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Thematic Report

High Yield Bonds – The Rise of the Fallen

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Introduction

The global high yield bond markets have witnessed significant growth and diversification over the last few years aided by the extraordinary monetary policy accommodation provided by central banks across the world. The unprecedented liquidity made available at record low yields has thus led to a significant pick up in both primary market and secondary market activity in the asset class. Banking disintermediation in Europe and regulatory changes in the financial sector further contributed to the deepening and diversification of the high yield bond markets even as emerging market issuances entered the fray.

From a risk-reward perspective, the improving macro-economic situation and robust credit fundamentals have led to significantly low default rates and tightening credit spreads. While concerns have been raised around stretched valuations, weakening lending standards and the possibility of a disorderly adjustment to tightening monetary policy in the US, they have been largely shrugged off. The frothy bull market, however, has been witnessing flashes of volatility, visible during the sell-offs, first in response to the initial proposal of tapering under Ben Bernanke in 2013, then to the negative news flow and rising geopolitical tensions in August 2014, and more recently in response to the risk-off mode adopted by the market following the significant decline in crude oil prices and slowing growth outside the US, particularly in Europe and China.

While the overall outlook for the market remains sanguine at this juncture, volatility in the market has stepped up amid rising challenges.

New bond issuances are expected to remain high in the range of US$260 billion to US$340 billion, in line with the last two years. US HY issuances were up 24% y/y to US$48.5 billion in YTD Feb. 2015. Returns however, are projected to trend down from a high of 16% in 2012 to a more modest low-to-mid single digit levels in 2015.

The yield (YTW) on the S&P U.S. Issued High Yield Corporate Bond Index have tightened moderately to around 6% levels over the YTD March 2015 period after widening to around 6.8% in December 2014 from a historic low of 4.9% in June 2014. The widening was largely in response to declining crude oil prices and a shift in investor sentiment to risk-off mode. This has since been partially offset by the start of the €60bn per month QE program in Europe even as economic data in the US is expected to be mixed in the near term.

Both the Fed and the markets remain skeptical around the strength of the US recovery as its largest trading partners slow down and oil prices plunge to almost five year lows. The European economy has been stagnating with deflationary pressures, China continues to cool down – dragging down broader commodity prices with it, and the risk of systemic shocks has stepped-up in the Eurozone with the re-entry of the Grexit scenario. While declining oil prices are expected to significantly benefit oil consuming countries, a possible weakening of demand in the wider economy as an additional driver of oil price declines beyond the supply glut, cannot be ignored and is indeed being feared. Three months into the year, 10-year US Treasury yields remain tight at 1.9% in March 2015 compared to around 2.2% in late December 2014 and against consensus estimates that had projected an increase in 10-year US Treasury yields to 3.0% by end-2015.

The more than 50% fall in crude oil prices to five-year lows of around US$50 per barrel may lead to a rising level of defaults in the US energy sector over the next few years. Default rates in the energy sector credits are expected to increase to around 30% after 2015 if oil prices remain stranded at US$60–65 per barrel over the next three years. A spill-over effect on the non-energy sector may result in rising default rates across the high yield market. This is expected to be a largely US phenomenon, given that energy is the largest sector in the US high yield corporate bond market, with roughly 16% weight in the BofA Merrill Lynch High Yield bond Index, while issuances have been negligible in comparison in Europe.

Liquidity concerns have increased with changing regulatory environment, rising capital requirements and declining risk appetite leading to decreasing bond inventories at both banks and other dealers even as corporate bond issuances are at an all-time high. The market's ability to thus absorb a large sell-off in the event of rising interest rates or other financial or political shocks is a cause for concern.

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Primary market issuances in the US and Europe to **remain strong in 2015**

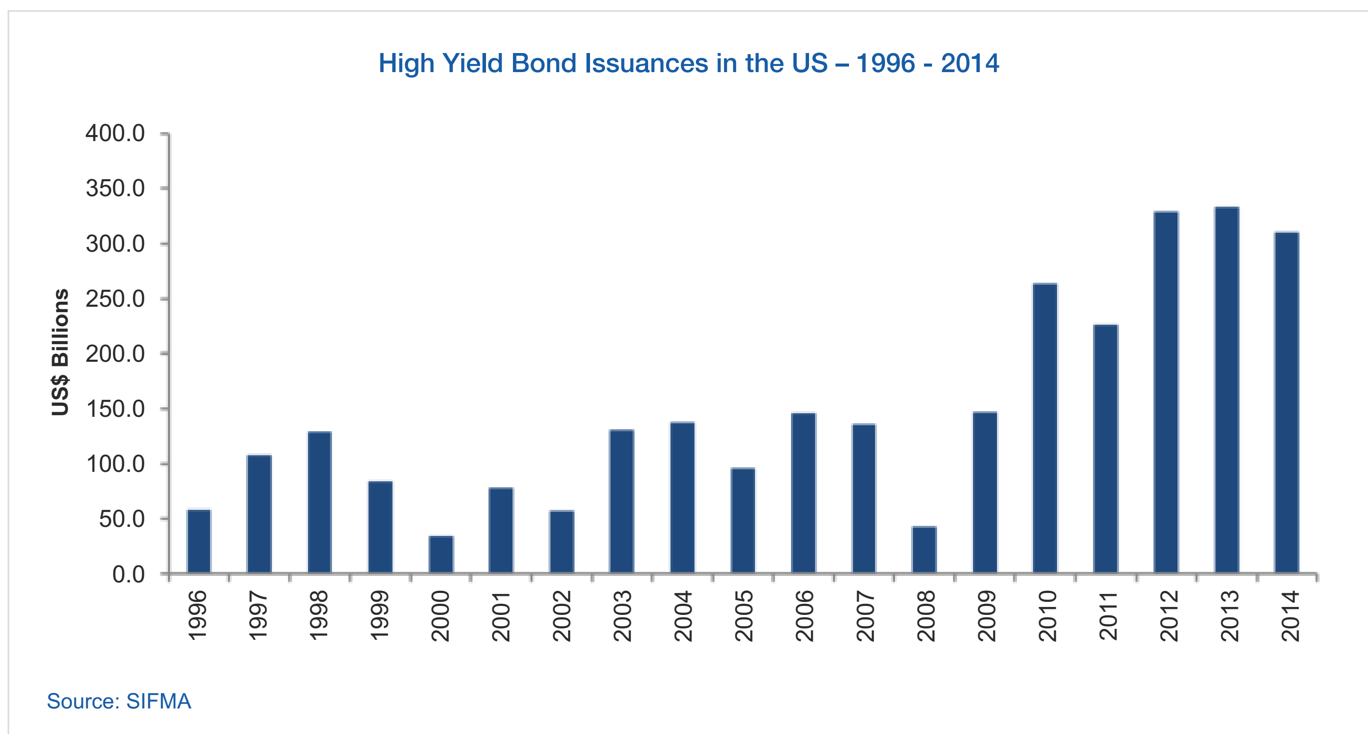
Outlook for the US high yield bond market has remained unfazed in the face of the recent sell-off in the US high yield bond market, widening spreads toward the end of the year, and an increase in volatility.

New issue volumes in the US high yield corporate bond market to remain high.

According to S&P Capital IQ, banks active in the US credit market forecast new issue volumes in the US high yield corporate bond market to remain high in the range of US$260–340 billion in 2015. The wide range of projection, particularly the lower end, reflects the anticipated weakness in energy sector issuances going forward in addition to rising interest rate risks. The energy sector in particular has been one of the largest issuers in the US high yield bond market since 2005. It has grown progressively to account for 18% of the outstanding corporate high yield bond market in 2014 vis-à-vis just 8% in 2005.

The new issue momentum in the corporate HY bond markets has been strong over the last few years, with new corporate high yield bond issuances more than doubling to US$329 billion in 2012 from the pre-crisis issuance level of US$136 billion in 2007. New issue volumes have since remained high, reaching its peak of US$334.1 billion in 2013 and US$311 billion in 2014. Year-to-date issuances in February 2015 were up 24% y-o-y to US$48.5bn vs. US$39.1bn in YTD February 2014.

Europe, which has been historically funded by bank loans, also witnessed a significant surge in high yield bond issuances on account of rising bank disintermediation in the region. Issuances in the European corporate high yield bond market have been growing over the last few years. They increased from €29bn in 2011 to €55bn in 2013, and are expected to be around €65bn in 2014 and €63bn in 2015. The outlook for primary high yield issuances in Europe is underpinned by expectations of continuing monetary policy accommodation by the ECB and projected debt maturities of US$649 billion between H2 2014 and 2019 (according to S&P estimates).



Source: SIFMA

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Extraordinary **liquidity from central banks** have propped up the credit markets

The strong new issue momentum in recent times can be safely ascribed to the extraordinarily accommodative monetary policy adopted by central banks across the world that flooded the market with cheap liquidity and drove long-term and short-term rates to all-time lows. This abundance of cheap liquidity whetted the risk appetite of investors and helped override concerns around credit quality despite weak macro-economic growth and struggling corporate earnings.

Credit markets were further supported by the concerted ECB action in Europe, and the Federal Reserve's 'QE' program in the US, which together, helped the markets safely navigate the European sovereign-debt/banking crisis in the Eurozone, the US government shutdown on reaching the debt ceiling, and the threat of sequestration resulting from the Congressional deadlock around deficit reduction that had threatened recovery in the US.

The high yield markets thus opened up to several new issuers from diverse sectors with even the relatively lower rated issuers within the high yield universe gaining access to the market.

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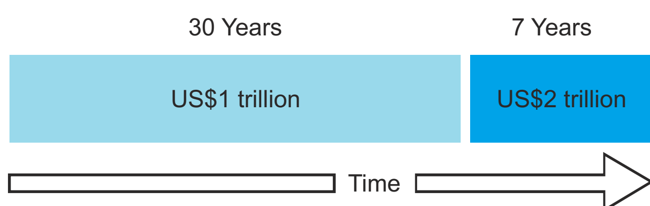
High yield markets have deepened with **global diversification**

At the macro level, the current momentum is reflective of both the expansion of the global high yield markets and its geographical diversification. To put it in perspective, while the global high yield market took almost three decades to grow to a size of US$1 trillion, it took just seven years to grow to the current size of almost US$2 trillion.

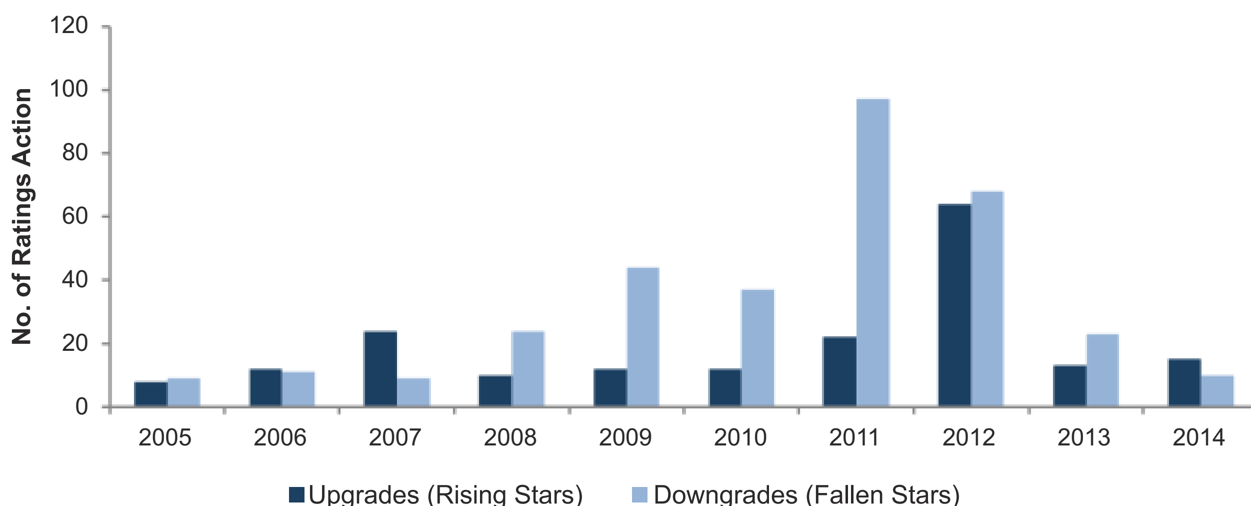


According to Markit, about US$1.037 trillion were invested in the high yield market between January 2009 and March 2013 alone, reflecting the momentum in the recent years. The absolute growth in value has been further accompanied by geographical expansion, with increasing penetration of high yield bonds in the bank loan dominated market of Europe and the emerging markets.

The high yield market originated in the US in the 1970s and even by the end of 1999, less than 1% of the high yield corporate bonds were issued outside the US. This however, is changing and according to Alliance Bernstein, Europe's share in the high yield bond market has now increased to 18%. The US, however, still accounts for almost 75% of the global high yield market, with the remaining 7% made up of emerging market issuances.

One of the major contributors to growth in the European high yield bond market was the rising number of downgrades into the junk rated category, which added new issuers to the high yield bond markets. Between 2008 and 2014, Moody's downgraded almost 303 issuers to junk category while elevating just 148 issuers to the investment grade category over the same period. Furthermore, as the sovereign crisis deepened into a banking crisis, particularly in Europe, banks cut lending and the resulting disintermediation led several issuers to refinance their bank debt in the high yield bond markets.

Moody's – No. of Downgrades (Fallen Angels) vs. No. of Upgrades (Rising Stars) in Western Europe



Source: SIFMA

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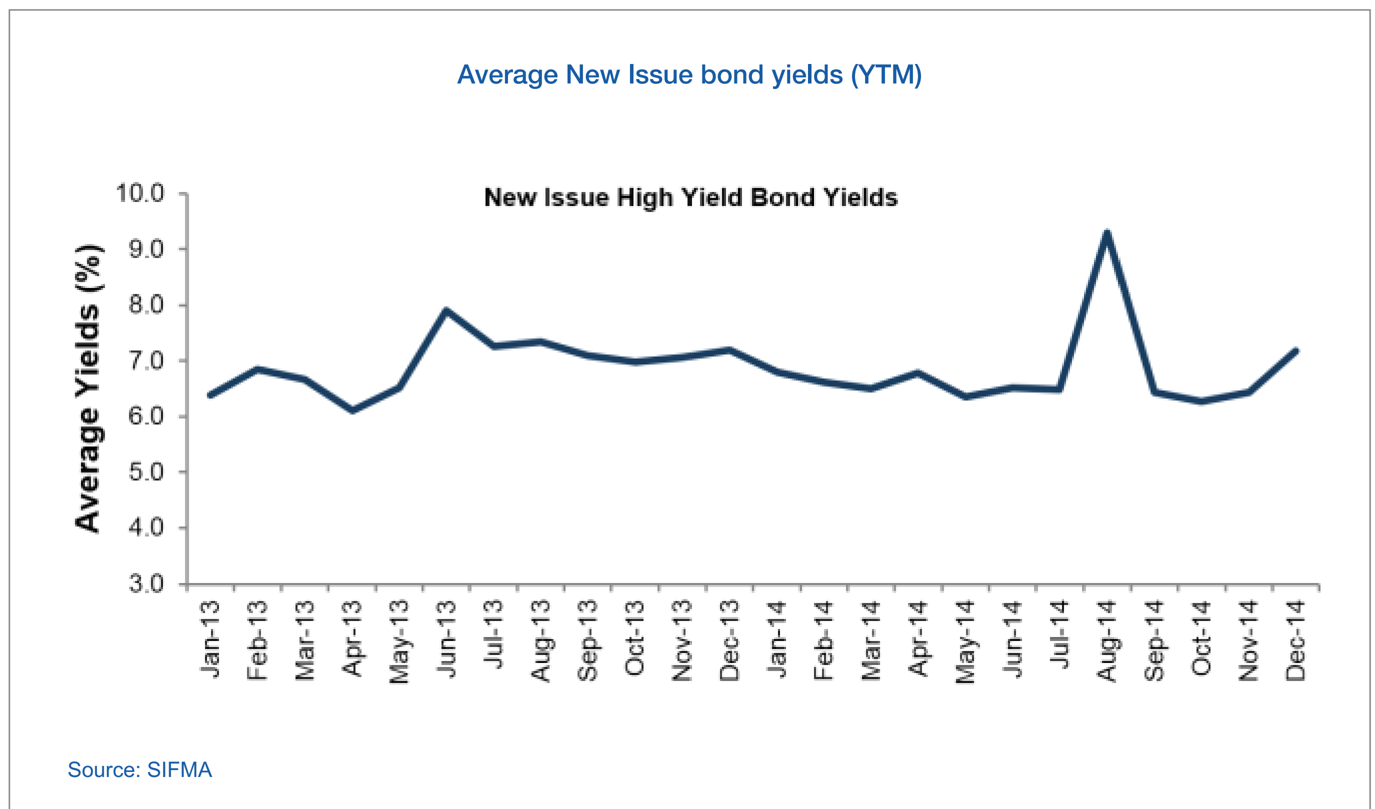
In addition to the downgrades and the banking disintermediation, growth in high yield issuances were further driven by the growing need for Basel–III compliant capital instruments by the financial sector across the US and Europe that led to a large number of deeply subordinated bond/junior debt issuances by financial institutions. According to Alliance Bernstein, the European high yield index currently has a financial sector allocation of 22.8% up tenfold from 10 years ago. In the US, financial sector issuances currently account for 10% of the US high yield indices.

Average New Issue bond yields (YTM)



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Market euphoria giving way to **weaker lending standards**

While the primary and secondary high yield markets have been euphoric, lending standards have suffered, with investors willing to accept more aggressive terms and weaker covenant protection offered by issuers. Issuers have been testing the markets with riskier structures and aggressive terms that have involved cov-lite bonds, shorter non-call periods, a special call structure that allows repurchase of up to 10% of the original issue amount annually at 103%, and the return of the PIK-toggle notes.

Issuers have been testing the markets with riskier structures and aggressive terms.

Shorter call structures...

The short call structure that includes a non-call period of around 3 years on a 7-8 year term with higher-than-usual call premiums was virtually non-existent as early as 3 years back, but has been more or less accepted by the market. The 103 special call structure however, has been extremely unpopular and investors have pushed back hard on this prepayment covenant.

According to covenant research firm Covenant Review LLC, Blackrock and Wall Street Journal, the provision, which was standard in leverage loan documents, was initially included in secured bond deals in 2009 when the loan market collapsed but was then written-in on unsecured deals toward the end of 2010 like in the HealthSouth Corp and Interface Inc. deals. The provision was actually utilized in some cases, for example, in April 2012, Seally Mattress exercised the special call on its 10.875% Notes due 2016 within 3 years of its issuance in May 2009. LyondellBasell's exercised the special call option within a year of its bond sale in April 2010, causing a loss of US$20 million or 7% of the market value of the bonds redeemed to its investors.

Although prepayment is typically at 103% of par, there have been instances where issuers paid a higher price on the special-call, like the CEVA deal, which paid 105% on par in Jan 2012 and the Saratoga Resources, which paid 106.25% in 2011 in consideration of their investors. These deals have, for obvious reasons, faced significant resistance and investors have been pushing back against the provision wherein some issuers like American Greetings and Yonkers Raceway have had to drop the special-call structure from its offering at the marketing stage. There also have been cases where deals have been scrapped altogether over disagreements on the special call option.

Revival of PIK-toggle notes...

The PIK-toggle notes that allow the issuer to pay interest by issuing new bonds rather than paying in cash however, have witnessed a revival of sorts, with new issuances worth more than US$10 billion finding their way to the market in 2013, almost at par with the 2008 level of US$13.4 billion and compared to US$20 billion in 2007.

The momentum remained strong in 2014, with new PIK issuances touching US$4 billion by the end of June 2014. PIK-toggle notes were once popularly used to fund some of the biggest LBOs like Harrah's and Energy Future Holdings during the buyout boom years of 2005 to 2008 before the crisis. According to Moody's however, almost one-third of the PIK issuers that had borrowed before the crisis were in default between 2008 and mid-2013 period. While the LBOs have not come back with the same vengeance, most of the PIK-toggle notes issued in 2013 are said to have been issued at the holding company levels to fund shareholder returns.

Weaker covenant packages...

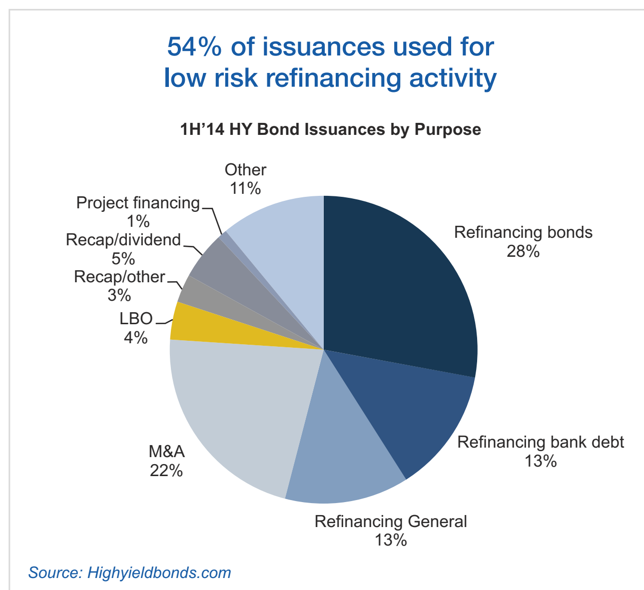
The concessions did not end there and issuers have been able to push through weak covenant packages along with liberal redemption structures. Covenant protection across the US high yield market has thus been declining with the Moody's average score on covenant protection in the US hovering in excess of 4 so far in 2014 on a scale of 1 to 5, where 1 indicates the strongest level of investor protection and 5 the weakest. More than 19% of the issuances in Q1 2014 were high yield lite according to Moody's estimates, almost three times more than similar issuances in 2011.

High yield lite bonds do not have debt incurrence or restricted payment covenants exposing bondholders to significant losses in case of defaults. While the more favorable terms of the issuers in an exuberant market are not without precedent, what is indeed worrying is the fact that investors have been willing to take on a similar or higher level of risk for much lower compensation.

Default rates at an all-time low on strong technicals and improving credit fundamentals

The deepening and diversification of the high yield bond markets were further supported by the search for yield amid near zero interest rates and narrowing investment grade spreads against the US Treasury/ German bunds. While the technical support was solid, the credit risk profiles of issuers also improved with the strengthening of the economy, rising corporate earnings, low yields and increased market access to junk-rated issuers. This in turn contributed to stronger, well-funded balance sheets with well spread debt maturities lowering refinancing risk and consequently default rates.

The de-risking of balance sheets continued well into 2014, with 54% of the HY bond issuances in the US in H1 2014 used for low risk refinancing purposes (2013: 56%; 2012: 61%). All these have thus led to a significant decline in default rates in the global high yield markets, reinforcing the investment rationale in favor of the asset class.

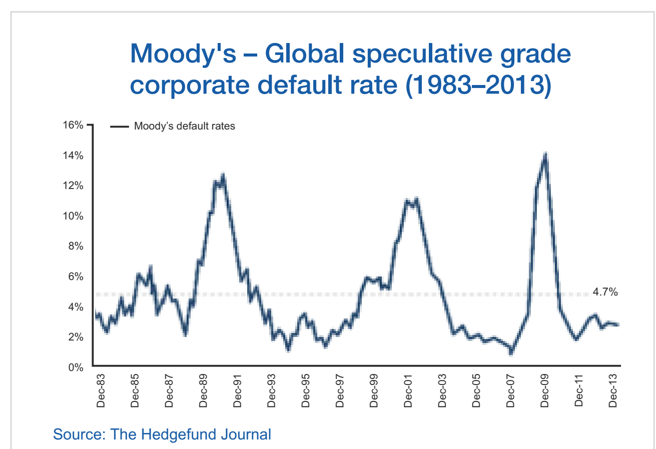


54% of issuances used for low risk refinancing activity

Source: Highyieldbonds.com

Refinancing activity however, is expected to trend down with M&A related financing expected to emerge as the new growth driver for primary market issuances. This was evident in the second half of 2014 when the proportion of refinancing related issuances declined from 54% in H1 2014 to just 38% in H2 2014 while M&A related financing increased from 27% in H1 2014 to 43% in the second half of the year. This is expected to continue into 2015, with M&A related transactions emerging as the key growth driver in primary market issuances.

According to Moody's, the trailing 12-month global speculative-grade default rate was at a low of 2.2% in November 2014 compared to the long term historical average rate of 4.7% since 1983. The global speculative grade default rate had increased to a high of 12.9% in November 2009 at the height of the credit crisis, surpassing its previous peak of 12.2% recorded in 1991. The default rate in both the US and European high yield markets stood at 1.8% each in August 2014 compared with 2.8% in the US and 4% in Europe a year ago. Moody's currently expects the global speculative-grade default rates to be around 2.3% toward the end of 2014 and increase moderately to 2.7% in 2015.



Moody's – Global speculative grade corporate default rate (1983–2013)

Source: The Hedgefund Journal

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Persistent drop in oil prices may result in a **wave of defaults in the energy sector**

The outlook for US high yield default rates may deteriorate with the distress in energy sector bonds that have been hit by the more than 50% drop in crude oil prices since June 2014 to 5-year lows of around US$47 per barrel in early January 2015. The fall in oil prices have thus raised the specter of a significant increase in default rates over the next three years with both JP Morgan and Deutsche Bank indicating that default rates in the energy sector could climb to around 25–30% if oil prices remained stranded at US$60–65 per barrel over the forecast period.

Default rates are likely to pick up from 2016 onwards as hedges roll-off.

While hedged exposures may avert defaults in 2015, default rates are likely to pick up from 2016 onwards as hedges roll-off.

The estimates for rising default rates may not be too far-fetched given that almost 30% of the total distressed bonds, with spreads of over 1000bps, in the Bank of America Merrill Lynch High Yield Index are made up of energy bonds and with expected default rates of almost 33% according to Martin Fridson, CIO of Lehmann Livian Fridson Advisors LLC and Capital IQ. This alone may push the market-implied default rate for the energy sector to 4.6% compared with just 1.8% for the non-energy sector and 2.6% for the overall US high yield bond market in 2015, in line with S&P and Moody's estimates of around 2.7 – 2.8% for 2015. Default rates may however, increase to around 4.5% in 2016, coinciding with falling hedges and rising oil & gas defaults.

This disproportionate influence of declining crude prices on US high yield bond markets reflects the status of the energy sector as the largest issuer of high yield debt in the US high yield bond market since 2005. The energy sector accounted for c.18% of total high yield bonds outstanding in December 2014 compared with just 8% in 2005, according to JP Morgan estimates. In comparison, the oil & gas sector related issuances in Europe were less than 1.5% of this year's new issue volumes in Europe. Furthermore, while the Bank of America Merrill Lynch US High Yield Energy index accounted for c.16% of the Bank of America Merrill Lynch High Yield Index, the energy sector accounted for just 0.6% of the Bank of America Merrill Lynch European High Yield Index emphasizing the significance of the oil & gas sector in the US high yield bond market. Not all sub-sectors, however, have been equally impacted, and the negative performance has been most pronounced in the Exploration & Production and Oil Field Equipment sub-sectors.

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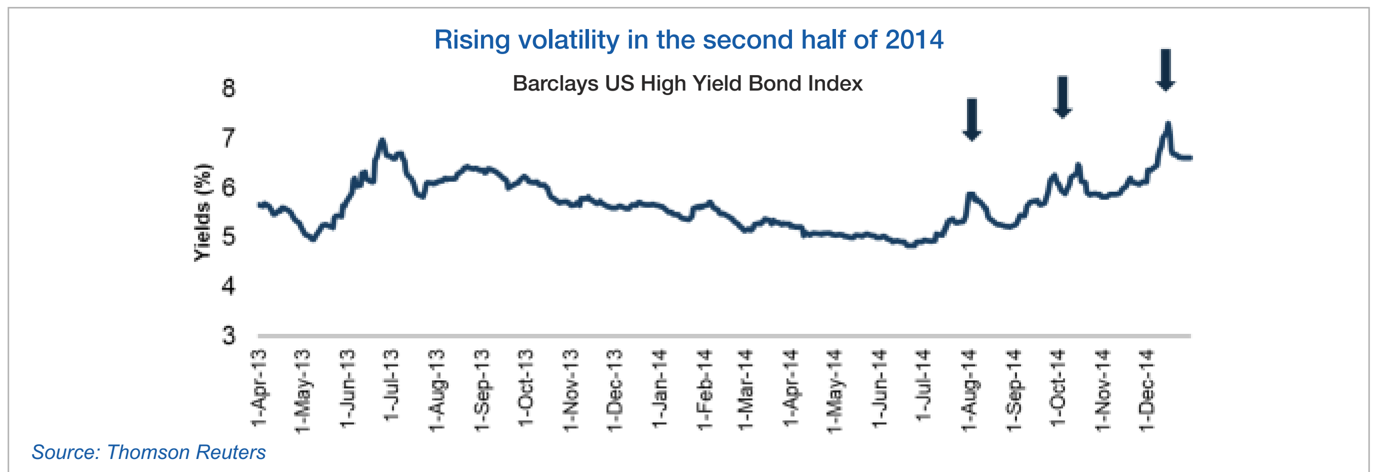
High yield bond investors remain **vulnerable to volatility**



Source: Thomson Reuters

The more than 50% decline in WTI crude prices to around US$60 per barrel in December 2014 and to below US$50 per barrel in January 2015, the lowest since 2009, has thus somewhat muddied the outlook for US high yield credit in 2015. The negative impact was clearly visible as energy sector spreads widened to more than 800bps contributing to the rising volatility in credit markets during Q4 2014.

The second round of sell-off in December 2014 led to an increase in the yields (YTW) of the S&P U.S. Issued High Yield Corporate Bond Index to a peak of 7.13% on December 16, 2014 although yields have since retraced their steps back to levels of around 6% in March 2015. This volatility was also in evidence in August 2014, when the market sold-off and yields (YTW) spiked to around 5.9% from a low 4.8% in late June 2014 driven by the:

- Intensifying geopolitical tensions in Ukraine and the Middle East,
- Concerns around a possible default in Argentina and Portuguese bank - Banco Espirito and
- Fed comments around stretched valuations in the high yield bond markets.

While the negative impact of declining crude oil prices are clearly evident, the overall global-risk off theme also contributed to the widening of spreads. The recent bout of risk averseness stemmed from the prolonged stagnation of the European economy amid continuing deflationary pressures, the rising systemic risk perception with the re-entry of the Grexit scenario and the tense geopolitical situation in Central Europe with Russia in crisis. Furthermore, the slowdown in China and the accompanying decline in a wide range of commodity prices also had a negative impact. All these developments, along with declining oil prices, thus raised doubts around the strength and sustainability of the recovery in the US.

Investors in search of safe haven assets.

Investors thus flocked to US, German and Japanese government bonds in search of safe haven assets. The 10-year US Treasury yields tightened to 1.97% on January 7, 2015, despite the Fed guidance indicating a gradual increase in interest rates in 2015. The widely anticipated sell-off in treasuries that was expected since early 2014 did not materialize and the recent rally continues to indicate that the market lacks conviction on the strength of the recovery and is thus expecting a more dovish stance on monetary policy by the Fed. Furthermore, the modest inflation outlook that continues to under shoot the 2% target, mixed economic data and slowing growth in the US do accord the Fed, both reason and headroom, to be more patient. Goldman Sachs strategists have since cut their 10-year treasury yield forecast to 2.5% by the end of 2015e versus consensus estimates of 3.01% in early January 2015, acknowledging the progressive slowdown in US growth from 5% in 3Q 2014 to 2.2% in 4Q 2014 and 1.8% - 2.0% in Q1 2015e. The impact on the high yield market however, has been largely muted with the start of €60bn per month quantitative easing program in Europe, ongoing QE in Japan and market speculation around additional monetary easing expected from China.

While the markets remain rational, the market sell-offs in response to:

- The possibility of tapering in 2013.
- The recent negative news flows in August 2014.
- Declining oil prices through H2 2014.
- The re-emergence of political and macroeconomic turmoil in Europe give away the inherent volatility of high yield bonds and the consequent vulnerability of its investors.

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Liquidity concerns emerging with rising outstanding bonds and declining dealer inventory

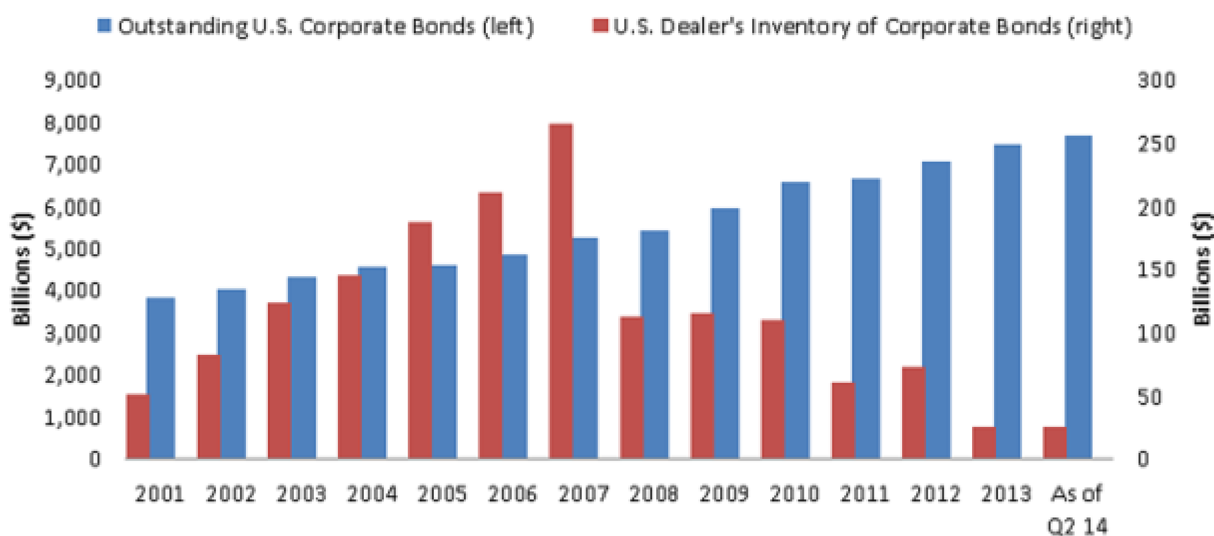
The ability of ETFs (Exchange Traded Funds) to liquidate their high yield positions during the sell-off in August 2014 indicated that liquidity was robust and investors had actually used the 'correction' in the yields to enter or expand their positions.

Emergence of a new regulatory framework with increasing capital requirement rules has, however, led to declining risk appetite amongst both banks and dealers to hold bond inventories. Therefore, while corporate bond issuances and inflow into high yield retail ETFs are at an all-time high, the level of bond inventories held by dealers and banks has been declining.

> The market's ability to absorb a major sell-off is a matter of concern.

Given the scenario, the market's ability to absorb a major sell-off is thus becoming a key issue of concern. Furthermore, the possibility of a potential liquidity disruption in case of a sell-off may also magnify the price sensitivity of bonds, resulting in sharper-than-expected decline in bond prices.

Outstanding corporate debt increasing while inventory declines



Source: Federal Reserve Bank of New York. Primary Dealer Statistics, Net Positions in Corporate Bonds and SIFMA. Annual data as of Q2 2014

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Conclusion

The high yield bond market continues to offer an attractive risk reward return proposition in the current scenario even as current yields of around 6–6.8% on average are significantly lower than the 8–10% yields on offer during late 2011. Moreover, the recent sell-off that started in July–August 2014 has provided discerning investors an attractive opportunity to re-enter the high yield markets.

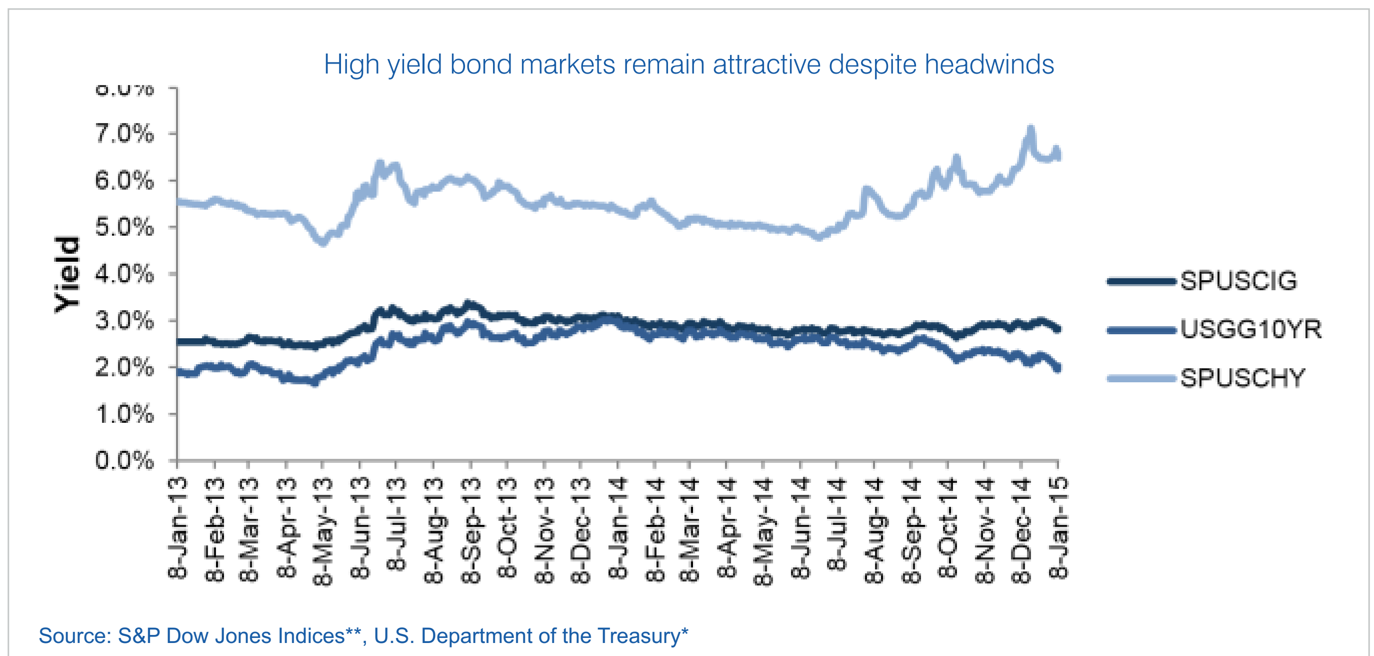
From an issuer's perspective, low yields will continue to make it attractive for issuers to refinance opportunistically. While refinancing has been one of the key drivers of primary market issuances in 2013 and the first half of 2014, deal flow in 2015 is expected to be driven by M&A related financing.

Outlook for primary issuances is robust.

The outlook for primary issuances is robust with new issue deal flow expected to remain at 2014 levels. With the market expecting the US Fed to start raising rates toward the end of 2015, new stimulus provided by the ECB and Bank of Japan will continue to provide technical support to the market. Default rates are expected to remain low and although that is reassuring, the recent slide in oil prices and the distress in the energy sector have raised fears related to contagion effects. Low inflation expectations are now giving way to disinflation and deflationary fears in the developed world, raising concerns around earning prospects of HY issuers as growth slows down.

The political turmoil in Greece is again giving wind to rising systemic risk issues in Europe and threating the existence of the Eurozone as it currently stands. The market is thus currently in risk-off mode with 10-year treasury yields at sub-2% levels.

The rising uncertainty and volatility in the market with declining liquidity cushion offered by market makers thus warrant greater stock selection and independent research by portfolio managers to avoid pockets of weakness in the high yield bond markets.



**SPUSCIG: S&P U.S. Issued Investment Grade Corporate Bond Index **SPUSCHY: S&P U.S. Issued High Yield Corporate Bond Index
*USGG10YR: US Generic Government 10-Year Yield

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