ETF Securities Fixed Income Research

US HY credit market (Ex- Energy, Mining and Metals sectors) remains attractive

Summary

- US High Yield Ex-commodities issuers’ fundamentals are less compromised than what the market implies
- In our opinion, HY Ex-commodities offers one of the best risk adjusted yields in the fixed income universe
- US HY Commodity-related sector default rates are expected to continue to rise above to 10% in 2016

Lower profits for US corporates but nothing to worry about yet

The combination of external factors such as weak emerging market (EM) growth, a strong US dollar, the collapse in commodities prices and the slight pick-up in wage inflation has eroded corporates profits in the US (~8% over the fourth quarter of 2015), leading to a rise of risk-aversion in the first quarter of 2016. However, fundamentals are less compromised than what the market has priced in.

Outside of the commodity sector, these factors have had limited impact on US corporate performance. The average free cash flow – representing the cash generated by a company after capital expenditures – for US HY Ex-commodities corporates has been relatively stable during the post crisis period. Over the same period the free cash flow of commodity-related sectors deteriorated sharply with the fall in commodity prices and weaker international demand. More recently the average free cash flow turned less negative likely reflecting the recent stabilisation of the energy prices.

In our opinion, the bulk of risks remain limited to natural resource issuers, there is little evidence of distress spilling over into the broader market. The average leverage ratio – measured by Net Debt to EBITDA – for US HY Ex-commodities declined to 6.5x, while the same ratio for commodity-related US HY issuers spiked to 7.8x.

Defaults and ratings downgrades in Energy, Mining and Metals sectors

The large spreads in US HY credit since mid-2015 suggests that market participants are worried about the deterioration of fundamentals among US HY creditors, as a result of the rise in default rates. The ratings company Fitch forecasts that the overall US HY credit market default rate will reach 6% this year (up from 4.5%). Although, two-thirds of this increase comes from the rise of default rates in Energy and Mining and Metals.

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sectors, which have increased to 10% and 20%, respectively. They now stand at their highest level since 1999. The default rate of HY Ex-Energy and metals and mining issuers, remains near post-crisis lows at 1.5%, which is below Fitch’s non-recessionary average of 2.2%.

No refinancing risk in the near term

The widening of spreads at the beginning of 2016 led to a sharp decline in new issue volumes in the HY primary market. Investors are in turn questioning the ability of US HY issuers to refinance their debts in a tightening environment, in particular for commodity-related sectors. However, refinancing risk should not be a problem in the near term, as relatively little HY debt is maturing in 2016: only 4% Ex-Energy HY debt and 3% of Energy HY debt will mature this year. The bulk of outstanding debt will mature in 2020 for Ex-Energy HY issuers (US$271bn) and in 2022 for Energy HY issuers (US$77bn). In addition, the total amount of debt outstanding for the US HY Energy sector – the most at risk – represents only 15.6% of the overall HY credit market.

Furthermore, any refinancing risk is likely to be mitigated by a gradual rate normalisation from the Fed and higher corporate revenues in the second half of the year. For the past 6 years, the US GDP registered a series of weak first quarter growth for various cyclical or non-recurring reasons (weather, international developments), followed by a rebound in the second quarter, this rebound is likely to benefit high yield.

US HY Ex-Commodity market valuations attractive

Credit valuations continue to look attractive in the current growth environment, in particular for US high yield credit. Since mid-February, US HY bonds are up 7% versus 1% for the S&P 500, suggesting a notable improvement in risk sentiment.

Looking at yield-to-worst – the lowest potential yield that a bond can offer without the issuer defaulting – the Risk/Reward profile for US HY Energy looks the most favourable. However, the volatility of yields in this sector is also the highest. Besides, the uncertainty as to whether the commodity sector has bottomed-out yet adds to the risk in this market. Thus, we prefer US HY Ex-Commodities credit market, which offers the second best risk adjusted yield in the fixed income universe.

Conclusion

US HY Ex-commodities issuers’ fundamentals are less compromised than what the market implies. With default rates at post-crisis lows, we believe the fears over a recession in the US are overdone. In our opinion, this market segment offers one of the best risk adjusted yields in the fixed income universe.
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