A Survey of the Tiered Landscape of Corporate Credit

Robert Cohen | November 2020

The year 2020, and the decade leading up to it, have led to some interesting reversals in U.S. corporate credit, including irregularities across the investment grade (IG), high yield and bank loan markets. What is the state of play? Investment grade, due to years-long falling Treasury yields as well as spread compression and now buying by the Federal Reserve, has yields at or near all-time lows across all rating cohorts as of the publication date of this paper. In below investment grade credit, the distinction has blurred between the bank loan market, once regarded as higher quality, and the high yield bond market, historically regarded as riskier. In this paper, I will examine the different states of credit quality and risk pricing in these sectors.

Let's look at snapshots of the differing states of credit quality and risk pricing in these sectors. Then I'll delve into historical causes of this differentiation and share my outlooks.

Investment grade credit quality has deteriorated for years, with bonds rated BBB forming the largest sector of the market. Furthermore, cash flows have declined (albeit by a small number) while leverage has proliferated. Notwithstanding this build-up of risk, yields in the sector today are at or near record lows, and credit spreads, the presumed cushion to compensate for the risk of default, have stayed close to long-term averages.

In the world of below investment grade corporate credit (credits rated below BBB by the rating agencies), the riskiness of high yield bonds has converged with that of bank debt. Unlike high yield bonds, most of which are unsecured, bank debt is secured by assets that investors can seize and liquidate in the event of default. Thus, for most of the history of these asset classes, bank debt was considered less risky than high yield bonds. Today, I believe the risks are similar.

How did corporate credit come to change its stripes? Part of the answer, of course, comes from unprecedented interventions in some of these markets, direct and indirect, by the Fed in the wake of the economic shock related to the COVID-19 pandemic. However, risk profiles evolved in different ways and along paths that predate 2020 by years. Let's examine each market on its own terms.

Investment Grade

The investment grade story is perhaps the more widely known. For example, here at DoubleLine Capital, CEO Jeffrey Gundlach has publicly warned about the sector with respect to credit risk and duration, aka interest rate risk. The build-up of BBBs, a development that occurred over several years, many of which carry junk-bond levels of leverage, are a notable subject for concern. Following the Global Financial Crisis (GFC), yield suppression by the Fed in the Treasury market spilled into the investment grade corporate bond sector. Massive debt issuance at or near record-low yields has driven duration, or interest rate risk, on investment grade corporates to higher levels than at almost any time in the past.[1] Much of the issuance has been driven by a cost-of-capital arbitrage, as companies replace more-expensive equity with cheap debt on a company's balance sheet.

Thus, post-GFC, investment grade corporates on an index basis have periodically represented increased credit risk while duration has extended. A unique exception came in the COVID-19-induced market panic in March. For a window of a few weeks, many bonds of high-grade issuers fell to discounts of double-digit yields. Then, the Fed stepped in. For the first time in its history, the Fed backstopped liabilities of investment grade corporations by directly buying their bonds, and pricing came roaring back to pre-March levels. For example, Occidental Petroleum's 6.6% senior notes due March 15, 2046, traded at a high on February 20, 2020, of $136.80, yielding 4.25%.[2] Moody's on March 18 was the first to downgrade Oxy from Baa3 to Ba1. By March 31, these notes fell to a low price of $46, yielding 14.78%. By October 7, the notes had recovered to a price of $84.50, yielding 8%. Occidental Petroleum is now the second-largest issuer in the Bloomberg Barclays US Corporate High Yield Index.

Consequently, the investment grade sector avoided a normal downgrade/default cycle, the last of which came during the GFC. The necessary deleveraging to wring out excess risk and reposition the sector for a renewed expansionary cycle has been kicked down the road.

High Yield

The Fed intervened indirectly in the high yield sector, buying high yield exchange-traded funds rather than actual issues of below investment grade bonds. As a result, the recovery of high yield to pre-March levels unfolded more slowly relative to its investment grade counterpart.

At this point in time, the opportunity to generate outsized returns on a beta trade in high yield – such as buying a high yield index ETF – probably is in the rear-view mirror. Even in the event of renewed market concerns (such as the scenario of a "second wave" of the pandemic), the Fed is now in this market. However, investors who understand an individual credit's fundamentals, its critical loan-to-value ratio (LTV) and the liquidity of the issuer, can find attractively priced credits in high yield.

Coming out of the credit crisis of 2008-2009, high yield issuers benefited from an exuberant lending environment. A significant number of this new issuance financed the boom in energy – shale oil plays, in particular. These were very negative-cash-flow business plan financings, underwritten with the expectation of lifting $100 barrels of oil out of the ground. In a classic credit bubble, leverage continued to build; smaller, riskier business ventures got access to capital; oil production soared. By September 2014, bonds issued by energy companies accounted for 16% of the capitalization of the Bloomberg Barclays US Corporate High Yield Index. This roughly coincided with the peak in oil at $100 a barrel.

The subsequent collapse in oil prices, which took crude down to a low of $26 a barrel, sent the high yield index into contraction through 2019, reaching a low of $1.13 trillion in market cap in February 2016. During that period of shrinkage, delinquent issuers were washed through bankruptcy courts; excess capacity went off line; leverage was unwound; energy dropped to 10% of the index. *(Figure 1)*

U.S. High Yield Energy Debt vs. U.S. High Yield Debt

January 4, 1991 to October 14, 2020

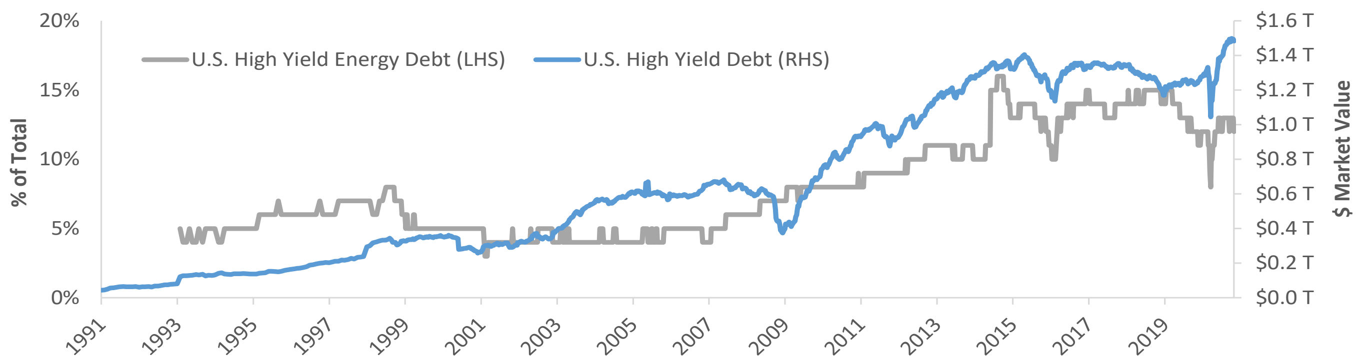

Figure 1
Source: Bloomberg, DoubleLine

During this credit contraction, lending standards tightened to the point where BB credits, by definition the upper band of high yield in terms of credit quality, came to represent 47% of the high yield market by February 2016. Following the COVID-19 shock in March, bonds rated BB have grown to represent more than 55% of the high yield market in part due to a record number of fallen angels. *(Figure 2)*

U.S. Corporate High Yield Debt vs. U.S. High Yield Debt

January 4, 1991 to October 14, 2020

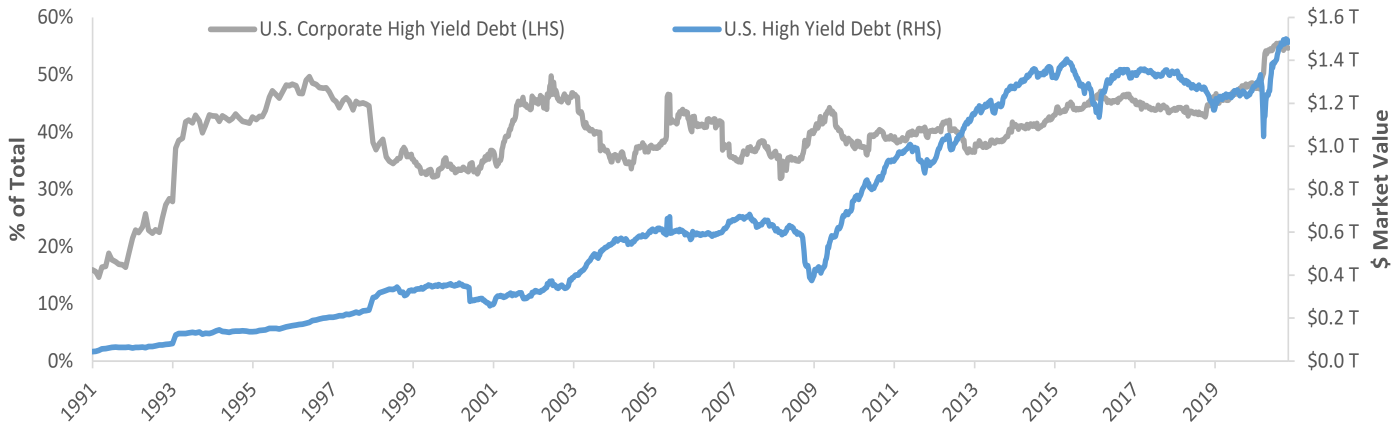

Figure 2

Source: Bloomberg, DoubleLine

Thus, in contrast to BBBs, which are being propped up by the Fed and have not experienced a crisis that flushed out excess risk in over a decade, high yield has undergone a protracted and significant unwinding of defaulted credits and repricing as well as new issuance and refinancing under more-rigorous underwriting standards. As a result, active managers can find investable assets in this sector, including in industries hit hard by the COVID-19 pandemic.

Consider, for example, a fallen angel cruise line corporation that has been idled by the pandemic since March 13, 2020, but was able to issue $4 billion in securitized debt on April 1, 2020, with a coupon of 11%. Clearly that high yield is due to the risk involved in the travel sector. That being said, these bonds were issued with the fleet collateral of ships so investors are willing to take risk within sectors that have been crushed due to COVID 19. If the company were later to be restructured, that part of the capital would probably be impaired, in which case investors in that debt would by definition suffer losses. The junior-most capital in directly COVID-19-impacted sectors such as airlines, cruise lines, retail and energy appear highly dependent on a continued recovery in order to recoup the full principal value of those securities.

Bank Loans

Historically, bank loans have been considered a lower-risk asset class relative to high yield corporate bonds since they are secured against the borrower's assets and stand first in line for repayment. By comparison, high yield bonds are typically unsecured and stand second in line for repayment behind bank loans. However, the distinction between these two asset classes (and yield differential) has diminished significantly. During this credit cycle, bank loans skirted the contraction that cleared out some of the excesses in the high yield sector. In 2013-2014, investor certitude that interest rates were set to rise unleashed a frenzy of floating-rate assets (notably, bank loans and collateralized loan obligations (CLOs) as well as other asset-backed securities). Indeed, the hunger for bank loans led to a boom in floating-rate mutual funds and CLOs – to the degree that CLOs today hold 67% of bank loan debt versus 43% in 2013. *(Figure 3)*

Leveraged Loan Holder Base

As of September 30, 2020

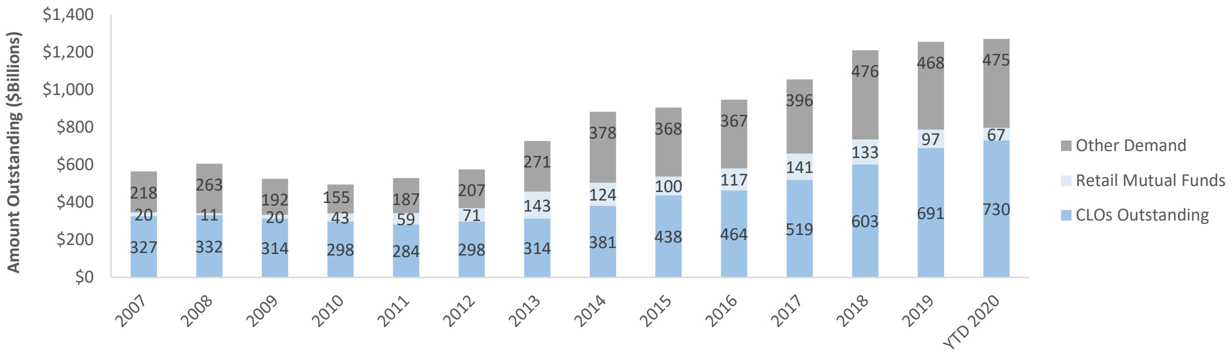

Figure 3

Source: S&P Global Inc., DoubleLine

The flood of money into CLOs and loans led to a relaxation of credit standards. Loans rated B now represent 35% of the market, much higher than in previous periods. So-called "covenant lite" loans now make up approximately 85% of all institutional loan issuance. *(Figure 4)*

Covenant-Lite Loans as a Percent of All Institutional Loans

As of September 30, 2020

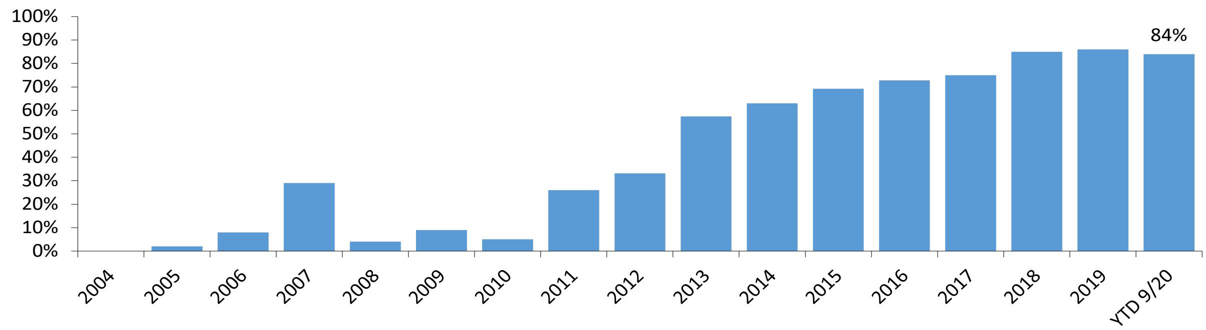

Figure 4

Source: S&P LSTA

The inflows experienced a pause in 2016, but by 2017, the risk build-up resumed. The pandemic-related March-April crisis shook up loan issuance and pricing, but the episode was too brief to bring about the degree of corrective market contraction that we have seen in past recessions. While the Fed has not been buying bank loans, the sector has experienced tangential effects from the central bank's asset purchases. To buy time, bank loan issuers are issuing in the high yield bond market to obtain liquidity and to extend debt maturities.

Bottom-Up Credit Selection, Industry Outlooks

Given the tightening spreads across corporate credit in the wake of the Fed intervention into the space, I see scant opportunity to buy broad index exposure in the hope of enjoying significant spread compression. The game today is about idiosyncratic trades: identifying securities and loans with the best prospects for credit improvement and ratings upgrades – a BBB headed for promotion to A, an on-the-mend CCC on the way to B, etc.

Broadly speaking, with regard to below investment grade corporate bonds and loans, our bottom-up investment approach hinges on three essentials: understanding the individual credit fundamentals (risk of default), loan-to-value ratio (prospects for recovery in the event of default) and liquidity. This last factor is about time. Companies with liquidity have time to work out problems in periods of stress.

Overlaying the analysis of individual credits are industry outlooks. For this reason, the corporate credit analysts at DoubleLine specialize in specific industries. When the U.S. emerges from the pandemic and economic activity starts to normalize, some industries will recover more slowly than others. For example, I expect energy will continue to struggle more than other parts of the economy. Cruise lines and airlines are likely in for a long slog. So, we'll inevitably see tiering of credit performance by companies due to industry conditions as well as for idiosyncratic reasons.

This does not necessarily rule out opportunities within the industries hit hardest by COVID-19 or industries that will take longer to recover. Depending on factors such as loan-to-value ratio on secured debt, an investor can choose a spot in the capital structure in line with the investor's outlook for the credit and its industry as well as the investor's risk appetite. For example, with airlines operating at 35% capacity, aerospace is at risk. Manufacturers of aircraft systems, structures and maintenance providers are severely depressed and face uncertain recovery in air travel, and yet they offer a 10% yield to maturity (YTM) as of October 8, 2020. So, given the investment team's depth of analysis, these beaten-down sectors do at least offer opportunities to be rewarded. The gambling industry is another prime example of an industry beaten down by COVID-19 with 10% YTM opportunity. Having a large credit team at DL allows us the advantage to thoroughly analyze opportunities within the credit sector.

Niche Opportunities and Forced Sellers

Given the Fed's commitment to keeping rates low, bank loans lack a clear catalyst to drive inflows and tighten spreads. Nonetheless, the asset class can offer idiosyncratic opportunities. CLOs have a hard time holding lower-rated credits and, thus, can become forced sellers of collateral that is downgraded to B and CCC. The larger managers, who need $200 million per name to move the needle, compete less for loans that are too small to fit in an index. This creates somewhat of a closed market for DoubleLine's bank debt teams, which can be the providers of liquidity rather than fighting it out with other buyers for allotments.

In conclusion, the chance to participate in the broad recovery across much of the corporate credit landscape has faded as the Fed's intervention has helped avoid a large default cycle and credit spreads have since compressed back to their long-term averages. For now, the recovery has created idiosyncratic opportunities that favor active managers. Thus, I believe this bodes well for DoubleLine's investment team. Our seasoned team of portfolio managers, analysts and traders has the collective knowledge to weather the storm while exercising caution and waiting for niche opportunities to arise. ■

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Author Biography

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Mr. Cohen joined DoubleLine's Global Developed Credit ("GDC") Group in 2012. He is a Portfolio Manager and the Director of the GDC group. He is also a permanent member of the Fixed Income Asset Allocation committee. Prior to DoubleLine, Mr. Cohen was a Senior Credit Analyst at West Gate Horizons Advisors (and its predecessor ING Capital Advisors) where he worked as an Analyst covering bank loans and high yield bonds. Prior to ING, he was an Assistant Vice President in the Asset Management Group of Union Bank where he managed a diversified portfolio of leveraged loans as well as a portfolio of CDO securities. Previous to Union Bank, he was an Associate Director of Corporate and Investment Banking at the Bank of Montreal in its Natural Resources Group. Mr. Cohen holds a BA in Economics from the University of Arizona and an MBA from the University of Southern California. He is a CFA® charterholder.

Definitions

Leveraged Loan (also known as bank loan) - A loan that is made to a company that has less than an investment-grade rating (below BBB-). These loans carry a higher risk profile and are typically made to smaller companies that investors may not be as familiar with. Because of the higher risk profile, leveraged loans carry a higher spread, are usually secured by the borrower's collateral and contain more restrictive terms and covenants. Leveraged loans comprise nearly all of the loans that are traded in the secondary market.

Collateralized Loan Obligation (CLO) – Single security backed by a pool of bank loan debt that uses leverage to enhance returns.

High Yield (HY) Bonds – Bonds that have a rating below investment grade (below BBB-).

Loan-to-Value - The ratio of the total debt borrowed by a company to its full enterprise value.

Bloomberg Barclays US Corporate High Yield Index – This index measures the U.S. dollar-denominated HY fixed-rate corporate bond market. Securities are classified as HY if the respective middle ratings of Moody's, Fitch and S&P are Ba1, BB+ or BB+ or below. The Bloomberg Barclays US HY Long Index, including bonds with maturities of 10 years or greater, and the Bloomberg Barclays US HY Intermediate Index, including bonds with maturities of 1 to 9.999 years, are subindexes of the Bloomberg Barclays US Corporate HY Index.

Bloomberg Barclays US Cororate Index – This index measures the investment grade, fixed-rate taxable corporate bond market. It includes U.S. dollar-denominated securities publicly issued by U.S. and non-U.S. industrial, utility and financial issuers.

Covenant-Lite Loan – A type of financing that is issued with fewer restrictions on the borrower and fewer protections for the lender.

Fallen Angel – A bond that was initially given an investment grade rating but has since been reduced to junk-bond status. The downgrade is caused by a deterioration in the financial condition of the issuer.

Citations

[1] For more on the duration profile of the investment grade corporate sector, please see Monica Erickson's guest column, "Why top-tier bonds are not as safe as they might seem," Financial Times, January 7, 2020. https://doubleline.com/dl/wp-content/uploads/Erickson_Whe-top-tier-bonds-are-not-as-safe_1-7-2020.pdf

[2] Bond prices in this paper are quoted as a percentage of par. For example, OXY's price of 136.8 on February 20, 2020, reflects the bond's price at 136.8% of par.

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