TRADE WAR, BREXIT, RISING RATES: NAVIGATING RISKS IN TODAY'S HIGH YIELD MARKETS

MARTIN HORNE
HEAD OF GLOBAL HIGH YIELD

> *"High yield bond markets have historically reacted fairly well to rising interest rates, as you can see from returns over time."*

This piece was adapted from an interview with Martin Horne. The full audio podcast can be found at BARINGS.com/podcast/high-yield-wall-of-worry.

IN THIS Q&A, BARINGS' HEAD OF GLOBAL HIGH YIELD, MARTIN HORNE, DISCUSSES HOW THE BARINGS TEAM IS NAVIGATING SOME OF THE MAJOR RISKS—FROM A TRADE WAR AND BREXIT NEGOTIATIONS TO RISING RATES AND A MATURING CREDIT CYCLE—WEIGHING ON THE MARKETS TODAY.

Looking at the markets today, there is a lot of uncertainty, much of it pertaining to the credit cycle. What is your take on the state of the high yield market—are you seeing riskier behavior on the part of issuers and investors?

We hear lots of questions from investors regarding where we are in the credit cycle and when we might experience a downturn. Many are somewhat unsettled by the fact that the American equity markets, in particular, have run for so long. These concerns aren't unfounded—history has shown that these runs always have an end date. With that in mind, the question becomes how to stay invested in the high yield markets.

At this stage, we think it's important to draw some comparisons between today's markets and the pre-financial crisis markets, which in reality look very different. One of the key differences is that, heading into the 2008 crisis, no one was thinking about the inevitable downturn, or questioning the sustained high returns. Today it's much different—forecasts show growth, but they show relatively measured growth. Capital structures look far more resilient and are holding up well to stress tests. And the vast majority of the index is still very investable, in our view.

That said, there are definitely parts of the market that we would avoid, underscoring the importance of an active approach versus just tracking an index. While that is always the case to some degree—there are always issuers you're going to be more cautious about—this approach can be particularly valuable as you move through the later stages of a prolonged cycle.

Some investors seem to also worry about weakening documentation, and an increase in covenant-lite transactions—is this something that concerns you?

I don't think covenant-lite transactions are necessarily as worrisome as some investors perceive them to be. There is not a lot of data showing that covenant-lite loans lead to lower recoveries. Rather, recoveries are all about the underlying quality of the business. Larger, more established companies tend to have more tools at their disposal to help avoid losses—they may be able to sell non-core business, for example—which has historically led to relatively high recovery levels.

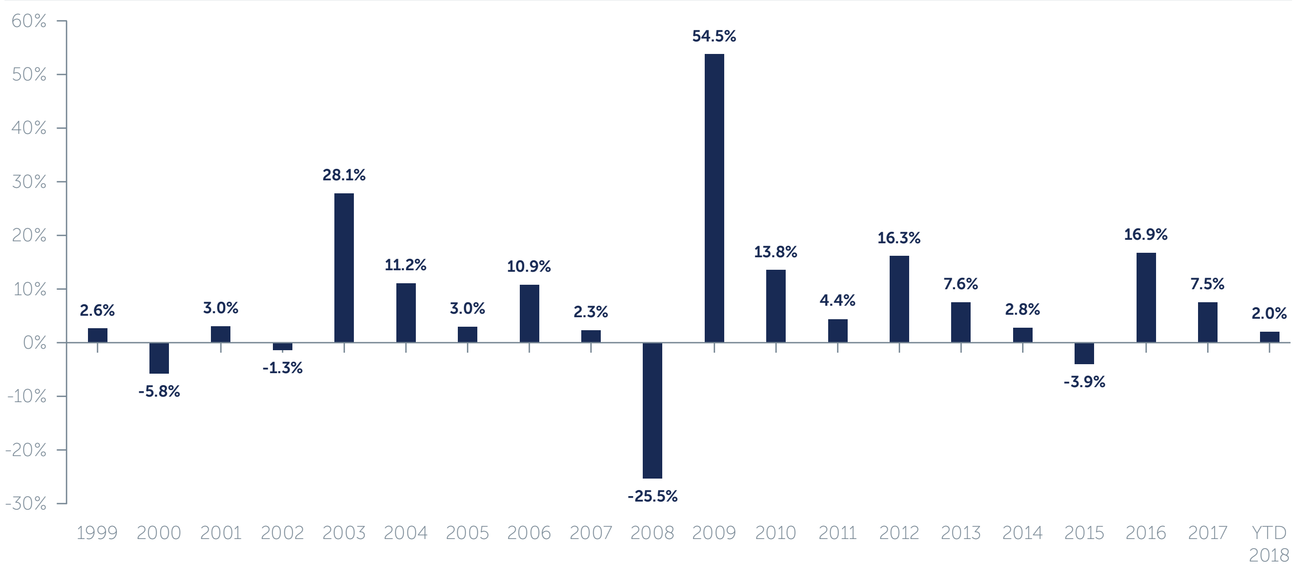
More pertinent, in my view, is weakening documentation. The high yield industry and the companies in it have evolved tremendously. Unlike a decade ago, we're seeing multiple billion dollar issuers in the marketplace. As larger companies enter the market, it's not unusual to see some document flexibility, as these tend to be better-quality companies. With smaller businesses and less liquid businesses, higher standards of protection may be more critical.

When investing in high yield, you're primarily looking at two types of risk: credit risk and interest rate risk. Regarding rate risk, what is your stance right now on rising rates and how do you expect that to impact the companies in your universe?

There are two main considerations we take into account when thinking about rising interest rates. The first relates to the absolute interest costs and the burden of interest costs for the companies that we invest in. At the most basic level of credit analysis, if an increase in interest rates by a couple of percentage points means the difference between a company having a viable capital structure or not, it's probably not a good company to be invested in in the first place.

The second consideration is the impact of interest rate hikes on the bond market more broadly. To take a step back, you generally only get rising-rate environments in relatively good economies. At Barings, we've studied the most aggressive interest rate rises in the U.S., stretching back to the 1990s, and found that high yield bond markets have historically reacted fairly well to rising interest rates, as you can see from returns over time.

GLOBAL HIGH YIELD BOND ANNUAL RETURNS



SOURCE: *BANK OF AMERICA MERRILL LYNCH. AS OF AUGUST 31, 2018.*
PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS.

In fact, during that time period, there have only been two occasions where the bond market reacted negatively to an aggressive interest rate rise in the three months following that rise. One was in 2000 when the tech bubble was bursting. The other was in May 2008, just before the collapse of Lehman Brothers. In both of those instances, there were other factors at play that contributed to the market's negative reaction. Against that backdrop, we believe a change in the credit cycle represents a much greater technical risk to the bond market than rising interest rates.

In the last year or so in particular, we've seen increasing rhetoric around a trade war. Is that something that's worrying you at this stage?

While we certainly factor escalating trade tensions into our process, we're much more focused on maintaining a credit-intensive, bottom-up approach. With regard to a trade war, some industries are going to be more impacted than others. For example, there are agricultural producers in the U.S. that are suffering at the moment because they're not able to penetrate all the markets that they're used to.

When investing in these more challenged industries, we look for companies with healthy capital structures that can withstand and adjust to these developments. In our experience, we've found that there are always good businesses, even in weaker industries or bad cycle points—you just have to do your homework and find where those opportunities exist.

And what about Brexit, what are your thoughts there?

Brexit is another one of the events that's bringing deep uncertainty to the market, and frankly, it's impossible to predict how things will ultimately play out—an agreement between the E.U. and U.K. either will or will not be reached. Strictly from a credit perspective, I think it's possible the U.K. could go into a mild recession in a worst-case Brexit scenario. I say mild because the country's two major trading counterparties, the U.S. and Europe, are in pretty good shape right now. The other thing to keep in mind is the potential devaluation of sterling and how that may or may not impact the companies in which you're investing. As is the case with any currency move, some companies will fare better than others.

On a more positive note, our team has been investing in high yield through some notable recessions and/or periods of volatility over the last decade—the bankruptcy of Lehman Brothers and the sovereign debt crisis, to name a few. As a result, we have a deep knowledge base when it comes to the companies in this market and are well-positioned, in our view, to make decisions on how these companies will perform amid the risks in today's markets.

VALUE IN HIGH YIELD SHIFTS OVER TIME

RETURNS	2011	2012	2013	2014	2015	2016	2017	YTD 2018
higher	4.91%	24.93%	9.65%	5.39%	4.87%	18.32%	8.28%	3.65%
	1.82%	14.74%	9.26%	2.53%	1.46%	11.82%	7.31%	3.44%
	-1.38%	10.93%	7.22%	2.10%	-0.38%	9.88%	5.79%	2.04%
lower	-1.36%	9.43%	6.15%	2.06%	-5.38%	6.89%	4.25%	2.00%

U.S. LOANS | U.S. BONDS | EUROPEAN LOANS | EUROPEAN BONDS

SOURCE: *BANK OF AMERICA MERRILL LYNCH, CREDIT SUISSE. AS OF AUGUST 31, 2018.*
PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS

All of this said, whether you're looking at the trade war or Brexit, fundamentals are always the bottom line. Headline events certainly matter, but only to the extent that they impact fundamentals, which for us comes down to the issuer's ability to repay the money we have invested. If that hasn't changed, we look to take advantage of technical weakness, where appropriate, to bolster returns for our investors. In every industry or geography, no matter what dynamics are at play at a given point in time, there are going to be select investments that do well. You just have to dedicate the resources to find those opportunities and invest with an appropriate risk-reward tolerance.

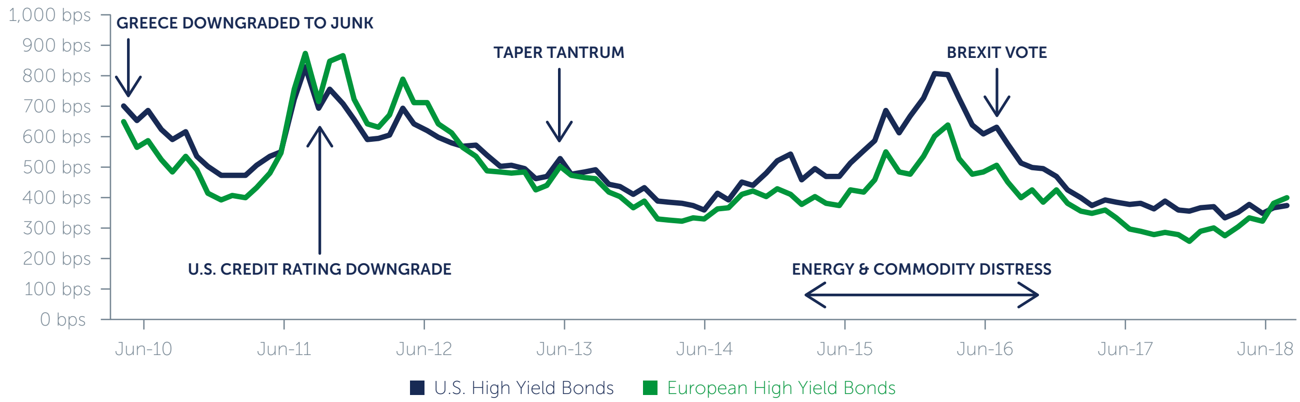
As you consider the risks to the market today, how should investors be thinking about their high yield allocation?

When it comes to investing in today's high yield market, we see many benefits to a multi credit approach. At Barings, we think of multi credit investing as a corporate-focused rather than go-anywhere strategy, consisting primarily of allocations to what we call "core four" high yield sub asset classes—U.S. high yield bonds, U.S. loans, European high yield bonds and European loans—with the ability to make opportunistic allocations to collateralized loan obligations (CLOs), and stressed and distressed credits (special situations).

While the U.S. and European high yield markets tend to exhibit some correlation and share similar risk/return profiles, these markets have historically experienced bouts of dislocation during which prices have decoupled from underlying corporate fundamentals, creating widely different opportunities. This variation in performance and pricing between high yield sub asset classes is often the result of headline risk or technical factors, which are typically temporary and sentiment-driven. While these factors may drive prices down in the short term, they have often been followed by a relatively quick recovery, particularly in cases where the underlying fundamentals remain solid. A multi credit strategy can help an investor take advantage of the short-term opportunity that has emerged, by positioning them to promptly reallocate assets to the area that may be offering the most value at any given point in time.

Moving in and out of these markets effectively requires a large presence in both markets. Where managers run into

U.S. VS. EUROPEAN HIGH YIELD BOND SPREADS



SOURCE: *BANKS OF AMERICA MERRILL LYNCH. AS OF JUNE 30, 2018.*

trouble with global strategies is when they have someone in Texas making a decision about investing in a French industrial. The landscape is very different in the U.S. than in Europe, and in Europe, that landscape also varies by country—solvency laws, rules of the game, competitive dynamics are all different. In order to execute on a global strategy, it's imperative to have teams on both sides of the Atlantic, who have local knowledge of the countries they're investing in.

What is your view on senior secured bonds, an area that seems to be gaining in popularity among investors globally?

We think senior secured bonds can present an interesting opportunity for investors, particularly for those willing to give up a bit of yield in exchange for senior secured status. Senior secured bonds are a type of high yield bond, offering a similar return, coupon and liquidity profile as traditional unsecured bonds. Spreads between senior secured bonds and traditional, unsecured bonds have also, over time, been largely comparable.

However, senior secured bonds are more senior in the capital structure and are also secured, or backed by issuer collateral. The seniority of these bonds means that in the event of a default, bondholders are positioned ahead of junior or subordinated debtholders during the recovery process. As a result, senior secured bonds have historically offered higher recovery rates relative to unsecured bonds, including through recessions.[1] For these reasons, if you're a high yield investor thinking about where we are in the credit cycle, senior secured bonds may present a potentially attractive opportunity.

SENIOR SECURED BONDS HAVE HISTORICALLY OFFERED HIGHER RECOVERY RATES

SOURCE: *BANK OF AMERICA MERRILL LYNCH. AS OF AUGUST 31, 2018.*

1. Source: Moody's Corporate Default & Recovery Rates. As of July 2018

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