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Credit markets will remain challenged amid market volatility from COVID-19

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Investment insights
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Credit markets will remain challenged amid market volatility from COVID-19

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- Current market volatility is affecting all parts of the fixed income and equity markets.
- We are likely entering a recession, which could result in higher default rates.
- The risk of increased volumes of downgrades and defaults remains high, and we remain cautious on credit.
- As fundamental, bottom-up investors, we are looking to identify attractive credits at good valuations.

Current environment

- Prior to the outbreak of COVID-19, our economists and Portfolio Strategy Group were modestly constructive on the economic outlook for 2020. In large part, this was driven by progress on trade negotiations between the U.S. and China, more clarity around Brexit and improving global manufacturing activity. That said, in our broad fixed income portfolios, we have held a less-than-benchmark exposure to credit due to high valuations and the late-cycle imbalances building in the global economy.
- As COVID-19 cases have mounted, the expected economic impact has shifted from a supply shock emanating from China to a supply and demand shock impacting much of the globe. As a result, Capital Group's economists now view a U.S. recession as a near certainty. The reaction in credit markets, as well as other risk assets, has been swift, with credit spreads widening at a faster pace than at any other time, including the global financial crisis.
- Liquidity in credit markets, as well as the U.S. Treasury market, has been challenging. This has been driven by several factors, some of which make this cycle unique. Redemptions from both investment-grade and high-yield ETFs have been significant. Some of this appears to be driven by rebalancing by both traditional asset allocators and hedge funds and, most prominently, investors pursuing risk-parity strategies. The result has been significant selling pressure on investment-grade and high-yield bonds amid a dearth of buyers.
- Liquidity has been further hampered by the inability of the dealer community to take on more risk. Dealer capacity has been hurt by the quick downturn in U.S. Treasury rates, the need to maintain required capital ratios, and business continuity measures that have forced market participants to work remotely. While secondary market liquidity has been challenging, high-quality companies have found solid demand in the new-issue market.

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Credit implications

- Capital Group's investment-grade and high-yield investors have navigated multiple credit cycles in the past. As in most market cycles, we expect downgrades across the credit spectrum: within investment grade, from investment grade to high yield, and within high yield. For perspective, fallen angels (companies downgraded from investment grade to high yield) following the 9/11 attacks, the financial crisis and the 2015-2016 oil market volatility totaled $208 billion, $206 billion, and $229 billion, respectively.
- There has been a lot of focus on the growth in BBB-rated issuers within the U.S. investment-grade universe and the risk that they could be downgraded to high yield in the next downturn. Based on our historical analysis, approximately 15% of nonfinancial BBB-rated issuers, on average, are downgraded to high yield during a recession. We may reach that level in this cycle, although many BBB companies have multiple levers that they can pull to avoid a downgrade. These include cutting the dividend, eliminating share repurchases and reducing capital expenditures.
- Within high yield, default rates have historically ranged from 15% to 20% in a default cycle, but they could be higher this time. Leveraged loans have exhibited similar default rates, and we believe this will not be that different in this cycle. However, our credit analysts think that loan recoveries will be much lower than the historical average, owing to much looser loan covenants and loan-only capital structures. That said, the poorer quality of bank loans appears to be priced in as loan and bond returns have been similar year to date.

Potential opportunities

- In most selloffs of this nature, the market does not always make distinctions in terms of quality. Investors in search of liquidity are willing to sell whatever they can. This often creates opportunities to acquire higher quality credits across industries at attractive spreads. Because of its unique nature, this downturn is having a dramatic impact on the level and types of consumer spending and industrial activity. In addition, the downturn in oil prices is having a distinctly negative impact on energy companies. However, there are credits across the investment-grade universe, including companies in some of the more severely impacted industries, such as consumer, industrial and energy sectors, that have the balance sheet strength to weather the storm. Our analysts have been stress-testing their models seeking to invest in the survivors.
- While the high-yield new-issue market is effectively closed, the selloff has presented some attractive risk-adjusted investment opportunities. Short-duration bonds or higher-quality bonds in both investment-grade and high-yield bond secondary markets have seen spreads widen dramatically, creating what may be attractive entry points. Additionally, many bonds are oversold relative to the risk of default, even within the energy sector, which is facing a high level of stress given the sharp decline in the price of crude oil. We analyze each investment's idiosyncratic risk and will determine its appropriateness at this time.

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