Dealing With Defaults and Dollar Strength

MAY 2017

Energy sector defaults infecting other areas of the market and a strong U.S. dollar are two of the chief concerns for bond investors in 2017. Here, **Parmeshwar Chadha** and **Carl Shepherd**, members of **Newton Investment Management's** Global Dynamic Bond investment team, reveal their views on each topic.

Both investment-grade and high yield credit spreads in the energy sector continue to demonstrate significant correlation with oil prices.

Despite the massive wave of defaults (about 25%) in high yield energy in 2016, the sector continues to account for approximately 16% of total high yield debt. Even within investment grade, the energy sector remains significant, at around 10% of total investment-grade debt. Risks still remain of "fallen angels" (investment-grade companies downgraded to junk) coming into the high yield index.

Median leverage (debt/EBITDA) levels within the high yield energy sector are around nine times. Both investment-grade and high yield energy companies face significant maturities from 2018 onwards—the debt of these companies cannot be refinanced at anywhere near current rates, and earnings need to grow (which would require the oil price to reach more than US$65 per barrel) in order for them to do so. If one takes the view that oil prices remain bound between US$45–US$55, then the question becomes "when" and not "if" these companies will default.

DESTINED TO DEFAULT?

High yield energy spreads are highly correlated with the differential between the breakeven price (currently estimated at US$43 per barrel) of shale oil and the 12-month forward price of oil. In the past, when the forward price has dipped below the breakeven price, high yield energy spreads have widened significantly, which has usually spilled over into the wider high yield universe. High yield energy spreads have rallied significantly over the past year and now trade in line with, if not more tightly than, the overall high yield index.

Our conclusion remains that this sector is highly overvalued, and that we should continue to avoid it. Nevertheless, we think the prospect remains for a much better entry point somewhere down the road.

EMERGING MARKET EXUBERANCE

Previously, we had expressed concerns about some over-exuberance in emerging markets (EM) and favored short-dated U.S. dollar (USD) exposure in EM government debt. Over the past few weeks, we have had a change in view and have started to look at local currency bonds again.

The main reason for this is that inflows have remained solid, thus reducing rollover risk and indicating liquidity in the asset class.

In addition, the rate rise in the U.S. was followed by a dovish statement from the Federal Open Market Committee (FOMC). Immediately after the U.S. rate rise, yields on the 5-year and 10-year Treasuries actually

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fell. Our expectations were that there would be a possibility of the market pricing in U.S. rate rises too aggressively, that this would cause a spike or increase in hard currency spreads, and we would have looked to add EM hard currency duration at this point as these fears or factors reversed or dissipated.

This dovish statement, however, has provided us comfort that there is not likely to be a rapid reversal of loose monetary policy and that a cautious approach by the FOMC remains the order of the day. As this rate rise was so well telegraphed and did not precipitate a "risk-off" bout of behavior, and broad commodity prices have held up well, we thought it was an opportune time to increase local currency EM government debt exposure, to take advantage of the extra yield or "carry" the asset class offers. On a real effective exchange-rate basis, despite some EM currencies performing strongly recently, due to a reduction in inflation across economies such as Brazil and Russia, and a closing of current account deficits, there should not be undue concern about a bout of EM currency weakness at this point.

CHECKS AND BALANCES

We were also previously concerned about the current U.S. administration, and whether the presidential Trump would be as aggressive towards EM (particularly Mexico and China) as the campaign Trump. We felt this "known unknown" should have caused more quarrels within EM government bonds, but recognizing that President Trump has already had his wings clipped somewhat in pushing controversial policy through (e.g., health care reform), we can see that there are checks and balances to his executive power. Therefore, if the global economy gradually staggers from the shadow of the financial crisis, blinking in the new sunlight of "normal" monetary policy, then we could also argue that an index spread of around 335 bps versus U.S. Treasuries is too compensatory compared to the years before the financial crisis.

Despite not seeing a blowout in EM spreads from the scenario outlined above, this likelihood of interest rates being lower for longer coupled with other factors mentioned gives us more confidence in holding longer-dated USD-denominated EM government debt, where periodic episodes of weakness in the underlying U.S. Treasuries could be offset by a spread compression if this is due to stronger U.S. demand. Recent market issuance has also been enthusiastically received, such that some countries at the lower end of the credit rating scale have been able to meet budgetary requirements for 2017 early on in the year.

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RISKS

Bonds are subject to interest-rate, credit, liquidity, call and market risks, to varying degrees. Generally, all other factors being equal, bond prices are inversely related to interest-rate changes and rate increases can cause price declines. **High yield bonds** involve increased credit and liquidity risk than higher-rated bonds and are considered speculative in terms of the issuer's ability to pay interest and repay principal on a timely basis. Investing in **foreign-denominated and/or domiciled securities** involves special risks, including changes in currency exchange rates, political, economic, and social instability, limited company information, differing auditing and legal standards, and less market liquidity. These risks generally are greater with emerging market countries. **Currencies** are subject to the risk that those currencies will decline in value relative to a local currency, or, in the case of hedged positions, that the local currency will decline relative to the currency being hedged. These risks may increase fund volatility.

DEFINITIONS

Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA): EBITDA is essentially net income with interest, taxes, depreciation and amortization added back to it. **Real effective exchange rate:** the weighted average of a country's currency relative to an index or basket of other major currencies, adjusted for the effects of inflation.

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