The Way Forward How to Safely Navigate Credit Opportunities in an Age of Uncertainty

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This has been a year of surprises for investors. The longest economic expansion on record and the bull market in credit came to a swift and unexpected end with the global spread of COVID-19. Then just as quickly as the dire outlook had taken hold, it was overtaken by a surge of investor optimism, as U.S. policymakers took significant steps to bolster the economy. However, significant uncertainty remains about when a recovery will begin, and what shape it will take. John Fekete, head of Crescent Capital Group's Capital Markets team, discusses potential signals of an economic rebound and how expanded intervention from the Federal Reserve could alter how investors approach the credit markets.

Q: How has credit risk changed in this economic environment?

One of the big-picture themes is that yields were relatively low pre-COVID-19 and they're still low, but for different reasons. They were low before the pandemic because you could argue they were overbought, and perhaps investors were complacent. Yields are low now on an absolute basis because the Fed's plans to buy corporate bonds have given investors confidence that the securities will retain their value and could potentially appreciate.

Looking back at the most recent recession, it took about seven months to go from a bull market to a bear market in credit. Around the 2001 recession, it took about 14 months amid anemic growth. This most recent sell-off only took one month.

My view today is that things are not nearly as bad as we feared in March and April. At that time, I was expecting corporate default rates to exceed 10%, and many strategists were expecting the same or even higher. Today, I've lowered that expectation considerably — 6%-8% is my forward default forecast. That's mainly because the capital markets have been open to borrowers that need liquidity, and the equity market has been supportive. This is critical because when companies default, it's

usually because they can't refinance their debt or they've run out of cash, not just because their leverage multiples get high.

Q: What do you anticipate moving forward?

People are unsure of the shape of the economic recovery: Is it V, is it U, is it L, is it W, is it something else? A few data points suggest that the recovery is sharper and picking up more quickly than we'd expected. That's one reason the environment for risk has changed.

The May retail sales report blew away expectations. It was up 18% month over month, a gain more than double the market's consensus expectations. What that says to me is consumers are spending as if they don't foresee permanent damage to their incomes. Either they haven't lost their jobs or those who are on furlough expect to regain their jobs relatively quickly. The stronger-than-expected job gains in June lend confirmation to the idea that the U.S. is in the midst of a rebound. If that's true and that's part of the trend, then the risk to growth estimates is probably upside risk, not downside risk.

However, we should temper our optimism. While economic data recently have been positive, recoveries rarely follow a straight line. There are still plenty of things to worry about. A spike in COVID-19 cases, or a second wave — that risk is definitely worrisome both from an economic standpoint and a public health standpoint.

In the bond market, credit spreads and bond prices recently reached levels that are consistent with prior recessions. They bottomed out in March and April, and we've since recovered off the lows. I think that's largely because the default expectations are no longer as gloomy, and also the Federal Reserve's support for corporate bond markets has been a real game-changer.

Q: What has the Fed's support done for the market?

The Fed's stimulus, which includes purchases of government and corporate bonds, and many other more targeted kinds of support to the markets, has been unprecedented. These measures, coupled with the stimulus spending and loans from the federal government, have been crucial in improving demand for corporate credit. The idea of the Fed purchasing investment-grade and high-yield ETFs and individual bonds is really incredible and certainly unexpected.

However, when you take a step back, this support is consistent with the seeds that were planted in 2008-09 during the financial crisis when central bankers were responding to a loss of investor confidence in markets and institutions. My hunch is that the Fed never wants to see that happen again. The Fed wanted to intervene very quickly and make a strong statement, and it absolutely did, and it has made clear its intention to keep interest rates near zero for a very long time.

Q: Could the Fed's response have a longer-term impact on high-yield bond prices?

It could change how asset-allocators think about credit. If you know the Fed is there as a backstop, then you can reap all the benefits of the excess return that credit offers — and you also know that if the market crashes, the Fed is there to save the day. So institutional investors like pension funds, endowments and insurance companies may change their approach to investing: There may be an opportunity to get excess return for five, six, seven years, knowing that when the market has one bad year, their risk will be tempered.

We're not going to know for a while if those institutions change their allocations, but this could make credit a more impactful, more meaningful part of institutional investors allocations for years to come.

Q: Will an active Fed make it safer to invest in credit if your goal is preserving capital?

Absolutely. Some companies won't make it — I don't want to convey that nobody is going to fail — but certainly fewer will fail than people feared. The Fed's support, as long as it lasts, really does suggest credit could be a safer asset class — more upside and less downside.

Q: What parts of the high-yield bond market look attractive?

Some areas have done incredibly well, like grocery stores and pharmacies. I would point out that retail in general has fared better than we expected. Notably, home-related purchases have been a real bright spot in retail, which might

suggest a stronger-than-expected housing market.

The sector of double-B-rated credits also looks intriguing. This is the highest-quality part of the high-yield market, so it has the lowest default risk among high-yield credits. It's also the fastest-growing segment, representing 56% of the market, up from less than 30% in 2000. What's interesting is that credit spreads are very, very cheap. They are cheaper today than 85% of the time over the past quarter century. To me, that's an opportunity.

Q: Double-Bs were very expensive last year — what happened to that part of the market?

Yes, they were incredibly rich. At the start of the year, the segment's yield was 2 percentage points over Treasury yields. Today they're at 4.9 percentage points over Treasuries. So while the broad high-yield market is cheaper than it was in January, that particular segment sticks out as being especially oversold, and it's one where we see value.

What's happened is there have been a lot of fallen angels — that is, investment-grade companies whose credit ratings have fallen to high-yield territory. Year to date, those downgrades total as much as $175 billion. The affected companies have very recognizable names: Ford Motor, Kraft Heinz, Apache Corp., Occidental Petroleum Corp. When these downgrades happen there is selling pressure, which pushes their prices down and their yields higher. That's because many of their bondholders, like insurance companies and income funds, get tapped on the shoulder, either by the risk department or their regulators, and they become forced sellers. That forced selling from the sudden, new supply of double-B bonds causes the other, legacy double-Bs to reprice. Sometimes it causes the whole segment to get cheap, and that's what we're seeing today.

For us, that's a value opportunity. We're going to step in. When we see that forced selling, we can take advantage of the value opportunity.

Q: What parts of the high-yield market face the most trouble?

Some companies in the leisure and transportation space — whether it's cruise lines, rental car companies, movie theaters, etc. — are at the greatest risk because their future is most uncertain and it's hard to see a path to short-term recovery.

Airlines are the most vulnerable, despite support on Capitol Hill to save them. Traffic is picking up, but it's still well below pre-COVID-19 levels, and most people on airplanes these days are not business travelers; they're not paying full fare. They're only flying because they're getting a discounted rate, and that's not what the airlines need to survive.

Something we must do now in assessing risk — and this is not normally something fixed-income analysts do — is determine the impact of government stimulus programs and rescue financings. We have to understand which companies and sectors are the beneficiaries and which have been excluded, because that could be the reason a company goes bankrupt, like Hertz, where they don't get the support.

Q: Are you worried that the high-yield market has started to overheat?

One factor I monitor to determine whether the market is healthy or not is aggressive risk-taking in triple-C-rated bonds. I'm not seeing that today.

If you look at all the new bond issuance this year, only 9% of new issuance is rated triple-C. That tells me investors are not being indiscriminate; they're not showing interest in the riskier, lower-rated tier. That's a healthy sign, but it also means that the few triple-C-rated bond issuers that do need capital could find that the market is closed to them. So they're going to be at the greatest risk during the recession, as well.

Q: One reason bond prices have been high for years is the low-interest-rate policies of central banks around the world. Has this picture changed with COVID-19?

Because of worldwide low central bank interest rate policies for the better part of the last 10 years, macro factors have been more dominant in making investing decisions than idiosyncratic credit factors. By that I mean

most high-yield shops, most credit shops are set up with research teams that are looking to avoid potential defaults. However, we've had a decade where default rates have been below average. If there aren't a lot of defaults to avoid, there have to be other factors that are more impactful on performance.

Factors like interest rates and commodity prices had been the greater determinants of returns. That's all changed today. Default rates are already twice what they were in January and are probably going to increase further. It's really a bond-picker's market now, where understanding things like which companies have the liquidity to survive and which won't benefit from government assistance is key.

Q: What's the most important thing when it comes to winning in this market?

You need to be able to minimize credit losses and also be able to fully participate in the recovery in the market. Look at just the last three months. Bond prices had one of the worst months in the history of credit in March followed by one of the fastest, strongest recoveries ever on record. If your process was solely based on avoiding losses, you would've done great on the downside, but you would've missed the entire recovery. So you really need to be nimble. You've got to be able to constantly reassess value because it's shifting, not static.

Q: How do you balance opportunities against risks and surprises?

One of our tenets is to have an all-weather strategy that can generate above-market returns in both positive and negative credit market environments.

The best way to avoid problem credits is not to have them in your portfolio to begin with. That's the goal with our due diligence process. The second part is trying to avoid being in a first-loss position should something go wrong. We always try to have some debt below us in the credit structure, which gets repaid after us, or large equity checks from the private equity sponsors whom we're investing alongside.

There are going to be unforeseen challenges — for example, nobody saw the pandemic coming. Another aspect of how we've mitigated risk before the pandemic is helping now. We've typically avoided buying bonds from companies whose operations leave them little margin for error. Companies where there's no debt or equity cushion below you are the situations that today are the most vulnerable.

The reason we do those things is that when you have a market dislocation, such as we've seen with COVID-19, reducing unnecessary risk can be the difference between a manageable decline and a catastrophic loss. That's really why we've done it.

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