

VOLATILITY IN THE HIGH YIELD BOND MARKET: KEY IMPLICATIONS

THE COVID-19 PANDEMIC HAS LED TO CONSIDERABLE STRESS ON HIGH YIELD BONDS AND A VERY OPAQUE SECONDARY MARKET



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INTRODUCTION

The Coronavirus pandemic has had a vast impact on global markets, spurring the governments and Central Banks of developed markets to intervene to mitigate the economic effects of the lockdowns.

While their efforts have generally been successful – corporate bond yield spreads have narrowed from 370bp to 200bp and high-yield spreads have narrowed from 11% to 7.3% – trading volumes within the high yield space, show that there might still be difficulties for issuers of high yield debt.

CMi2i selected a sample of European corporate high yield bonds using the constituent list of the Bank of America Merrill Lynch Global High Yield European Issuers Constrained ex Russia and analysed trade volumes for the period January 1st to May 25th, comparing them to the same time last year. This index has more than 700 corporate bonds as constituents for a combined value of EUR480 billion. CMi2i also compared these volumes to that of the general investment grade market using the constituent list of the Bloomberg Investment Grade European Corporation Index. This index has over 2,600 constituent bonds with a market capitalisation of more than EUR2 trillion.

Our analysis shows, that while trading volumes have remained largely stable for investment grade bonds, high yield bonds saw a significant

spike in trading activity, especially in February and March, both compared to last year and previous months. A breakdown of bonds by sector and country of domicile shows that there are significant discrepancies among issuers.

Higher levels of trading activity in the secondary market is particularly problematic for issuers intending to interact with their bondholders. The opaque nature of the secondary market, coupled with a significant number of trades, means that issuers will no longer know who their bondholders are and cannot rely on the original order books at a time when yield dispersion amongst bonds with the same credit rating is elevated.

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TRADING VOLUMES IN HIGH YIELD BONDS - 2020 VS 2019

Trade volume data shows a significant increase in activity due to the Coronavirus crisis. February saw the largest increase, with volumes over EUR33.7billion in total, more than 7% of the universe in one month alone.

This figure is a significant increase on volumes from a year ago; an increase of almost 50%.

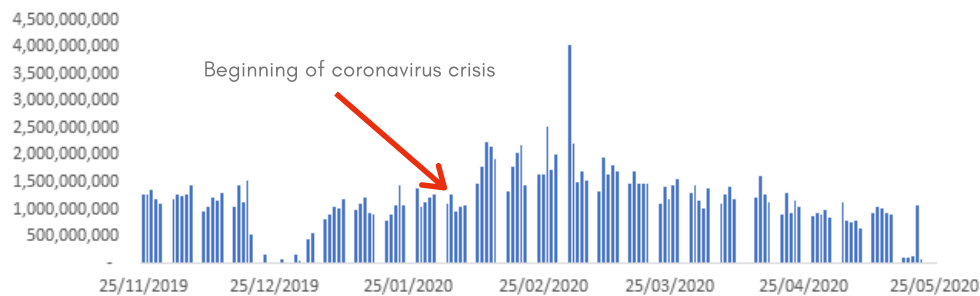


Chart 1 - European High Yield Volumes - 6 Months
(data compiled using Bloomberg)

Overall, the first 4 months of 2020 saw average daily volumes exceed EUR1.3 billion, up 21.4% compared to the same period last year, for a combined total of over EUR127.5 billion (26% of the notional universe).

As the available data does not encompass all trades, but only the trades reported, it is likely for these numbers to be considerably higher. Either way, it is certainly clear that the pandemic and the resultant worries about the global economy had an impact on the high yield bond market.

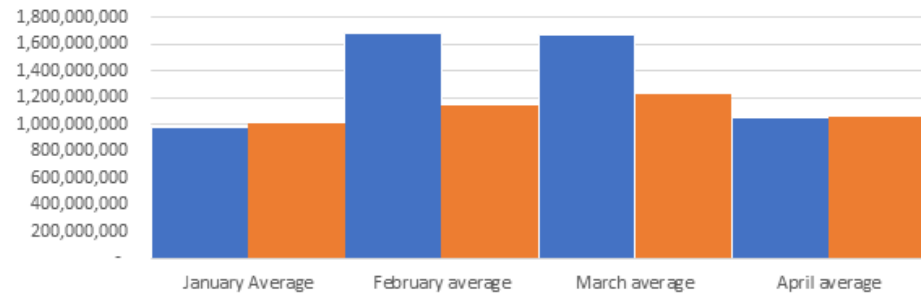


Chart 2 - European High Yield Average Daily Volumes 2020 vs 2019
(data compiled using Bloomberg)

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Volumes settled down in April, but this does not come as a surprise. By the end of March, both the Federal Reserve and the European Central Bank pledged and then maintained a high level of liquidity in the bond markets, by offering emergency lending facilities as well as buying bond funds and commercial papers. The Federal Reserve included “Fallen Angels” bonds into its ‘buy list’ on March 23. The support of the main global central banks contributed to calming the markets and restoring investor confidence with high-yield spreads narrowing from 11% to 7.3%.

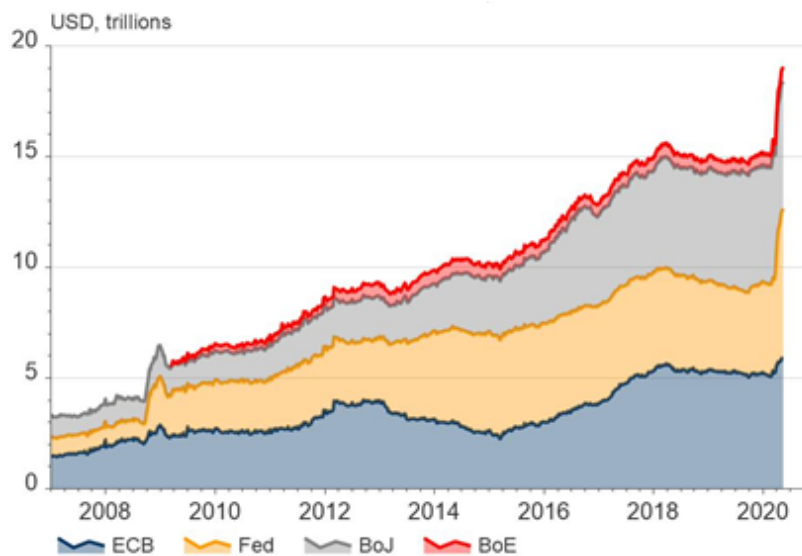


Chart 3 - Central Bank Balance Sheets, Total Assets (Source: Refinitiv Datastream / Fathom Consulting)

In a period of unprecedented market volatility, there were significant outflows from the European funds industry in Q1, with assets under management (AUM) in the European fund industry falling from EUR12.3tn to EUR10.6tn. Bond funds saw the highest overall outflows at EUR73.9 billion, contributing to significant trading activity.

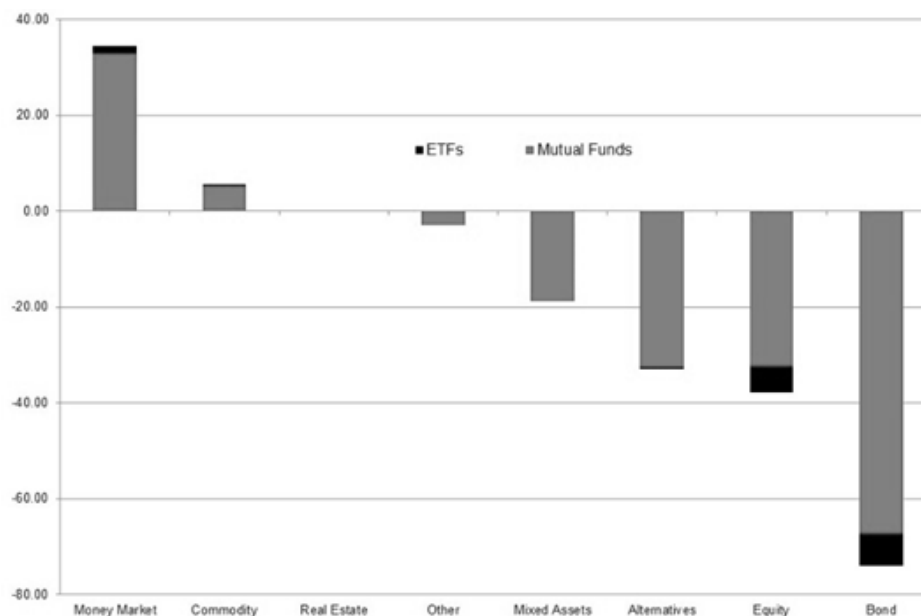


Chart 4 - European Funds: Estimated flows by Asset Type Q1-2020 (Euro Billions) (Source: Refinitiv)

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HIGH YIELD BONDS VS INVESTMENT GRADE TRADING VOLUMES

While we saw an increase in HY trading activity, this was not the case for IG bonds. Interestingly, trade volumes decreased across the investment grade universe, with the total volumes for the period down 4% since 2019 to EUR204.5 billion.

grade corporate bonds first, and only later including high yield bonds.

Second, the IG space has had a flood of issuance. Year-to-date supply has risen to around USD 970bn and EUR 310bn in U.S. and European IG primary markets, respectively (see graph below). As primary issuance offers more attractive valuations than outstanding bonds, bond investors have been busy trading in the primary markets. Broker research reports have estimated the average new issue premium in March this year for U.S. and European IG markets at 25-40 basis points, which is a significant premium to secondary market yields.

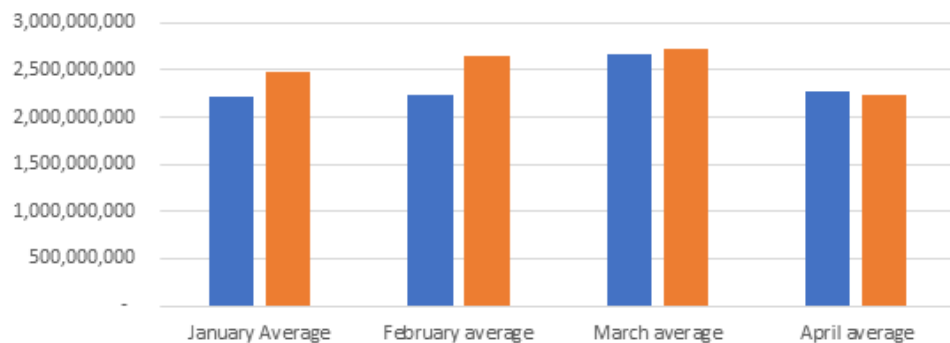


Chart 5 - IG Average Daily Trade Volumes - 2020 vs 2019 (data compiled using Bloomberg)

Analysis of the daily volumes shows a further difference between high yield and investment grade bonds. High Yield bond volumes picked up in February and March, while investment grade volumes picked up in March and April, with only the April volumes higher than last year.

This difference in trading activity can be explained by perceived risk, as most global central banks announced they would be buying investment



Chart 6 - YTD US Investment Grade Supply Volumes (USD Billions) (Source: Bondvigilantes)

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HIGH YIELD VOLUMES BY SECTOR

Not all high yield bonds saw a surge in volatility. Again, risk perception and the potential negative effect of the pandemic on different sectors played a key role. Financials and Consumer Discretionary bonds were the most traded, representing almost 50% of total volumes.

UniCredit, Italy’s largest financial institution, saw over EUR5 billion traded across 2,000+ trades and is the most liquid issuer in the sample. Conversely, and this should not come as a surprise, healthcare and utility bonds were the least traded, accounting for combined volumes of less than 5% (see graph below).

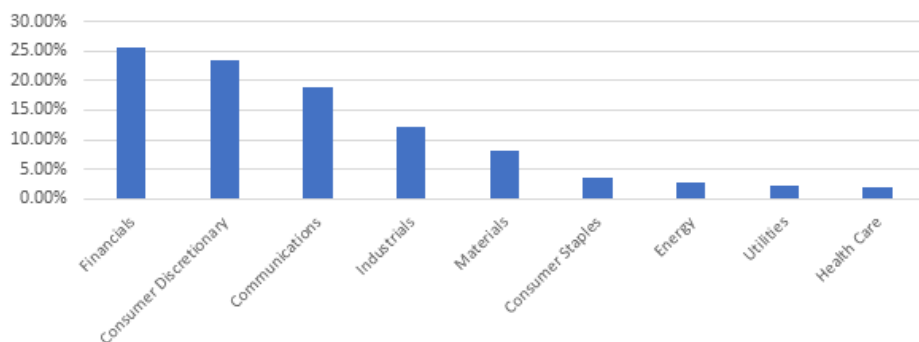


Chart 7 - High Yield Volumes by Sector (data compiled using Bloomberg)

Only two sectors saw a decline in trading activity – communications and consumer staples. This may be explained by the fact that as countries imposed lockdowns, consumer staples and communication companies, especially online ones, became one of the few sectors of the economy that were still needed as much as ever. Nonetheless, communication companies were still some of the most traded bonds, with Telefonica (EUR2.3 billion), Telecom Italian (EUR 1.9 billion) and Vodafone (EUR1.8 billion) among the most traded credits.

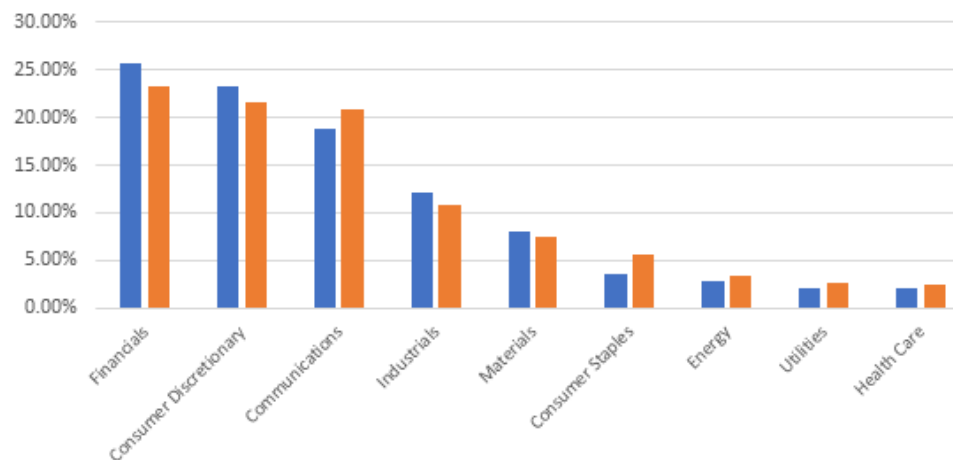


Chart 8 - Volumes by Sector 2020 vs 2019 (data compiled using Bloomberg)

Data for the same period last year shows that in 2020 volumes were up over 20% compared to the same period last year. For example, Barclays PLC high yield bonds saw an increase in trading volumes of over 300% compared to last year, while Banca Monte dei Paschi di Siena, the third most traded issuer, saw an increase of 500%.

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HIGH YIELD VOLUMES BY COUNTRY OF DOMICILE

Our analysis of trade volumes by country, shows a relationship between the extent of virus pandemic on the real economy, with Italian, German and French bonds being the most traded over the period. Indeed, the three most traded issuers are all Italian with Unicredit, Autostrade per l’Italia and Banca Monte dei Paschi di Siena, having combined volumes of around EUR10 billion.

Comparing volumes to the same period last year shows that French companies saw the largest increase. Renault, for example, saw an increase of over 200% compared to the same time last year and total volumes of EUR2.3 billion. German issuers, on the other hand, saw a decline in trading activity, most probably due to the belief that these companies would be better able to withstand this crisis.

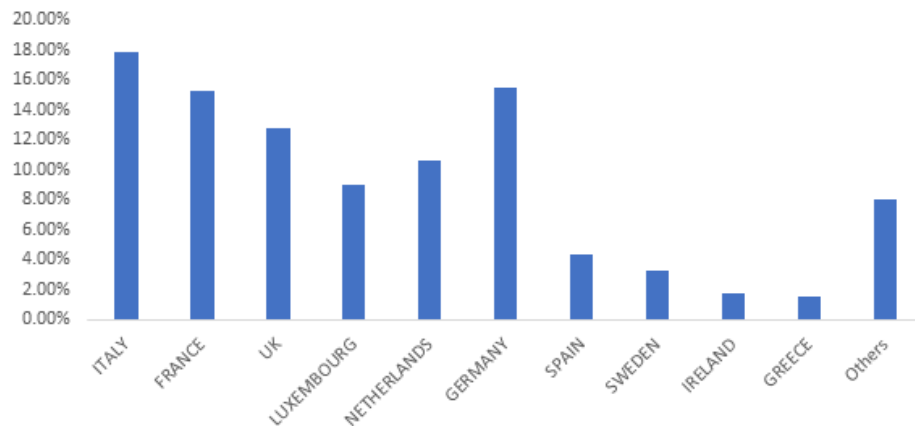


Chart 9 - Volumes by Country
(data compiled using Bloomberg)

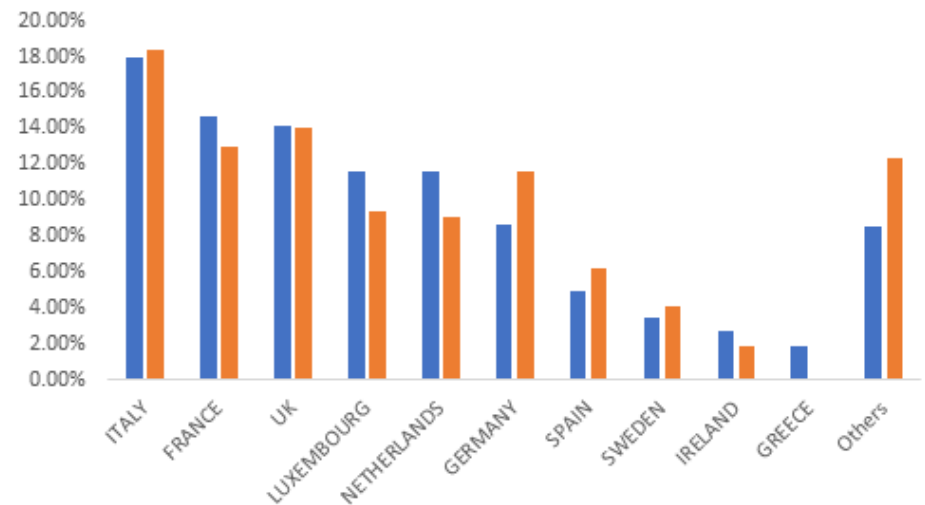


Chart 10 - Volumes by Country 2020 vs 2019
(data compiled using Bloomberg)

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CONCLUSION

The Coronavirus pandemic has had a substantial impact on the high yield bond space, resulting in notably high turnover. While the intervention of global central banks has helped stabilise the investment grade universe, many high yield credits are still under considerable stress.

Record volumes have been traded over the last five months, but not all sectors and issuers have been affected in the same way. Any issuer of high yield debt should continue to monitor trading activity as high volumes and a high number of trades, coupled with an opaque secondary market, can result in a fragmented and largely unknown bondholder base. At times like this, engaging with bondholders can be critical, and when yield dispersion between issuers of bonds with the same credit quality is at high levels, knowing who your bondholders are can result in significantly improved pricing when issuing or restructuring debt.

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ABOUT CMi2i

We are specialists in Bondholder ID, engagement and vote solicitation, providing:

- Unparalleled forensic equity and debtholder identification
- Preparatory Risk Analysis
- Governance & Regulatory Analysis
- Share & bondholder outreach, mobilisation and vote solicitation

CMi2i provides the most accurate Bondholder identification available due to our unique methodology. We work closely with institutions, corporates and their advisors and have provided insights on over 1000 Corporate Transactions, Proxy Battles and Activist Defences, where accurate owner & decision maker mapping and technical knowledge is a critical part of success.

CORE TEAM



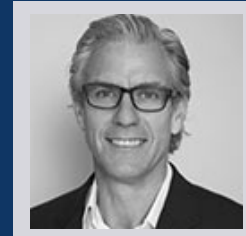
The CMi2i core team have worked together for over a decade, performing bondholder and shareholder identification and mobilising holders to vote in support of proposed issuer items at AGMs. We have worked for more than 500 of the largest companies across the globe on over 1000 corporate transactions, proxy battles and activist defences, and 1200 general meetings.



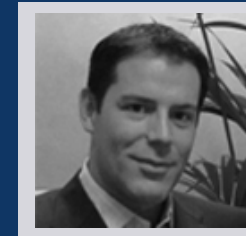
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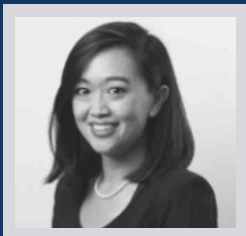
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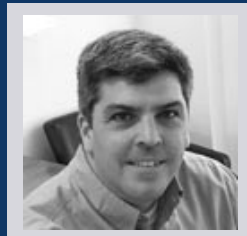
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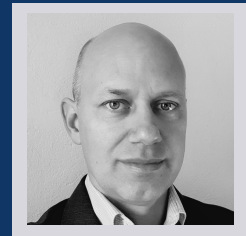
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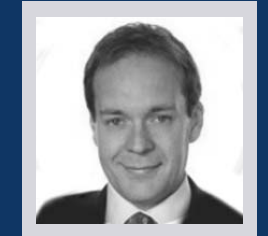
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