In the spotlight:
Portfolio manager Q&A with Justin Jewell

Justin Jewell, Partner, senior portfolio manager and co-head of BlueBay's high yield long-only strategies alongside Thomas Kreuzer, talks current themes in high yield, his approach to investing and his market outlook for the remainder of this year.

Justin Jewell
Partner,
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Global high yield bonds have rallied since mid-February's lows. What do you think have been the main drivers and do you see this trend continuing?

I think the drivers are twofold: monetary policy from the Federal Reserve (Fed) and macroeconomic factors. A year ago, we were anticipating the next leg in a monetary tightening environment, but the Fed has since eased off and that's been pretty important. This has combined with a rebound in oil prices and improvements on the macro side, including Chinese economic stimulus, which has led to falling risk premiums and lower default risk. If the Fed remains cautious and indicates a much lower terminal rate, like it did in September's Federal Open Market Committee (FOMC) meeting, I think spreads will probably continue to perform and duration will reach a point where it can't deliver much more. The Fed's policy mix remains vital.

Some market participants believe the rally in high yield has been technically driven as opposed to fundamentally; does this concern you and describe your current approach to investing?

Yes, it's true that the rally has been driven by the demand for income, and the stability of those flows is something to ponder. But we have also seen improvements in the fundamentals. For example, companies in the resources sectors have benefited from Chinese stimulus, higher commodity prices and focused on deleveraging—which I believe makes them less risky from a creditors standpoint.

In terms of our investment approach, when it comes to high yield (HY), I think you have to really understand the companies themselves and what drives them and their cash flows. Therefore when it comes to any individual investment, top-down views such as Fed action are less of a concern. The market is currently highly bifurcated and being selective is important. Irrespective of where the credit sits on the spectrum we are focused on the risk/reward payoff—we have to ask, am I being appropriately compensated for the risk taken? On this metric, I believe it is still possible to source what I would view as attractively priced risk. However, when it comes to building a portfolio and measuring risk, understanding top-down factors and how they are likely to impact flows in your market is also vital. Central banks, for example, exert their influence on markets in a more broad-based way now than they used to and that's brought specific challenges that need interpreting. It's an area where we have bolstered our expertise recently, with our focus on G7 markets, meeting with policy makers regularly and analysing front ends of rates curves with respect to trades around central banks.

Global Asset Management

Defaults in the US HY resources sectors have increased this year; does this have the potential to spread to the wider HY market? How has the relationship between oil and the HY energy sector changed?

I think it is manageable as long as it doesn't develop into a meaningful default cycle. Defaults away from the resources sector remain very low and we haven't seen much in terms of risky behaviour, like accelerated CCC-rated bond supply and aggressive private equity sponsored deals. Overall the trends aren't great, but I don't think we've reached a bad place in terms of credit quality and our rational is to expect defaults to come down in 2017. Companies have become less sensitive to oil price declines, even in the short term and to have any meaningful negative impact on spreads the oil price needs to stay low, not just go lower for a bit. Markets are trying to look through that short-term volatility, and that's why we're not seeing spreads respond in the same way as before because the industry is focusing on improving fundamentals, the cost of production and repaying its creditors.

HY recovery values have been falling; how has this impacted the way you think about investing, especially since a key aspect of your investment philosophy is capital preservation?

This has definitely called for caution around the energy sector. The business models deployed were very aggressive, with pretty poor covenant structures and small capital buffers which meant each individual potential investment had a big Achilles heel. Being prudent in our approach to investing is important. It's easy to forget bonds that were trading at 50 or 60 (cents to the dollar) at the start of the year may have tipped into bankruptcy given another two months of very low oil prices, which would have seen a 10% recovery and those returns weren't asymmetric in our favour. Being conscious of capital preservation has brought challenges to investing in sectors with very binary outcomes. However, it is and remains a fundamental part of our investment process and something that I believe is a key consideration for our investors over a long-term horizon.

How do you think the European Central Bank has changed the dynamic in European HY? Are low yields in developed markets opening up the emerging market high yield market?

I think the European Central Bank (ECB) has definitely changed the dynamic since a section of the European HY market is directly affected by ECB quantitative easing. The ECB's goal is to encourage companies to access the corporate bond market and, while we are seeing success in the investment grade market, a spark in HY supply remains limited in our opinion. I think supply will eventually increase but it's a slower burn and more than anything, the ECB has forced investors into riskier assets and we see that dynamic very clearly in European HY. Retail fund flows haven't done a lot, but institutional investors are finding themselves trapped and need to find higher-yielding assets.

For us, as HY investors there's a big grey area in between developed markets and frontier emerging markets (EM), where we believe there's going to be demand for capital in economies where there is potential to diversify sources of funding, like Poland and South Africa. The lower for longer rates stance we feel is going to encourage investors into EM HY. This is already playing out in the market as asset allocation products have shifted more towards EM HY over the last three months, and that demand will no doubt be met by supply. However, the Fed remains a key driver in the EM rally so any change in direction from the Fed will have an impact in our view.

How is liquidity holding up in the HY bond market?

The ability we had to press a button and sell whatever we want, whenever we want has gone down a lot recently as investment banks aren't warehousing risk in the same way as before. However, there is still volume and a vast amount of bonds changing hands, so liquidity still exists. But in times of stress, the price for that liquidity becomes increasingly dislocated resulting in a more volatile trading environment. The market retains that Jekyll and Hyde characteristic, so it's important to remain aware of that as investors.

In today's investment environment, how important is it to have a global approach?

It's important because it brings meaningful diversification opportunities. For example, as the European market has grown and matured, we have seen it become more global in nature while continuing to offer compelling diversification opportunities versus the North American HY market. You only have to look at instruments such as AT1s (contingent convertible bonds), which still offer a very high coupon in an environment where investors are hungry for yield. They do bring risks, as seen by the recent market pressure on Deutsche Bank AT1s, but our base case has been European banks are much better capitalised today than they have been over the past decade. Policy mix is also turning in banks' favour, all of which bodes well for risk premia. In addition, spreads in European and US HY (ex-resources) are very similar, so a global approach to HY has benefited from outsized European HY returns in recent years.

In addition to a global diversification, we also strongly believe having the ability to choose where one invests in the capital structure is an important feature in leveraged finance. Our ability to make a relative value call and invest in secured leveraged loans when we observe opportunities and valuations is key. Given we are in the latter stages of the credit cycle and valuations are increasingly full, the option to invest higher up the credit capital structure in what are typically more defensive income generating assets is an important one. In addition, we believe that the floating rate nature of leverage loans offers a natural hedge against rising interest rates or changing central bank rhetoric – something which will become increasingly important as monetary policy rotates into "normalisation phase".

As an investor give us your outlook for the next year?

The US economy is showing signs of being relatively late cycle. As yet, however, this is not translating into overly worrisome corporate fundamentals for the broader US HY market (despite several quarters of revenue and earnings deterioration). Overlaying this backdrop with what we have seen as incredibly strong technical support for higher yielding assets would tend to suggest to us that, while market levels are reaching the tighter end of the spectrum, current levels are broadly fair but do leave little margin for error.

In terms of risk, political uncertainty in the form of the US election and Italian referendum will undoubtedly play a part in the latter part of the year as will future rate expectations from the Fed and ECB. In Europe, technicals remain incredibly supportive and, while there are signs valuations are increasingly full, an early stage corporate cycle and encouraging credit fundamentals add further to the case for the asset class. However, with current yields offering little downside protection, our focus as ever is on ensuring our bottom-up security selection is strong.

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