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**RESEARCH NOTE** MARCH 2020

Corporate credit

# Quantifying COVID-19: Impact on credit markets

The coronavirus outbreak has become a full-fledged global pandemic, and its effects have been felt on economic activity, financial markets and the daily lives of most Americans. In this note, we'll revisit the impact that COVID-19 has had to date on credit markets specifically as well as the best course of action we see for investors moving forward.

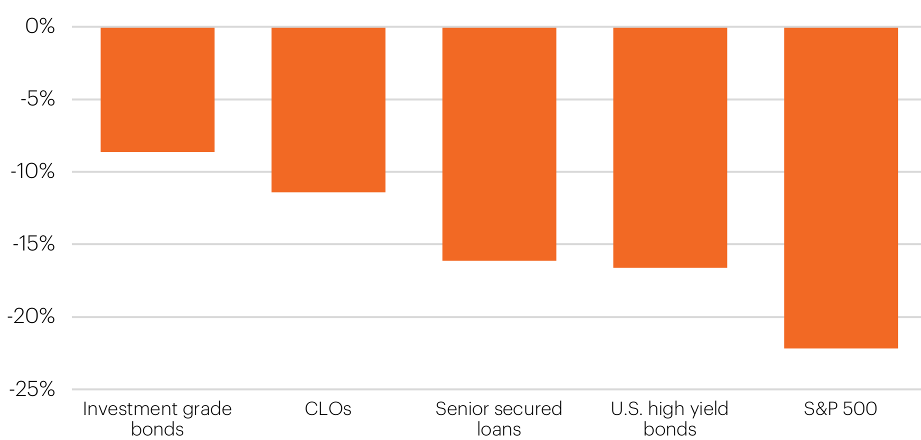
**KEY TAKEAWAYS**

- Credit markets have sold off alongside equities in "round two" of the global sell-off.
- While extreme, returns by sector tell us that the sell-off has remained orderly and logical.
- Recent Fed policies will have indirect impacts on sub-investment grade credit.
- Funds with the ability to remain active and tactical during this environment will be best positioned for the ultimate recovery.

What a month it's been. Just a few weeks ago, we wrote about the impact of the novel coronavirus on credit markets. We noted that, generally speaking, credit had fared relatively well, as high yield bonds and senior secured loans ended February down -1.55% and -1.32%, respectively, versus the -8.23% decline in equities. Things look different now, with the historic rout in risk assets continuing through March with few signs of abating. Let's check back in on the same data points we discussed in February.

News of an oil price war between OPEC+ participants Saudi Arabia and Russia broke on March 8. This new challenge, combined with continued news of the growing spread of coronavirus, spurred what we view as "round two" of the global sell-off. This time, we saw some capitulation in credit markets as they plunged rapidly while equities continued their descent. To date, loans and high yield bonds have captured roughly 58% and 62% of the equity downside, respectively.

**PERFORMANCE SINCE BEGINNING OF SELL-OFF (2/20/2020)**




Source: Bloomberg, as of March 26, 2020.

## Impact on returns

While it is undeniable that high yield bonds have been hit hard, given their moderate correlation to stocks and historic tendency to draw down less than equities during market stress, performance has been roughly as expected. High yield bonds have outperformed the S&P 500 by over 1,200 basis points (bps) since February 19.

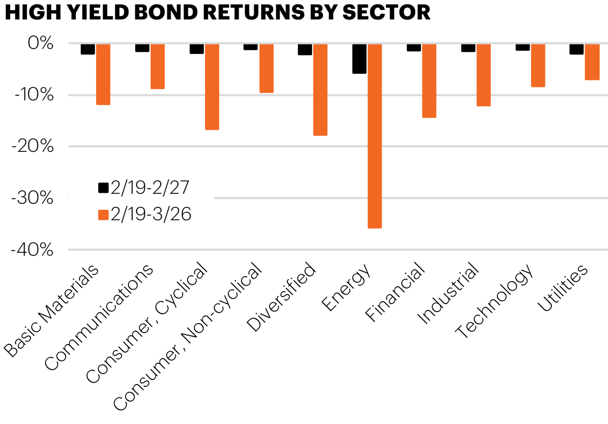
The loan market has fared similarly, outperforming the S&P 500 by roughly the same margin as high yield bonds. This, however, is not necessarily in line with our expectations. Given their seniority in the capital structure, we would expect loans to offer more downside protection than high yield, yet they are trading roughly in line with the bonds that are typically subordinate to them. In fact, loans have gone through a historically bad stretch recently, with four of the five worst trading days on record for the asset class occurring between March 12 and March 19. We believe that this can be attributed to some cracks we've already seen in the loan market, as we discussed in a previous research note.

We believe managers with the ability and expertise to remain flexible and invest across asset classes and capital structures in search of the most compelling risk/return profiles will be best positioned coming out of this sell-off.

## Impact by sector

Analyzing high yield returns by sector shows that the sell-off has not been uniform. Last month we observed that energy was the clear laggard; while that has not changed, other sectors have sold off significantly as well. To date, industries that may be most impacted by the economic fallout from the coronavirus (such as entertainment, leisure and hospitality) have traded down the most, suggesting that thus far the sell-off has been relatively orderly.

**HIGH YIELD BOND RETURNS BY SECTOR**




Source: Bloomberg Barclays U.S. High Yield Corporate Bond Index.

## Impact on spreads

Spreads have widened considerably from the relatively tight levels we saw entering 2020, with high yield spreads crossing 1,000 bps on March 20. The velocity of these moves is historic: five of the six largest days of spread widening occurred within the last month. While wide, spreads still sit well below the peak reached in 2008 of 1,940 bps.

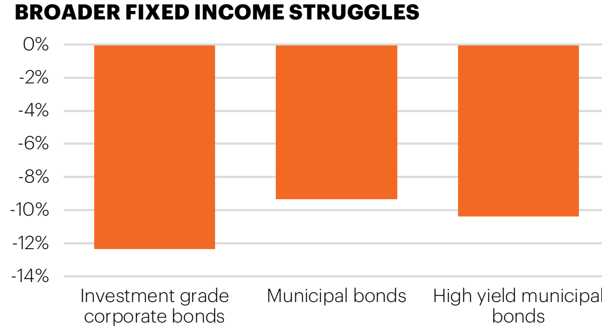
High yield had looked richly valued to start the year but now looks considerably less expensive. What do forward returns look like when "buying low" in high yield?

Spreads have widened past 900 bps 25 times in high yield bond history. If held for at least 12 months, investors have never lost money when spreads are this wide. The median forward annualized 1-, 2- and 3-year returns for the periods following such spread levels are 36.9%, 25.5% and 20.8%, respectively.[1]

## Impact on broader fixed income markets

While we have certainly seen sub-investment grade credit markets hit hard, the weakness has extended to higher-quality areas of the fixed income markets as well, including investment grade corporates and municipals.

**BROADER FIXED INCOME STRUGGLES**




Source: Bloomberg, ICE BofAML U.S. Corporate Bond Index, ICE BofAML Municipal Bond Index, ICE BofAML High Yield Municpal Bond Index, as of March 23, 2020.

Following intervention by the Federal Reserve, these markets rebounded to a degree, but the initial pattern of the sell-off was telling. Spread widening across fixed income isn't unusual given the dramatic declines for equities, but the magnitude of the declines within the investment grade markets was

1 J.P. Morgan.

abnormal. We believe this was a liquidity-driven sell-off as large, retail and institutional investors sold assets to raise cash.

## Impact of recent Fed policies

In an unprecedented move, the Federal Reserve announced essentially limitless quantitative easing (QE), meaning that they are prepared to purchase unlimited amounts of Treasury debt and mortgage-backed securities to inject markets with liquidity. Even more historic, the Fed can now purchase primary and secondary issues, subject to certain restrictions, of investment grade corporate debt. These measures also extend to investment grade bond ETFs, whose mismatch between the liquidity of the structure and that of the underlying investment has become especially apparent in recent days, with many bond ETFs trading at significant discounts to NAV (meaning the price per share is less than value of the underlying securities). The added liquidity for investment grade corporate bonds was implemented by European central banks following the financial crisis in 2008, but this action has never previously been taken by the U.S. Federal Reserve.

While these measures do not explicitly impact high yield bond or senior secured loan markets, we do think that the sub-investment grade market will benefit from greater stability in broader credit.

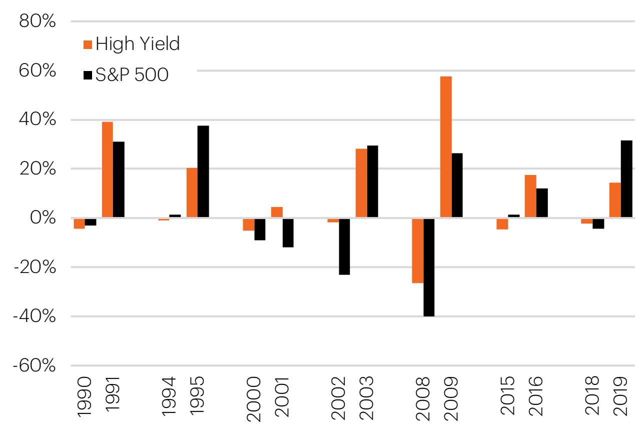
## Impact on CLO markets

The collateralized loan obligation (CLO) market, which is inextricably linked to the senior secured loan market which serves as its underlying collateral, remained relatively benign during February. Since then, CLOs have seen major oscillations as loans have remained under pressure. As part of its new measures, the Fed now allows banks to supply AAA rated CLOs as collateral for overnight lending. AAA CLOs had initially been caught up in the liquidity squeeze as investors rushed to raise cash, as these were relatively high-dollar priced, investment grade rated assets. Banks have historically been large purchasers of CLOs, and their ability to continue holding them should provide some stability and relief to the entire asset class. This could help eventually shore up demand in the loan market as well, as CLOs serve as the primary demand source for senior secured loans.

## What now?

There is no doubt that this sell-off has caused a great deal of pain and many uncertainties remain. However, credit has historically been very resilient. Senior secured loans have only experienced two calendar years of negative returns. While high yield has had seven, neither market has ever experienced two consecutive years of negative returns, and each typically generates strong returns in the year following a sell-off.

**HIGH YIELD HAS NEVER HAD TWO CONSECUTIVE YEARS OF NEGATIVE RETURN**




Source: Bloomberg.

We do not know how long the impact of the virus outbreak will be felt, but we have little reason to believe that credit's ultimate recovery will not mirror those that we've seen in the past. In this environment, we think managers that can remain active and tactical have a distinct advantage. These markets can reward those with fundamental, bottom-up investment capabilities as, ultimately, a slower economy and rising defaults may create winners and losers among credit issuers.

**Robert Hoffman**

Managing Director, Investment Research

As Managing Director of Investment Research, Robert leads the team that analyzes the fundamentals behind market movements, macroeconomic trends and the performance of specific industries – as well as their potential impact on investors. His nearly two-decade tenure in the financial services industry includes experience as a loan portfolio manager and senior credit analyst focused on corporate loan issues. Robert serves as the firm's primary subject matter expert on the corporate credit markets and select alternative investment solutions, developing targeted communications and educational resources

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