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Amundi ASSET MANAGEMENT

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Revisiting the global high yield outlook in the wake of the COVID-19 pandemic

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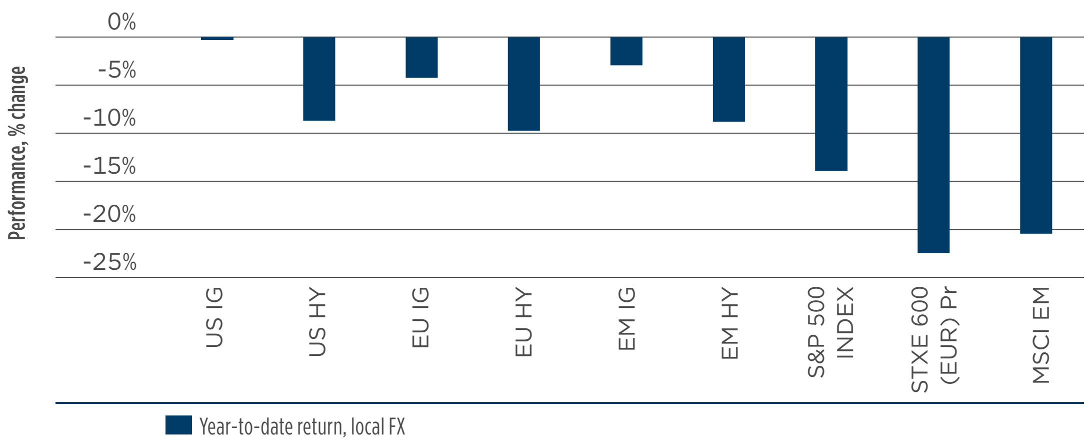
- **Global HY markets sold off aggressively** between February and March in response to the COVID-19 outbreak, the oil price war and the liquidity freeze in some markets. An analysis of past peak-and-trough episodes in the US HY market shows that on most occasions investors have enjoyed positive market returns just one year after the peak. Three years past such a peak, market returns have proven positive in all six occurrences since 2000.
- **The current sell-off may not be the most severe in terms of drawdown but its rapidness was unprecedented** as it took place over just one month. The recovery phase has historically been slower than the sell-off, as a wave of defaults is triggered after the market has bottomed out. This might be the case in 2020 as well, but conditions are different from those of 2008, when the crisis originated from the financial sector. Today, it originates from the pandemic and its impact on the global economy. **Corporate fundamentals deteriorated after the GFC, with generally higher leverage and slowing sales growth. However, the debt servicing cost is lower today than it was in 2008 and policy stimulus is being delivered quickly, with significant easing not only on the monetary policy side, but also on the fiscal side**. For the first time ever, the Fed has launched a purchasing programme for recently downgraded HY bonds. **These measures should help cushion the HY default spiral**. With US GDP contracting by 2% this year (our base scenario) and given the current distress levels, we foresee the US HY default rate jumping to 11.5% by February 2021 from 4.5% in February 2020, then rapidly declining as the economy recovers. Therefore, the US HY market appears to have already discounted most of the bad news and any further deterioration is unlikely.
- **Investment convictions: on US HY, selectivity will be of paramount relevance, with a focus on industries and companies that are relatively insulated from the effects of the virus**. Active long-term investors could identify mispriced securities and reposition their portfolios to achieve ample liquidity and take advantage of possible price dislocations. Given the current market stress, the downgrade wave should prove an important dynamic. However, fallen angels have had very strong return profiles historically and the Fed's decision to buy them could limit the pressures on this segment. The market volatility is probably not over yet and markets are likely to stabilise only when indications emerge that the virus can be brought under control through an effective vaccine and the mortality rate reduced through drugs that lessen its effects.
- On **EU HY, we favour BB names in defensive sectors due to the current low visibility on the economic outlook**. The EU HY primary market was closed in March, but this situation is likely to prove transitory and we expect solid BB names in the defensive sectors to return with fresh issuance. In cyclical sectors, investors should wait for more clarity on how long the lockdown measures will last. The rating distribution of EU HY issuers compared with their US peers shows a higher share of BB-rated names. Hence, the EU HY market is of better average quality and could offer diversification opportunities.
- On **EM HY**, we believe that this asset class is oversold. EM HY offers high diversification, both from a regional and sectoral perspective, and has low duration, which should help the rebound once the market recovers. Volatility could remain high and **investors should look for a combination of value and quality styles, with a preference for defensive sectors**. We believe that there is value in sectors such as TMT, real estate, healthcare and – selectively – financials and utilities. From a regional perspective, we see value in China and Latin America. There are risks and opportunities in these markets. The risks are that the economic weakness is prolonged by an extension of the lockdowns across the global economy. However, opportunities could be found through robust credit analysis to find resilient credits with depressed valuations.
- From a global HY perspective, current market conditions are complex, with an unprecedented crisis accompanied by an unprecedented policy response. Much of the current gloom is already priced in, but diversification is paramount. **Exposure to the global HY market allows investors to benefit from different growth drivers, corporate fundamentals and recovery timings from the pandemic**. While we cannot call the bottom of the market and acknowledge that volatility is likely to remain high, we believe that the market will normalise and strengthen once the pandemic's peak has passed. **Current dislocations may be seen as opportunities for investors who are able to bear some volatility and who have an appropriate investment horizon**.

Past performance is not indicative of future returns.

Keep nerves steady and look beyond COVID-19 dislocation for HY market

Since our **H1 2020 global HY outlook**, a lot has happened in financial markets. Risky assets have sold off to an extent not seen since the global financial crisis (GFC). This market sell-off has happened in response to three different negative catalysts: the **coronavirus outbreak, the oil price war between Saudi Arabia and Russia and the liquidity freeze in some market segments**, especially HY and EM. Since the market's bottom in March, central banks and governments have implemented large-scale measures in a race against time, with the Fed's decision to buy into the HY space being the latest in a long line of measures. **Market conditions have improved since then, but we are still far from normalisation**.

Figure 1. Market reaction to coronavirus and oil price shock

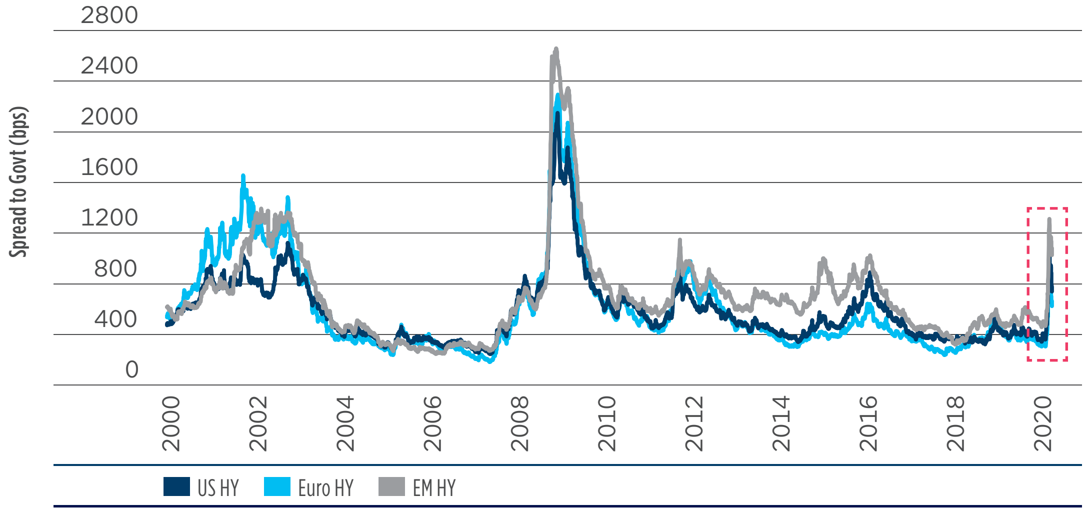


Source: Amundi, Bloomberg. Data as of 14 April 2020. **Past performance is no guarantee of future results.**

In credit markets, the amount of distressed debt has surged to its highest level since April 2009, with the value of US corporate bonds trading at spreads above 1,000 bp over Treasuries quadrupling in less than a week to nearly $1tn (Bloomberg data). US HY spreads – which started the year at 362 bp and narrowed to 338 bp in mid-January – have widened to above 1,000 bp and peaked at 1,087 bp on 23 March.

EU HY spreads have followed a similar trend, though they peaked at a lower point – 866 bp. The EU outperformance is mainly due to the lower exposure to the troubled energy sector. In line with the rest of global HY, the EM HY space has seen a large drawdown in a short time span, with a sharp adjustment to bond prices, where spreads reached a current crisis peak of 1,300 bp in March before narrowing somewhat towards 950 bp by the end of the month.

Figure 2. High yield spreads and a comparison with previous crises

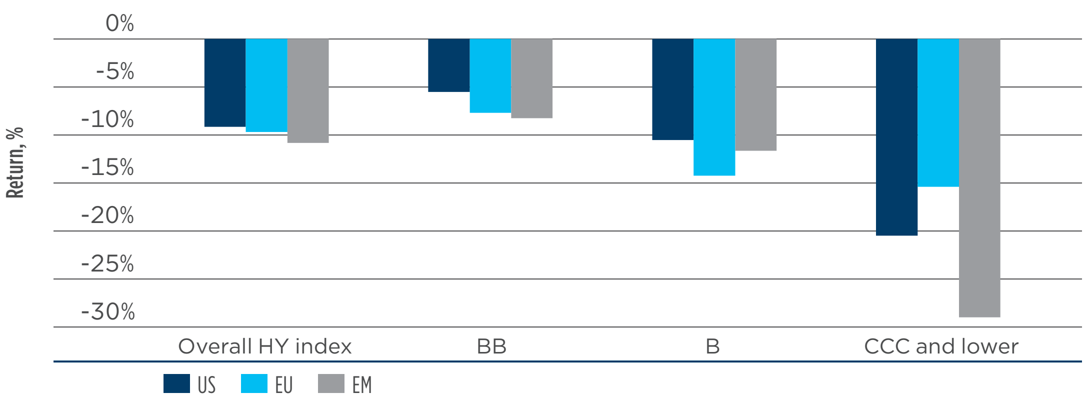


Source: Amundi, ICE BofA indices. Data as of 14 April 2020.

"Tourism, transportation, gaming and retail were the most affected sectors due to unprecedented lockdown measures in many EU countries."

In **US HY**, energy has been the worst performing sector, while in **EU HY** cyclical sectors such as tourism, transportation, gaming and retail were the most affected due to the unprecedented lockdown measures in many countries. In **EM HY** cyclicals underperformed, with energy, transportation and industrials among the hardest hit. Regionally, Central Asia and Latin America underperformed, while CEEMEA and Asia Pacific fared marginally better. More generally, **BBs outperformed B and CCC issuers**, as companies in the last two categories have less leeway to absorb such a growth shock due to their more leveraged balance sheets.

Figure 3. US, EU and EM HY YTD performance by rating bucket



Source: Amundi, ICE BofA indices. Data as of 15 April 2020. **Past performance is no guarantee of future results.**

What can we learn from the past?

"Analysing previous crisis episodes, the US HY market took more than one year to get back to the previous peak only during the global financial crisis."

HY markets have gone through other sell-offs over the past 20 years. Such occurrences may be a useful comparison to obtain some clues on the possible trends ahead. Besides the current sell-off, we have identified **six peaks in the US HY market**. Often those sell-offs have not been matched by an economic recession and have rather originated from other stress conditions (e.g., sovereign debt crisis, oil price fall). The only occurrence when such a sell-off has come with a recession was the 2008 global financial crisis. This was also the episode with the steepest market sell-off and the longest recovery time. However, even under such extreme circumstances, investors enjoyed positive returns two years past the peak.

Table 1. Past sell-offs and recovery episodes in the US HY market

Market peak	Peak-to-trough return	Recovery time (days)	1y return	2y return	3y return	Recession
Feb 2020	-21,5%	NA	NA	NA	NA	NA
Oct 2018	-5,6%	126	5,5%	NA	NA	No
Nov 2015	-8,9%	164	9,0%	19,8%	21,1%	No
July 2011	-9,7%	181	6,4%	17,4%	28,2%	No
June 2008	-34,5%	424	-7,3%	17,7%	38,8%	Yes
May 2002	-14,0%	314	7,9%	23,4%	31,5%	No
Sept 2000	-8,9%	145	-4,2%	-8,1%	14,6%	No

Source: Amundi, ICE BofA indices. Data as of 9 April 2020. Data refer to the H0A0 total return index. Recovery time is the time needed for the index to get back to its previous peak level. 1y, 2y and 3y performance is intended from previous peak. **Past performance is not indicative of future returns.**

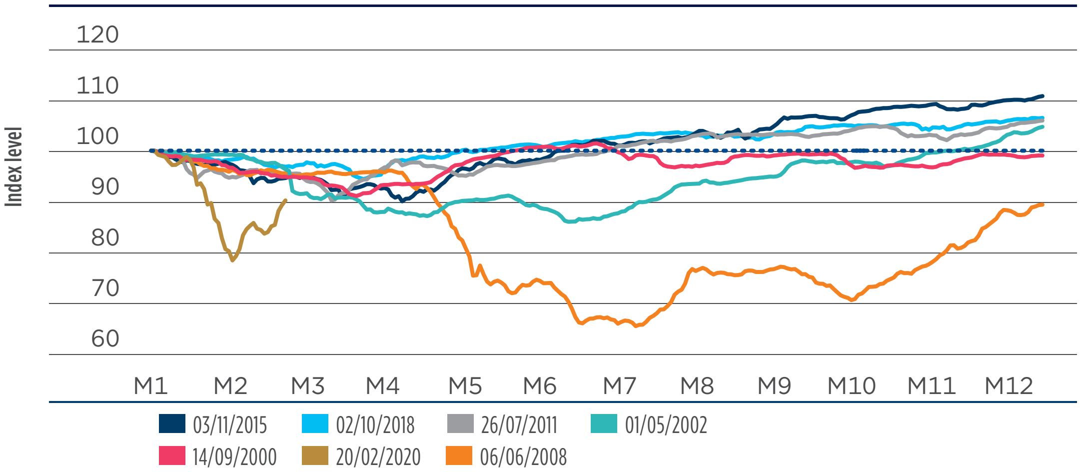
Market recovery time **depends on a series of elements, including the magnitude of the sell-off and whether or not the economy falls into recession**. In any case, in most cases, investors enjoyed positive market returns only one year after the peak. Three years past the peak, the market return was positive in all six episodes.

"This may not be the most severe drawdown but its rapidness is unprecedented as it took place over just one month."

Where are we today?

The 2008 market sell-off was the deepest of the above market drawdowns, with a peak-to-trough return of about -35%. In 2020, the US HY market peaked on 20 February and since then has lost more than 20%. This may not be the most severe drawdown but **its rapidness is unprecedented** as it took place over just one month; the index has then rebounded somewhat from its trough.

Figure 4. US HY in major drawdowns after one year



Source: Amundi, ICE BofA indices. Data as of 14 April 2020. Data refer to the H0A0 total return index. M1, M2 etc. refer to 1st month, 2nd month etc. after peak. Index rebased to 100 on peak dates.

"Corporate fundamentals have deteriorated since the GFC, but the nature of this crisis and the policy response should avoid a similar outcome."

In the past, the recovery phase has usually been slower than the sell-off **as a wave of defaults is typically triggered after the market has bottomed out, slowing the recovery path. This might be the case in 2020 as well, but we should note that the**

conditions are very different from those of 2008, the most severe crisis ever in the HY market.

The current economic crisis is different from the GFC. While in 2008 the crisis originated from the financial sector, today it originates from the **coronavirus pandemic** and its impact on the global economy due to restrictions and lockdown measures in many countries. It is a demand- and supply-side shock at the same time, hitting both the manufacturing and services sectors, but this time the financial sector is not the origin of the troubles.

On one hand, **corporate fundamentals have deteriorated after the GFC**, with generally higher leverage and slowing sales growth. On the other, **the debt servicing cost for US HY corporates is lower today than it was in 2008**: this year the average yield to worst of the US HY market peaked on 23 March at about 11%, falling to about 9% currently. At the height of the 2008 crisis it peaked above 22%.

In addition – and unlike in 2008 – policy stimulus is being delivered quickly, with significant easing not only on the monetary policy side, but also on the fiscal side, which lagged behind during the GFC. Countries where fiscal support was massive at that time are now delivering even larger fiscal support packages. For instance, in 2009 the United States delivered the American Recovery and Reinvestment Act, worth about $800bn; today the US Congress has already delivered a $2tn package. These measures are **larger, more timely and more comprehensive than they were in 2008**. In detail:

- The **Fed** slashed rates to 0.00-0.25% and announced drastic measures to bolster market conditions: it will buy an unlimited amount of Treasury and mortgage-backed securities (MBS). It also **established two facilities to support credit markets**: the Primary Market Corporate Credit Facility (PMCCF) for new bond and loan issuance and the Secondary Market Corporate Credit Facility (SMCCF) to provide liquidity for outstanding corporate bonds. The Fed has also expanded central bank liquidity swap lines. Considering all these measures, the Fed balance sheet could reach up to $9tn. As part of its ongoing efforts to support the US economy throughout the COVID-19 crisis, **on 9 April the Fed unveiled a plan to buy HY bonds that were IG as of 22 March and later downgraded to a rating of no lower than BB-**. It will also buy ETFs that track HY debt. With this plan, the Fed will support up to $850bn in credit and is on track to buy a potentially large number of bonds that could fall into HY territory over the next months as the crisis hits corporate cash flows. This is a game changer for the market;
- In the Eurozone, the **ECB** announced the Pandemic Emergency Purchase Programme (PEPP). This is a public and private securities purchase programme worth €750bn and is in addition to the existing programmes (€20bn monthly and envelope of €120bn until the end of the year). **The ECB will buy assets at a pace never seen before, even in previous crises**: it will buy more than €110bn per month by December; in the past the ECB has bought €80bn per month at most.

"The policy measures implemented should help cushion the HY default spiral this time."

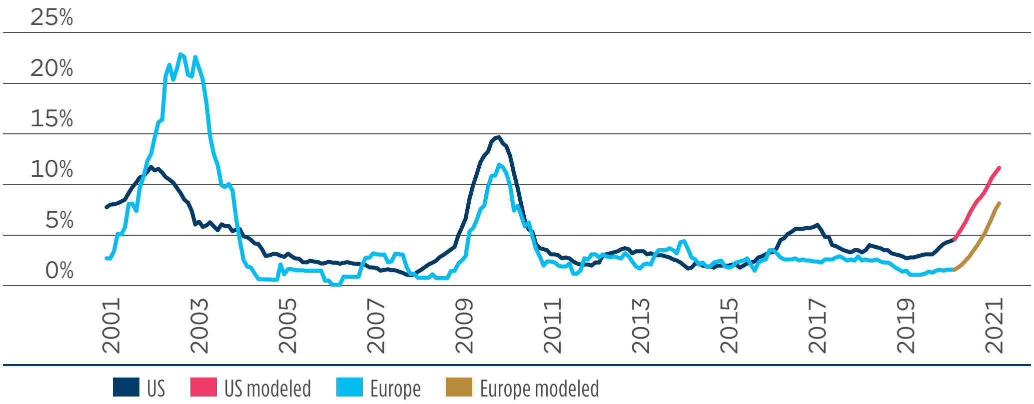
The above measures should help cushion the HY default spiral this time. The exception is the US HY energy sector, where the oil price plunge is threatening many US shale oil corporations, which may go through a deep wave of defaults.

Sergio BERTONCINI
Head of Rates and FX Research

What is market pricing currently?

The US HY market has sold off aggressively since February to reflect the new growth scenario and current distress levels. With US GDP contracting by 2% this year – as per our latest **macroeconomic forecasts** – and given current distress levels, we foresee the US HY default rate **jumping to 11.5% by February 2021 from 4.5% in February 2020**. In a downside scenario of 2020 US GDP shrinking by 5% – similar to what happened during the financial crisis – such a default rate could spike to 15% over the same time span, basically matching the peak recorded during the GFC. However, this is not our base-case scenario. The US HY energy sector is another story: it may experience a higher default rate (estimated at about 25-30%) due to its idiosyncratic issues. **The EU HY default rate is estimated to rise to about 8% by February 2021**.

Figure 5. US and EU HY default rate, an historical perspective and outlook



Source: Bloomberg, Moody's, Amundi Research. Data as of 6 April 2020.

Considering the current spread level of the US HY market and a recovery rate of about 40% in case of defaults, the market is currently pricing in a default rate of about 10-11%, in line with our estimates under a -2% US GDP growth scenario. Therefore, the **US HY market appears to have already discounted most of the bad news and any further deterioration is unlikely given the substantial policy action that has already been delivered**.

Investment convictions

"Selectivity will be of paramount relevance, with a focus on industries and companies that are relatively insulated from the worst downstream effects of the virus."

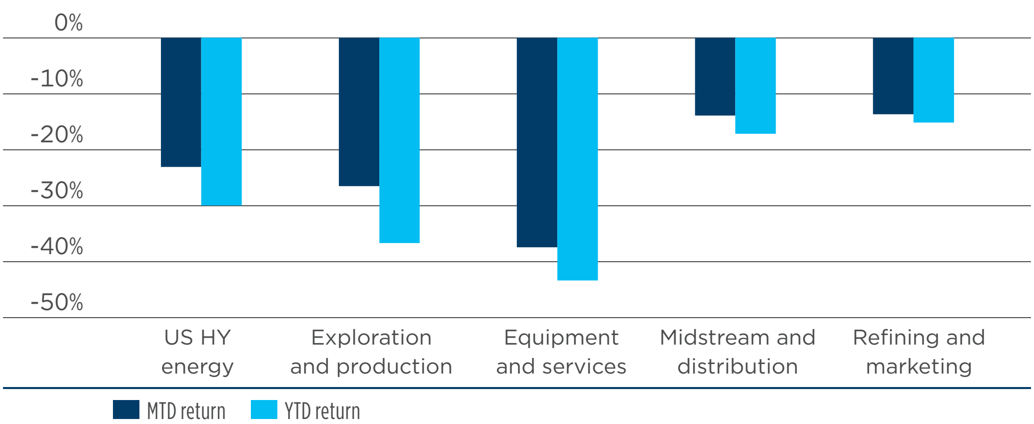
US HY

In such troubled times, **selectivity** will be of paramount relevance, with a focus on industries and companies that are relatively insulated from the worst downstream effects of the virus, such as those producing essential goods and services (e.g., supermarkets). At the same time, **companies dependent on consumer discretionary spending may be the worst affected**, for example, theatres and restaurants. **Liquidity and flexibility** are top priorities in the current phase and need close monitoring. Active long-term investors could identify mispriced securities and reposition their portfolios in an effort to **achieve ample liquidity and take advantage of possible dislocations in asset prices**.

Given the current market stress, the **downgrade wave should be an important dynamic**. According to JP Morgan, we could face up to $215bn in downgrades into the US HY market this year, which would be a record. This would increase the current size of the HY market by 15% and significantly reshape the HY universe. Fallen angels have had very strong return profiles historically, as investment grade (IG) companies are generally larger and more diversified than companies that were always HY. Nevertheless, many of the fallen angels will experience major challenges to their business models, so selectivity will be key. For instance, since many US energy companies are likely to be downgraded, portfolio managers will have to analyse their operations in depth to determine field by field if they can survive the oil price plunge. **The Fed's decision to buy fallen angels is a powerful backstop that could limit pressures on that segment**.

Although since the last week of March we have seen a significant market rally, the **volatility is probably not over yet**, even if the policy responses from central banks and governments are encouraging. Markets are likely to stabilise only when indications emerge that the virus can be brought under control through an effective vaccine and the mortality rate is reduced through drugs that lessen the virus's effects.

Figure 6. Energy sector and subsector returns



Source: Amundi, Bloomberg. Data as of 14 April 2020. **Past performance is no guarantee of future results.**

At the sector level, energy has been hit heavily but the differences among its subsectors are substantial, with **the exploration and production (E&P) and equipment and services (E&S) subsectors the worst performers**. We had previously expected many E&P companies to default in 2021 and beyond. **Now those defaults are likely to happen in 2020**. The oil services companies that have been dependent on E&P spending will be under extreme pressure. We believe that the **midstream and distribution and refining and marketing subsectors appear safer**.

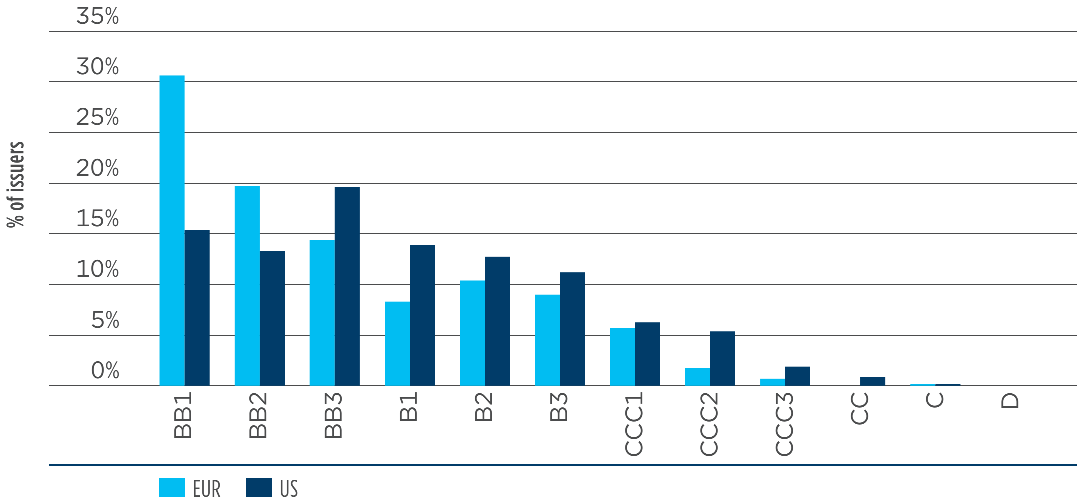
Marina COHEN
Head of Euro HY Bond Portfolio Management

Euro HY

In **EU HY**, we favour BB names in defensive sectors such as telecommunication, media and technology (TMT), healthcare and packaging due to the current low visibility on the economic outlook. **We expect these more resilient issuers to reopen the primary market over the coming weeks**. The EU HY primary market was closed in March. This situation is likely to prove transitory and we expect solid BB names in the above defensive sectors to come back with fresh issuance at some point. This could even be in the very short term, especially if there are some inflows, as has been the case in US recently. For B- and CCC-rated names, it could be more difficult, though achievable if they are willing to pay a higher price. **In cyclical sectors** such as automotive, investors should wait for more clarity on how long the lockdown measures will last, especially considering the fact this sector is likely to grow, with a new wave of fallen angels offering new opportunities. Finally, on B- and CCC-rated corporations, investors should take a **case-by-case approach**, looking for beaten-down bonds that could successfully overcome the coronavirus crisis. The rating distribution of EU HY issuers compared with their US peers shows a higher share of BB-rated names. In our view, the EU HY market is of better quality than the US market, on average, and could therefore offer appealing diversification opportunities.

"Markets are likely to stabilise only when indications emerge that the virus can be brought under control through an effective vaccine and the mortality rate reduced."

Figure 7. US vs. EU HY, rating distribution as a share of issuers



Source: Amundi, Bloomberg. Data as of 6 April 2020.

Colm D'ROSARIO
Deputy Head of EM Fixed Income

Emerging markets HY

Emerging markets entered this crisis in better shape compared with prior crises, with EM credit fundamentals in good condition and EM sovereign vulnerabilities generally lower than at any point in the recent past. We believe that as an asset class, **EM HY is oversold for a number of reasons**:

- A large portion of the spread widening was triggered by **outflows from EM debt**, which created a technical overhang. EM HY, as a less liquid asset class by nature, suffered disproportionally compared with other asset classes;
- Some of the illiquidity was triggered by **disruptions in trading infrastructure** in light of the COVID-19 outbreak and government actions urging people to work from home. With EM HY yields currently above 10%, **the default rate implied by current spreads is above 50% for the next five years**. We believe it is very unlikely to experience such a high default rate for the following reasons:

  - **Almost 50% of the EM HY universe is BB-rated**, with many of these companies being systemically important to their respective countries;
  - **The refinancing risk is relatively low**, with most companies having already refinanced their debt over the last few years; and

- Historically, **default rates have not reached such a level even during the GFC**. For instance, in 2009 the default rate peaked at 10.5%. In addition, at that time, the crisis originated from the financial sector, while this year we do not expect a banking crisis. Default rates dropped sharply in subsequent years and returns were significant.

- **EM HY is well diversified**. From a **regional perspective**, the exposure to the lowest-rated sovereigns is modest, with larger exposures instead to Brazil, Russia, Turkey, India and China. On a **sectoral basis**, standard benchmarks for the EM HY market have financials as the largest sector, followed by telecoms and other consumer-related sectors. Other sectors such as transportation – heavily hit during the current crisis – have a low weight in such benchmarks; and
- EM HY has, on average, **low duration** (about 3.65 years); this may help the rebound for performing credits once the market recovers. Following other recent sell-offs, **EM HY has more than compensated investors for drawdowns in subsequent years, and value could be found in the market at the right moment**.

"We believe there is value to be found in sectors such as TMT, real estate, healthcare and – selectively – financials and utilities."

On the other hand, investors should bear in mind that the **full effects of the shock to growth from the pandemic and the oil price war have yet to be fully realised**. In addition, while the shock to the oil market was initially a supply-side shock, it has now developed into a demand shock as well, depressing oil prices further. Governments and central banks have committed to delivering fiscal and monetary stimulus and OPEC talks could resume, but it may take some time to see the effects. As a result, we expect volatility to remain high and investors should look for a **combination of value and quality styles, still with a preference for defensive sectors**.

Since the sell-off has happened across the board, we believe that there is value to be found in sectors such as **TMT, real estate, healthcare and – selectively – financials and utilities**. In **energy**, despite the decline in oil prices, **we favour the integrated players** that could weather the current crisis or **independent producers (preferably natural gas) with strong balance sheets**.

From a **regional perspective**, we see **value in China** as we believe that both governments and corporates have the flexibility to adjust to the changing conditions, and China is the most progressed along the COVID-19 curve. Despite this, we find China's industrials less attractive. In addition, we believe there is value in **selective exposure to Latin America, particularly to Brazil and Chile**, which currently may offer attractive valuations, **while in Central and Eastern Europe we look for value in higher quality credits in Turkey and Ukraine**.

"Opportunities could be found through robust credit analysis to find resilient credits with depressed valuations that could benefit from any recovery in the global cycle."

There are risks and opportunities in this market. The risks are that this period of economic weakness will be prolonged by extensions to the lockdowns across the global economy, and that prolonged commodity price weakness will continue to drag on emerging economies. That being said, we believe there could be opportunities to be found through robust credit analysis to find resilient credits with depressed valuations that could benefit from any recovery in the global cycle. While many companies are dependent on local growth drivers within EM, many are also export dependent, so while there will be pressure on earnings as long as the global economy is slow, there could also be a quick recovery once the global economy picks up. Significant stimulus measures will drive this movement. Experienced investment teams will be able to minimise defaults through **strong security selection and could offer investors attractive USD yields**.

Conclusions

At the global level, current market conditions are complex, with an unprecedented crisis accompanied by an unprecedented policy response. **Much of the current gloom is already priced in, but investors should remain alert and flexible**. Being invested in the long term has usually paid off in the past, allowing investors to make up for the losses recorded during sell-offs.

In our view, **diversification** is paramount. Exposure to the global HY market allows investors to benefit from different growth drivers and different recovery timings from the pandemic. While we cannot call the bottom of the market and acknowledge that volatility is likely to remain high, we believe that the market will normalise and strengthen once the pandemic's peak has passed. **Current dislocations may be seen as an opportunities for investors who are able to bear some volatility and who have an appropriate investment horizon**.

Definitions

- **Basis points:** One basis point is a unit of measure equal to one one-hundredth of one percentage point (0.01%).
- **Bond ratings:** If the ratings provided by Moody's and S&P for a security differ, the higher of the two ratings is used. Bond ratings are ordered highest to lowest in a portfolio. Based on S&P measures: AAA (highest possible rating) through BBB are considered investment grade; BB or lower ratings are considered non-investment grade. Cash equivalents and some bonds may not be rated.
- **CEEMEA:** Central and Eastern Europe, Middle East and Africa.
- **Credit spread:** Differential between the yield on a credit bond and the Treasury yield. The option-adjusted spread is a measure of the spread adjusted to take into consideration possible embedded options.
- **Cyclical vs. defensive sectors:** Cyclical companies are companies whose profit and stock prices are highly correlated with economic fluctuations. Defensive stocks, on the contrary, are less correlated to economic cycles. MSCI GICS cyclicals sectors are: consumer discretionary, financial, real estate, industrials, information technology and materials, while defensive sectors are consumer staples, energy, healthcare, telecommunications services and utilities.
- **Default rate:** The percentage of issuers that failed to make interest or principal payments in the prior 12 months. Default rate based on BofA indices. Universe consists of issuers in the corresponding index 12 months prior to the date of default. Indices considered for the corporate market are ICE BofA.
- **Drawdown:** The peak-to-trough decline during a specific record period of an investment, fund or commodity, usually quoted as the percentage between the peak and the trough.
- **Fallen angel:** A fallen angel is a bond that was given an investment-grade rating but has since been reduced to junk-bond status due to the weakening financial condition of the issuer.
- **Option-adjusted spread (OAS):** The measurement of the spread of a fixed-income security rate and the risk-free rate of return, which is adjusted to take into account an embedded option.
- **Quantitative easing (QE):** QE is a monetary policy instrument used by central banks to stimulate the economy by buying financial assets from commercial banks and other financial institutions.
- **Spread:** The difference between two prices or interest rates.
- **Volatility:** A statistical measure of the dispersion of returns for a given security or market index. Usually, the higher the volatility, the riskier the security/market.
- **Yield to worst (YTW):** The lowest potential yield that can be received on a bond without the issuer actually defaulting.

With the contribution of

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