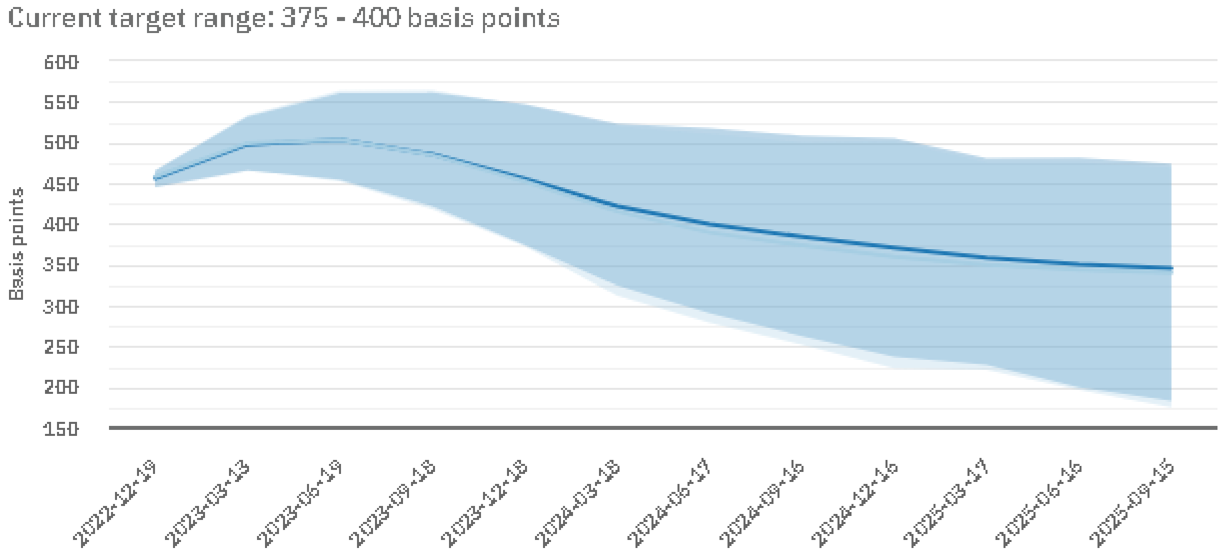
November 2022 High Yield Market Insights

- Inflation appears to be moderating
- Markets are anticipating the end of Fed tightening
- High yield bonds typically appreciate in the wake of tightening cycles

Inflation has begun to show signs of moderation. The fight is not yet over but markets tend to look forward. They have begun to price in a pause and, perhaps, a reversal in the Federal Reserve's policy stance. Fed speakers have indicated that rate hikes could slow to 50 basis points (bp) from the 75 bp hikes of the last four meetings.

Figure 1: The Expected Future Path of the Fed Funds Rate



Source: CME

Since markets are expecting the end of the Fed tightening cycle, let's see how high yield reacted to the end of rate hikes in earlier cycles. In four out of six cases HY performed extremely well for the three, six and twelve months following the pause in rate increases. The exceptions were after the 1989 peak and the 2000 peak.

Figure 2: High Yield Returns Following Peaks in the Fed Funds Rate

Fed Funds Peaks	3 Months	6 Months	1 Year	2 Years
5/17/1989	2.41%	-1.03%	-2.58%	6.51%
2/1/1995	7.79%	12.79%	20.83%	15.37%
3/25/1997	4.11%	8.14%	14.13%	7.73%
5/16/2000	1.72%	-1.87%	2.44%	1.78%
6/29/2006	4.49%	8.90%	12.27%	4.85%
12/20/2018	6.97%	9.89%	14.08%	9.65%

Source: BAML, Concise Capital. Two year returns are annualized.

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HY was at the epicenter of both the 1989 and the 2000 cycles. The HY crisis in 1989 occurred as the Fed tightened amidst excessive issuance for takeovers and overextended commercial real estate lending. Some failing Savings and Loan industry players got caught with large portfolios of HY bonds as they tried to gamble their way out of insolvency. The S&Ls' model of borrowing short at floating rates and lending long at fixed rates was upended when Paul Volcker's Fed raised rates to combat inflation. It took most of the 1980s for the industry to die. In the 2000 cycle, Fed tightening caught up with outsized HY issuance to build out telecom, optical fiber and cable systems for the internet. Many bankruptcies ensued. The HY recovery took the longest coming out of this cycle.

In the other four cycles HY was collateral damage and, thus, better situated to recover quickly. The lesson for HY investors, when considering whether to add exposure as the Federal Reserve winds down, is to determine whether HY itself is an underlying cause of the current cycle. The answer in this cycle appears to be no.

There has been no excess of investment by below investment grade issuers in recent years. If anything, they have displayed an excess of caution, refinancing at historically low fixed rates for several years. There is no HY maturity wall until 2025. HY quality has improved in recent years. The overall index quality has moved towards BB from B in earlier cycles.

The risk now is with inflation. Has it has truly begun to ease? Will it remain high compared to the Fed's 2% target for an extended period? We do not know the answers to these questions. If inflation becomes endemic, and the Fed keeps rates relatively high or raises them further, HY could suffer – although a great deal is already priced-in. Longer maturity debt could suffer disproportionately. The inverted yield curve indicates that the treasury market is pricing a recession. If we skirt a recession, but inflation stays elevated, the Fed will likely keep policy tight for longer. In that scenario the short end of the HY market will likely be a good place to earn yield while avoiding duration risk.