Do we have a credit supply problem?

Hotchkis & Wiley

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The number of US corporate bonds rated by a major credit rating agency

According to a 2012 report published by the SEC[1], Standard & Poor's provided a formal credit rating on approximately 1.2 million bonds, Moody's on approximately 1.0 million bonds, and Fitch on approximately 350 thousand bonds. These figures include not only US-based corporate credits but also government, asset-backed, and corporate bonds across the globe. The same report noted that these three agencies, often referred to as the "Big 3", have about 95% market share. Opinions vary greatly in terms of the Big 3's ability to cover such a broad universe with appropriate quality controls, but there is little debate about the tremendous influence that these agencies exert over capital markets. Any entity that has debt is well aware of its credit rating, and often take painstaking measures to maintain or improve its rating. Further, credit ratings are an important consideration for investors analyzing the risk/return prospects of not just bonds but also public and/or private equity.

The high yield bond universe is sculpted by the rating agencies, which draw a line in the sand between investment grade and high yield. Widespread downgrades from investment grade to high yield, or upgrades from high yield to investment grade, affect the market directly and shape the benchmarks to which high yield investors are compared. Accordingly, we pay close attention to credits on the fringe of the investment grade and high yield market (i.e. BBB and BB credits) so that we can be prepared for any risks or opportunities that may transpire. In recent years, the lower end range of the investment grade credit market (i.e. BBBs) has expanded more quickly than other credit market segments, which has the potential to influence the high yield market in a big way in the event of widespread downgrades. This newsletter will explore the rapid growth of this market segment as well as the underlying risks and opportunities this may present to diligent high yield bond investors.

[1] www.sec.gov/divisions/marketreg/ratingagency/nrsroannrep1212.pdf

The US corporate bond landscape

Chart 1 summarizes the corporate credit market by credit quality. The investment grade universe is represented by the ICE BofAML US Corporate Index and the high yield universe is represented by the ICE BofAML US High Yield Index. To define the credit rating, we use a composite provided by Bloomberg which averages the ratings of the Big 3 plus DBRS, another rating agency[2]. At about $6.2 trillion, the total face value of the investment grade credit index is nearly 5 times bigger than the high yield index (~$1.3 trillion)[3]. The BBB segment—the lowest rated group still considered investment grade—is more than twice the size of the entire high yield segment. This is the fringe group we reference earlier to which we monitor closely.

Chart 1: Corporate market by credit rating (3/31/18)
$billions of face value

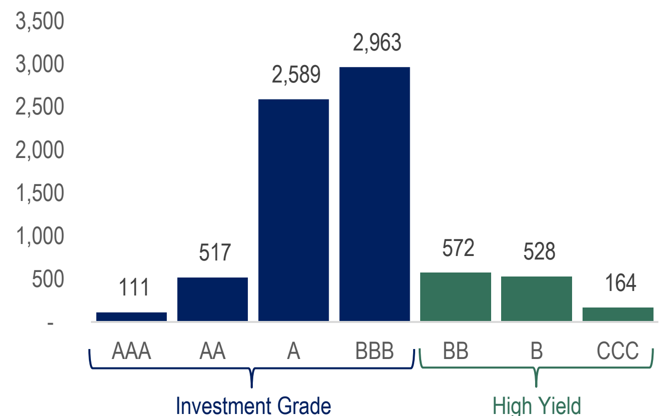

Chart 2 parses the corporate credit landscape at a more granular level, by including the "+" and "-" in the ratings. It highlights that $777 billion worth of bonds are rated BBB-, tiptoeing the line between investment grade and high yield. This cohort alone is more than 60% the size of the high yield bond index, therefore widespread downgrades of this category could reshape the high yield landscape.

[2] Bloomberg averages the ratings of the four agencies on an equal-weighted basis (only those that have a formal rating), and then rounds down if needed.
[3] In other materials, we refer to the size of the high yield market as closer to $1.7 trillion using data from JPMorgan. The primary difference is that JPMorgan's figure/index includes more USD denominated foreign credits.

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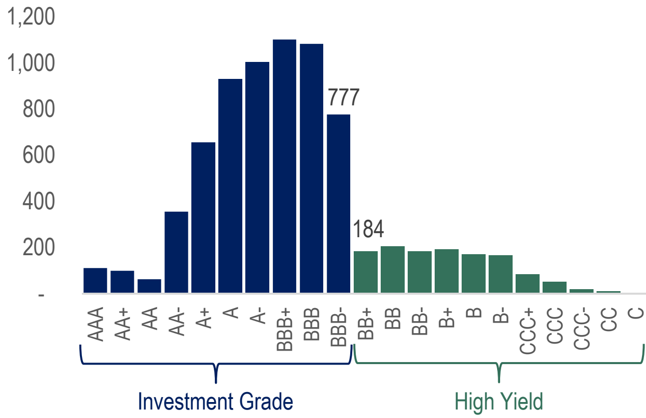
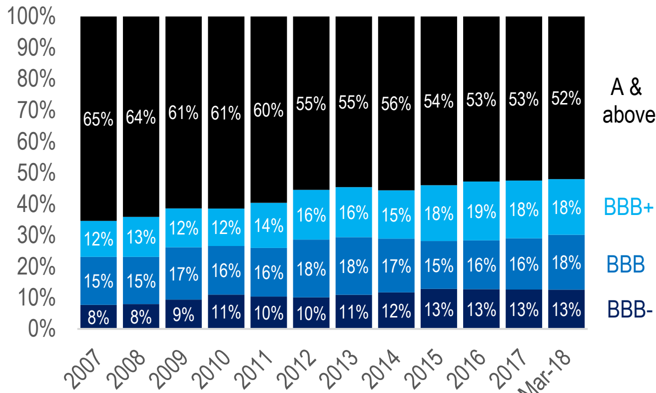
Chart 2: Corporate market by credit rating (3/31/18)
$billions of face value



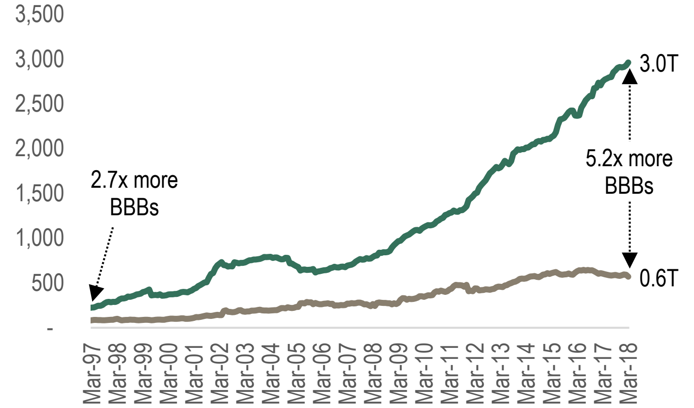
The investment grade credit market has always dwarfed the high yield market, and the cliff between BBB- and BB+ credits is not a new phenomenon. The size of this cliff has grown; however, as BBB rated credits have comprised an increasing share of the market over the past decade (see Chart 3).

Chart 3: Investment grade corporate bond market
Allocation by credit rating, % of total face value



The growth in BBBs has far outpaced the growth in BBs[4]. As shown in Chart 4, the total face value of BBB rated credits is more than five times the total face value of BB rated credits—a much larger multiple than existed historically.

Chart 4: BBB and BB rated credits
Total face value



Charts 5 and 6 show the sector composition of all BBB credits and the BBB- subdivision, respectively. Energy and healthcare are important constituents in both.

Chart 5: Composition of BBB credits (3/31/18)
$billions of face value

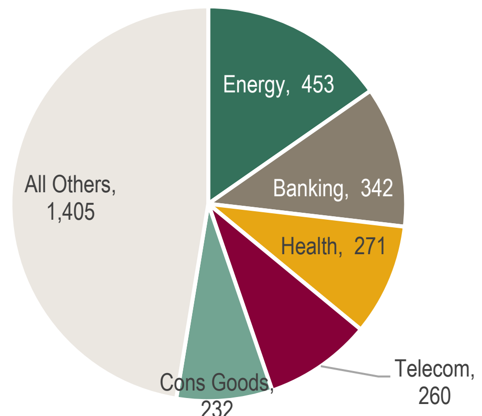
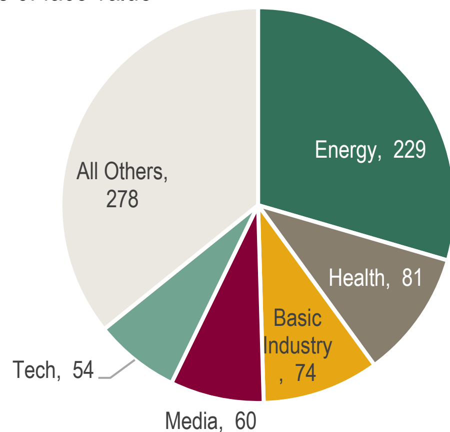


Chart 6: Composition of BBB- credits (3/31/18)
$billions of face value



[4] Unless noted otherwise, when we refer to BBB or BB rated credits this includes those with a "+" or a "-".

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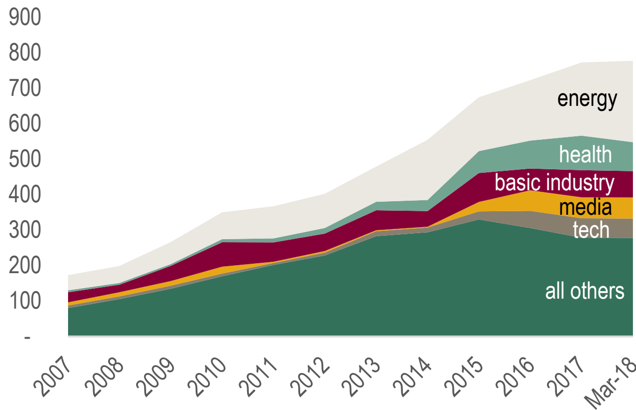
Energy comprises nearly 30% of all credits rated BBB-, followed by healthcare (10%), basic industry (10%), media (8%), and technology (7%). Chart 7 shows how the composition of BBB- credits has evolved over the past decade. The size of this group increased by $371 billion in the five year span 2012-2017, a cumulative growth rate of 92%; more than half of that growth came from the energy and healthcare sectors.

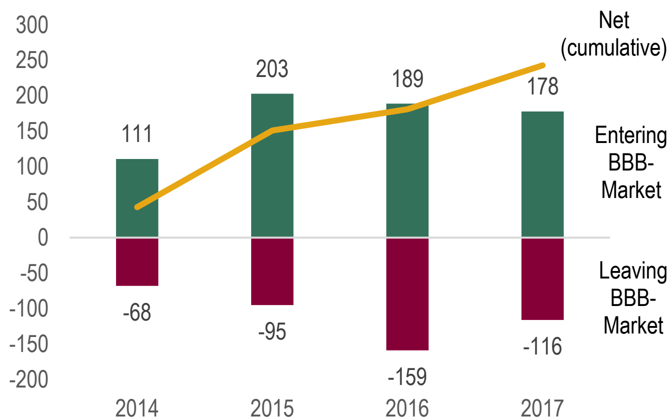
Chart 7: Historical composition of BBB- credits
$billions of face value



BBB- migration

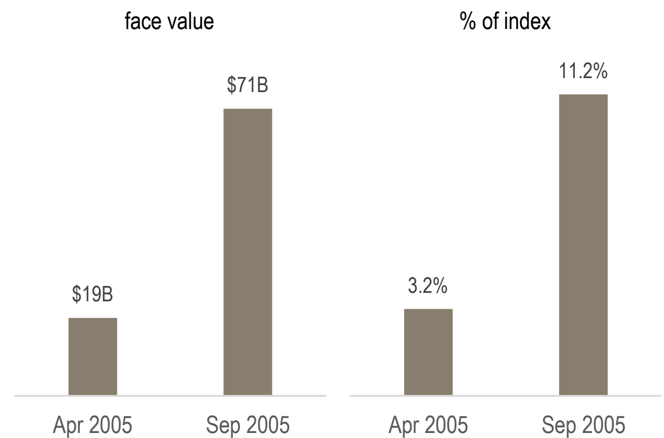
Each rating cohort is constantly evolving. Chart 8 highlights the net changes to the BBB- rated cohort over the past four calendar years; new entrants exceeded new departures each year. While our mandate is to invest in high yield bonds, we monitor this market cohort closely. A reversion downward has the potential to flood the high yield market with excess supply. This would be caused by widespread downgrades from BBB- to high yield (BB+ or lower).

Chart 8: Migration to/from credits rated BBB-
$billions of face value



Widespread and/or large downgrades can quickly and significantly reshape the high yield market's composition. To illustrate, consider the downgrading of General Motors and Ford in mid-2005, both of which were downgraded from BBB- to BB+. As shown in Chart 9, the automotive industry comprised about 3% of the high yield index prior to the downgrades, representing $19 billion in total face value. After the downgrades, the industry comprised more than 11% of the index, representing $71 billion in total face value. GM alone was 6.5% of the index. Many high yield managers were left in a quandary, unable to take a market weight in the credits without violating investment guidelines.

Chart 9: High yield automotive credits
Before and after GM/Ford downgrades in 2005



Characteristics of BBB- rated credits

Credit markets experienced widespread downgrades in the energy sector shortly after oil prices began to plummet in mid 2014. Elsewhere, credit markets have not experienced a broad downgrade cycle in a while. The economy has been healthy/growing and so have corporate revenues and profits, but the duration of economic expansions are difficult to predict and not our specialty. We prefer to evaluate corporate fundamentals, with the amount of balance sheet leverage among the most important characteristics.

Chart 10 shows how the average leverage for various credit quality groups have evolved over the past 10 years. Over the most recent 5 years, leverage in the high yield market has remained relative stable while leverage in the investment grade market has increased—particularly in BBB rated credits. Over the last decade, BBB rated bonds have comprised a growing portion of the investment grade credit market and the leverage of this group has increased—this combination is indicative of a deteriorating investment grade credit market.

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Chart 10: Gross leverage
Debt/EBITDA

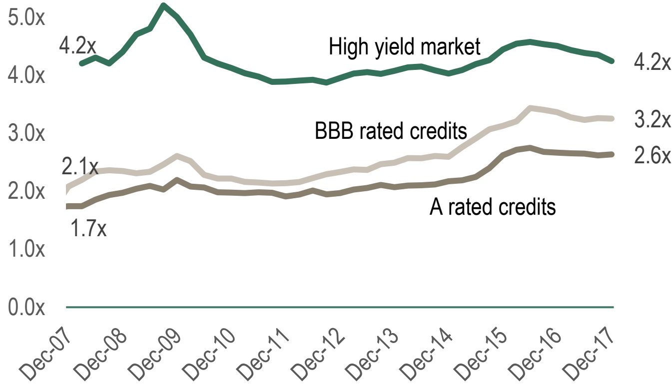
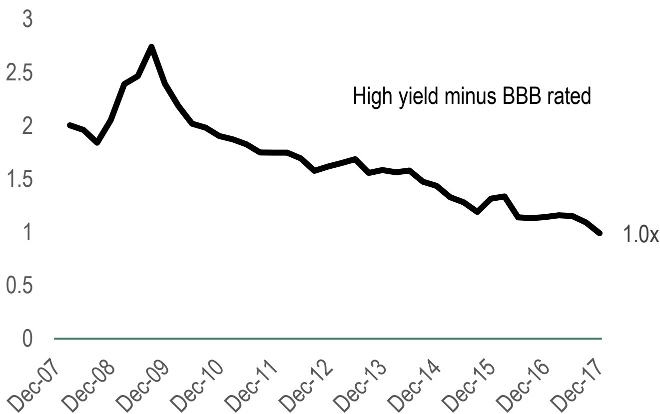


Chart 11 shows the difference in leverage between the high yield market and the BBB rated portion of the investment grade market—there has been a noticeable and somewhat unprecedented convergence.

Chart 11: Difference in gross leverage
Debt/EBITDA



The rapid growth in BBB- credits combined with an increase in the financial leverage does not guarantee a massive high yield supply influx, but it has our attention. The economic expansion could persist and balance sheets could improve, but greater leverage increases credit risk in the event of economic contraction.

High yield supply and demand history

The primary sources of high yield supply are newly created issues and bonds that have been downgraded from investment grade to high yield, i.e. fallen angels. Chart 12 shows these two factors over the past ten years. While new issuance appears to be the dominant driver, it is somewhat misleading because much of the new issuance is refinancing, and is thus offset by bond calls (see Chart 13). New issuance that is not used for refinancing is partially offset by coupon payments that need to be reinvested (the analysis assumes 75% of coupons are reinvested).

Chart 14 shows the net effect of all the supply and demand factors. While technically the high yield market has shrunk, we believe this to be transitory and not a cause for concern.

Chart 12: High yield supply
$billions of face value

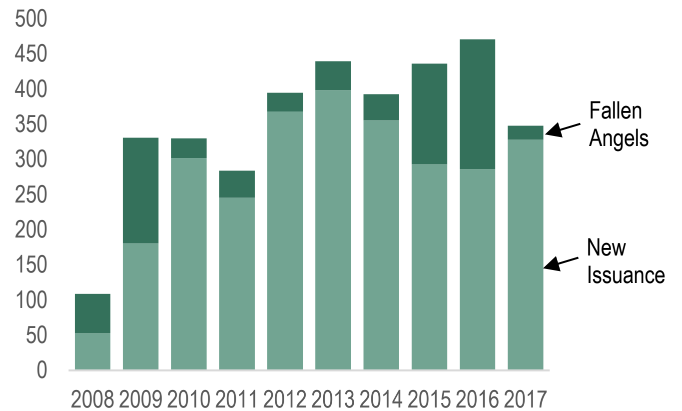


Chart 13: High yield demand
$billions of face value

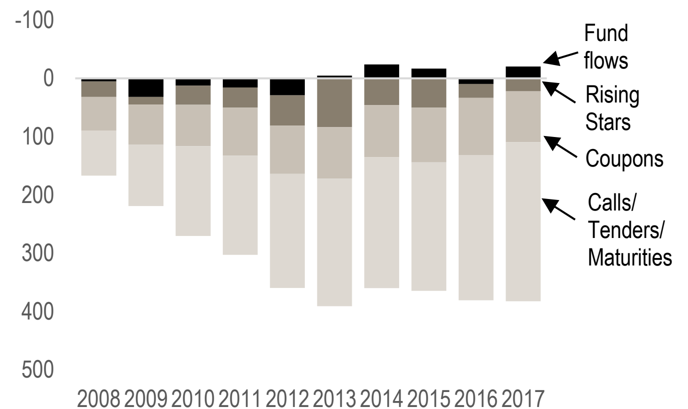


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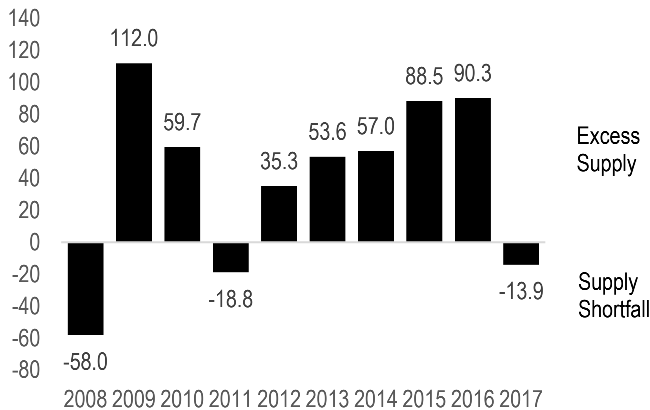
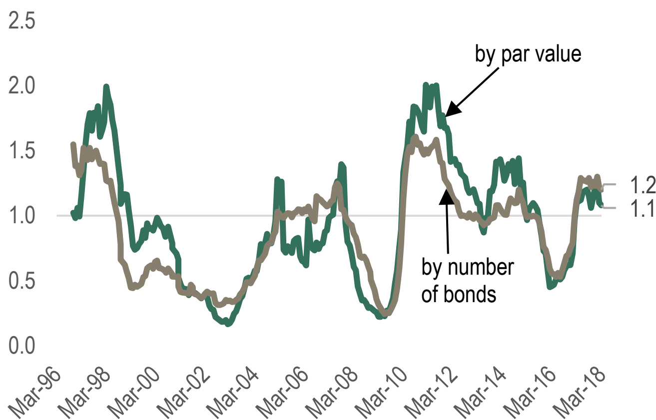
Chart 14: High yield net supply
$billions of face value



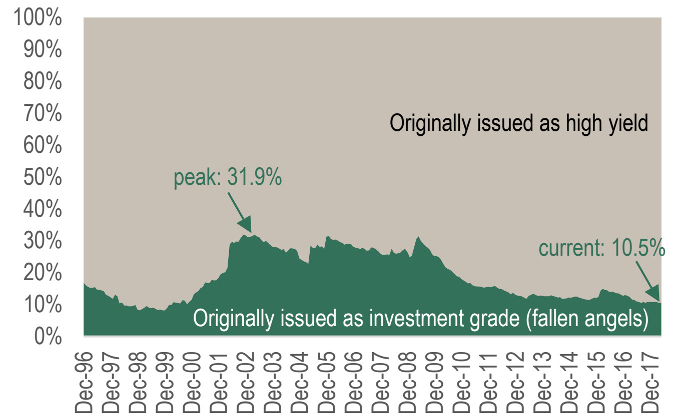
Fallen angels that migrate from investment grade to high yield are offset by rising stars that migrate from high yield to investment grade; however, large downgrade cycles rarely coincide with large upgrade cycles. Consequently, a large influx of fallen angels into the high yield market is unlikely to have offsetting demand. Chart 15 shows the upgrade/downgrade ratio for the high yield market historically. The ratio moves in cycles and is often far from 1.0, which would represent an equal amount of upgrades as downgrades.

Chart 15: High yield upgrade/downgrade ratio



Currently, nearly 90% of the high yield market is composed of bonds that were rated high yield when first issued, and only about 10% is composed of bonds that were originally rated investment grade but have since been downgraded (see Chart 16). This is below the historical median of 15.5% well below the historical peak of nearly 32%. A widespread downgrade cycle—a large influx of fallen angels—would be far from unprecedented.

Chart 16: High yield market composition
Originally high yield vs. fallen angels



Summary

In the long run, it is fundamentals and valuation that matter, but a meaningful supply/demand imbalance can have a market impact in the short term. Excess supply puts downward pressure on prices in any market, high yield bonds included, and it takes time for excess supply to be absorbed. Excess supply could eventually produce compelling valuation opportunities, but until such opportunities surface, we are content limiting our exposure to this market segment. We prefer jumping on the train to jumping in front of it.

Hotchkis & Wiley High Yield Research

All investments contain risk and may lose value. Investments in debt securities typically decrease in value when interest rates rise. This risk is usually greater for longer-term debt securities. Investment by the fund in lower-rated and non-rated securities presents a greater risk of loss to principal and interest than higher-rated securities. The Fund may invest in derivative securities, which derive their performance from the performance of an underlying asset, index, interest rate or currency exchange rate. Derivatives can be volatile and involve

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various types and degrees of risks. Depending on the characteristics of the particular derivative, it could become illiquid. Investment in Asset Backed and Mortgage Backed Securities include additional risks that investors should be aware of such as credit risk, prepayment risk, possible illiquidity and default, as well as increased susceptibility to adverse economic developments. The Fund may invest in foreign as well as emerging markets which involve greater volatility and political, economic and currency risks and differences in accounting methods.

Investing in high yield securities is subject to certain risks including market, greater price volatility, credit, liquidity, issuer, interest-rate, inflation, and derivatives risks. Lower-rated and non-rated securities involve greater risk than higher-rated securities. Investment grade bonds, high yield bonds, and other asset classes have different risk profiles which should be considered when investing. High yield securities have greater price volatility and credit and liquidity risks (presenting a greater risk of loss to principal and interest) than other higher-rated securities. Any discussion or view on a particular asset class or investment type are not investment recommendations, should not be assumed to be profitable, and are subject to change.

Data sources - Initial statistic, Charts 1-7, 9, 16: BofAML, Bloomberg; Charts 8, 10-15: JPMorgan.

The ICE BofAML US High Yield Index tracks the performance of below investment grade, but not in default, US dollar-denominated corporate bonds publicly issued in the US domestic market, and includes issues with a credit rating of BBB or below, as rated by Moody's and S&P. The ICE BofAML US Corporate Index tracks the performance of US dollar denominated investment grade corporate debt publicly issued in the US domestic market. The indices does not reflect the payment of transaction costs, fees and expenses associated with an investment in the Fund. It is not possible to invest directly in an index.

Debt/EBITDA is a measure of a company's ability to pay off its incurred debt (EBITDA-Earnings Before Interest, Taxes, Depreciation and Amortization). Fallen angels are credits that were investment grade rated when issued (BBB- or above), but have since been downgraded. Upgrade/Downgrade ratio is the number of ratings upgrades divided by the number of ratings downgrades (by the major ratings agencies). Credit Quality weights by rating were derived from the highest bond rating as determined by S&P, Moody's or Fitch. Bond ratings are grades given to bonds that indicate their credit quality as determined by private independent rating services such as Standard & Poor's, Moody's and Fitch. These firms evaluate a bond issuer's financial strength, or its ability to pay a bond's principal and interest in a timely fashion. Ratings are expressed as letters ranging from 'AAA', which is the highest grade, to 'D', which is the lowest grade. In limited situations when none of the three rating agencies have issued a formal rating, the Advisor will classify the security as nonrated. Top 10 holdings as of 9/30/18 as a % of the Hotchkis & Wiley High Yield Fund's net assets: American Zinc Recycling 1.3%, Momentive Performance Materials 1.0%, Rayonier A.M. Products Inc. 1.0%, Weekley Homes LP 0.9%, Rain CII Carbon LLC 0.9%, CCO Holdings LLC 0.9%, Shelf Drilling Hldgs Ltd. 0.9%, Zachry Holdings Inc. 0.9%, Century Aluminum Co. 0.9%, and Telesat Canada/Telesat LLC 0.9%. Portfolio weightings, sector allocations, and/or fund holdings are subject to change and should not be considered a recommendation to buy or sell any security.

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