US Junk Bond Market 2020

The Issuance Frenzy and What Lies Ahead

The year 2020 kicked off with equity markets soaring and high yield (HY) spreads at historic tights. However, the coronavirus pandemic spread globally, sending out one of the strongest exogenous shock waves in history that threw financial markets in a turmoil. At the lowest levels in March, the Dow was down ~35% YTD, while the JPM HY index spread-to-worst almost doubled toward the end of the month compared to that at the beginning of the year. However, as governments and central banks lent strong support to financial markets, asset prices took off, touching new record highs by the end of 2020.

Efforts to address the pandemic around the globe, and especially in the US, were remarkable and swift. As part of the stimulus, the US Federal Reserve cut the Fed Funds Rate to nearly zero and bought unprecedented levels of corporate bonds. Consequently, spreads normalized, bond prices recovered, and yields decreased.

At the beginning of the second quarter, companies drew on revolvers and issued HY bonds to stock-up liquidity and be war-ready. Furthermore, near-zero rates gave speculative-grade issuers the opportunity to refinance existing debts and rationalize their debt maturity structures at relatively cheaper rates. By the first week of October 2020, HY bond issuance had exceeded USD345 billion, surpassing the previous record set in 2012. Fall in nominal rates and over-abundance of capital prompted investors to go on a hunting spree for risk-on trades. The proportion of CCC rated bonds of the total HY issuances grew in 4Q20 compared to the previous quarters, indicating increased risk appetite among investors as the pandemic progressed.

The implications of this debt frenzy are manifold. The most severe impact of the pandemic is concentrated in selected industries and sectors: transportation, travel and tourism, hospitality, and energy. These sectors led HY issuance in 2020. Lending to these sectors is based on the optimism that economic revival will be swift and consistent.

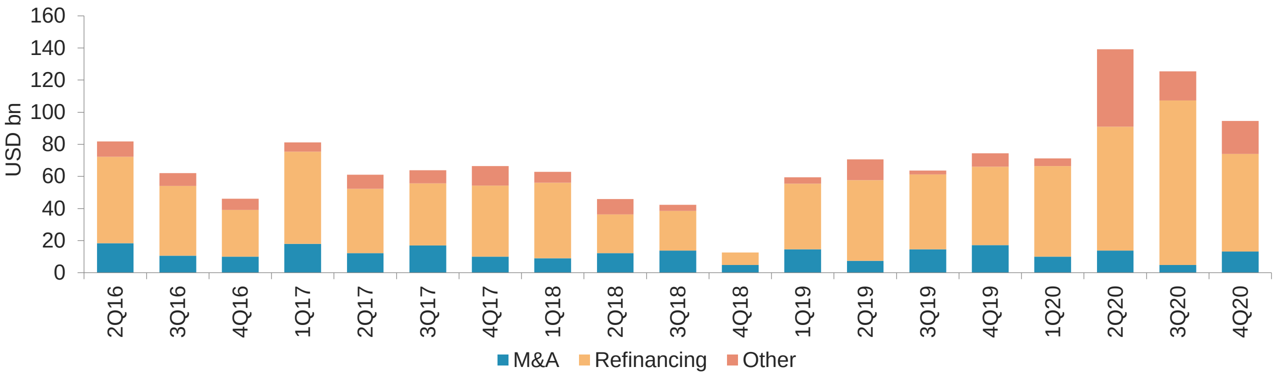
Another consideration is ballooning global debt. S&P predicts global debt to surge to USD200 trillion in 2020, implying global debt to GDP of 265%. It expects the ratio to moderate at around 150% toward 2023 as governments scale back stimulus and the balance sheets of companies recover gradually. The reduction in debt could lead to curtailment in revival efforts and have a bearing on growth.

The revival of operating performance and cash flows is critical for improvement in debt service capabilities of highly leveraged companies. We need to wait and watch what turn the pandemic takes; how effective are the measures against the new variants of the virus; what is the speed and effectiveness of the vaccination drive; and what will be the pace, robustness, sustainability, and distribution of growth across industries and geographies.

Record HY bond issuance in the US in 2020

Companies, hit by the lockdown, initially tapped the HY market to build cash reserves, extend maturities, and preserve liquidity. However, later, as the market started to stabilize and the economy began to recover, companies took advantage of low interest rates and refinanced outstanding shorter-term and variable-rate debt on better terms. Lower interest rate and investor appetite for riskier assets turned the market in favor of borrowers. Overall, refinance activity accounted for 68% of total HY issuance in 4Q20. The purpose of issues shifted from general corporate purposes and refinancing in 2Q20 to predominantly refinancing from the third quarter onwards (Exhibit 1).

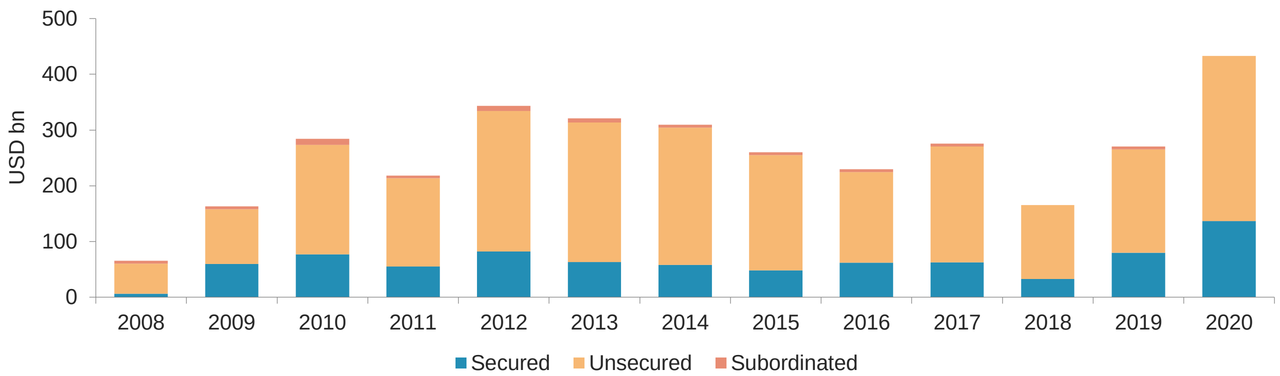
Exhibit 1. US HY Bond Volume – By Use of Proceeds



Data Through Dec. 18, 2020
Source: LCD - S&P Global Market Intelligence

Although unsecured bonds, in line with earlier trends, accounted for majority of issuances, secured bond papers gained traction in 2020. To lock lower borrowing cost for a longer period, companies avoided variable-rate leveraged loans and issued secured bonds to raise fund at fixed rate.

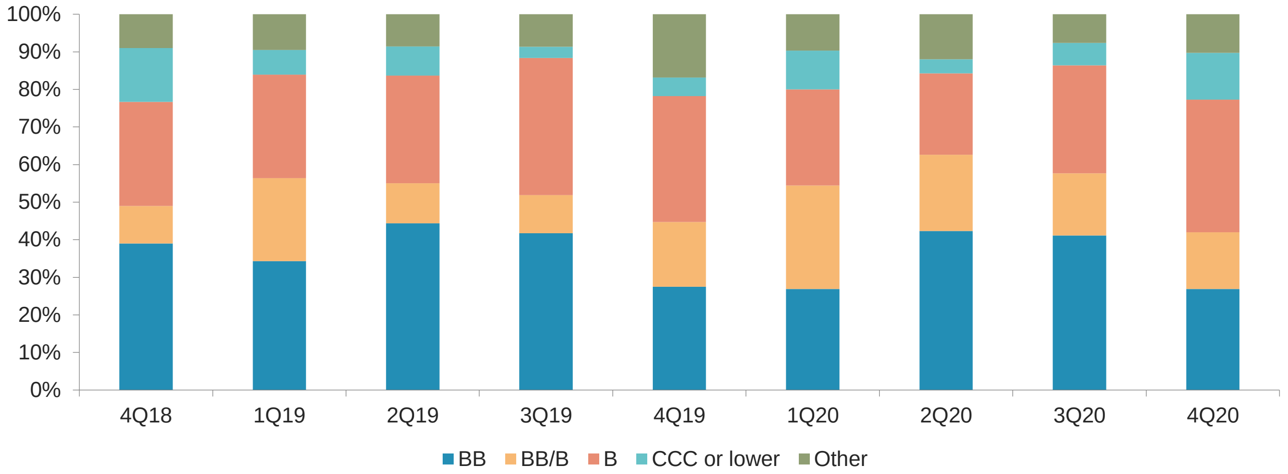
Exhibit 2. US HY Bond Volume – By Seniority Rankings



Data Through Dec. 18, 2020
Source: LCD - S&P Global Market Intelligence

The share of Double-Bs rated papers increased in 2Q20, following support provided by the central bank. The proportion of CCC or lower rated paper issuances increased to more than 12% of the total in 4Q20 from 4% in 2Q20, reflecting increased risk appetite among investors as the year progressed. Similarly, the proportion of Single-Bs increased significantly toward the end of the year compared to 2Q20 (Exhibit 3).

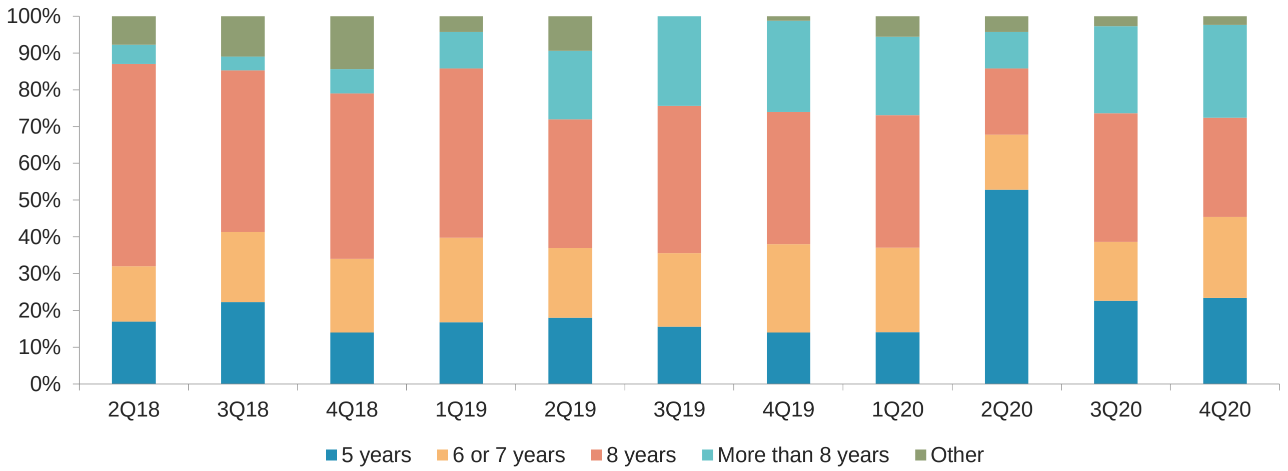
Exhibit 3. US HY Bond Volume – By Rating



Data Through Dec. 18, 2020
Source: LCD - S&P Global Market Intelligence

As credit spreads widened in 2Q20, issuers opted for bond papers with shorter tenure. However, bonds with tenure eight years and more re-emerged as the preferred choice once spreads started to narrow in 3Q and 4Q20. By deal count, these bonds accounted for ~53% of total HY issuance in 4Q20 (Exhibit 4).

Exhibit 4. US HY Bond Volume – By Maturity (based on count)

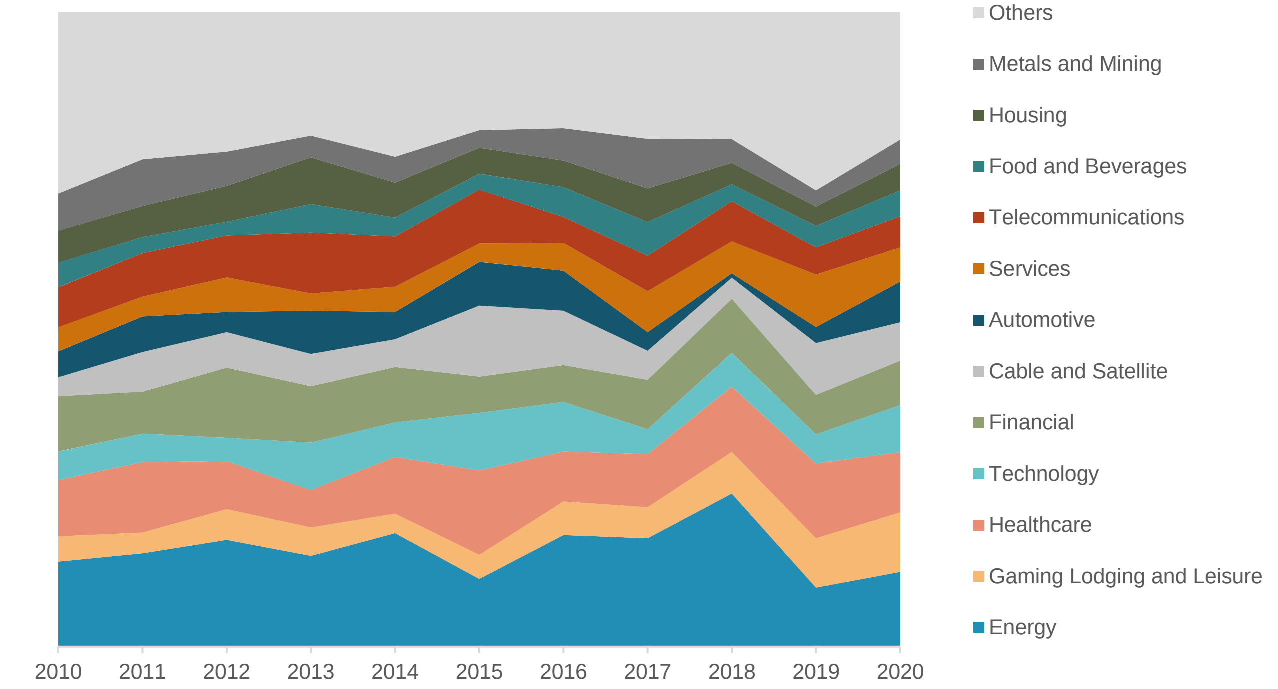


Data Through Dec. 18, 2020
Source: LCD - S&P Global Market Intelligence

Sectors hit disproportionately by pandemic

Energy, leisure, healthcare, technology, and finance accounted for close to half of new HY issuance in 2020, continuing with the trend observed recently.

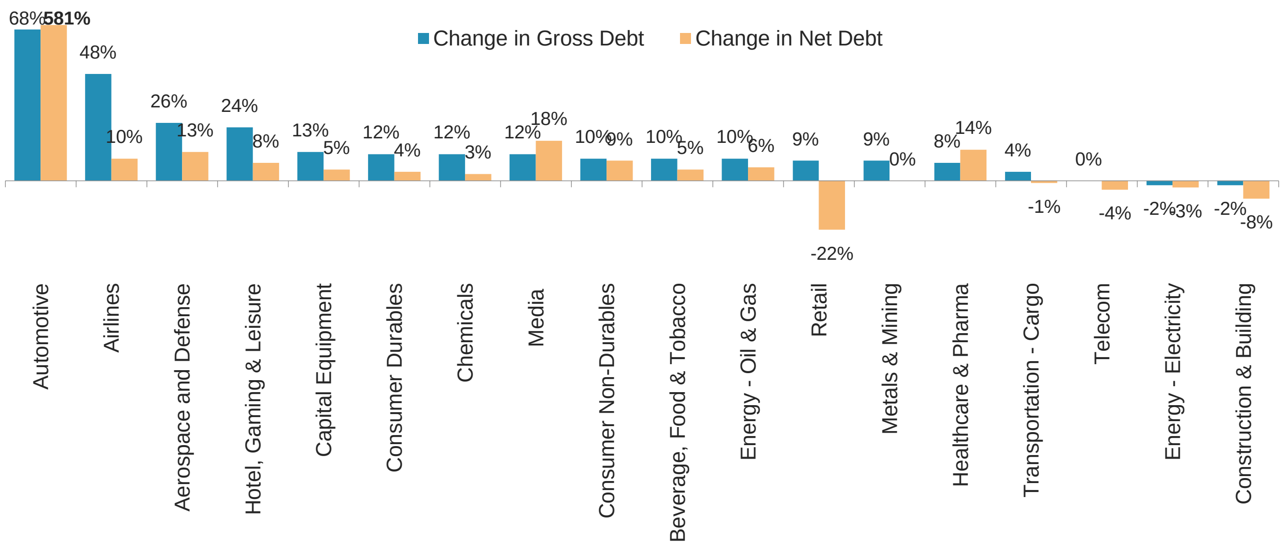
Exhibit 6. HY New Issue Activity – 2020



Source – J. P. Morgan

As Exhibit 7 shows, while most sectors witnessed a sharp rise in gross debt as companies intended to stock-up liquidity in H1 2020, the rise in net debt was considerably lower in many sectors. Only worst impacted sectors recorded large jumps in net debt due to severe decline in earnings in the first half of the year.

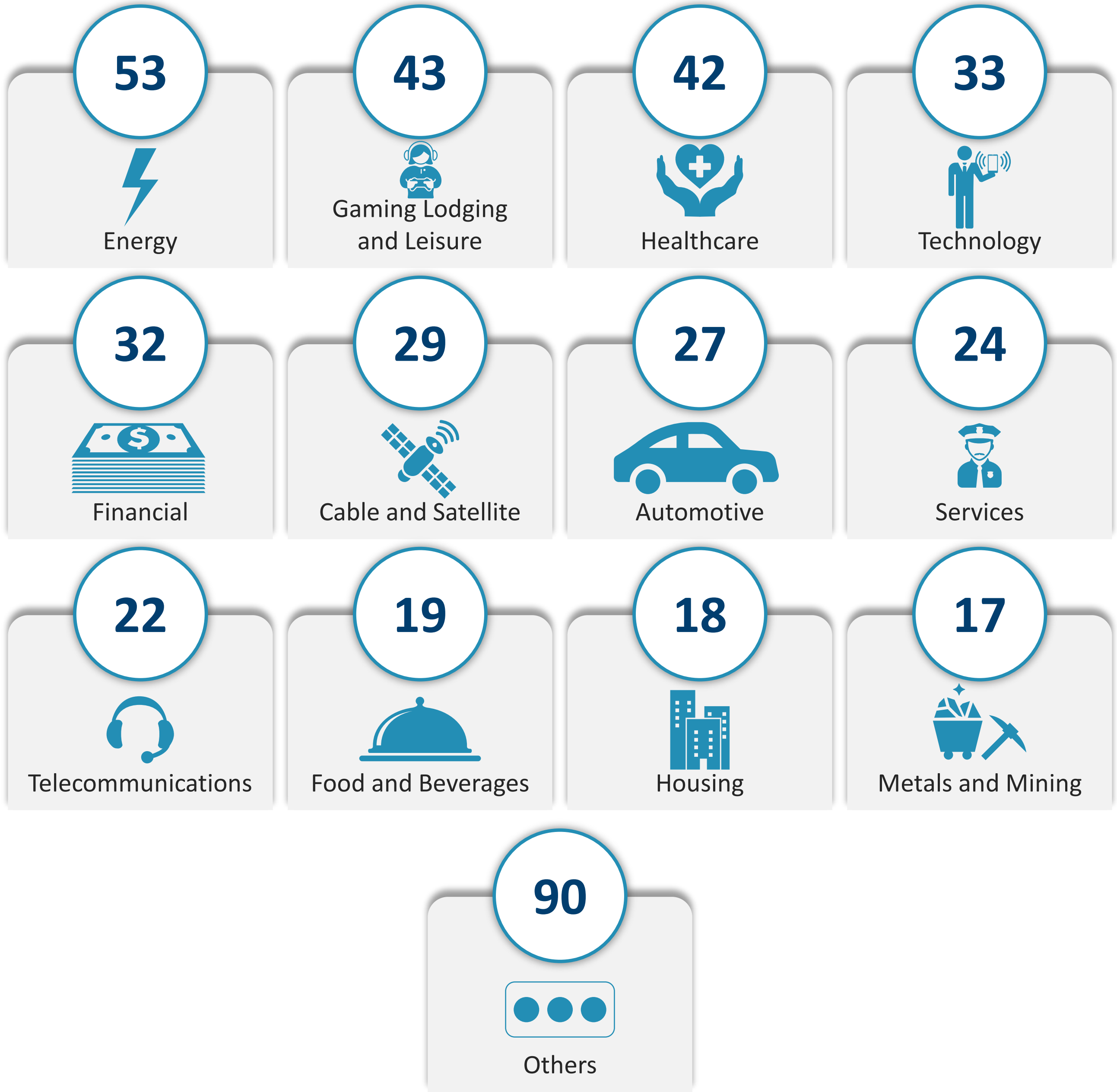
Exhibit 7. Global Corporate Debt Jump Across Sectors (from 4Q19 to 2Q20)



Source: Moody's

Energy was the top HY bond issuing industry in 1Q20 and 3Q20, sharing the spot with healthcare in 2Q20 and accounting for ~24% of HY issuances in December 2020.

Exhibit 8. 2020 US HY Bond Issuance Composition (USD bn)

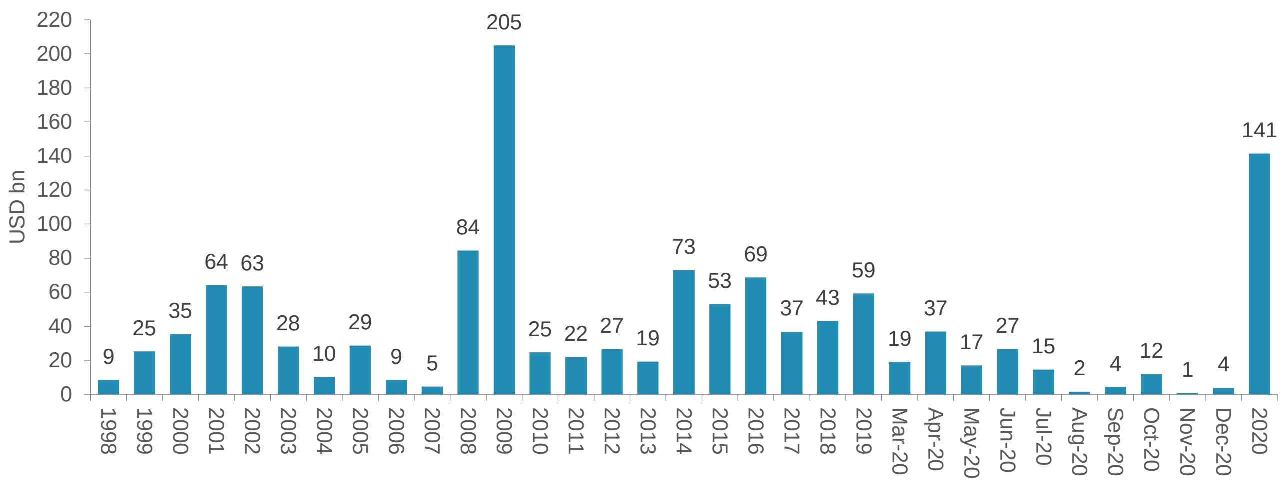


Source – J. P. Morgan

Significant rise in defaults, downgrades & fallen angels in 2020

Default activity picked up significantly in the US in 2020. The market recorded the second-highest default volume annually, trailing the USD205 billion level recorded in 2009. Sectors that saw the maximum defaults in 2020 were energy, for the second year consecutively; retail and consumer products segment; and telecommunications and cables sector, which witnessed two large defaults.

Exhibit 9. US Default/Distressed Exchanges Volume in 2020 (HY bonds, institutional bank loans and distressed exchanges)

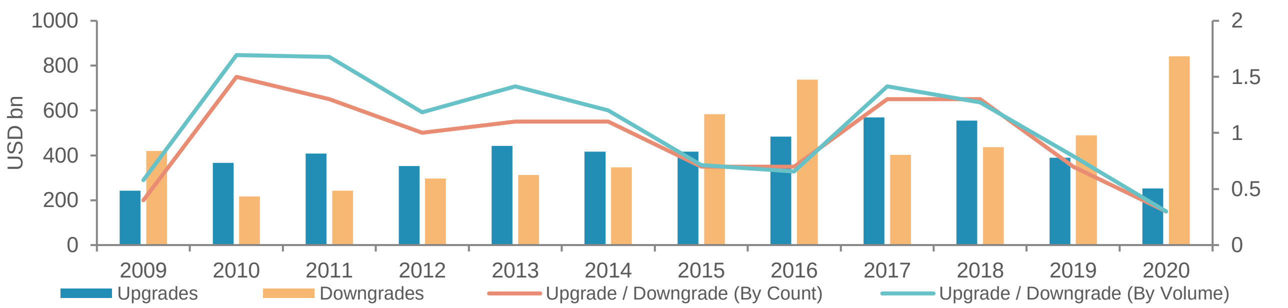


Source: J. P. Morgan

In total, 88 companies, with USD129.6 billion in debt, defaulted in 2020, while another 21 completed distressed transactions aggregating USD11.8 billion. Default activity slowed as the pandemic progressed with November 2020 witnessing USD871 million in distressed exchanges and no actual defaults, and December 2020 saw just two defaults totaling USD3.9 billion in bonds and loans (Exhibit 9).

The upgrades/downgrades ratio deteriorated significantly in 2020. In the wake of the coronavirus pandemic, rating agencies downgraded the credit ratings of high leverage companies. Most of the downgrades happened in 1Q20 and 2Q20. However, as equity markets surged to record levels in 4Q20, the market value of collateral backing business assets increased, and the upgrade/downgrade ratio improved to 1.0x (Exhibit 10).

Exhibit 10. US HY Ratings Upgrades & Downgrades

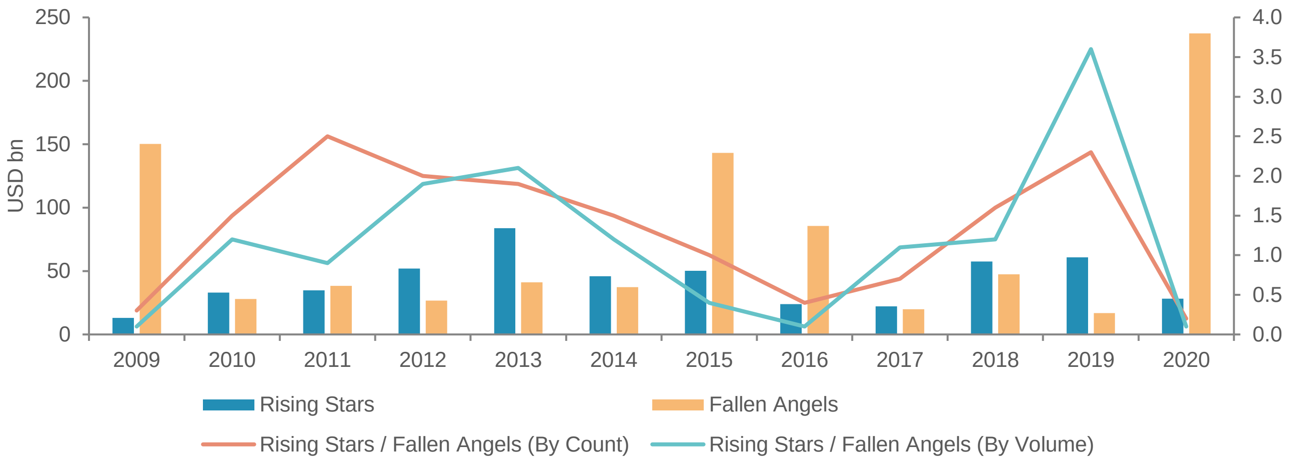


Source: J. P. Morgan; Moody's Investors Service; S&P

At the end of 2020, S&P's rated corporates and governments had a 36% negative bias, implying further scope for downgrade in 2021. About 9% of non-financial corporates were in the 'CCC' category, dangerously close to default. In the aftermath of the crisis, servicing the stupendous public and private debt will likely prove highly challenging. Vulnerabilities will surface once the stimulus measures are withdrawn, and the magnitude of the havoc caused by the crisis is revealed.

The US HY market was hit by a wave of fallen angels in March and April 2020, but it started to stabilize after the Fed announced two credit facility programs to support high-grade and fallen-angel issuers. In December 2020, only one issuer had been moved to speculative grade rating. Furthermore, fallen angels were concentrated in energy and automotive that accounted for more than half of fallen angels in 2020. During the year, the outstanding debt of fallen angels rose to an all-time high of more than USD200 billion (Exhibit 11).

Exhibit 11. US HY Fallen Angels & Rising Stars

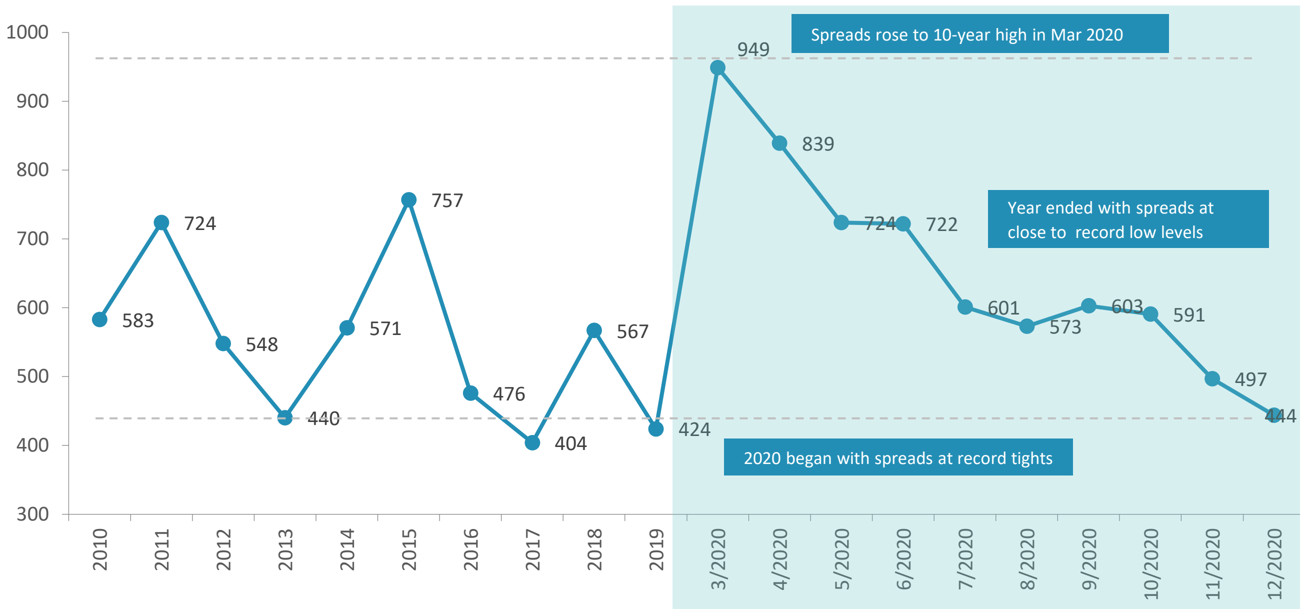


Fallen Angels refer to IG corporate bonds that are downgraded to speculative grade
Source – J. P. Morgan; Moody's Investors Service; S&P

Spreads spike in March but end the year at record lows

The year 2020 started on an optimistic note with equity markets at all-time highs and debt market spreads at record tights. Then, amid the outbreak of the pandemic mid-March, equity markets plummeted and HY spreads widen to seriously high levels in record time, beating the pace of increase seen during the 2008 financial crisis and the Great Recession. At the height of the pandemic-triggered disruption in March, spreads were at a 10-year high. However, the avalanche of liquidity and falling yields pushed spreads to multi-year lows toward the end of the year (Exhibit 12).

Exhibit 12. JPM US HY Index Spread-to-Worst (bps)



Source: JP Morgan

What Does This Hold for The Future?

Increase in BBB-rated debt posing risk of increase in fallen angels

BBB-rated non-financial debt in the US rose ~10.6% from USD2.7 trillion as of March 2020 to USD3 trillion as of October 31, 2020. The increase was particularly more in EMEA, up ~27% from USD1.7 trillion to USD2.2 trillion during the same period.

As per its December 2, 2020 report, S&P expects ~USD190 billion (or 6.5%) of outstanding US, long-term, non-financial, BBB debt as on October 31, 2020 to be vulnerable to fallen angel status in 2021, which would be the third highest annual total recorded in history.

Non-secular and patchy recovery likely to pose problems

Recovery may not unfold as expected for all sections of the economy, given that different sectors have been affected in varying proportions. The impact has also been uneven for corporations, with fundamentally strong and well-governed organizations managing to consolidate market share, as happens in any crisis, and thereby becoming more resilient; on the other hand, organizations that were in poor shape when the crisis unfolded have dwindled further and just managed to survive.

Airlines, leisure, oil & gas, retail, commercial real estate, transportation, and mass transit infrastructure are in for acute stress. On the other hand, sectors such as utilities and telecoms, have been largely unharmed by COVID-19, while some, such as healthcare and software, have benefitted. If corporate earnings do not revive and grow as expected, it will become increasingly difficult to service the soaring debt load, especially for HY companies and sectors that have been fundamentally disrupted. The ramifications of indiscriminately rescuing companies by injecting liquidity, irrespective of where they stand, would become clear once the measures cease to be in effect and as companies jostle to stay fit in their bid to survive.

Sectors that would continue to feel the heat as long as social distancing is practiced, such as airlines, transportation, retail, lodging and leisure, and oil & gas, are more vulnerable to downgrades in the near term.

Financial institutions predict sustained high default rates in 2021

Bank of America Merrill Lynch expects the HY bond default rate to be 5% in 2021, whereas Morgan Stanley, taking a more aggressive view, believes it will peak to about 10% and end at 6% toward the end of the year — with a bear case of 8% and bull case of 3%.

S&P, in *Global Credit Outlook 2021*, predicts a rise in defaults in 2021, despite very low funding costs, considering the higher leverage and a large proportion of vulnerable corporates. It estimates the default rate (12-month, speculative-grade) to touch 9% in the US and 8% in Europe by September 2021 from 6.3% and 4.3%, respectively, in September 2020.

Lower coupons and rationalization of maturity schedule to provide cushion

HY bond yields have been on a downtrend in the US since 2008. The continuous fall in government bond rate, along with tightening spread, is skewing the HY market in favor of issuers.

Companies have also taken advantage of low-cost, abundant liquidity by refinancing existing near-term debt with lower coupon HY bonds, stretching their maturity schedules. A sizeable chunk of leveraged loans maturing in 2021, 2022, 2023 and 2024 has been pushed to 2026 and beyond. Debt in the S&P/LSTA Leveraged Loan (LL) 100 Index maturing in 2024 fell from ~50% at 2019-end to 34% as of November 27, 2020, reflecting a decline of ~14% (USD166 billion) of the USD1.2 trillion LL Index. A similar reduction is noticeable across other recent maturities.

Credit Positive Scenarios

- ☑ Quick and efficient rollout of vaccines
- ☑ Effective containment of further waves and virus mutations
- ☑ Economic recovery back on track ubiquitously across sectors and geographies
- ☑ Favorable financing conditions through continued stimulus

Credit Negative Scenarios

- ☒ Slow and patchy economic recovery
- ☒ Ineffective rollout of vaccines
- ☒ New mutation triggering another wave of infection
- ☒ Faster-than-expected pull-back of fiscal and monetary support or insufficient support provided
- ☒ Permanent changes in consumer behavior
- ☒ Social unrest due to growing inequality
- ☒ Tightening of credit conditions
- ☒ Sovereign defaults

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Advisory

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Technology
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