CAUTIOUSLY CONSTRUCTIVE IN A CRISIS: WHY WE'VE MAINTAINED OUR CCC OVERWEIGHT

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As the virus-related lockdowns took hold across the U.S., our broad market high yield portfolios were generally positioned with an overweight to the CCC-rated portion of the market. At the time, some may have characterized that positioning as "caught leaning the wrong way," to use a sports analogy. Yet, throughout the worst of the market volatility, gradual economic re-openings, and lingering uncertainty about the next turns for the virus, we believe that a CCC overweight continues to provide the appropriate balance between upside and downside risk in the U.S. economy and the high-yield universe.

When Default Rates Plateau

While many participants point to default experiences from the prior recession in 2008/2009, U.S. high yield underwent another cycle thanks to 2015's energy sector meltdown, which was concentrated within the lower-rated segment of the market. These cycles spanning less than a decade reveal that, after bearing the brunt of the volatility as default rates rise, a peak or plateau in defaults is typically accompanied by positive high-yield total returns over the next year and is often led by CCCs (Figure 1) as a path out of the default mire emerges. And based on the monthly number of defaults, a plateau may be forming as July was the first month with less than 20 defaults since April.

FIGURE 1: CCCS HAVE LED THE POST-PEAK DEFAULT GAINS IN THE PRIOR TWO CYCLES

High Yield Cycle Default Peak	1-Year Total Return Post-Default Peak (%)			
	HY Index	BBs	Bs	CCCs
January 2009	+41.63	+31.93	+33.65	+69.52
August 2015	+9.08	+9.50	+7.68	+11.98

Source: PGIM Fixed Income, Moody's Investors Service, and Goldman Sachs Global Investment Research. The High Yield Index and the respective cohorts are based on the ICE BofA High Yield Index. An investment cannot be made directly into an index.

We believe that the initial decline in default activity will continue and that rates will fall significantly beyond the next 12 months. In mid-August, CCC spreads implied an annualized default rate of 13.4%, which continues to appear quite elevated given the expectations for declining default rates going forward (Figure 2). Therefore, we believe carefully selected CCC spreads provide sufficient compensation for the default risk and present further opportunities to generate alpha, particularly given the probability for a "U" shaped recovery (see concluding section).

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FIGURE 2: CCC SPREADS APPEAR TO PROVIDE SUFFICIENT COMPENSATION FOR THE DEFAULT RISK

CCC Spread Implied Default Rate	Spread Wides in March	Mid-August Spreads
Current Spread	+1962 bps	+1235 bps
- Risk Premium	+300 bps	+300 bps
= Implied Default Loss	+1662 bps	+935 bps
÷ (Par - Recovery Rate)	(100% - 30%)	(100% - 30%)
= Annualized Implied Default Rate	23.7%	13.4%

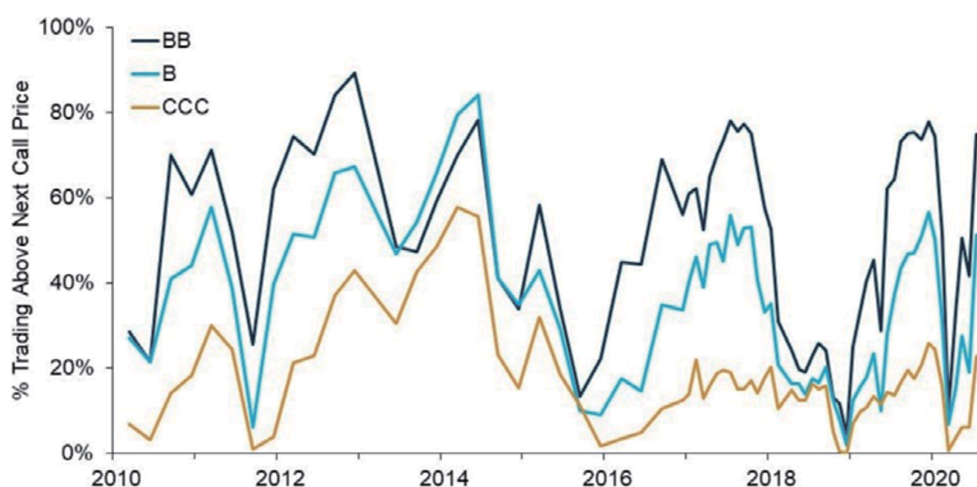
B Spread Implied Default Rate	Spread Wides in March	Mid-August Spreads
Current Spread	+1189 bps	+547 bps
- Risk Premium	+300 bps	+300 bps
= Implied Default Loss	+889	+247
÷ (Par - Recovery Rate)	(100% - 30%)	(100% - 30%)
= Annualized Implied Default Rate	12.7%	3.5%

Source: PGIM Fixed Income as of August 2020. Mid-August spreads represent the CCC and B-rated portions of the ICE BofA U.S. High Yield Index. Excess spread measures the 20-year monthly median of the difference between actual spreads and actual default loss. An investment cannot be made directly into an index.

Room for Further Participation

As investors' search for yield has resumed, their trepidation about the prolonged strength of the economic recovery has led many to frequently overlook CCC-rated bonds. For example, only about 23% of the CCC universe is trading above its next call price (Figure 3), making it unlikely that issuers will exercise the call option on these bonds. Indeed, while August brought a torrent of issuance and refinancing activity, the CCC portion has been largely excluded—its YTD issuance has only comprised 9% of the total high yield primary volume, which would be a post-crisis low if it holds through year end.1 Given that CCCs are less likely to be called, that convexity should allow select credits to continue participating in an economic recovery even as their downside risk to an economic reversal, or slowdown, remains.

FIGURE 3: LESS THAN A QUARTER OF CCC-RATED BONDS TRADE ABOVE THEIR NEXT CALL PRICE



Source: Goldman Sachs Global Investment Research as of August 2020

While the upside/downside dynamic of CCCs can increase the beta of a portfolio that is overweight to this segment of the market, we've partially hedged that beta with higher-than-normal cash balances, AAA CLOs, and short credit positions via high yield credit default indices. In addition, we're finding value in certain fallen angel candidates and BB names, although we remain underweight to the latter segment. As a result of this barbell approach, our systematic risk remains modest relative to our benchmark.

The Adaptation of CCCs and Scenarios Going Forward

At the weak end of the corporate credit spectrum, CCCs are the most exposed to economic risk. However, companies, such as those in the retail, restaurant, energy, and technology sectors, continue to adapt under the virus-related strains.

This adaptation, complemented by the significant fiscal and monetary stimulus, has contributed to what we see as a 50% probability for a "U" shaped economic recovery supported by another round of U.S. fiscal stimulus (perhaps in September), ongoing global central bank support, and an eventual vaccine for the virus. In the "U" shaped scenario, we estimate that high yield spreads could tighten by about 85 bps within a year, with CCCs possibly outperforming based on prior recovery experiences. But even in a probability weighted forecast of recovery scenarios (V, U, L, and W shaped) over the next 24 months, we estimate high yield spreads could tighten by slightly more than 150 bps within two years.2

Risk assets have certainly performed well since the worst of the market volatility in March, leaving investors to consider where they might find the next relative-value opportunities. Given the experience in past cycles, the potential for further participation in an economic recovery, and our ability to evaluate the shifting dynamics across the most distressed credit sectors, we continue to believe an overweight to CCC-rated credits provides an appropriate upside/downside balance to U.S. high yield portfolios.

[1] Supply breakdown is from J.P. Morgan

[2] Our current recovery scenarios place a 10% probability on a V-shaped recovery, a 50% probability on a U-shaped recovery, a 15% probability on an L-shaped recovery, and a 25% probability on a W-shaped recovery.

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