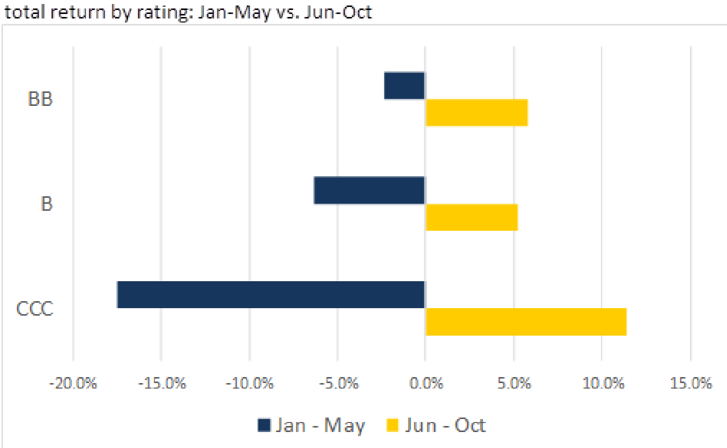
SKYView: Value in CCCs

To say that 2020 has been a tumultuous year would be an understatement. The coronavirus pandemic brought about an abrupt end to the relatively benign risk environment enjoyed early in the year, leading to one of the most dramatic contractions in economic output on record. High yield spreads widened over 700 bps amidst the first US and European lockdowns, with weakening economic and market conditions necessitating central bank intervention and various government stimulus programs to prevent a downward spiral. Despite a third wave of coronavirus cases, we view renewed policy support and positive developments on the vaccine front as another step toward a sustained re-opening. In this *Weekly Briefing*, we examine total return potential in lower-quality credits given our expectation that the economic recovery will continue in 2021.

Rating bucket total returns were closely grouped through the first six weeks of the year, with a mere 6 bps separating BBs from CCCs (though BBs were outperforming more significantly on a beta-adjusted basis). COVID-fears and a drastic reduction in economic output led to significant spread widening in the subsequent weeks, with the ICE BofA US High Yield Index (H0A0) reaching an OAS peak of 1,087 bps on March 23, 2020. BBs continued to outperform CCCs in the initial stages of spread tightening, maintaining a cumulative total return advantage of over 15% through the first five months of the year (Jan – May). Performance of lower-quality credits has since stabilized, with CCCs outperforming BBs over the subsequent five months (Jun – Oct), though a sizeable YTD performance gap remains. From a spread ratio perspective (CCC/B and CCC/BB spread ratios), CCC attractiveness relative to higher-quality credit registers just better than parity on a percentile ranking basis.

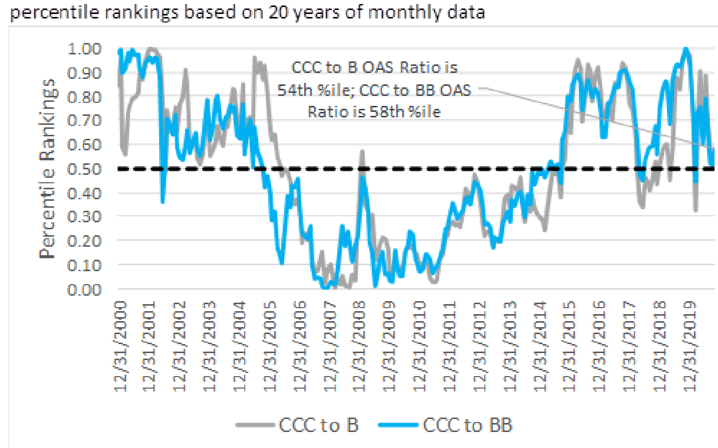
CCCs Have Begun to Chip Away at Underperformance vs. BBs

total return by rating: Jan-May vs. Jun-Oct



Rating Bucket Spread Ratios Modestly Favor CCCs

percentile rankings based on 20 years of monthly data

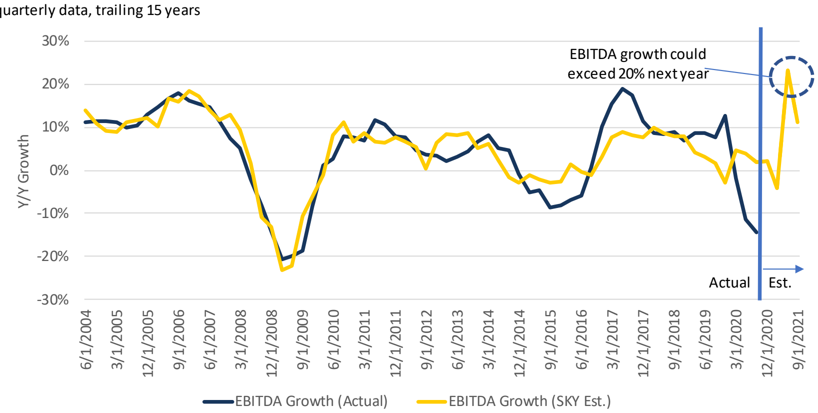


Source: SKY Harbor, ICE Data Indices. Past performance does not guarantee future results. The referenced indices are shown for informational purposes only and are not meant to represent the AXS Investments Funds. Investors cannot directly invest in an index.

Far from a ringing endorsement of CCC risk, we look beyond spread ratios to gauge the likelihood of CCC outperformance in the coming months. Though we have written about upside earnings surprise among US corporates in both Q2 and Q3 2020, absolute earnings growth has been deeply negative, consistent with recessionary conditions. In our view, however, an inflection in corporate earnings is almost upon us, as our multi-factor regression model projects EBITDA growth among S&P 1500 constituents to exceed 20% by mid-2021. Using quarterly data over the last twenty years, we find that spreads tighten, on average, during quarters in which corporate EBITDA growth is positive, and widen, on average, during quarters in which corporate EBITDA growth is negative (an intuitive, but nevertheless important distinction). Further nuancing this dynamic, we find the spread change beta of CCC bonds (relative to the index as a whole) is ~ 1.7x, implying greater compression opportunity for lower-rated credits in an elevated EBITDA growth environment, such as the one we expect in 2021.

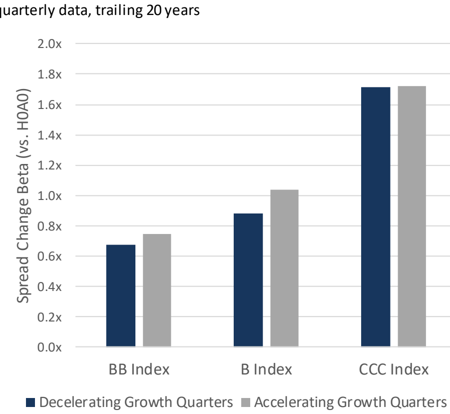
S&P 1500 Index EBITDA Growth: Actual vs. Predicted

quarterly data, trailing 15 years



Rating Bucket Spread Change Betas

quarterly data, trailing 20 years

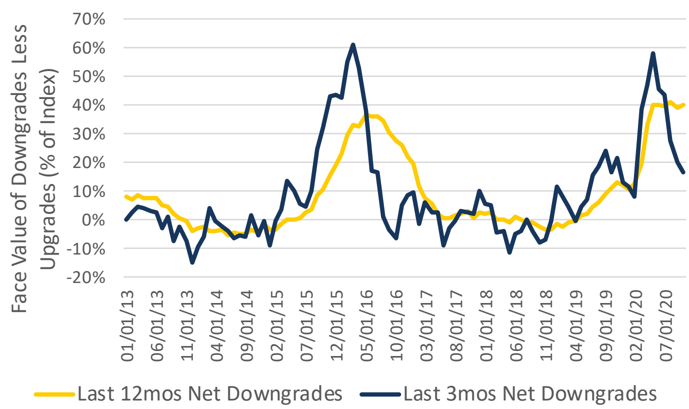


Source: SKY Harbor, ICE Data Indices, Federal Reserve, Baltic Exchange, Chief Executive Magazine, Bloomberg. Actual results may vary. Forecasts are inherently limited and cannot be relied upon.

With the expectation of EBITDA growth as business conditions normalize, it is also our view that underlying credit fundamentals are likely to strengthen in 2021. At present, we estimate net leverage for the high yield market, in aggregate, to be approximately 4.4x. EBITDA growth of over 20%, assuming a prudent use of free cash flow, should allow HY issuers to deleverage in the coming quarters, perhaps down to the long-run index average of approximately 3.7x. Concurrent with improving fundamental metrics, we expect rating agency cuts to moderate, perhaps bringing about an end to a period in which the face value of downgrades far outweighed upgrades. As demonstrated in the chart below, next 12-month total returns of the CCC sub-index relative to the HY index tends to be positive as the trailing 12-month value of downgrades reaches parity with upgrades. As such, we think CCCs are likely to be the biggest beneficiary of an anticipated inflection in credit migration rates.

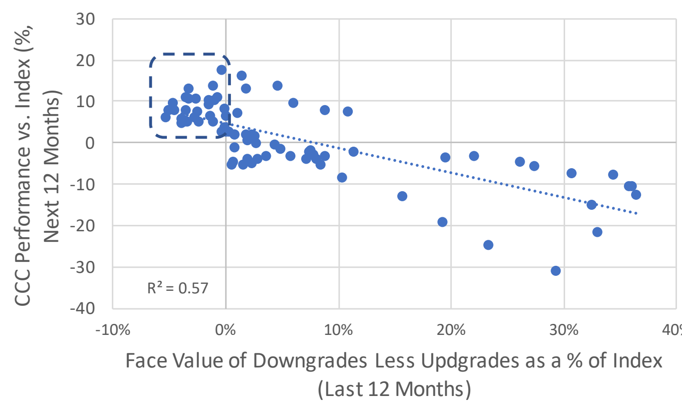
Period of Elevated Net Downgrades Nearing End

monthly data



CCCs Typically Outperform Index After Downgrades Subside

monthly data

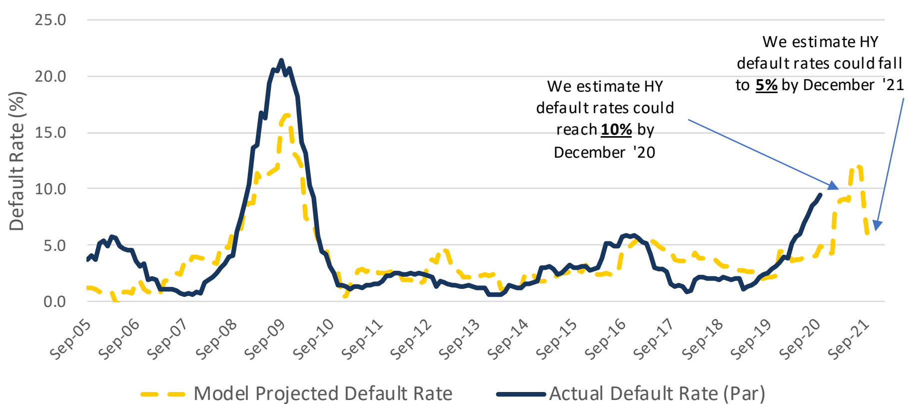


Source: SKY Harbor, BofA Merrill Lynch, ICE Data Indices. Past performance does not guarantee future results.

Defaults have also been topical over the last several months, with par and issuer-weighted rates in the 8% range as of prior month-end (October 31, 2020). Our multi-factor regression model projects a peaking of defaults in the 10% range by December of this year, followed by a moderation to approximately 5% by December 2021. Since 2005 (the limit of our dataset), BBs have outperformed CCCs, on average, by nearly 45 bps of total return per quarter in periods in which the default rate was on the rise. When the default rate was on the decline – which we expect in 2021 – CCCs have outperformed BBs by nearly 115 bps, on average, per quarter.

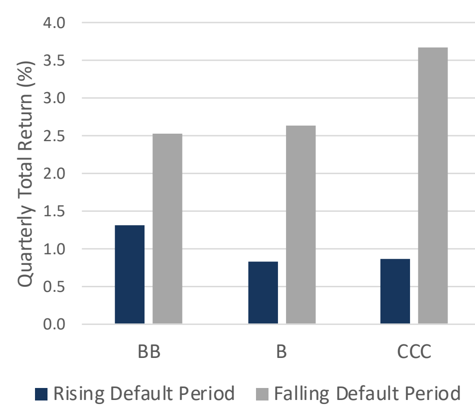
SKY Harbor Default Model

based on monthly data



Returns by Rating Bucket

based on quarterly data



Source: SKY Harbor, BofA Merrill Lynch, ICE Data Indices, Moody's, Federal Reserve. Actual results may vary. Forecasts are inherently limited and cannot be relied upon.

Significant risks undoubtedly remain in the high yield market, but we believe the YTD performance gap sets up for outperformance of CCC-rated debt over the coming 12 months. In our view, the combination of positive EBITDA growth, a reduction in net downgrades, and a halving of the default rate bode well for a rally in lower-rated credit over the intermediate term. On the margin, we think selectively adding more speculative risk to portfolios can generate alpha as global economies continue to recover.

Definitions

Alpha is a measure of performance on a risk-adjusted basis. Alpha takes the volatility (price risk) of a fund and compares its risk-adjusted performance to a benchmark index. The excess return of the fund relative to the return of the benchmark index is a fund's alpha.
Basis points (bps) refer to a common unit of measure for interest rates and other percentages in finance. One basis point is equal to 1/100th of 1%, or 0.01%, or 0.0001, and is used to denote the percentage change in a financial instrument.
Beta is a measure of the volatility, or systematic risk, of a security or a portfolio in comparison to the market as a whole. A beta of 1 indicates that the security's price will move with the market. A beta of less than 1 means that the security will be less volatile than the market. A beta of greater than 1 indicates that the security's price will be more volatile than the market. For example, if a stock's beta is 1.2, it's theoretically 20% more volatile than the market.
Credit Ratings are used by the S&P and Fitch credit agencies for long-term bonds and some other investments. They range from the highest rating of AAA (the borrower's capacity to meet its financial commitment the obligation is extremely strong) to D (the borrower is in default). Ratings in order of quality include AAA, AA, A, BBB, BB, CCC, CC, C and D.
EBITDA is earnings before interest, taxes, depreciation, and amortization, is a measure of a company's overall financial performance and is used as an alternative to net income in some circumstances.
ICE BofA US High Yield Index: An index that tracks the performance of US dollar denominated below investment grade rated corporate debt publicly issued in the US domestic market. The index is further defined by sub-indexes associated with credit ratings (e.g., the CCC sub-index).
Leverage is an investment strategy of using borrowed money, specifically, the use of various financial instruments or borrowed capital, to increase the potential return of an investment.
Option-Adjusted Spread (OAS) is the measurement of the spread of a fixed income security rate and the risk-free rate of return, which is then adjusted to take into account an embedded option.

Important Disclosures and Disclaimers

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