April 2021 High Yield Market Insights

Summary:

- COVID and the monetary and fiscal responses to it have affected valuations across assets
- Extreme liquidity and low bond yields have pushed investors into higher yielding assets
- Even with credit spreads and yields near historic lows, high yield should perform well into next year
- Short-duration, smaller-cap HY issues are poised to outperform the broad market despite stretched valuations

These are interesting times across global assets. Investors, academics and analysts continue to scratch their heads, trying to understand valuations. We've never had a situation where markets faced a coordinated front from global fiscal and monetary authorities like that required to combat the COVID pandemic. The discussion has shifted to when central banks, in general, and the Federal Reserve, in particular, will begin to taper.

The conundrum is acute in fixed income and high yield. There is no shortage of opinions about the repercussions surrounding credit spreads and yields being too low for the presumed risk. Most recently, red flags have been waved with a focus on the CCC credit segment. Anxiety has increased with the group's spread and YTW closing out April at or near all-time lows of 504 basis points (bp) and 6.06%. It was only as recently as September 2020 when CCCs traded with a weighted average credit spread above 1,000 basis points.

Despite varying concerns about valuation, the Fed and Chair Jay Powell have made clear that monetary policy will not change. Even as it has upgraded its view on economic growth, the Fed has remained steadfast in maintaining its new average inflation targeting paradigm. This new paradigm is all about observed data and much less about model-based forecasts. When you combine this shift in philosophy and the Fed's view that current inflation will be transitory, monetary policy can be expected to remain supportive over the near-term and the medium-term.

With the Fed in high yield's corner, history tells us that the market is poised to turn in attractive results in 2021. An empirical look at periods when yields and credit spreads approached historical lows shows that the high yield market delivered solid returns during these times.

In Figure 1 we chart the market's daily OAS and yield-to-worst going back to the mid-1990s. We then calculate the market's 6-month and 12-month forward results for each of these observations. Examining the periods where the high yield market's OAS and YTW trended on a sustained basis below the historic median levels of these measures reveals that the high yield market has performed well during periods of "rich" valuations.

Figure 1 shows three periods when credit spreads and the yield-to-worst traded below their historical medians of 482 bp and 8.04%. The first period, from 12/31/03 to 5/31/07 benefited from an accommodative Fed, following the unwind of the TMT bubble and the Enron and WorldCom fiascos. During this period HY spreads averaged 337bp and the median six-month forward return was 3.21% while the 12-month return was 7.41%.

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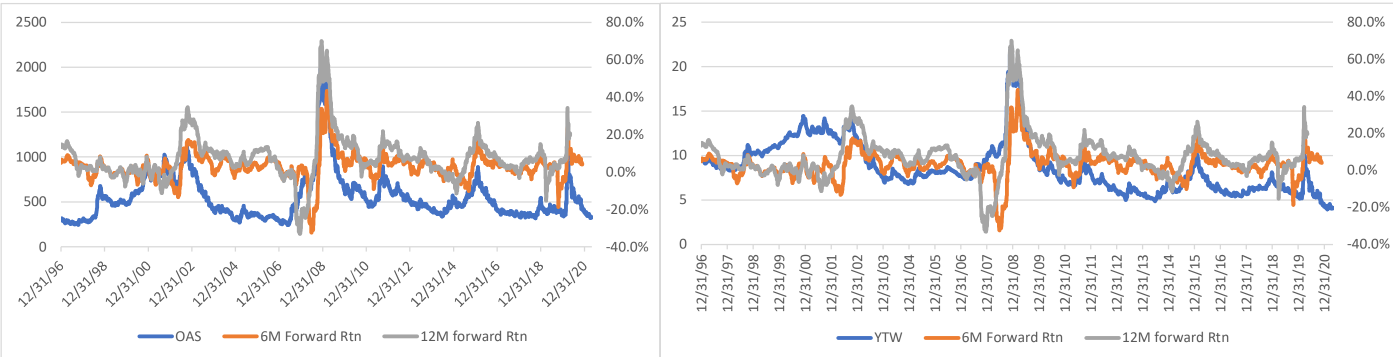
Figure 1: U.S. HY OAS and YTW vs 6-Mth and 12-Mth Forward Returns



Source: Bloomberg, Concise Capital

The second period ran from 9/30/13 to 5/31/14 when spreads averaged 402bp. This period delivered a median six-month return of 4.28%, although the 12-month return of 2.46% suffered from turmoil in oil. The third period ran from 2/28/17 to 1/31/20 where spreads averaged 381 bp. During this period the median six-month and 12-month returns, which included the start of COVID, were 2.00% and 3.69%.

At year-end 2020 Wall Street forecast low single digit returns for the high yield market in 2021. Through April, the U.S. high yield market has posted a total return of 2.01% according to the ICE BofA HY Master Index. Should we realize similar results during the next few months, the full year results will surpass street estimates.

Global technical factors should also support U.S. high yield. While many will argue that investors are not being compensated for the risk, what are the alternatives in fixed income? Even as U.S. high yield closed out April with a YTW of 4.12%, European high yield yields a mere 2.90% with spreads 40 bp tighter than in the U.S. Asian credit markets yield even less. Private credit, direct lending, and real estate investments are impractical for many investors.

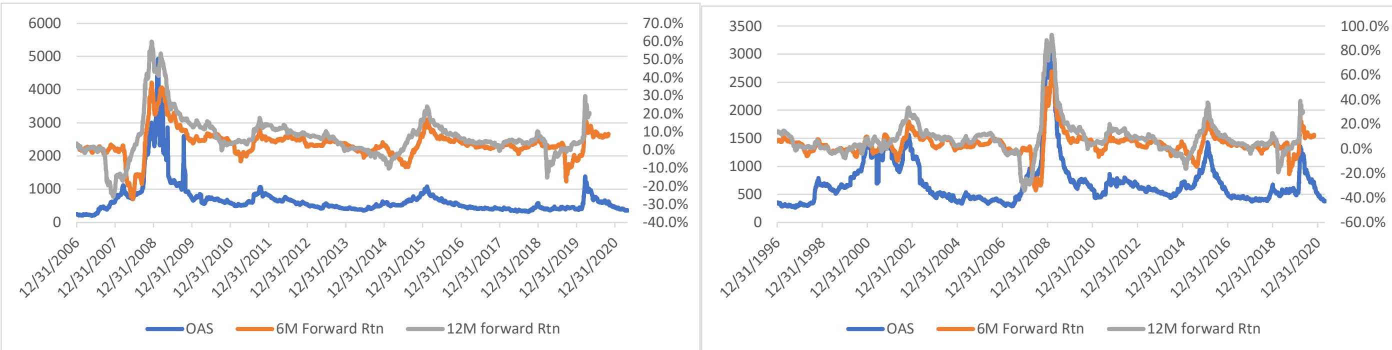
In a recent article Bloomberg noted increased interest in high yield from insurers, pensions and investment grade managers, both in the U.S. and Europe. We are seeing increased participation in high yield, counter to the narrative of inconsistent fund flows data.

For the historical dynamics within the short-duration and small-cap high yield segments, see Figure 2. With a reduced dataset for the short-duration cohort, we were able to evaluate two of the three previous periods. From 10/13 to 5/14 the short duration market generated 6-month and 12-month returns of 2.25% and 1.07% while the 3/17 – 1/20 period saw results of 1.88% and 4.12%.

Examining the smaller-cap market, where we have similar data as for the broad market during the 1/04 – 6/07 period, we find the group returned 6-month and 12- month results of 3.39% and 7.32%. The period of 10/13 – 5/14 saw 6-month results of 4.41% while the 12-month return was much reduced at 0.98%, due to a market disruption in 2015. Finally, for the period of 3/17 – 1/20 smaller cap issues returned 1.55% and 3.66%, respectively.

Expected attractive results for the short-duration, smaller-cap cohorts are further enhanced by the likelihood of higher nominal yields, such as those that affected longer-duration assets during the first quarter. As we have argued in previous reports, we remain overweight short-duration, smaller-cap names with a focus on B rated issues over CCC on a valuation basis.

Figure 2: HY Short-Duration (left) & Small-Cap (right) U.S. HY OAS & YTW vs 6- and 12-Mth Forward Returns



Source: Bloomberg, Concise Capital

The current environment of monetary and fiscal accommodations should continue well into 2022. These policies should fuel growth in profits and depress default rates. We are constructive on high yield with a particular focus on short-duration, smaller cap names.

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