PGIM FIXED INCOME

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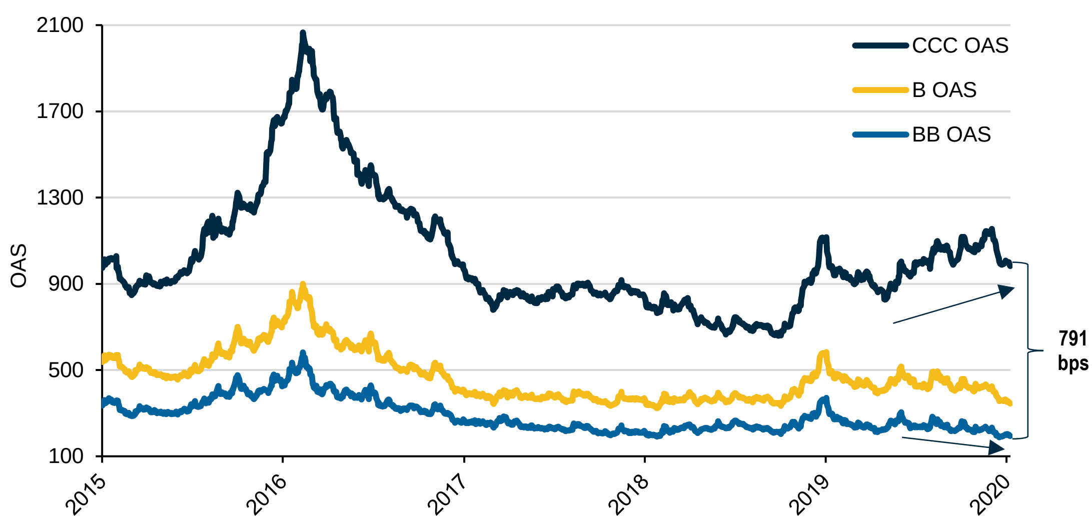
# Capturing Value in Lower-Rated U.S. High Yield

Overweighting the riskiest portion of the U.S. high yield market in a late-cycle environment may appear counterintuitive on the surface as these credits would be among the most affected by an economic downturn. However, we believe an overweight allocation to weak B-rated and CCC-rated credits is warranted based on global investors' ongoing search for yield, overvalued BB-rated issues, a constructive view of the global economic expansion, and credit spreads that imply a notably higher default rate than we expect.[1]

With about $11.75 trillion in negative-yielding debt globally (down from a peak of nearly $17 trillion in 2019), investors' need for yield remains palpable. The scarcity of yield is also indicated by an increasing number of non-U.S. investors who are concerned that hedging costs may eat into potential returns from U.S. assets and are choosing not to hedge FX exposure, as well as some European BB-rated debt that recently priced with coupons of less than 1%.[2]

The lack of value in BB-rated names is not isolated to Europe. In addition to nominally positive yields, investors also seem to prefer U.S. BB-rated issues over lower-quality high yield amid concerns about a possible global slowdown. The composition of the lower-quality portion of the U.S. high yield market may also play a significant role in this preference as half of these issuers are in economically sensitive, cyclical industries. After generally moving in synch in recent years, mid-2019 marked a clear directional divergence between the highest and lowest-quality portions of the market, resulting in a spread differential of nearly 800 bps as of mid-January 2020.

**Figure 1: The Directional Split Between U.S. BB and CCC Option-Adjusted Spreads**




*Source: ICE BofA and PGIM Fixed Income as of January 2020.*

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[1] *The credit ratings in this paper are based on those from Nationally Recognized Statistical Ratings Organizations and are based on weightings on the ICE BofA indices.*

[2] *For example, Crown European Holdings recently priced a BB-rated issue due on February 15, 2023 that priced with a coupon of 0.75%, and Ball Corp. recently priced at BB+-rated issue due on March 15, 2024 that priced with a coupon of 0.875%.*

Yet, amid progress on trade agreements between the U.S. and China, signs that the global manufacturing sector may have reached a bottom, and continued accommodation from major central banks, we see a backdrop that appears ideally suited to prolonging the global economic expansion. As such, we also maintain a low probability, say 10%, of the U.S. entering a recession in 2020.

Therefore, with the divergence in the lower-quality portion of the market resulting in a relatively attractive spread pickup (again, see Figure 1), we set overweights of up to 10 percentage points on the weak B and CCC-rated portions of the market as the year began.

Given our expectations for the global credit cycle to continue, lower-quality credit spreads continue to imply a default rate that is significantly higher than we expect in 2020. For example, the CCC-rated OAS of 983 bps as of mid-January, as referenced in Figure 1, implied a default rate of nearly 11.4% (see Figure 2), well above the historical annual rate of about 7% on the CCC-rated segment of the market.[3] In addition, we see the broad-market default rate remaining below the long-term historical average of about 3.5% and possibly below 3.0% should the energy and commodity sectors, which comprised about half of the default activity in 2019, stabilize further.

### Figure 2: The Default Rate Implied by CCC OAS Appears Elevated…

| CCC Spread Implied Default Rate | |
|---|---|
| Current Spread | +983 |
| - Historical Excess Spread | +300 |
| = Implied Default Loss | +683 |
| ÷ (Par - Recovery Rate) | (100%-40%) |
| = Implied Default Rate | 11.38% |

*Source: PGIM Fixed Income as of January 2020*

Our preferred positions in the B and CCC-rated segment of the market consist of overweights to independent power producers and U.S. consumer-related names. We recently shifted to an overweight in the energy sector, which appeared especially oversold, with a particular focus on producers and distributors of natural gas and related fuels.

We're also opportunistically and selectively adding healthcare issuers. We're offsetting the overweight to higher-beta issues with CDX and positions in AAA-rated CLO tranches. In considering environmental, social, and governance factors as part of our investment process, we're cognizant of the effect that ESG concerns may have on lower-rated energy and commodity names. Although these OAS may tighten and contribute to attractive risk-adjusted returns, we acknowledge that these issues could ultimately continue to trade at a discount to similarly-rated names with fewer ESG concerns.

There are caveats to moving down in credit quality. A primary concern is that we may be misjudging the general strength of the global economy, and if a downturn approaches, many weaker B and CCC-rated names could be severely affected. Furthermore, while credit selection is a key component of generating alpha across varying investment backdrops, the move down in quality emphasizes the importance of picking credits that may withstand weaker economic conditions.

In addition, identifying an attractive lower-rated credit is one thing, but finding fairly-valued bonds from the same issuer is another. These issues can be difficult to source, particularly in the belly of some steep credit curves, yet we have added exposure during some periods of lower liquidity. Volume in the high-yield primary market has also accelerated recently and should provide opportunities to adjust exposure as needed.

In conclusion, when evaluating allocations in the current late-cycle environment, the U.S. high yield market remains vastly bifurcated with overvalued BB-rated issues and some deeply discounted weak B and CCC-rated names. Granted, there are risks to overweighting the lower-quality portion of the market, but given our base case for a prolonged credit cycle, the larger risk to performance could be maintaining overweights to the BB-rated segment of the market, particularly as lower-quality credit spreads imply a far higher default rate than we expect in 2020.

[3] *From January 1, 1982 to December 31, 2018, the five-year cumulative default rate for the CCC-rated portion of the market was 33.9%.*

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Source(s) of data (unless otherwise noted): PGIM Fixed Income as of January 2020.

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