FUNDAMENTAL FIXED INCOME

Riding the Crossover wave – Opportunities in high yield

Since president Draghi announced that he was introducing QE at the beginning of 2015, we have experienced a phase of progressively higher yields in both investment grade and high yield credit markets. In recent months we have seen traditional BBB-BB universes move in line with what we have seen throughout history; a move wider than investment grade but not nearly as wide as high yield. Although we have been in a spread widening environment in investment grade, absolute yield levels remain very low due to QE, and financial repression.

We believe that the BBB-BB segment of the credit market displays more attractive risk and return characteristics when compared to traditional asset classes of investment grade and high yield. The BBB-BB universe can provide better annualised return potential while displaying similar volatility characteristics to investment grade. The BBB-BB universe is predominantly invested in BBB rated assets which highlights that the universe has a high allocation to investment grade.

2015 was a challenging year for all financial assets with the generation of positive returns proving difficult. While it was a good year for European high yield, this was not the case in the US due to the high concentration in the Energy sector within the US high yield market. Our fundamental BBB-BB strategy is deliberately underweight sectors such as Energy and this fundamental approach (implemented across both Europe and Global strategies) proved beneficial for our US exposure in 2015. Please note that holdings and/or allocations are subject to change.

Last year was an extremely difficult year for BB credit, particularly within Europe, with yields increased substantially in comparison to BBB. This was driven a wobble in Chinese valuations during the summer and a large sell-off in BB risk heading into 2016, a great deal of which occurred in the Oil, Metal and Mining space.

In 2016 we have seen both high yield and investment grade spreads move wider, yet total return within both markets has diverged substantially. Investment grade has been very well supported by extreme risk aversion and the strong bid for treasuries and European government bonds. We have seen high yield suffer as we experience a move away from Oil, Metals and Mining towards sectors such as Financials.

Strangely we are witnessing a number of BB issues trading higher in yield than many B issues. We believe this is partly caused by the “crossover phenomenon”, where companies are transitioning towards non-investment grade. This transition causes the market to re-price the risk. However, in our opinion, the market is re-pricing a downgrade rather than re-pricing the real risk of credit quality. We believe that this can create an elevated illiquidity premium. This attitude from the market is giving rise to very distressed yield levels for companies that are, in our view, nowhere near a default scenario. In addition, this dysfunctional behaviour in crossover credit has led to high levels of underperformance.

In Europe, there is currently EUR 10 to 15 billion of potential downgrades into high yield, against an overall market size of around EUR 300 billion in size. In the US, this potential level of fallen angels has risen from USD 50 billion to around USD 70 billion since October 2015[1]. However, against an overall high yield marketplace of around USD 2 trillion, this would appear to be manageable. In our view, these levels of potential downgrades are not abnormal when compared to history. In fact, our historical analysis has shown us that downgrades of this size have been comfortably absorbed by both the US and European markets.

At Lombard Odier IM we aim to capture the opportunity as assets transition from BBB to BB. We believe there can be sufficient returns to be made without adding too much risk to the portfolio. As a strategy, we do not want to be positioned in B assets as our analysis suggests that the default risk for B and below rated credit goes up exponentially in comparison to BB and above.

We believe there are great dislocations in the pricing of credit risk within the market, caused by illiquidity and a lack of intermediation from banks. In our opinion, the expected wave of crossover assets is not outsized compared to history or to the amount that the market can absorb. We remain optimistic towards finding opportunities in BBB-BB credit and trust that diversified portfolios will enable us to navigate these challenging conditions.

[1]Source: Citigroup Research as at 12 February 2016, and Moody's.