds offer strong positive return potential, with the range of returns skewed to the upside.

WHAT ABOUT DEFAULT RISK?

Given spiking volatility and geopolitical shocks seem to have become the macro norm, one doesn't require too vivid an imagination to think that we could see a rise in default rates. If we do, the context to remember is that any rise would be from today's ultra-low level of less than 1%.

Given we've had such easy refinancing markets, there's potential for default rates to climb to 2–2.5% over the next 12 months. Or if we were to enter a recessionary cycle, then the figure might be closer to 5%. But what we're not seeing this time versus prior years where defaults increased are the associated concentrations within the asset class.

For defaults to spike, you need one dominant sector to experience a crisis. For example, in 2015, the oil market imploded with oil going to USD20 a barrel and high yield energy names, which made up 14.8% of the universe, hit a default rate of 20%. Today, oil is USD90 a barrel and energy is a lesser 13.7% of the universe.



Similarly, during the 2000 tech crisis, 35% of the index was telecoms companies.

Today, you could potentially point to US homebuilders as being vulnerable, but they make up less than 2% of the index. Chemicals are also struggling but are less than 1% of the index. We're not seeing any one sector currently dominating the universe that looks vulnerable to a blow up.

Rigorous credit analysis and considered portfolio construction also have a part to play in managing the default landscape.

Our top-down methodology typically takes challenged sectors out of our investment universe. Given we follow an unconstrained approach, we find it best to identify good companies in good sectors, rather than searching for the one or two names that might outperform in a bad sector.

Overall, sentiment for risk assets is very negative right now, but a lot of those negative outcomes are priced in. We are closer to the end of tightening cycle than to the beginning. We acknowledge the downside risks, so are taking an "up in quality" approach to investing right now – focusing on the US over Europe, as we believe the economic slowdown in the US will be milder without the European gas crisis, and a preference for BB credit over the more economically sensitive CCC ratings band.

WE ACKNOWLEDGE THE DOWNSIDE RISKS, SO ARE TAKING AN "UP IN QUALITY" APPROACH TO INVESTING RIGHT NOW – FOCUSING ON THE US OVER EUROPE.

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