High Yield Strategy

What's Next In Energy Defaults?

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Oleg Melentyev, CFA
Credit Strategist
BofAS
+1 646 855 6379
oleg.melentyev@bofa.com

Eric Yu
Credit Strategist
BofAS
+1 646 855 8663
eric.x.yu@bofa.com

HY reverses all of its YTD spread tightening

The latest selloff entered its second week as growth impact of the Wuhan virus continued to weigh on investor sentiment. HY spreads widened 35bps earlier this week to over 400bps before retracing 20bps, amid a 10bps rally in 10yr Tsy, 1pt decline in crude oil and 2pts rise in VIX. Over the last week, the HY index lost 50bps in total returns and CCCs were hit with 130bps in returns. Ex energy, losses were 35bps for the index and 75bps for CCCs. HY also underperformed broad credit for the second straight week.

Energy sector lost 195bps in total returns over the last two weeks and its CCCs segment lost 360bps. Telecom was the second most hit sector as it rounded 100bps of losses this week, largely due to Intelsat. In terms of diffusion in prices – a measure that is agnostic to issue sizes – gaming sector was the most severely hit with a net 88% of its bonds declining in value over the week.

With 20% the Q4 financial results reported, earnings are showing a +3.7% yoy growth, while sales are up 1.5% yoy based on the broad R3k index membership.

New issue supply has slowed down this week with only $2.9bn priced since Friday, taking the MTD supply to $35.5bn. This makes it the heaviest January of all time in terms of issuance and 11th heaviest month overall, despite the weak seasonality at this time of the year. About $20bn of the proceeds will be used for refinancing bonds and another $10bn for refinancing loans. Dealers sold a net $0.5bn since last Thurs and retail funds aggregated $2.6bn outflows. Calls/tenders were running at average pace this week, totaling $3.8bn from Fri-Thurs, we expect them to pick up to $5.9bn next week.

Of the $2.6bn net outflows in retail funds, $2.2bn came out from ETFs with HYG experiencing the largest single-day withdrawal of $1.4bn last Friday.

What do we think here

With the HY index reversing all of its YTD spread tightening and sitting about 60bps above its recent tights, we find this reversal both natural and expected in the context of our existing 450bps spread target. While some of our positioning recommendations – such as a preference for single-Bs cyclicals and BBs energy – felt heavy over the past two weeks, the degree of their underperformance was modest relative to their earlier gains over the past four months. Certain pockets of our preferred underweights, such as BBs gaming and healthcare were hit hard in this episode as their earlier valuations provided little cushion against any adverse scenarios.

Away from this we reaffirm most of our views in light of latest developments. We still believe that defaults are likely to stabilize in coming months and unlikely to exceed 4% threshold by much. This leaves us comfortable with our existing 450bps spread target; we add some beta to our recommended portfolio positioning on recent weakness.

Refer to important disclosures on page 7 to 9.
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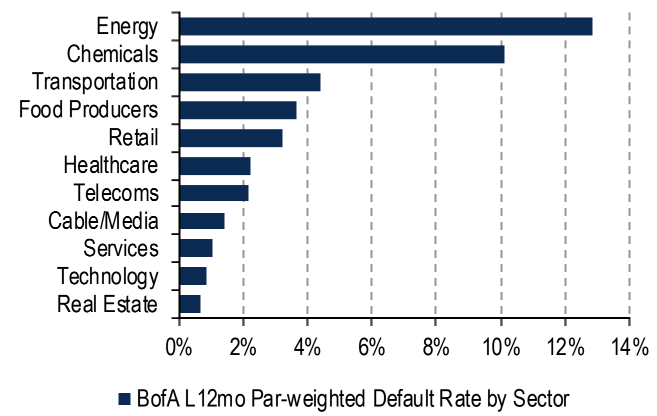
Timestamp: 31 January 2020 05:00AM EST

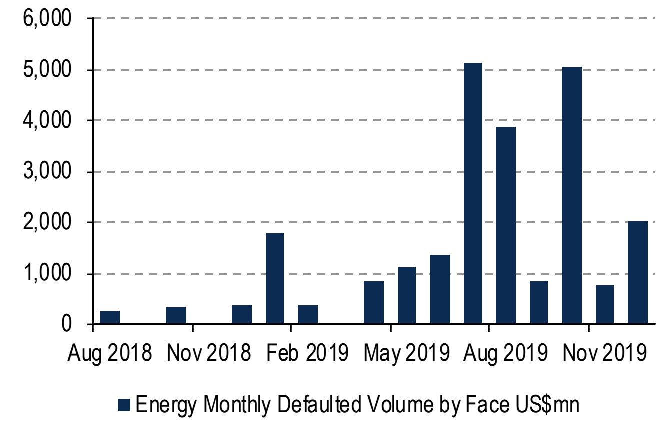
The Energy sector has contributed disproportionately to HY defaults last year, with roughly a half of all defaults – by issuer count or by par – originating here. Given the sector's index weight of 13%, its contribution rate was 3.8x its natural size. Energy par-weighted default rate entered 2019 at 1% and ended the year at 13% (Figure 1).

Figure 1: HY sector default rates, pct of face, L12mo through Dec 2019



Source: BofA Global Research

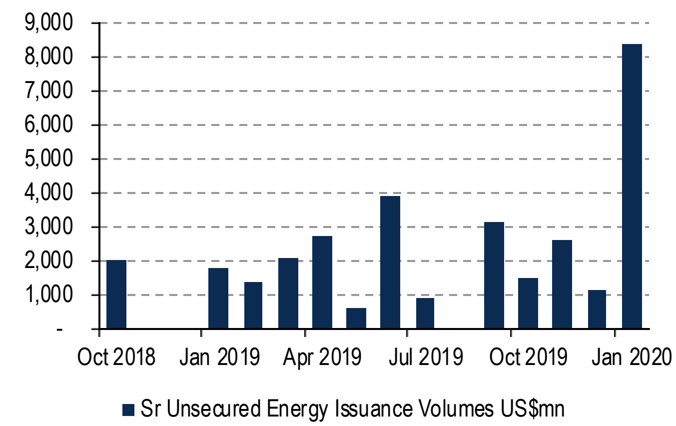
Figure 2: Energy HY monthly default volume, US$mn



Source: BofA Global Research

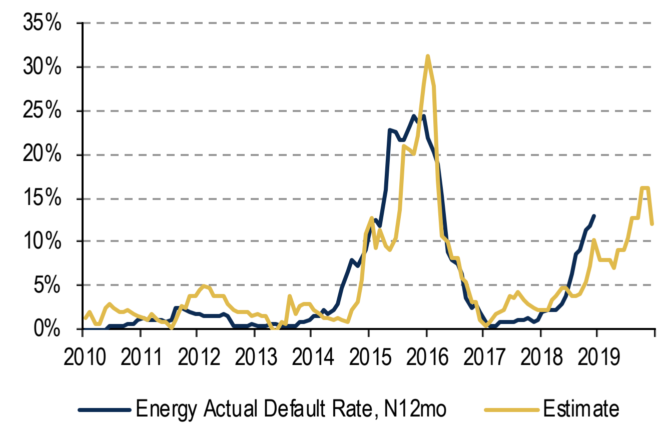
Figure 2 shows monthly dollar default volume within the sector, which appears to have peaked in July-Oct timeframe, although this dataset alone provides too little evidence to say so conclusively. Another important datapoint is shown in Figure 3 where we plot sr unsecured issuance in this sector, which has spiked to over $8bn in January, by far exceeding any of the previous months in the last two years. Access to sr unsecured financing is critical to staving off liquidity-driven defaults.

Figure 3: Energy HY sr unsecured issuance volume, US$mn



Source: BofA Global Research

Figure 4: Energy HY default rate, actual vs estimate, pct of face



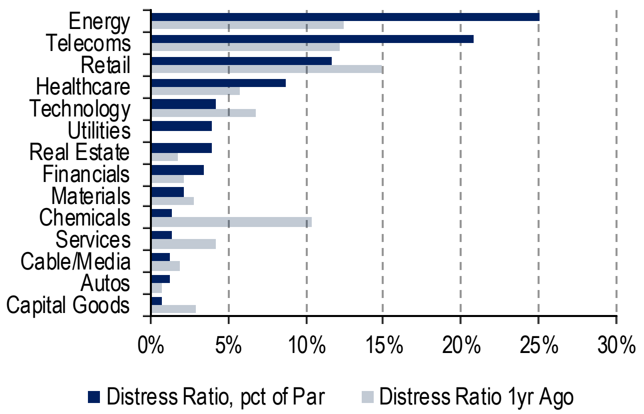
Source: BofA Global Research

Which brings us to Figure 4 where we show realized HY Energy par-weighted default rate against our estimates, which are derived by applying sector-specific variables to our broad HY market default rate model. Our estimates suggest that energy defaults are likely to peak at around 15% in coming months, before subsiding to 12% in a year.

We note that defaults do not need to accelerate from their recent pace to reach 15% rate in coming months – this will happen naturally as a result of low-default months of early 2019 dropping off from the sample. In fact, defaults could even decelerate by about a quarter from their pace of the past six months for us to get there. A decline to 12% rate by the end of 2020 would imply further deceleration of pace.

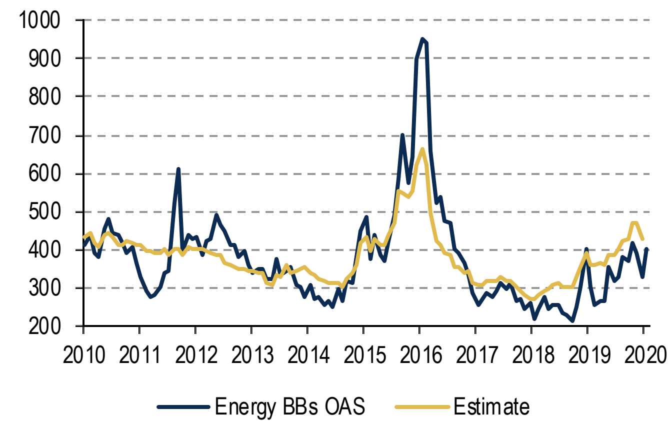
These default estimates compare to the current distress ratio[1] of 25% in the energy sector. In other words, if you agree with this default estimate, then it implies that roughly 10-13% of energy names marked at distressed levels today are not likely to default over the next year. This potentially resembles the situation in late 2015/early 2016 when over 40% of the energy index was consistently trading at distressed levels, whereas default rates subsequently peaked at 25%.

Figure 5: Distress ratio by sector, pct face >1,000bps, as of Jan 28, 2020



Source: BofA Global Research

Figure 6: Energy BBs spreads, actual vs estimate, bps



Source: BofA Global Research

Away from this, we are also looking at Figure 6, which plots energy BBs OAS against our estimates, derived from our existing liquidity premium model, again with energy-specific inputs. Note that the current OAS of 380 is not materially different from the model estimate of 420bps in the context of what we believe overall BB sector spreads being about 75bps too tight to fair value. This evidence further supports our continued moderate preference for BBs energy risk over other BBs.

While we do not rely on specific oil price forecasts in arriving at our conclusions described above, a further decline in underlying commodity poses a clear risk to this assessment. We do note however that broad commodities were by far the worst performing asset class over the past decade. Within that broad category, precious metals have actually done very well, which leaves industrial metals and oil as key contributors to weakness. Between these two, oil has underperformed.

Normally, weak pricing over prolonged periods of time leads to underinvestment, which in turn leads to capacity constraints and better pricing in the future. And while we do not rely on any specific oil price path assumptions, we tend to think its long-term prospects are positive from current levels. The immediate risk to this view the potential negative impact from the Wuhan virus on the Chinese economy; the longer-term risk is a tilt towards ESG-driven mandates among the largest institutional investors.

Our credit analysts have identified ten issuers representing 8.3% of the energy index that are overleveraged and could potentially default, as shown in Figure 7. They see three issuers (representing 2.0% of the HY Energy index) with the potential to default in 2020 due to liquidity issues. In addition, there are seven issuers (representing 6.3% of the HY Energy Index) that they believe could default in 2021 or later as they still have too much interest burden if they do not deleverage further. Note that their figures exclude potential distressed exchanges and offshore drillers. For the full description of their assumptions and methodology please see page 23 here.

[1] Proportion of bonds with spreads of 1,000bps or wider.

Figure 7: BofA Credit Research US HY Potential Default Rate Schedule

Potential 2020 Default Candidates					Potential 2021+ Default Candidates				
Name	Ticker	Unsec. Bond Price	Tradeable Debt O/S	Debt O/S in ICE HY Energy Index (%)	Name	Ticker	Unsec. Bond Price	Tradeable Debt O/S	Debt O/S in ICE HY Energy Index (%)
E&Ps									
Ultra Petroleum	UPL	$11.32	$2,093	0.3%	California Resources	CRC	$36.77	$4,531	1.3%
					Chesapeake Energy Corporation	CHK	$55.50	$7,325	2.8%
					Denbury Resources	DNR	$93.88	$532	0.9%
					Jonah Energy	JONAHE	$27.50	$496	0.3%
Total E&P - Index Eligible			**$584**	**0.3%**	**Total E&P - Index Eligible**			**$8,921**	**5.3%**
OFS									
KCA Deutag	KCADEU	$70.00	$1,752	0.8%	Superior Energy Services	SPN	$61.17	$1,300	0.8%
					Pioneer Energy Services	PESX	$22.00	$300	0.2%
					Hornbeck Offshore Services	HOSS	$31.31	$224	0.1%
			$1,310	**0.8%**	**Total OFS - Index Eligible**			**$1,824**	**1.1%**
Midstream									
Ferrell Gas Partners LP	FGP	$84.63	$1,810	0.9%					
Total Midstream - Index Eligible			**$1,475**	**0.9%**	**Total Midstream - Index Eligible**			**$0**	**0.0%**
2020 Total - Index Eligible			**$3,369**	**2.0%**	**2021+ Total - Index Eligible**			**$10,745**	**6.3%**

1. Default candidates are companies that have potential liquidity hurdles in 2020 (i.e. maintenance covenant or large maturities/liabilities that could accelerate a restructuring) and 2021+ candidates are companies that have at least 1 year of liquidity (no near-term insurmountable liquidity hurdles), but have significant leverage and therefore have longer term restructuring risk and potentially shorter-term if companies do not deleverage. The list of companies represents constituents of the ICE BofA HY Energy Index and other HY rated Energy issuers. All of these companies can potentially avoid bankruptcy if they successfully address their liquidity hurdles. Notably, we exclude offshore drillers from this analysis.

[2] Price of the representative unsecured bond of the issuer.

Source: BofA Global Research

Recommended positioning

In light of recent market weakness, we reduce our model portfolio cash position to 13% from 15% with an eye towards further reductions on any additional spread widening. As a reminder, all percentage weights discussed here are relative to overall portfolio size.

We move our BBs gaming underweight position from 2% to zero given the 50bps spread widening in this segment over the past two weeks. This leaves the sector trading in line with overall ex-energy BBs space, at 208bps.

Figure 8: Our current positioning recommendations

Index market value (MV) is scaled to $1bn; delta MV column adds up to zero, i.e. model portfolio value is also $1bn

	Index %	Index MV	Delta %	Delta MV	OAD	OAS	YTW	Price	Beta
Cash	0.0%	0	13.0%	130	1.0	40	1.92	101.8	0.00
BBs	49.5%	495	-10.0%	-100	3.7	222	3.88	104.7	0.89
Bs	38.7%	387	0.0%	0	2.9	391	5.60	101.8	0.98
CCCs	11.8%	118	2.5%	25	2.9	1,073	12.17	83.3	1.33
Two corners									
BBs Cable/Media	6.3%	63	-2.0%	-20	3.4	191	3.65	104.9	0.87
BBs Gaming	1.1%	11	0.0%	0	4.2	207	3.54	107.9	0.83
BBs Real Estate	3.5%	35	-0.8%	-8	3.8	192	3.56	105.7	0.60
BBs Healthcare	4.9%	49	-1.0%	-10	3.4	153	3.26	106.4	0.74
BBs Food Producers	1.0%	10	-0.8%	-8	3.2	184	3.46	106.2	0.71
Bs Capital Goods	2.3%	23	1.0%	10	2.8	376	5.39	103.2	0.87
Bs Chemicals	1.2%	12	1.0%	10	3.1	476	6.39	100.8	0.95
Bs Autos	1.6%	16	1.0%	10	3.0	391	5.57	101.2	0.96
Bs Retail	2.3%	23	2.0%	20	3.5	399	5.68	100.8	0.78
Bs Telecoms	4.0%	40	1.0%	10	3.6	360	5.17	105.1	1.19
BBs.OAD:0..2yrs	13.5%	135	-2.0%	-20	0.9	156	3.21	103.2	0.29
BBs.OAD:4..6yrs	13.4%	134	2.0%	20	4.9	258	4.23	105.2	1.01
Bs.OAD:0..2yrs	12.4%	124	-2.0%	-20	1.0	270	4.47	102.8	0.34
Bs.OAD:4..6yrs	9.7%	97	2.0%	20	4.6	493	6.59	99.1	1.19
Largest Issuers	88.2%	882	-10.0%	-100	3.9	303	4.39	103.1	0.83
Smallest Issuers	6.9%	69	10.0%	100	2.9	501	6.49	99.7	0.43
High quality energy overweight									
BBs ex-Energy	43.6%	436	-5.0%	-50	3.7	200	3.67	105.6	0.84
BBs Energy	5.9%	59	5.0%	50	3.9	377	5.42	99.0	1.21
Capital allocation cycle underweigths									
HY Healthcare	10.8%	108	-3.0%	-30	3.0	321	5.07	102.2	0.83
HY Technology	4.4%	44	-2.0%	-20	2.9	334	4.67	102.6	0.89
Valuations-driven adjustments									
Bs Chemicals	1.2%	12	2.0%	20	3.1	476	6.39	100.8	0.95
BBs Healthcare	4.9%	49	-2.0%	-20	3.4	153	3.26	106.4	0.74
Bs Healthcare	4.0%	40	-2.0%	-20	2.5	273	4.89	105.2	0.86
H0A0 (benchmark)			**0.0%**	**0**	**3.3**	**389**	**5.53**	**100.5**	**1.00**
Portfolio vs benchmark		**1,000**		**0**	**-0.3**	**+46**	**+0.43**	**-1.8**	**-0.08**

Source: BofA Global Research

We also add a new 2% underweight in healthcare single-Bs as this segment was relatively unaffected by recent market weakness and now trades about 100bps too tight against what we think is its fair value.

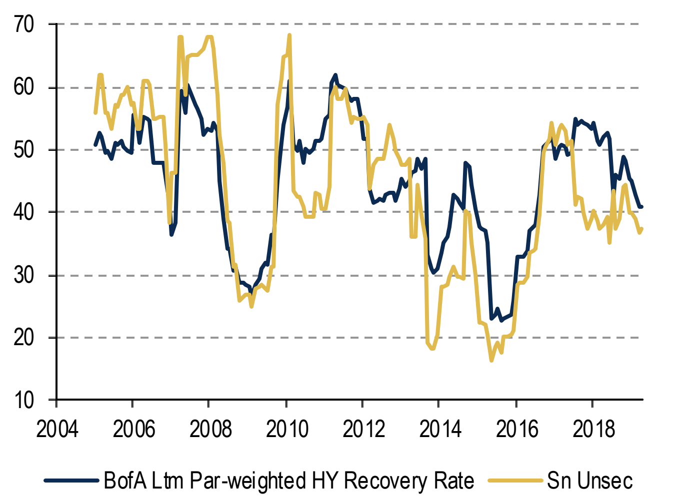
Accounting for these changes, our model portfolio beta has increased to 0.92x vs 0.90x previously, which its OAS remains 46bps wide relative to the benchmark H0A0 index. Each segment's beta is calculated based on weekly excess returns vs H0A0 going back to Jan 2010. Our effective duration is about 0.3yrs shorter and our weighted dollar price is 1.8pts below the index.

HY Market Performance Recap

Following our updated default rates, we took a step further to estimate recovery rates based on index transitions. As a reminder, for default rate calculation, all bonds that exit the index during the month-end rebalancing and traded below 80 cents on the dollar *anytime* within the same month were included in the defaulted population. Here the recovery rate calculation is based on the bond's *last available* price during the month of exit – this way we capture recovery rates the same time with default rates at the beginning of each month while avoiding any delay.

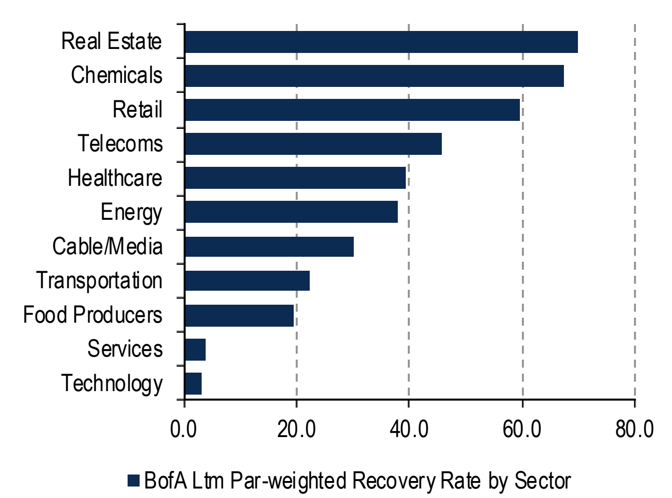
For the trailing 12mo ending December 2019, our calculation generates par-weighted recovery rate of 40.8 for overall US HY universe and 37.3 for US HY senior unsecured as shown in Figure 9.

Figure 9: US HY vs. senior unsecured recovery rates



Source: BofA Global Research

Figure 10: HY sector recovery rates, L12mo through Dec 2019



Source: BofA Global Research

When we broke the recovery rates down by sector in Figure 10, real estate kept the lead (70), followed by chemicals (67.5) and retail (59.6). Energy, while disproportionally contributed to overall US HY defaults, registered a 38.1 reading in the middle of the spectrum. The sector's recovery rate bottomed out at 20.4 in 2015-16.

Autos was the only sector with positive return (+0.24%) for the week while energy and telecoms underperformed the broad index by 90bps and 50bps respectively.

Autos benefited from the Delphi gains (benchmark bond due 2025 tightened by 450bps over thee week) In the meantime, as shown in Figure 11, all three agencies put Delphi on positive watch following the issuer's agreement to be acquired by BorgWarner. The agencies expect that Delphi's credit profile post-acquisition will be substantially stronger than its standalone credit profile.

Figure 11: Rating agency HY actions and related performance this week

Issuer Name	Agency		New	Old	L3mo[1]	Country	Industry	Total Debt	Bond ID	OAS	vs. Bmrk[2]	L1wk[3]	L3mo[4]
Rating Actions													
Frontier Communications Corp	Fitch	▼	CC	CCC	3x▼	US	Telecoms	17,663	FTR 11 2025	3169	2131	3	219
Washington Prime Group LP	Fitch	▼	B	BB-	4x▼	US	Retail	3,040	WPG 5.95 2024	813	594	147	250
WellCare Health Plans Inc	S&P	▲	BBB-	BB *+	2x▲	US	Healthcare	2,298	WCG 5.25 2025	202	-17	9	97
KB Home	S&P	▲	BB	BB-	1x▲	US	Real Estate	1,749	KBH 7 2021	105	-114	-4	-5
Pyxus International Inc	Moody's	▼	Caa2	Caa1	2x▼	US	Retail	1,527	PYX 9.875 2021	4439	3401	85	433
Calfrac Holdings LP	Moody's	▼	Caa2	B3	2x▼	US	Energy	726	CFWCN 8.5 2026	2876	1838	88	213
Hecla Mining Co	Moody's	▲	B3	Caa1		US	Materials	616	HL 6.875 2021	542	-496	13	-87
Emeco Pty Ltd	Moody's	▲	B1	B2	1x▲	AU	Autos	477	EHLAU 9.25 2022	278	-107	-69	-141
Cooper-Standard Automotive Inc	Moody's	▼	B2	B1	1x▼	US	Autos	451	CPS 5.625 2026	553	168	47	-101
Defaults													
Outlooks													
Silgan Holdings Inc	S&P	▼	BB+ *-	BB+		US	Materials	2,956	SLGN 4.125 2028	238	19	30	0
Delphi Technologies PLC	Moody's	▲	B2 *+	B2	2x▼	GB	Autos	1,621	DLPH 5 2025	139	-80	-450	-432
Delphi Technologies PLC	S&P	▲	BB- *+	BB-	2x▼	GB	Autos	1,621	DLPH 5 2025	139	-80	-450	-432
Delphi Technologies PLC	Fitch	▲	BB *+	BB	2x▼	GB	Autos	1,621	DLPH 5 2025	139	-80	-450	-432

Note: column L3mo1 measures the cumulative rating actions by notches per issuer within the last 3-month window. Empty value under the column indicates either no rating actions (excluding outlook) or the cumulative rating actions netted out for the issuer within the period. The performance metrics are based on the bond with biggest notional under each ticker and benchmarked against the quality-specific subindex (ex. H0A1 for BBrated bonds). L1wk3 and L3mo4 measure the spread changes for the week and the last 3-month.

Source: BofA Global Research, Fitch, Moody's, S&P

We saw multiple movers that contributed to the energy underperformance following 3pts lower oil price over the week. Unit Corp extended its downward trajectory and we previously wrote about the issuer here. Other notable movers included XOG 7.375 2024, WLL 6.25 2023, GPOR 6.375 2026.

Telecoms' underperformance was mostly contributed by the tumble of Intelsat (10% of the subindex). As FCC is signaling low payout for Intelsat on vacating the C-Band spectrum, the issuer's benchmark bonds (INTEL 8.125 2023, INTEL 7.75 2021, INTEL 8.5 2024) sank between 6pts to 18pts over the week and dominated the secondary space in terms of trading volume.

Healthcare issuer WellCare Health Plans was upgraded 2 notches by S&P to BBB- on the back of Centene's acquisition of WellCare. The issuer so far has $2bn debt in the US HY index and it's expected to stay in the index until further upgrade.

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