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Bracing for Near-Term Turbulence in U.S. Junk Bonds: Q&A

By Gowri Gurumurthy

(Bloomberg) -- Junk bond returns should remain strong as the economy recovers, but the easy money may have been made, and it might make sense to move into higher quality high-yield notes in the face of uncertainty fueled by Covid-19 and elections, according to Matt Freund, portfolio manager and co-chief investment officer at Calamos Investments in Naperville, Illinois, a suburb of Chicago.

Freund, who oversees $8 billion of fixed-income assets, spoke with Bloomberg's Gowri Gurumurthy on August 18. Comments have been edited and condensed.

How worried are you about junk bonds now?

Historically, high yield has offered equity-like upside, but with less volatility than stocks. As the economy recovers, we'd expect stocks to rebound and high yield to continue to perform well.

What parts of the high-yield market look good now?

We are overweight Bs and underweight BBs. On the margin we're looking to move up in quality as prices rise, especially given the virus and election uncertainty. We're optimistic on higher-quality energy names as they can win when commodity prices rise. Retail is much more idiosyncratic with more losers than winners.

What is your outlook for supply after a record June and August?

The new issue calendar has been strong as the Federal Reserve has come out with a series of programs designed to help access to capital markets. Issuance is expected to stay strong as companies borrow to be able to sustain revenue loss of more than 50%.

We expect issuers to take advantage of the tight spreads and fund near-term liquidity needs. As such, we expect coupons to trend down as issuers refinance higher-coupon debt with lower coupons available now. Despite the first quarter volatility, 2020 will clearly be a record year in terms of both gross and net issuance.

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What is your outlook for high yield from here?

Given that the Fed remains accommodative, and the historic resources being poured into an economic recovery on the fiscal side as well, the case can be made that high yield will outperform from here. Downgrade risks remain elevated, but spreads should continue to grind tighter, albeit at a slower rate.

With borrowing costs at historic lows, why is there so little buyout and acquisition activity?

Management teams are being conservative in the face of tremendous political and economic uncertainty, because it's not clear what the right mix of debt and equity should be. The use of leverage is being scrutinized carefully these days, and equity valuations are already discounting a return to pre-Covid world. These conditions aren't supportive of increased LBO activity.

Where do you see defaults trending?

We expect defaults to move considerably higher from where they are, potentially peaking at 8–9% on a trailing twelve month basis, up from roughly 6.5% currently. This would still leave them below the record double-digit rates the market saw during the Great Financial Crisis.

To contact the reporter on this story:
Gowri Gurumurthy in New York at gurug@bloomberg.net

To contact the editors responsible for this story:
Natalie Harrison at nharrison73@bloomberg.net
Gowri Gurumurthy, Dan Wilchins