

Great Expectations in Credit: Now What Comes Next?

Disruptive Forces in Investing

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Ashok Bhatia: The global credit markets have staged a terrific rally since the lows set in March. For investors, the question obviously is, what comes next? To set the stage briefly, this has been a pretty exciting year, not just for equity markets but for bond markets. We've seen the Federal Reserve and other central banks either go to zero percent interest rates or maintain zero or even negative interest rates. We've seen the introduction or reintroduction of quantitative easing programs and central banks that are buying not just government bonds and mortgage securities but now credit securities; and we're even seeing some of these types of purchase programs extend to emerging markets, in some cases for the first time in those areas. I'm your guest host, Ashok Bhatia, and I'm here today with Joe Lynch and Dave Brown to speak on this topic and more. Joe and Dave, thanks for joining me today.

Dave Brown: Thanks very much for having us.

Joe Lynch: Thanks Ashok, happy to be here.

Ashok: Maybe I can throw out sort of a question to both you, Dave, and you, Joe. And I think one of the questions that we often get is: You know, is this rally in credit markets, this spread tightening, this performance we've seen from a range of fixed-income securities, real? Or does it just simply reflect the central-bank policy responses, and spread levels and valuations are only there where they are because of what these central banks have been doing? So, you know, maybe Dave, we could, can start with you and, uh, get your, get your thoughts on that.

Dave: Sure. Thanks, Ashok. It's a great question, and you're right. We do get this question on a daily basis. So in our opinion, central banks, what they've really done is, they've allowed companies an environment to really adjust both their financial structure and their business models based on what's going to be the new economic realities going forward. So how do they do that? First, they did that by launching this, um, corporate purchasing program. That has been very effective in that it did calm markets that were disrupted by COVID entering the marketplace. But it's also been very small in size. When they launched the program, there were about \$300 million a week - that was being spent across corporate bonds, as well as ETFs. We stand today down to about - last week, um, \$12 million a day or so were spent to buy corporate bonds and ETFs. And that should continue to go down. So the Fed has been reducing their purchases as spreads have tightened and the market environments become much better. So I think it's pretty clear that with a very modest amount of actual spending in the bond and ETF purchasing program, they were able to have some effectiveness in terms of improving market conditions. But at this point, it's really become much more about the fact that the fundamental picture is more stable and, frankly stronger than I think many would have expected. But I, I think the Fed gets some credit for allowing companies the ability to rebuild their balance sheets through developing liquidity, giving them time at lower interest rates to term out short-term debt and extend the longer-term debt, which we're seeing in the investment-grade market. But other than the small, let's call them COVID-related sectors - by small I mean it's a relatively small part of the investment-grade market, about 20 percent of the market, are in things such as energy, autos, airlines, leisure, retail; meaningful and important sectors of the U.S. economy, but still only about 20 percent of the investment-grade credit market. The rest of the market has used this opportunity to manage through, um, this process of changing their balance sheets, adjusting their business models, adjusting their cost structures. And the central bank gets some credit, for sure, for allowing for that; but now that that's started to happen, we think that it's not so much just about central-bank buying. It's really become much more about better fundamentals, which we think should be sustainable.

Ashok: Joe, do you see the same thing in high yield, that there's more of a fundamental underpinning of some of these moves?

Joe: Yeah, I would agree with that. The rally in my view is definitely real, and I think it's really all based on fundamentals. The 2Q numbers were obviously weak, but not nearly as bad as we feared or as bad as many management teams were even expecting. I think more importantly, the outlooks that management teams have provided on the back of Q2 earnings have been quite positive.

So we're very encouraged that this rebound is durable and that it can last. You know, some of the reasons why it hasn't been as bad as feared, Dave touched on. The cost-cutting measures that many management teams took were significant. There were many situations where we thought something was a fixed cost, and it sure looks like a variable cost now, after the actions of certain management teams. So that's been quite positive, and for many cyclical companies, you have a big working-capital release as demand slowed down, that generated a lot of cash, and that's benefitting those businesses; and they'll rebuild that slowly as demand resurfaces. And that, that's the best way to reinvest in your business is when you're seeing that actual demand. So I think, for the vast majority of the high-yield market is in quite good shape; and we think, again, this is sustainable. And for those sectors that are most exposed to COVID, the sectors that Dave mentioned those companies have had access to capital. You've seen record new issuance in the high-yield market over the last three months, and many of it has been to COVID impacted sectors. So these companies now have sufficient liquidity to bridge any type of weakness in numbers well into 2021. And it's a big reason why we think the default rate's going to be a lot lower than people initially thought, and certainly the defaults that do occur are easily identified and very visible to the market. So fundamentals, because of all of that, probably surprisingly stronger than anyone would have expected.

Ashok: Joe, you just mentioned the COVID-related sectors. I mean, if you were to, to pick one, two, three sectors that you, you know, particularly like to focus your investing on right now, you know, what, what are they? Are they the COVID sectors?

Joe: Well, I think, I think some that are related to COVID are interesting to us. So healthcare may not be an, an obvious space, but many of the healthcare providers, whether it be hospitals or facility-based providers, they saw a decline in March and April in activity because people were just afraid to go into a hospital to have some sort of procedure done. But now we're seeing that volumes are coming back, and are coming back at roughly 90 percent of pre-COVID levels. So many of the procedures were not canceled. They were just deferred, and those are starting to occur. So we think the market oversold many of these healthcare companies just on fear of significant expenses related to COVID without much in the way of potential reimbursement. And certainly those are not the higher-margin type patients that, you know, maybe someone that's receiving cancer treatment or is having surgery might be. And so healthcare has been a spot that has been attractive to us. For the next, sort of, layer down, we find a lot of the gaming companies interesting, particularly the regional gaming companies. They have a much easier ability to manage cost and cut costs and open up casinos in a smaller way; and that's much more of a drive-in type consumer. So less about, say, destinations like Las Vegas; but more the regional gaming operators have a lot of flexibility on cost and are actually seeing demand come back. So those are two sectors that are interesting to us.

Dave: You know, additional sectors that are also interesting would be cable media and telecom. So Joe mentioned some sectors that have been kind of impacted by the virus specifically. Some sectors that still actually have some good spread and yield, though, we think have strong free cash flows and really have been more immune are cable media and telecom, right? So these are industries which generate strong free cash flow that, frankly, as we all know in the work-from-home environment, are all being used more extensively by people; have not been impacted by any sort of business disruptions; and yet, because they have financial leverage, still have a reasonable amount of yield relative to the rest of the investment-grade market. So those have been very attractive, in our opinion. Another area is, we do think it's been important to take, as Joe mentioned, really take some very thoughtful shots at credits that, while impacted by COVID have been – you know, are great opportunities. I mean, the market's filled with those. So the midstream sector within energy is an area that we think has been – it certainly has tightened up but is definitely an area that we remain well invested in and we think is relatively attractive. And there are even areas in the airline sector where we've been active in secured airline exposure that we think has been giving us some great opportunities. And then finally, you know, in this environment of really kind of low yields, search-for-yield environment throughout all markets, we think going overseas and looking at some structured opportunities there, both in corporate hybrids as well as subordinated bank capital, are interesting. They are credits that you get paid to take the complexity risk of structure, subordination in credits that we think are very strong and can really add some extra yield into portfolios, which today, that extra yield is even at more of a premium with low yields across the globe.

Ashok: Yeah. You know, what I've found interesting about this period is, we've obviously seen weakness in small businesses and real estate. But when we look at some of the big company issuers and in the bond market, you know, we've seen some downgrades in the auto sector. We've seen some downgrades among large energy companies. And on the default side, you know, you've seen a bankruptcy, you know, from a car-rental agency. But overall, it's been pretty muted, given the GDP weakness we saw in the second, and even into the third quarter. And what's both of your takes on this? Is the default and downgrade in some of those fundamental risks going to remain pretty muted, like we've seen so far?

Dave: I would expect, certainly on the downgrade side to be muted. We saw pretty quickly the agencies being aggressive with hitting sectors and companies that were being acutely impacted by the virus. So we saw downgrades in retail, in auto, and in energy. Those have played out, and now I think we're realizing that companies – you know, you get rash and much larger downgrades

when business models are no longer effective, right? Look back to – you know, you can look at banking 10 years ago when the business model that the banking industry constructed for themselves no longer worked. You can look at some of the telecom structures that were put together 20 years ago. That's when you see large downgrades and default cycles. This shock is of a different nature. Most business models that existed in our markets that were not bubbles in terms of capacity built in industries or anything like that, there was an exogenous shock. And because there has been support from fiscal and monetary areas, in general, companies have been able to manage through this and are reconstructing themselves from a cost and a balance-sheet way that allows them to manage through this. Now, if we get a different outcome, and we're still in a very low or negative-growth type environment in 2021, that will be challenged, and you'll start to see more downgrades at that point; but in my view, you're unlikely to get meaningful downgrades for the rest of this year.

Joe: Yeah. I think that the default picture in high yield is relatively muted. You know, Ashok, you mentioned a few; but the vast majority of the defaults really were on stressed businesses that were stressed before the pandemic hit. So think about energy companies or retail companies. Many of them were already trading at stressed levels in January and February when the economy was actually quite strong. And so those companies have defaulted out in the current environment, and we really don't expect to see much in the way of new defaults or companies that are acutely impacted by the downturn ending up defaulting. Now, that being said, we are issuing quite a bit of new debt to these businesses, and quite a bit of new debt to these companies that are directly impacted in a negative way from COVID. So to Dave's point, if we don't see more of a V-shaped or U-shaped recovery eventually, or into 2021, the issuance that is coming to market today certainly could become the raw material for the next credit cycle and the next wave of defaults that come two or three years down the line. So, despite us being fairly constructive on the market, it's not without risks. We obviously need to see the recovery be sustained and durable. Otherwise some of these companies that are receiving capital today, it just turns into too much debt or too much leverage in the future.

Ashok: Thanks. Before we wrap up this episode, why don't we do a real short, quick lightning round? So I'm just going to ask you both, and I'll direct a couple questions, and short, pithy answers. Dave, IG spreads: tighter or wider from current levels at year end?

Dave: Uh, tighter. That was a tougher question today than it was about a month ago, but I still think tighter from these levels.

Ashok: Joe, answer for high yield?

Joe: I'm going to say tighter, tighter as well, for high yield, based on constructive fundamentals and pretty healthy technicals and desire and need for income and yield.

Ashok: Okay, let's stick with you, Joe. How about a couple-of-sentence description of what does the world look like if high-yield spreads widen; let's call it, widen significantly, you know, significant retracement of the tightening we've seen? What does that world look like from now to year end?

Joe: I think it's a world where you see significant travel restrictions, mobility restrictions, either voluntary or enforced by federal or state governments. And that will cause a lot of these businesses to, I don't want to say return to the March or April levels, but certainly slowdown from where we are today.

Ashok: Okay, and Dave, what about the other side, the world where credit spreads are significantly tighter, we're through all-time tightens and shaking our heads at what's been going on in credit markets?

Dave: Yeah. I think, I think first and foremost, uh, a reasonably good outcome with the virus, which probably needs some sort of a vaccine; but then, really, as Joe mentioned earlier how important technicals are, the technicals in that environment can really take over. And low interest rates are going to persist, probably, regardless of these types of – a vaccine or the whatnot. So low interest rates are going to result in a need for yield if we have a positive fundamental backdrop with a reasonable vaccine solution. That's going to result in tighter spreads, and probably meaningfully tighter spreads. We have all underestimated, at various points, the power of technicals in a low interest-rate environment, and that's the environment in which you can get well inside of a hundred for IG spreads.

Ashok: And last question: To both of you, favorite thing about working from home?

Dave: Well, I'll start. You know, my easy part was having my adult and college kids home for quite a bit longer than I'm used to. I've also enjoyed working out a little bit more. The bad news has been, I've had a kitchen, a full kitchen, right around the corner

all day long. So I probably offset the health benefits of the workout with that, but nonetheless, it's all kind of related to family. It's been nice.

Joe: Yeah, I'd say, you know, lunch with my kids every day, that's fun. That's a nice, that's a nice perk; followed closely by my footwear of choice, which is flip-flops for the last five months. That's been a highlight as well. How about you, Ashok? What have you liked the best about working from home?

Ashok: You know, it's been having the five minutes between a call and just being able to wander out and, and say hi to the kids. I've got a couple of young daughters, and it's nice just to get to interact with them, you know, short amounts of time, but somewhat frequently during the day. And, that's been one of the, one of the positives from, from this whole period that we've been living through. So, I think that's, that's kind of a nice way maybe we'll just end the episode on that, and you know, let me just thank you, Joe, thank you, Dave, for taking the time to chat today.

Dave: Thanks very much, Ashok.

Joe: Great. Thank you.

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