CONCISE CAPITAL

January 2022 High Yield Market Insights

Summary:

- The impact of any Russian military action similar to the 2014 Russia-Ukraine conflict will likely only be felt in very specific corners of the US HY market.
- If a more serious conflict materializes, the Energy component of the US HY market is likely to outperform, due to higher oil and gas prices.
- Headwinds for US HY could materialize over the medium term, at around 9-18 months – the time frame for higher energy prices to visibly impact energy-intensive sectors and the revenue streams of the US HY companies more exposed to European and Emerging Market economies.

Headlines about a potential military incursion of Russia into Ukraine have become increasingly frequent over the past two months.

Our analysis shows that the correlation between the US CDX HY Index and the Russian sovereign CDS actually declines steeply during periods of conflict, such as the Crimean annexation in Jan-Mar 2014. More specifically from 0.57 (normal times) to 0.30 (the conflict period).

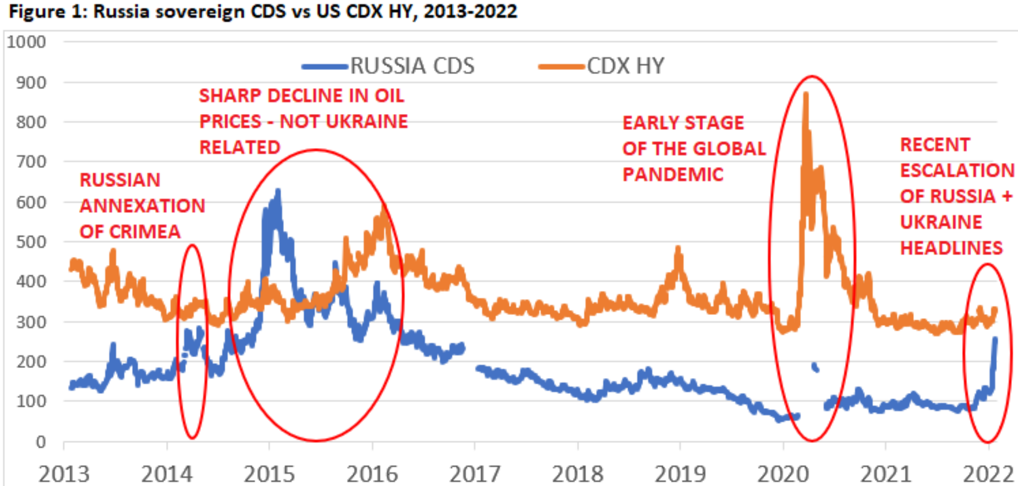
Reduced correlation indicates that the US HY market, as a whole, is very likely to remain initially immune to any limited conflict, such as the 2014 Crimean crisis. This is not surprising, considering that the US bond market is several times larger than Russia's, and driven by other more pressing concerns, such as monetary and fiscal policy, and the direction of the Covid pandemic.

For instance, from 1 January 2014 to 14 March 2014, Russian sovereign CDS widened by 68%, but US CDX HY only widened by 6% over the same period.

Per Figure 1, Russian CDS is now trading at similar levels to that of March 2014, which suggests that a crisis similar to the Ukraine annexation is already priced in for assets with correlation to Russia.

European assets are likely to be more sensitive to Russia than assets in the US, and emerging markets (of which Russia is a component) are significantly more vulnerable than the US and Europe.

Figure 1: Russia sovereign CDS vs US CDX HY, 2013-2022



Source: Concise Capital, Bloomberg

Whilst we can expect no meaningful impact from a Russia-Ukraine conflict for the US HY market, as long as the intensity of conflict stays at the level of the 2014 annexation of the Crimea, the outlook may be different if a more serious confrontation occurs.

Until now, the recent spike in crude oil prices has mostly been written off in the market as a short-term move, of little long-term significance. In a more intense conflict, the market is likely to price in a longer period of sustained oil and gas prices and the relevant consequences.

Lower spreads for Energy companies would lead to a meaningful outperformance of the US HY market vs both US Investment Grade and the overall stock market. Energy is a much larger proportion of the US HY index – 13% of the benchmark – vs 8% of the IG index and a paltry 3% of the S&P 500.

On the other side, companies with significant reliance on oil and gas inputs would fundamentally suffer, as would companies with meaningful exposure to Europe, and especially to Emerging Markets. But in our experience, the High Yield market tends to take an indirect, wait and see approach to these kinds of second round effects. High Yield investors are unlikely to reprice this kind of exposure across the board in a preemptive manner, and past custom has been to wait until the impact starts to materialize in quarterly earnings reports. We would estimate around a 9 to 18 month horizon for this process to play out.

Therefore, in the case of a serious conflict, we are likely to see an initial outperformance of the US HY market, driven by energy exposure, followed by gradual headwinds as quarterly results materialize from the most negatively exposed sectors.

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