August 2021 High Yield Market Insights

Summary:

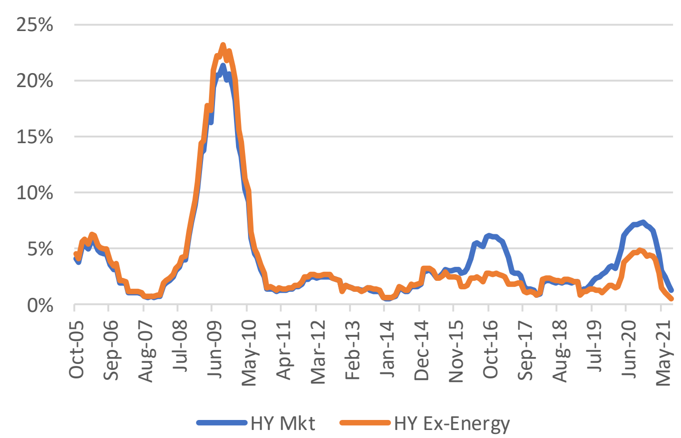
- The amplitude of the corporate default cycle has flattened since 2008 due to extraordinary liquidity
- QE has capped default rates, bolstered recoveries, shortened the default cycle, and lengthened the credit cycle
- Improving default cycles have supported HY returns coming out of recessions and market dislocations
- With default rates expected to trend at historically low levels, the HY market is poised to post attractive results

The corporate default cycle has followed a predictable pattern identified by the National Bureau of Economic Research (NBER). Before the Great Financial Crisis (GFC) in 2008, the median duration between business cycles, which correlates to default cycles, was 47 months. Since 2008, when the Federal Reserve became the buyer of last resort, the business cycle and the credit cycle have expanded. In fact, before the crash in March 2020, the duration of the business cycle had reached an all-time high of 146 months from peak-to-peak.

A by-product of the Fed's necessary, but heavy-handed, large-scale asset purchases (QE) has been a muted default cycle. In addition to dampening down the amplitude of the default cycle, the high amount of liquidity surging throughout capital markets has shortened the recovery phase. The shortened default cycle and quicker rebound in recoveries has supported high yield markets.

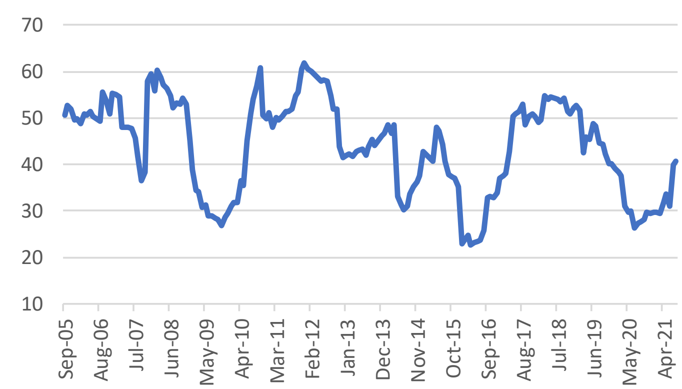
To illustrate the shortening of the default cycle, we compared the default cycles seen during the GFC in 2008 and 2009, the energy sector-induced cycle in 2016, and the recent pandemic driven cycle in 2020 (Figure 1). While the NBER designated the start of the GFC recession in December 2007, default rates didn't begin to move higher until February 2009. The pace jumped notably post the Lehman Brothers default in September 2008, with the high yield default rate eventually peaking a year later at an historical high of 21.4%. The GFC trough-to-peak in default rates took 20 months, during which the LTM recovery value dropped from 60.4% to 28.1% (Figure 2).

Figure 1: U.S. High Yield Par Value Default Rate



Source: BofA, Concise Capital

Figure 2: LTM Par-weighted HY Recovery Rate



Source: BofA, Concise Capital

The ICE BofA High Yield Master II Index declined -25.4% during Q3 and Q4 of 2008. In 2009, even as the default rate continued to surge, HY returned +57.5%, as spreads dramatically declined from 1,181 bp to 622 bp by year-end. During these 20 months, the Fed's balance sheet expanded from $1.2 trillion to $2.2 trillion.

The 2015-2016 period, which the NBER did not categorize as a recession, saw a smaller run-up in high yield defaults (from 2.4% to 3.2%) and a corresponding drop in recovery values, driven principally by a collapse of the energy sector as the oil price hovered in the mid-$40's. Ex-energy, the net default rate held steady at 2.4%. Much of the pain was felt during Q3 and Q4 of 2015, when the high yield market returned -6.96%.

2015-2016's default cycle was shorter than that of 2008-2009, partly due to significant liquidity from the Fed. It lasted just nine months from April to December of 2016, when LTM defaults peaked at 6.1% (ex-energy: 2.9%). Despite the energy sector defaults, high yield fared well, returning +17.5% in 2016, as spreads tightened by -273 bp to 422 bp at year-end. The positive performance of high yield bonds during this period is worth noting, since the energy sector typically has an oversized influence on the broad high yield market's performance.

2020's pandemic-induced recession was unlike anything ever seen. At no point in history has the U.S. economy come to a full stop, let alone the global economy. The fallout was immediate, with HY spreads jumping +371 bp in March 2020 to 877 bp. Default rates rose, and recovery values fell. In February 2020, high yield's LTM default rate was 3.3% - it peaked nine months later at 7.4%. In tune with the 2015-2016 cycle, excluding the energy sector the net default rate topped at 4.9% after just eight months - a far shorter timeframe than during the GFC cycle.

Particularly noteworthy, is how fast HY default rates improved in response to the Fed's efforts to stimulate recovery. In February 2020, the Fed's balance was $4.2 trillion. By the time the default rate peaked in October and November, the balance sheet had swelled to $7.3 trillion. The Fed's asset purchases, which included a first-time buying of corporate debt, enabled the market recovery.

Financial support has been paramount to the recovery of risky assets and high yield and fueled the decline in default rates. After collapsing -13.1% in March 2020, the high yield market jumped +22.2% from April through year-end, closing 2020 up +6.2%. Because of the extraordinary amount of liquidity, this cycle, the default rate has fallen from a peak of 7.4% in November 2020 to 1.3% by August 2021, after 10 months. The 2015-2016 recovery lasted 15 months, from a peak of 6.1% in December 2016, until the default rate bottomed at 0.86% in January 2018. During the GFC, after peaking at 21.4% in September 2009, it took 17 months to hit a cycle trough of 1.1% in February 2011.

Looking forward, we expect default rates to remain very low by historical standards, even with the Fed poised to start tapering its asset purchases. While the economy has displayed signs of slowing from the exceptional pace of Q2, due in part to the Delta variant, the pace of economic activity and therefore EBITDA growth, can be expected to remain robust. With spreads (321bp) already now tight, relative to the long-term median of 500bp, we are not relying on any significant further tightening in spreads. Indeed, we would not be surprised should volatility pick-up from current low levels, along with nominal bond yields, through year-end. In such an environment, bond returns are likely to rely on their coupon. Short duration high yield bonds with higher interest income should provide superior performance in this environment and our portfolios are positioned accordingly.

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