



State of the Markets: Credit's Evolution

February 2020

Risks & Opportunities in Today's Credit Environment

- Corporate credit markets persistently outperformed other fixed income asset classes for the majority of the last economic cycle. In 2019, surprisingly, higher rated investment grade credit outperformed its lower rated, high yield counterpart.
- Leverage levels and the growth in BBB-rated corporate credit could signal a warning to the market which presents both risks and opportunities.
- The below investment grade market underwent a meaningful structural change throughout this cycle, with supply and demand dynamics materially impacting the way investors access leveraged credit.
- Leveraged credit markets are more bifurcated than ever with select sub-sectors singing a different tune in terms of performance. As for quality, yield dispersions tell the story behind the song which could impact near term portfolio construction.

Throughout 2019, credit assets continued their dominant streak of performance across domestic fixed income markets. Corporate credit, in particular, rallied in the post-crisis era as yield oriented investors sought to increase returns during a consistently downward moving interest rate environment, save for brief periods of upward yield movements.

This consistent reign of performance has changed the relationship between credit and other asset classes in portfolios, and instigated questions about the timeline of this rally. These questions are justified, with both investment grade and high yield corporate credit rallying more than 14 percent in 2019 and investment grade credit generating better relative returns to its riskier leveraged credit counterparts.

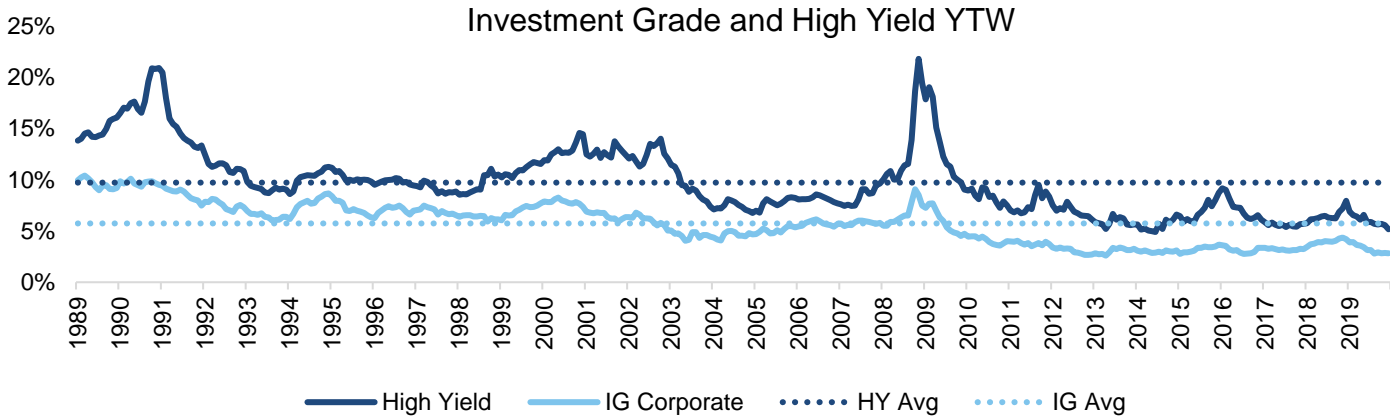
Benchmark	As of December 31, 2019			
	1-Year	3-Year	5-Year	10-Year
BBgBarc U.S. Government	6.8%	3.3%	2.4%	3.0%
BBgBarc U.S. Corporate Bond	14.5%	5.9%	4.6%	5.5%
BBgBarc U.S. Securitized	6.4%	3.3%	2.6%	3.3%
BBgBarc U.S. Corporate High Yield	14.3%	6.4%	6.1%	7.6%

Source: Morningstar, January 2020

When credit assets generate equity-like returns, investor questions fueled by forecasts of a credit bubble and recession from the financial news media are warranted. In addition, moving forward the relative opportunity set is less picturesque for the credit investor relative to 10-years ago, much less 12-months ago. As markets have grown and rallied, yields have grinded lower, as illustrated in domestic investment grade and high yield markets below. Both opportunity sets are trading inside of their 30-year average yields.

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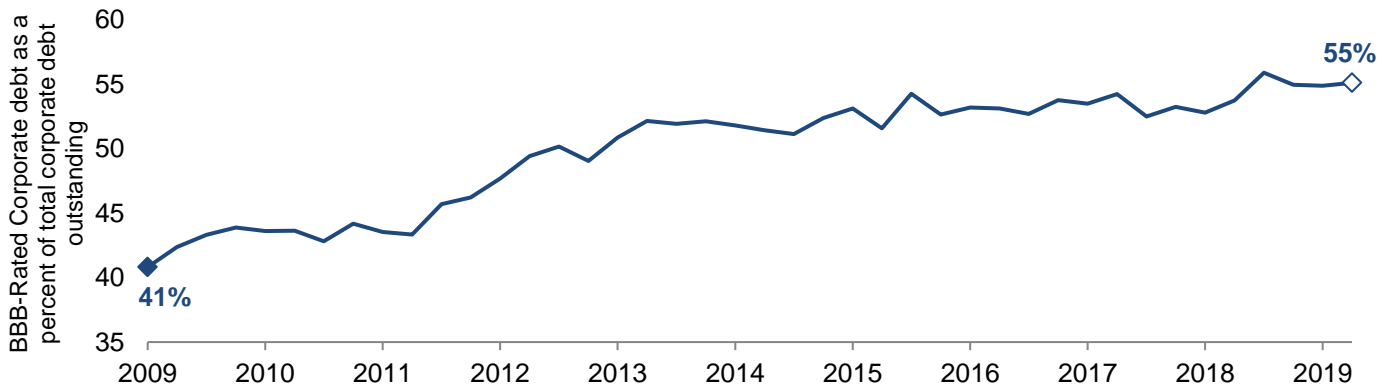
That begs the question, how much juice is left to squeeze out of this rally?



Source: Bloomberg, January 2020

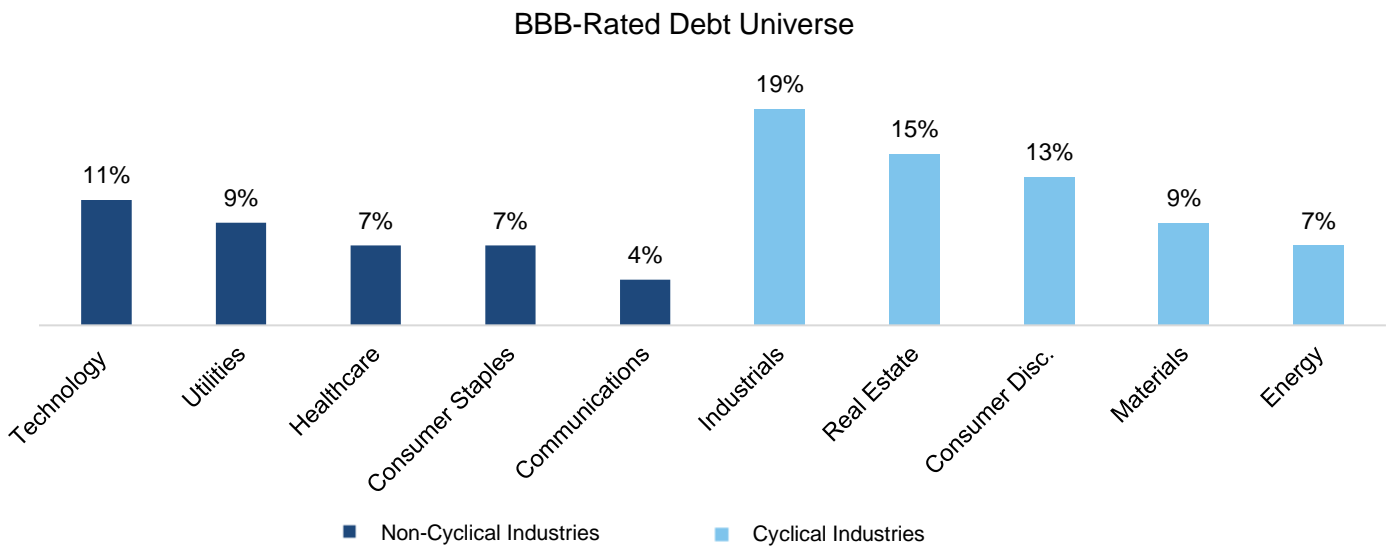
This kind of rally is unlike any experienced before. Over the last 10-years, lower interest rates resulted in a boom of new credit issuance, especially within the lower rated segments of the investment grade market. Today, there is almost double the outstanding corporate credit there was before the financial crisis. That would immediately sound alarm bells from investors if one was simply taking a cursory view of the landscape. Part of this growth in debt markets has been driven by a U.S. Federal Reserve-suppressed low interest rate environment. The outcome is a change in the composition of credit markets, specifically as it relates to credit quality with BBB-rated securities, which now accounts for the majority of investment grade corporate credit.

Growth of the BBB-Rated Corporate Debt



Source: Bloomberg, January 2020

As established, over the previous market cycle, the BBB segment of the investment grade market grew substantially. However, if the economy experiences any unexpected headwinds, the BBB segment may face downgrades. The current industry mix comprising the benchmark is what is driving this. More than 60 percent of BBB-rated credits in the index are from cyclical industries, which may be overexposed, and more prone to downgrades.



Source: Bloomberg, November 2019

Let's observe how credit markets operate while taking into account shifting supply and demand interests. If we look at the roughly \$2.8 trillion in BBB-rated securities, excluding financials, \$1.2 trillion of it is comprised of companies with leverage in excess of 4.0x EBITDA, with another \$712 billion in those cyclical industries. That's roughly \$2 trillion of the BBB universe at risk of being downgraded. That would swamp the existing high yield market today, as we'll explain next.

It's unlikely a wave of downgrades would drive the entire supply of risk credits into the below investment grade market. Various sectors, however, have undergone recessions in isolation including energy and retail and industrial companies, which resulted in downgrades. A broad recession impacting various sectors at once could dramatically increase supply in a much smaller market. That could result in material price dislocations, which would be a boon for credit investors in the high yield market.

High Yield Bonds and Bank Loans

Today, domestic high yield has an increasingly important role in investors' portfolios. In 2019, net inflows to the asset class approached \$20 billion which were driven by investors' quests for yield in a post-recessionary environment of low interest rates. Entering the latter stages of the cycle, to avoid potential pitfalls, it is critical investors understand the fundamental changes in the leveraged finance markets.

The Rise of the Bank Loan Market

The primary fundamental change is the rise in assets in the bank loans market congruent with a shrinking domestic high yield market. The domestic high yield market has enjoyed tremendous growth over the past decade with assets approaching \$1.1 trillion in October 2019, which was down from its high of \$1.2 trillion in 2014.

In 2018, bank loans surpassed high yield and today stand at nearly \$1.2 trillion.

Several factors contributed to this phenomenon. Demand from higher risk issuers such as leveraged buyouts – historically financed through high yield debt issuance – has migrated almost exclusively to bank loans. More relaxed lending terms is a factor driving demand for bank loans. These loans, labeled “covenant lite”, have increased flexibility regarding the borrower's collateral, level of income and payment terms (i.e. paying dividends while deferring scheduled interest payments).

Although the terms can be advantageous for borrowers, they lack of protection for investors. The growth of covenant lite loans has enabled companies too small to lure the high yield market to chase financing through the loan market. It has resulted in an increase of loan-only capital structure deals, another decrease in investor protections, with no subordinated bonds to absorb the losses in the event of a bankruptcy.

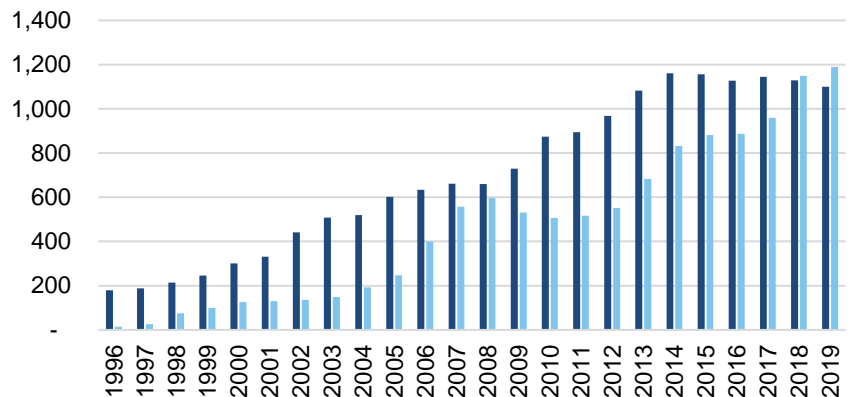
Currently, covenant lite and loan-only issuances comprise 85 percent² and 70 percent of the market respectively; up from 20 and 60 percent accordingly in 2008³, which highlights the importance of investors understanding the risks that markets bear. These dynamics result in greater disparity between the quality of the high yield and bank loans markets, as illustrated below.

¹ Morningstar, September 2019

² S&P Global Market Intelligence, December 2018

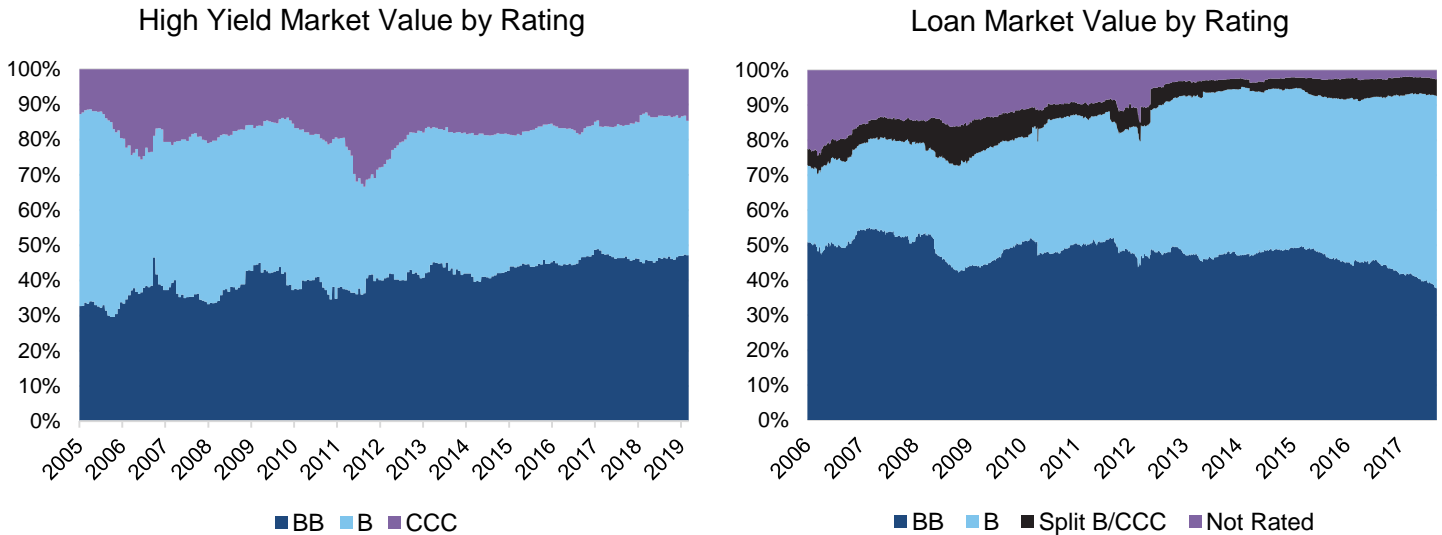
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Size of Public U.S. HY and Loan Markets
(US\$T)



Source: BAML, September 2019 ■ US HY ■ US Loans

³JPMorgan, 2018



Source: JPMorgan, September 2019

You can see both the high yield and bank loan markets are undergoing a transition in credit quality. High yield realized an increase in overall credit quality through the growth in BB rated debt and a decrease in CCC rated debt. Whereas, the loan market saw a decrease in credit quality, with an uptick in single-B rated debt and a decrease in BB rated debt.

The return of collateralized loan obligations (CLOs) as the primary buyer of loans and catalyst for syndicated loan growth is the second fundamental change, and one of concern. Understanding the underlying risk in CLOs is predicated on understanding their structure. Rating agencies mandate CLOs not hold more than 7.5 percent in CCC loans; as of September 30, 2019 the average CLO held 4.7 percent in CCC loans⁴.

With the growth of the single-B segment of bank loans, there is a greater probability the ratings agencies will downgrade the single-B segment to CCC as a result of the more relaxed lending standards, influx of smaller companies financing through loans and increasing corporate leverage ratios.

That could overwhelm CLO allocations, since they would have to mark loans to market instead of carry them at face value, which could cause automatic sales at a loss. Given CLOs hold about 70 percent single-B on average, a wave of downgrades could result in significant downward pressure and exacerbate already declining prices⁴.

⁴S&P Global Market Intelligence, 9/30/2019

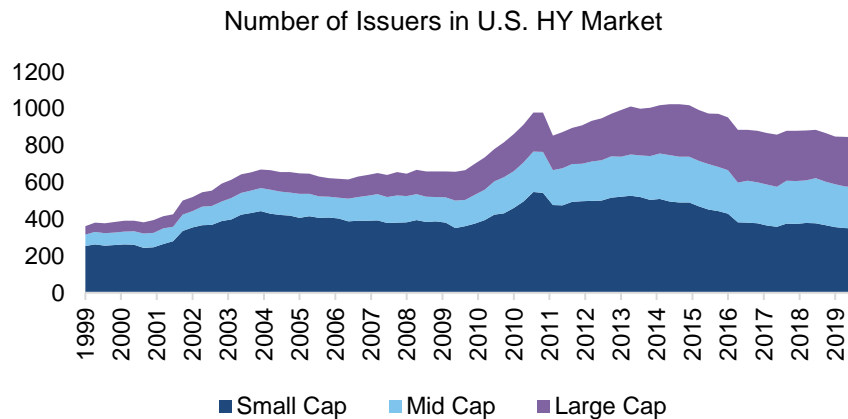
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Liquidity

Investors should consider lower liquidity when utilizing a high yield allocation in portfolios, because during market dislocations, it can be harder to find a bid. Amplifying the risk during times of stress is the absence of banks as buyers. Before the 2008 financial crisis, banks were prepared to buy credit and hold on their balance sheets for extended periods at a low cost, however, the impact of tighter capital constraints imposed by the government since 2008 has caused dealer inventories to reach multi-year lows.

This has led to a migration from principal trading, where the bank holds a bond on its balance sheet for trading, to agency trading, where the bank is the intermediary between two counterparties. As a result, trading has become more challenging, especially as time passes from bond issuance, which highlights the importance of investors understanding the quality of the corporate debt they are holding.

When choosing managers for allocation, the composition of the peer group can have liquidity implications. The largest mutual fund companies dominate the high yield market. For example, currently, the five largest high yield funds account for 33 percent of peer group assets under management⁵. As a result, these large funds need to allocate to more liquid, higher quality, large capitalization (large cap) issuers, however, large cap issuers are only 32 percent of the high yield market, as shown below.



Source: BAML, September 2019

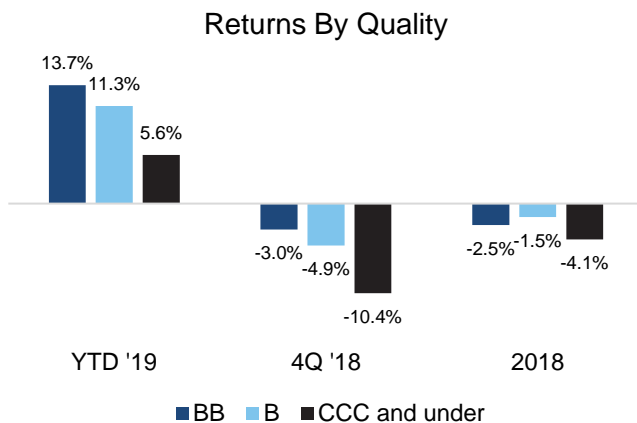
This can skew demand toward a smaller subset of issuers during times of investor inflows to the asset class and cause prices to bid higher and decrease the probability of out-yielding the benchmark. All else being equal, capacity constrained funds can allocate to higher yield than less followed small issuers who may have an advantage over their larger peers, though taking the road less travelled does not come without hazard. The danger can be observed through recent performance.

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⁵Morningstar, December 2019

Drivers of Returns

As shown in the exhibit, during 2018, lower quality bonds, particularly CCC rated debt, saw the sharpest drawdowns. As expected, higher quality debt held up better during periods of market stress. Interestingly, lower quality credit spreads tightened less after recent volatility due to rising idiosyncratic risks within the cohort, primarily the energy sector.



YTD Returns		
Rating	Energy	HY Ex- Energy
BB	10.3	13.4
B	3	13.1
CCC & Lower	-24.7	10.7

Energy	YTD Returns
E&P	-1.4
Pipelines	12.0
Oilfield Services	-5.9
Refining	14.6

Source: BAML, September 2019

As seen in the previous table, CCC rated debt in the energy sector sold off sharply, while the rest of the energy sector enjoyed positive returns. A closer look shows a great dispersion among energy sub-sectors with Pipelines and Refining sub-sectors posting strong gains.

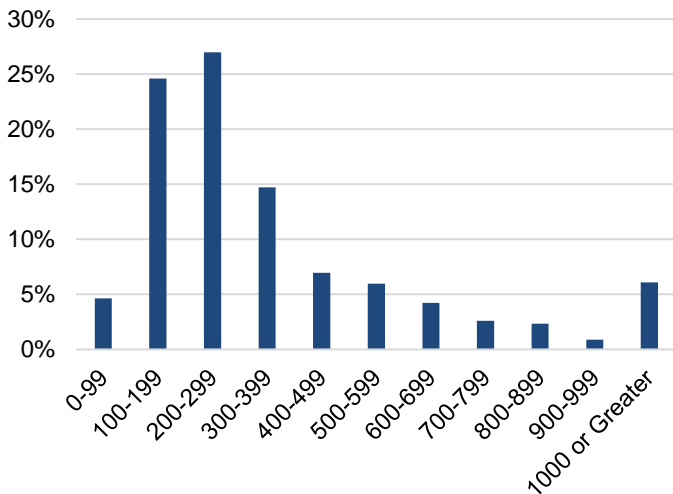
Conversely, defaults within the energy sector breached five percent, driven by smaller E&P and Oilfield Services companies, amid plummeting oil prices⁶. In aggregate, defaults within the energy sector accounted for more than 40 percent of the defaults in 2019⁶. Notably, this is far less than in 2015–2016, when all energy sub-sectors posted negative returns and defaults in the sector topped 20 percent⁶.

Hunting for Yield

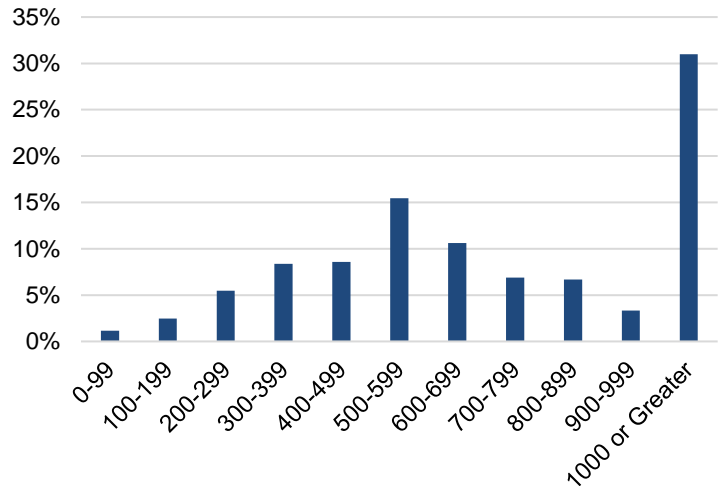
The selloff of CCC rated debt is a reminder there is still meaningful dislocation between high-quality and low-quality issuers. However, investors disagree with how the ratings agencies define quality. To illustrate the market's perception of quality, we measured the spread-to-treasuries for constituents of the Bloomberg Barclays U.S. High Yield Corporate Index, shown below.

⁶BAML, September 2019

Effective Spread of Total US HY Market



Effective Spread of CCCs



Source: Bloomberg Barclays, September 2019

Our findings show the overall high yield market has a prominent positive-skew with a majority of the distribution yielding less than the current option-adjusted spread (OAS) of ~400 basis points. In order for an investor to out-yield the benchmark, the ability to execute trades swiftly and find attractive credits in shunned areas of the market is critical to success. Such areas include CCC rated debt, which is shown.

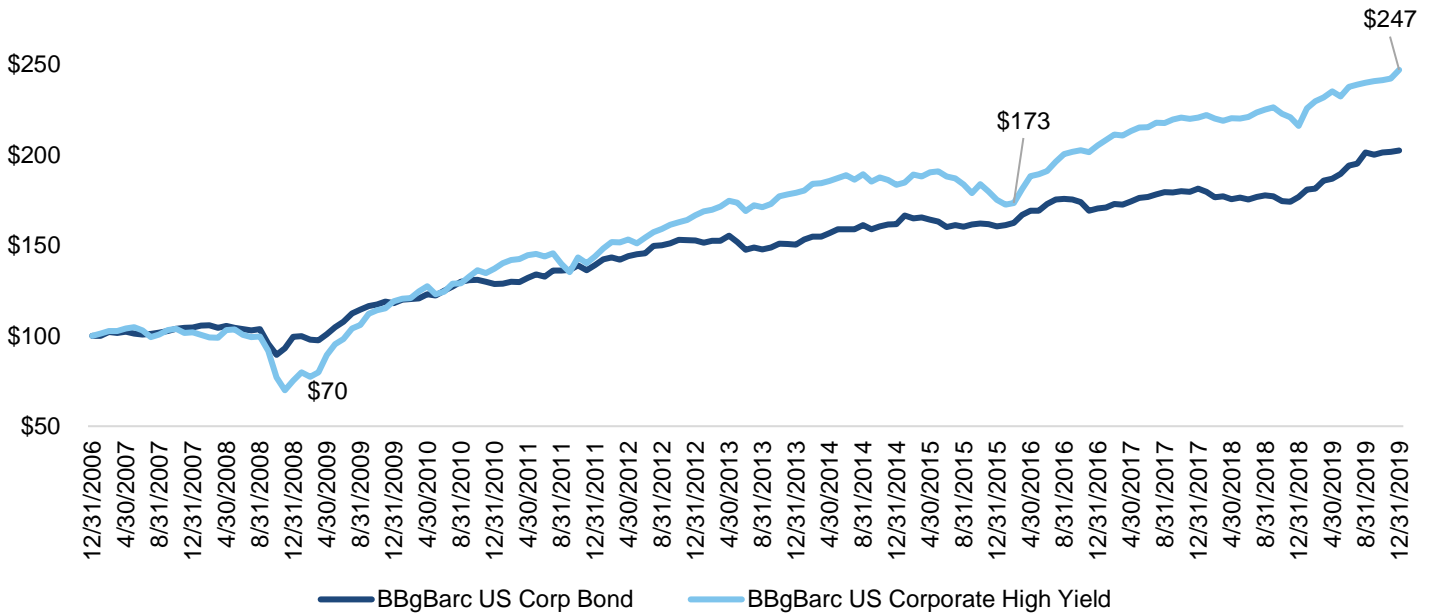
The exhibit shows the center of the distribution has a large portion of bonds with spreads from 400–699 basis points. This segment of the CCC cohort could yield favorable results for an investor possessing skill in credit selection. Moreover, this implies the market views some CCC bonds as having higher quality similar to BB and single-B rated debt. Conversely, six percent of the bonds trading at a spread >1000 basis points, 31 percent were within the CCC cohort, representing areas of the market investors would likely want to avoid in security selection.

Conclusion

The changes, composition and structural, undertaken by the markets throughout this prolonged credit rally have delivered significant return opportunities alongside less visible risks. Despite warning signs indicating the end of the credit cycle, we lean on our philosophy of maintaining a strategic allocation to credit across investment grade and high yield, while actively managing the asset class.

In our view, the “free lunch” is over in bond markets and portfolios reliant on in-depth credit diligence, with an eye on avoiding defaults and capital preservation, are best positioned to outperform in future markets.

Investment Growth



Source: Morningstar, January 2020

Like any market, credit experiences periods of heightened volatility and correction. And, much like other markets, performance has rebounded in short order, even following the financial crisis.

In 2015-2016, during the energy industry’s correction, the industry right-sized itself and across the entire asset class performance quickly recovered. This, with the aforementioned findings, strongly supports maintaining allocations to credit asset classes, being cautious and tempering expectations about what to expect from short-term performance.