Market Update as of 17 March 2020

Global High Yield Market Update

During this unprecedented period of extreme market volatility, the global high yield market has suffered a relatively severe drawdown, as we would have expected in the current market environment, but notably less of a drawdown versus equities:

<table>
<thead>
<tr>
<th>Major indices performance comparison (as of 16 March 2020)</th>
<th>1 Jan – 16 March 2020</th>
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</thead>
<tbody>
<tr>
<td>MSCI World (AUD Hedged)</td>
<td>-28.43%</td>
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<tr>
<td>S&amp;P 500 (AUD Hedged)</td>
<td>-27.43%</td>
</tr>
<tr>
<td>ASX 200 TR</td>
<td>-24.26%</td>
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<tr>
<td>ICE BofA Global High Yield Index (AUD Hedged)</td>
<td>-12.52%</td>
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Source: Bloomberg.

Coronavirus and the OPEC price war combine for a one-two punch to high yield markets

The impact of the coronavirus (COVID-19) had already sent the high yield credit spreads north of 550 basis points before the “OPEC+” meeting last weekend.

Traders and investors hoped for a cut in production from the oil-producing nations in the face of falling demand. Instead they got an all-out price war between Saudi Arabia and Russia. That sent oil prices plummeting toward $30 per barrel (bbl), setting the scene for a historic week across financial markets: Equities suffered their worst down day since Black Monday in 1987; we saw an extraordinary liquidity crunch in U.S. Treasuries; and the spread of the ICE Bank of America U.S. High Yield Index, where energy companies account for more than 11% of market capitalization, raced above 700 basis points.

Selling in high yield was broad-based. In fact, the biggest declines were in the larger, more liquid names, partly because of outflows from exchange-traded funds and partly because these were the easiest securities to offload. That is likely to create attractive value opportunities.

When assessing those opportunities, it’s important to recognize that COVID-19 and the oil price war will affect completely different sectors. The picture remains uncertain, but we also think that the impact of COVID-19 will likely be short-term and temporary, whereas the impact of lower oil prices could be longer-term and, in many cases, permanent.

Travel and Leisure

COVID-19 is likely to affect businesses dependent on travel, leisure and large gatherings. In the world of high yield, think theme park operators, for example.

Short-term demand destruction for these businesses will likely be acute, but a permanent impact on enterprise value is unlikely for the vast majority. Few have debt maturities coming due and most have adequate liquidity to sustain themselves over two or three quarters of slow takings, or ready access to capital should it prove necessary.

Caution is advisable, as there is still a lot of uncertainty about how big an impact COVID-19 might have on the U.S. consumer and the broader economy. We are keeping a sharp eye on U.S. initial jobless claims, in particular. At this point, however, we see this as an opportunity to seek out robust balance sheets in these sectors while they are trading at material discounts to par.
Oil and Gas

The oil and gas sector looks very different.

Here we anticipate a 12- to 18-month price war that anchors the price of oil between $25/bbl and $45/bbl. Very little exploration is economical at these levels and a number of U.S. shale producers do face near-term debt maturities. That implies permanent impairment and rising defaults in the sector.

There are likely to be value opportunities, however. The exploration and production (E&P) subsector has been cutting costs and rationalizing its capital expenditure since its last crisis in 2015 – 16. That limits what they can do this time around, but we are already seeing dividend cuts and other welcome actions. Those who survive may emerge in a stronger state.

Second, while they are selling off now, companies focused on gas rather than oil could benefit as U.S. shale production falters and the energy market rebalances.

And finally, midstream distributors have sold off sharply despite owning critically important infrastructure.

The oil price war is mainly an issue for investors in U.S. high yield. The European market has very little exposure. The equivalent sector there is autos, where the sharp slowdown in demand from China has delivered a short-term shock that exacerbates the sector’s existing troubles. Pent-up demand may provide some relief as the effect of COVID-19 eases.

Selective

Overall, the high yield markets have held up pretty well so far. They remain open to new issuers and daily secondary market trading volumes have held up well. Bid-ask spreads widened substantially last Monday, with some larger issues trading five percentage points wider, but they tightened some way back again as the week progressed.

When high yield spreads have traded at 600 basis points or more, or loans in the low-90c range, these have tended to be attractive entry points for long-term investors in the past. The amount of issues trading at distressed levels has doubled in the past few weeks. Defaults will rise, but we believe the increase will likely be contained almost exclusively in the energy E&P sector. So-called “fallen angels,” downgraded from the investment grade universe, may also create value in energy, consumer products and cyclical sectors such as autos.

Amid the turmoil, it is critical to be selective. But we are already seeing some of the most attractive opportunities to add value to high yield portfolios that we have had in four years.