Laissez les Bon Temps Rouler!

After the strongest fourth quarter performance since 2002 is there any room left for credit to rally? John Fekete, Crescent Capital Group's Head of Capital Markets, discusses the state of the US economy and the outlook for debt markets.

John Fekete
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John Fekete is Head of Capital Markets and is the lead Portfolio Manager of Crescent Capital Group's High Yield Bond, High Income and Syndicated Credit Solutions strategies. He is a member of Crescent Capital Group's Management Committee.

Q: Few people were expecting markets to recover so quickly in 2020. How did the US High Yield asset class fare?

Investors who maintained exposure to credit within their overall portfolio have, once again, been rewarded. Returns have been strong since the Covid-led downturn in 1Q, when the ICE BAML US High Yield Index ("Index") returned -13.1%. The asset class experienced a sharp snap-back and returned 6.17% in 2020. The rebound was faster than many expected thanks largely to the Federal Reserve and US Treasury's swift policy responses to quickly restore stability to the functioning of credit markets.

Q: Where are valuations today?

The Index spread of 383 basis points as of Feb 1, 2021 is slightly higher than pre-Covid levels (372 basis points on Jan 1, 2020), while the Index yield-to-worst hit an all-time low of 4.28% on February 1, 2021 thanks to record low Treasury rates. Spreads look attractive relative to Investment Grade Corporates ("IG"), especially given US High Yield bonds are much more resilient when interest rates rise. The High Yield to Investment Grade spread ratio continues to look wide at over 4:1, the second-highest reading in the last four years despite the fact the US High Yield universe has its highest average credit rating since inception. We expect to see additional inflows into below investment grade credit given negative real yields in the IG market.

Q: How would you describe the overall quality of the US High Yield market today?

The quality of the US High Yield market has improved as defaulted debt exited and fallen angels entered the benchmarks. January was the biggest month in two years for rising stars and became the first month where rating upgrades outpaced downgrades since the Covid-19 pandemic began, with $19 billion of net upgrades within US High Yield and $7 billion net upgraded to IG. At the same time, credit quality has never been higher, with only 29% of the US High Yield market rated B- or lower, the smallest percentage since 2004.

Q: What is your outlook for below investment grade credit?

We see further upside in credit in 2021. The worst of the pandemic's economic impact is behind us. The economic outlook is firmly positive, supported by record stimulus. Credit investors have grown more confident that a dovish Fed and central bank support can sustain the credit market rally into its second year, fueling demand for higher-yielding assets. Globally coordinated monetary policy and low US government bond yields make it difficult to be bearish on credit today. GDP growth is forecasted to strong in 2021, in the mid-single digits, corporate defaults have peaked and are declining, and credit rating upgrades are expected to outpace downgrades, providing a path for credit spreads to tighten further.

Q: Any signs the Fed is considering withdrawing market support?

The December FOMC meeting suggested near-term tapering is not planned. The median dot plot showed the Fed on hold through 2023. As a result, we expect Fed Funds to remain at the effective lower bound through 2023 until the US economy has achieved full employment and inflation is above 2% on a sustained basis. This is similar to 2009, when the Fed's low rates and overall accommodative policies pushed investors further out the risk curve to help support the economic recovery. While longer term interest rates (10-year and 30-year US Treasury bonds) have begun to move higher, short-term rates have not budged. In fact, 3-month LIBOR set a new low record of 19 basis points in early February. This puts a lid on interest expense for most borrowers.

Q: Last year you were closely monitoring the surge in corporate defaults. How did things play out and what is your current outlook?

The corporate default rate has not been nearly as bad as feared in the first half of 2020, when many investors were expecting corporate defaults to exceed 10% of the US High Yield market. According to Credit Suisse, the trailing 12-month US High Yield default rate was 6.4% at year end 2020, heavily driven by the energy sector. Excluding energy and retail, the trailing default rate was only 3.0%. Defaults stabilized and have been dropping since mid-2020, with revenue and profits beginning to recover. Credit strategists are expecting defaults over the next 12 months to be in the range of 4-5%, in line with the historical annual average for the asset class. Capital markets were accommodating in 2020 with primary supply volumes setting an annual record as issuers took full advantage to bolster liquidity and refinance near-term maturities. As a result, we don't expect to see a meaningful pick-up in debt maturities occur for another 4-5 years.

Q: What if the vaccines are ineffective against new Covid-19 variants?

Narrower spreads may leave investors vulnerable if vaccines prove ineffective against coronavirus mutations, but we think central banks would intervene once again should a major market correction take hold.

Q: Has the rally gotten ahead of itself?

The US economy looks to be on a path towards sustained recovery. The risk to consensus 2021 revenue and profit growth may be to the upside, supportive of value-oriented asset classes like credit, leading to additional spread tightening. One underappreciated risk may be inflation; accelerated consumer spending coming out of the pandemic could quickly put upward pressure on inflation. Berenberg Economics estimates more than $1.4 trillion of savings in the first three quarters of 2020, about twice as much as average, due to Covid-related spending reductions combined with income from individual stimulus payments. Should those savings patterns reverse, investors concerned about reflationary risks may do well to favor high yield bonds and bank loans over IG bonds as IG duration hovers near a record high.

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About Crescent

Crescent Capital is a global credit investment manager with $30+ billion of assets under management. For nearly 30 years, the firm has focused on below investment grade credit through strategies that invest in marketable and privately originated debt securities including senior bank loans, high yield bonds, and private senior, unitranche, and junior debt securities. Crescent Capital is headquartered in Los Angeles with offices in New York, Boston, and London and more than 180 employees globally.

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