Morgan Stanley

INVESTMENT MANAGEMENT

High Yield Outlook: Current Risks and Opportunities

FIXED INCOME | GLOBAL FIXED INCOME TEAM | MARKET PULSE | March 25, 2020

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Currently, we are not implementing any large-scale portfolio changes, as liquidity is extremely thin and transaction costs are as high as they have ever been. This makes it difficult and prohibitively expensive to reposition our portfolios. Given this, we do not believe making large-scale changes in this market serves our clients well. We have our credit research team focused on assessing liquidity needs of the companies we are currently invested in and will sell credits we deem to be a near-term default risk. Once we have more clarity around monetary and fiscal stimulus packages, and if markets start to stabilize, we will begin to slowly reposition the portfolios. Broadly speaking, here are our thoughts on sector positioning and where we see opportunities going forward:

We are cautious on a sector basis. In general, spreads in the high yield sector are pricing in 12-14% default rate, which is in line with what we saw during the financial crisis, so getting sector positioning right is critical for performance over the coming months. We have very little fundamental guidance to go on, as most companies directly affected by the coronavirus have begun to pull their financial guidance. What we do know is that some sectors will have their revenues effectively go to zero for the next 3 to 6 months. We would note that companies have generally done a good job terming out their debt so near-term maturities are minimal, which is positive.

Until we have a sense of the duration of the public health side of this crisis, we will likely not be adding exposure to some of the most impacted sectors **(Energy, Gaming, Lodging, Leisure, Airlines, Autos).** We need to understand more clearly the quality of these industries' balance sheets, liquidity, cash burn rates, and any near-term maturities before adding names in these sectors. Furthermore, many of these industries are likely to receive some form of bail out and at this point, it is impossible to predict the terms of a bail out, what it means for creditors, what limitations it will put on businesses, and where it will sit in the capital structure.

The **Energy** sector is also in distress given the unprecedented move lower in oil prices. Oil prices have dropped by more than 50%, driven by drastic demand declines due to COVID-19 and increased supply due to a collapse in OPEC negotiations. We would note that a key difference between the commodity crisis of 2015/2016 and today is that this sector today is experiencing a supply issue and a demand issue at the same time. If prices continue to remain low, liquidity concerns and bankruptcy risk will rise significantly. We expect defaults to tick up markedly and an increase in fallen angels from Investment Grade.

In all the problematic sectors, there will ultimately be companies that make it through this crisis, but it is too early to be able to accurately discern which. There will also be credits in less exposed sectors that may just be too over-levered to weather this. Despite this, we believe opportunities do exist. In our view, the baby has been thrown out with the bathwater in some sectors, and there are businesses that may actually benefit from the current environment. As the market has traded off, we believe good credit exposure can be had at levels not seen since the Great Financial Crisis.

We think **non-cyclical consumer credits,** primarily **Food and Beverage** and **Consumer Products,** should benefit from relatively stable demand in their end markets. Credits within **Technology** may benefit as work from home requirements are driving demand in various technology subsectors. There is upside to hardware and component demand driven by equipment needs, increased software demand for virtualization, end-point security, recovery and backups, and cloud access. With most of the country ordered to stay at home, strong demand for **Media** (television, streaming, digital) content should buoy valuations. **Telecom / Wireless / Wirelines** should see steady end markets as well and remain very defensive. **Healthcare** is a large and diverse sector and while we do not like the entire sector, facility based healthcare providers may see increased utilization with the Coronavirus. Smaller sub-sectors like healthcare equipment rentals and some pharmaceuticals should benefit from increased demand as well.

This is first and foremost a public health crisis. We need strong containment measures and policy responses to stem the spread of the virus so economic activity can return to normal. Markets are beholden to this, and a strong policy response in the form of both fiscal and monetary action from Washington is necessary to lessen the virus's impact and keep the economy out of a deep and prolonged recession. Historically, high yield has proven itself to be resilient and has provided strong total returns after periods of extreme spread widening. It is our view that active managers have the potential to outperform, avoid problematic sectors, and minimize default losses.

We are not calling a bottom, but looking back historically whenever HY spreads have been at this level the market has enjoyed subsequent years of good returns. Data shows that the median annualized return over the next 12, 24, and 36 months for high yield bonds, as measured by the JPM U.S. High Yield Index, as spreads cross 900bps is 36.9% 25.5%, and 20.8%.[1] In fact, with a horizon of a year or more, the index has never had a negative return historically, in 25 examples of buying HY bonds as spreads cross 900bp.[1] While this crisis is in many ways different from previous periods where the HY market has widened, we think that at these levels (11.51% yield, 1084bps spread for the Index, as of 3/25/20) investors who are comfortable with the heightened risks of high yield investing are starting to be compensated appropriately. That said, we are reserving dry powder in case we do go wider.

[1] The index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results.** See Disclosure section for index definitions. Performance above represents the median annualized return of the JPM US High Yield Index when spreads at month end were above 900bps; this has happened 25 times since the inception of the index on 1/31/1995 through the current month through 2/28/2020.

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