Seeing beyond the horizon

In view of lower oil prices, investors should exercise caution on US high-yield and investment-grade markets

By Sean Taylor

PHOTO: AFP

OIL prices have surged more than 50 per cent from around US$26 per barrel in mid-February 2016 to US$40 per barrel in a month. Despite the strong rally, they are still a far cry from their last peak of US$107 per barrel in June 2014. Not so long ago, the reaction to a lower oil price might have been positive with markets anticipating both consumer and corporate gains. This time, however, markets have been rattled.

Spreads of US high-yield debt over US Treasuries have been widening for months. During the shale boom, energy became the single largest sector in the US high-yield market, at its peak accounting for 15.5 per cent of the bonds issued.

High-yield issuers in the US are certainly having an increasingly difficult time raising money. Less accessible financing combined with the low oil prices is increasing expectations of default. The market now appears to be pricing in high rates of default for the market in aggregate.

However, this overall widening of spreads looks excessive, not least because of energy issuers' relatively small and declining share of the market. At some point the cheapening of this asset class will create opportunities in the non-energy segment of the US high-yield market. In fact, if oil price recovers to above US$50 per barrel, many high-yield energy names should survive.

All this also obscures the fact that for the US economy as a whole, including its riskier borrowers, cheaper oil should be a net positive – even though it will take a while for the benefits to come into focus, whereas the problems are more immediate. Against this background, we remain positive on US investment grade in the longer term. In the short term, however, we expect forthcoming quarterly reports to show continuing trends of low earnings growth, slowly increasing leverage and weakening coverage measures.

Key credit metrics (on a net-debt basis) remain in the middle of the historical range, but this provides little comfort as risk aversion increases. The recent spate of primary issuance has left support for the secondary market lukewarm at best. So even though the long-term negative effects of lower oil prices may have been overstated, continued caution on both US high-yield and investment-grade markets still looks advisable for now.

We remain tactically neutral on all maturity ranges of US Treasuries. Since the start of this year, market expectations regarding further Federal Reserve rate hikes in 2016 have been reduced sharply. The recent Federal Open Market Committee statement has been dovish and data-dependant. Economic data is mixed, but low rates may remain divergent from the economic environment.

In response to the financial market volatility, central banks across the globe have turned more dovish, and opted for additional easing tools such as negative interest rates and RRR (reserve requirement ratio) cuts. European Central Bank, Bank of Japan and the Fed reinforced their commitment to easy monetary policy, putting downward pressure on long-end rates.

Sovereign bond yields have plummeted this year, falling to several-month lows in many cases. We expect the core government bond yields to rise only slightly over the course of 2016.

We reduced US investment grade to underweight at the beginning of 2016. Although we expect the market to remain divided, with oil and mining issuers along with lower-quality issuers in general particularly priced down, even higher-quality corporate issuers could come under pressure.

Tactical approach

From a tactical perspective, EUR high-yield debt is currently regarded as one of the more interesting fixed-income segments, particularly as spreads have widened. Volatility is, however, expected to remain high since this segment currently follows closely the US high-yield market. But unlike the US market, EUR high yield is less directly exposed to the energy sector.

The emerging market (EM) country group is a heterogeneous one, with broad diversity over regions and rating categories. In EM fixed income, individual countries may present opportunities, but the sub-asset class as a whole could remain troublesome. Low commodity prices could compound existing political and economic structural weaknesses, with volatile currencies adding another level of complexity for investors.

While we have witnessed some stability in the Asian credit market, renminbi depreciation and China capital outflows with its associated impact on EM assets remain key risks for Asia credit. We are now more constructive on EM sovereign as US rates are not expected to rise so quickly.

Within Asia credit, we maintain our defensive stance of preferring Asia investment grade over high yield over the course of this year. Investment grade is also likely to witness more supply, while net supply in high yield could be negative with bonds getting tendered or called.

At the same time, the high-yield debt market is not accessible for a large portion of existing Asian high-yield issuers except solid China property companies. Unsurprisingly, high-yield supply so far has been underwhelming and we expect it to remain so in 2016. There is a possibility that the investment-grade spreads will widen along with high yield, but US Treasuries rally is supportive.

Worries about energy-related defaults caused US high-yield spreads to widen further in early 2016, possibly to the extent that they overstate real risks and therefore offer some longer-term opportunities outside of the oil sector.

Continued caution is however suggested on EM bonds. Market volatility, and the resulting demand for safe-haven investments, has pushed down yields on core government bonds and we expect yields to rise only slightly over the course of 2016. W

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