February 2021 High Yield Market Insights

Summary:

- Global bonds roared to life in February as investors priced in near-term inflation risks
- The back up in interest rates is unlikely to sway the Fed.
- Rising interest rates favor assets with a high Sherman Ratio
- A high yield portfolio is resilient to rising interest rates.
- Short duration high yield bonds protect a high yield portfolio even more.

Bond market repricing:

February served to remind investors that the bond market isn't as boring as many had believed. Late in 2020, the market began theorizing about a pending reflation trade after positive vaccine news emerged in November. However, nothing materialized, at least from the bond market's perspective. All of that changed in February, when rates across the global markets began backing up dramatically. Traders finally began pricing in an acceleration of inflation.

The narrative surrounding interest rates has morphed into a game theory about how the run-up in rates could pressure the Fed to change its current policy path. However, Fed Chair Powell continued to waive off concerns about the likelihood of an overheating economy producing long-feared inflation. Powell and many members of the Federal Open Market Committee (FOMC) remain focused on bringing the economy back to full employment while interpreting any near-term run-up in inflation, for example, in commodities as transitory because of supply and demand imbalances and base effects. However, in the market's view, the Fed's creditability is waning.

The backup in interest rates in February, most notable in the belly of the yield curve, has fixed-income portfolio managers planning on how to insulate their portfolios. High yield portfolios already have built-in insulation given their short duration profile compared to other asset classes, such as investment-grade bonds. Another form of protection that is derived in part from the high yield market's lower duration profile is a solid breakeven ratio or what is known as the Sherman Ratio.

A Look at the Sherman Ratio:

The Sherman Ratio (named after DoubleLine Capital's Deputy CIO Jeffery Sherman), otherwise known as the breakeven ratio, measures the amount of yield investors earn for each unit of duration. The ratio measures how much a security's yield can rise before incurring a capital loss.

Why does the ratio matter? Because it tells investors the risks that they face from owning fixed-income bonds. As we'll see, it also explains why short-term high yield offers shelter from the damage that rising interest rates can impose on a fixed income portfolio.

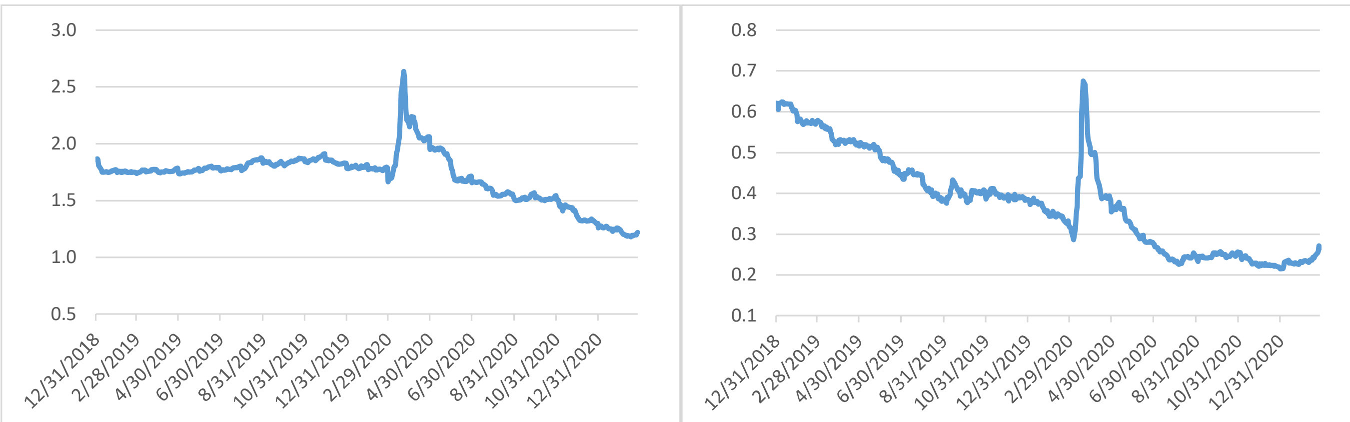
The topic has come to the fore recently due to the prospects for a rapid economic recovery coupled with a flood of fiscal and monetary aid. While the Sherman Ratio has drawn attention in the US investment-grade market, we'll primarily focus on the high yield market.

As illustrated in Figure 1, the IG Sherman Ratio has been trending lower over the past two years as yields tumbled and duration increased. In contrast, the HY Sherman Ratio stayed remarkably stable until the pandemic hit in March 2020. It only started to decrease when the Federal Reserve began to support corporate credit as part of its policy response to the panic and the economic disruption caused by COVID-19.

As of February 28th, at 1.22 and 0.26, the HY and IG Sherman Ratios are near their all-time lows, representing limited protection against rising interest rates. Figure 1 shows that the risk is much higher for investment grade.

After the initial shock of the pandemic, the IG Sherman Ratio fell more precipitously and bottomed at one-third of its level at year-end 2018. The HY Sherman Ratio dropped to about 80% of its year-end 2018 level post-pandemic and has only marched towards 70% in the face of a record number of new issues coming to market at low-interest rates.

Figure 1: US HY (left) vs. IG (right) Sherman Ratio



Source: Bloomberg, Concise Capital

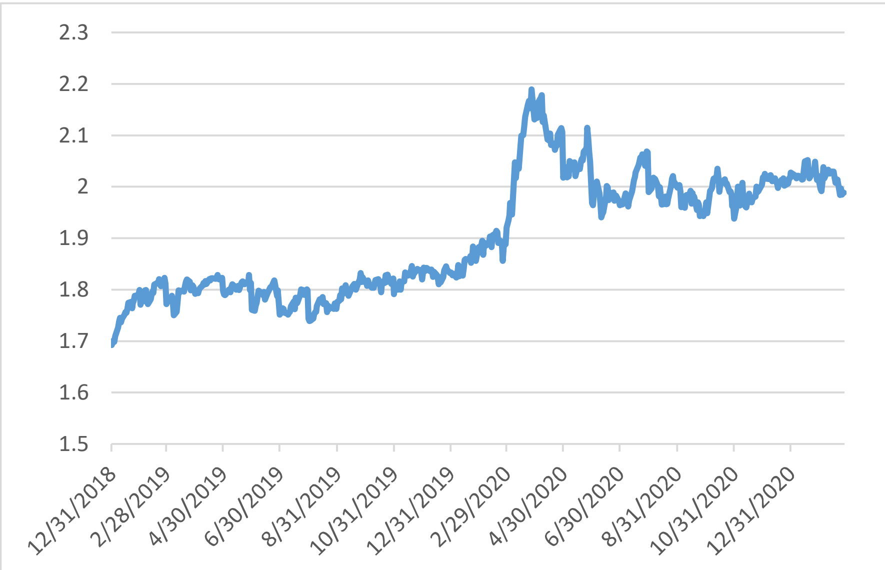
While we don't foresee inflation roaring back on a sustainable basis anytime soon, consensus expectations are for the 5-year UST yield to top out at 0.70% and for the 10-year UST yield to reach 1.34% by year-end. Even if credit spreads narrow, the high yield market is well-positioned to absorb the estimated 30 basis point (bp) back up in yields while the investment-grade market is not. Even as yields have moved higher in February than current year-end forecasts, the drag on monthly/quarterly performance will continue to be acute within investment grade and less so in high yield.

If we get more granular and examine short-duration high yield, an area where Concise specializes, we note that the Sherman Ratio is much higher in short-duration high yield at 2.43 than in the broad high yield market at 1.22. The obvious reason is that while the numerator (yield) is similar between short-duration (4.33%) and the broad market (4.27%), the denominator (duration) differs significantly at 1.8 years versus 3.5 years.

The superior Sherman Ratio coincides with the long-understood fact that shorter-duration securities are less sensitive to changes in interest rates than longer-duration securities. Naturally, it wouldn't make sense to benchmark two cohorts with similar yields and different durations, so we review their respective ratios in relative terms. If we benchmark the short-duration Sherman Ratio vs. the broad market, we get a relative measure in comparative attractiveness.

Figure 2 charts the short duration HY Sherman Ratio divided by the broad HY Sherman Ratio. From this analysis, we can judge the relative downside protection from the risk of rising interest rates. Through the first three quarters of 2019, the relative Sherman ratio held steady as the two groups performed in line with each other. But during Q4 of 2019, the broad market, populated with larger cap issues, outperformed, driving down the yield and with it the Sherman Ratio. The decline in the broad market yield was also aided by an active primary market where issues were priced at historically low funding levels. This trend accelerated in February when the broad market outperformed the smaller cap short-duration market as COVID concerns began to ramp up and led to a notable jump in the short-duration HY Sherman Ratio. While the momentum has ebbed as the economic recovery has progressed, the short-duration market continues to outshine the broad market within a rising interest rate world. This is evident in February's US high yield total returns where the broad market gained +0.29%, while short-duration securities returned +0.76%. YTD, the broad market is up +0.67%, while short-duration issues are up +1.54%.

Figure 2: Short duration / Broad HY market Sherman ratios



Source: Bloomberg, Concise Capital

The relative level of the short duration HY Sherman Ratio and our expectations for a further tightening in high yield spreads support our view that calls to underweight fixed income, particularly high yield, due to an expectation of higher nominal interest rates, are misdirected. To validate our point, we reviewed three historical periods when interest rates increased and the subsequent impact on high yield returns. From December 31, 1998, through April 30, 2000, a period that included the last tech bubble, the 5-year UST yield increased by +200 bp (4.56% to 6.46%). At the same time, HY spreads widened by a modest +22 bp to 588 bp, resulting in a total return over that period of +0.84%. From June 30, 2003, to June 30, 2006, interest rates increased by +264 bp to 5.10%. Yet because spreads narrowed by -278 bp to 335 bp, the HY market generated a return of 27.6%. From June 30, 2016, to October 31, 2018, the 5-year UST yield increased by +173 bp to 2.74%, while spreads narrowed by -241 bp to 381 bp, resulting in a positive return.

In addition to maintaining our positive view on the broad US high yield market, we advocate increasing exposure to short-duration high yield bonds with an added focus on smaller-cap issues from a relative value perspective. In February, smaller-cap high yield bonds outperformed the broad market by 62bp (+0.91% vs. +0.29%) while outperforming on a YTD basis by 123bp (+1.84% vs. +0.67%).

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