FINANCIAL MARKETS

FLASH

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HIGH-YIELD BONDS

Visibility looks better
on this asset class than
on the economy as a whole.

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The European high-yield bond market, ex financials, ended the first half of 2022 down by 15%, its worst showing since 2008! European high-yield credit spreads[1] have hit almost 700 basis points, a level unseen since summer 2012 when excluding exogenous shocks (i.e., Covid), i.e., just before Mr. Draghi's "whatever it takes". The cause of this crisis have been well documented: global inflation is too high and will have to be reined in aggressively by central banks, even if that means disrupting economic growth. The high-yield bond market is therefore being hit by a double-whammy – both an erosion of spreads through inflation and a worsening in credit ratios through the economic slowdown.

Unlike other phases of widening credit spreads, **performances have not discriminated among ratings.** BB and hybrid bonds, which are regarded as the most defensive segments of the high-yield market, ended far into negative territory (at -16% and -21%), as they are closely correlated to rising government bond yields. Meanwhile, B and C rated bonds, which are most heavily exposed to the economic slowdown, fell by 15% and 20%, respectively. More broadly, sectors that are heavily exposed to rising interest rates have also been hit hard, with utilities dropping by 16% and real-estate by 30%! By way of comparison, real estate had dropped by 28% during the 2008 subprime crisis. And, lastly, the resurgence of idiosyncratic risks on issuers* such as Paprec, BioGroup, Fnac, and SBB can also be compared to previous periods of stress. What's more, the corrections brought on by the emergence of these risks (whether well-founded or not) are being exacerbated by a lack of liquidity on the secondary market, by the absence of banks, which are being less authorised to carry such risks on their balance sheets, and by constant selling by ETFs. That being said, these price drops are creating real opportunities for investors who can overlook valuations somewhat.

CREDIT SPREADS, DEFAULT RATES AND ECONOMIC DOWNTURN

At current credit premium levels, and assuming an average 40% recovery rate, the market is therefore pricing in a 1-year default rate of 10% by high-yield companies and a 5-year default rate of more than 40%. If true, that would mean that all B and CCC rated companies will default within five years. Such default rates are decorrelated from historical examples, as well as rating agency forecasts, which point to an increase in default rates but a gradual and moderate one.

Beyond the default rate priced into these spreads, it is worth looking at the time lag between the widening of spreads and the increase in defaults. The widening of spreads is often a leading indicator of an economic slowdown. Over the past 15 years, spreads reached their widest levels just as the first corporate defaults began to occur, i.e., six to 12 months before the peak in defaults.

COMPARISON OF SPREADS AND ACTUAL DEFAULT RATES

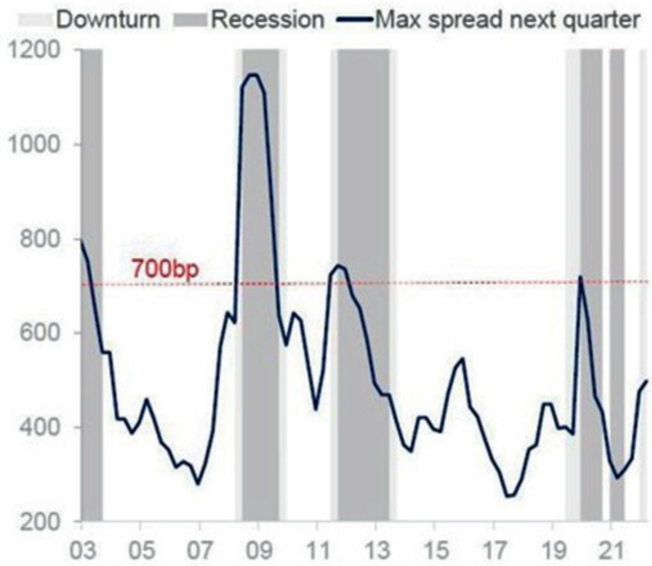
Sources: BOA, OFI AM, datas as of July 2022

CREDIT SPREADS, RECESSIONS AND RETURNS ON A HIGH-YIELD PORTFOLIO 12 MONTHS OUT

With a spread now close to 700 basis points, the market is pricing in not just a mere slowdown (which would be indicated by spreads of 500 basis points), but a **severe recession.**

That being said, and despite the various recessionary phases of recent years, the market has moved sustainably above 700 basis points only once – between June 2008 and August 2009, at the peak of the subprime crisis.

SPREAD TRENDS AND RECESSIONS

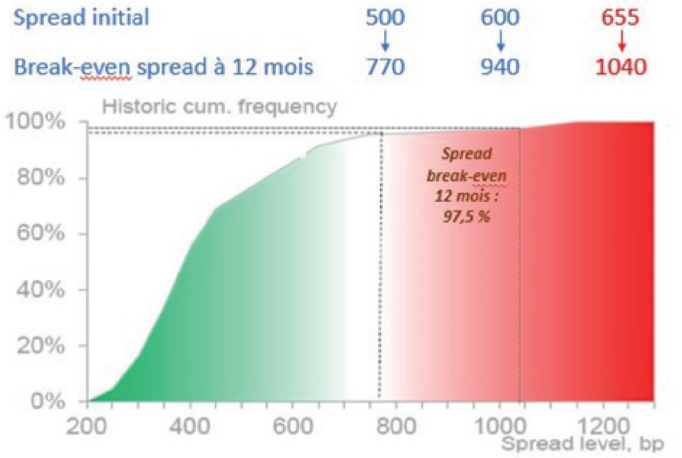


Source: Citi, datas as of June 2022

(1) Credit spreads representing the yield differential of a private corporate bond with that of a sovereign bond.
**For illustrative purposes only. Any reference to a specific company or security is not to be construed as a recommendation to buy, sell, hold, or invest directly in the company or its securities.*
The figures cited deal with past years. Past performances are not a reliable indicator of future performances.

So, it is important to keep in mind that, at current spreads, the 12-month yield of a high-yield portfolio will be positive, barring a widening in spread of almost 400 basis points (in government or corporate bonds).

WIDENING IN HIGH-YIELD SPREADS NEEDED TO ACHIEVE A NEGATIVE TOTAL RETURN (12 months out)



Sources: Citi, OFI AM, datas as of July 2022

OUR CENTRAL SCENARIO

The worsening economic environment will affect mainly the weakest high-yield companies, which are being squeezed by higher production costs and weaker consumption.

And yet, **from the point of view of their liquidity, high-yield companies are, on the whole, well financed.** 2021 was an outstanding year on the primary market, and most refinancing has been completed for 2022 and 2023.

Barring a liquidity wall before 2024, **the number of defaults should rise only moderately in the coming months** and remain far from levels the markets are pricing in. The worsening in companies' credit quality will then occur in an orderly fashion, which is a very positive point for the markets.

Visibility therefore looks better in this asset class than on the economy as a whole. Amidst high yields and satisfactory issuer liquidity, we forecast decent returns on investments in euro high yield over the coming months, as long as short-term volatility can be absorbed.

The figures cited deal with past years. Past performances are not a reliable indicator of future performances.

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