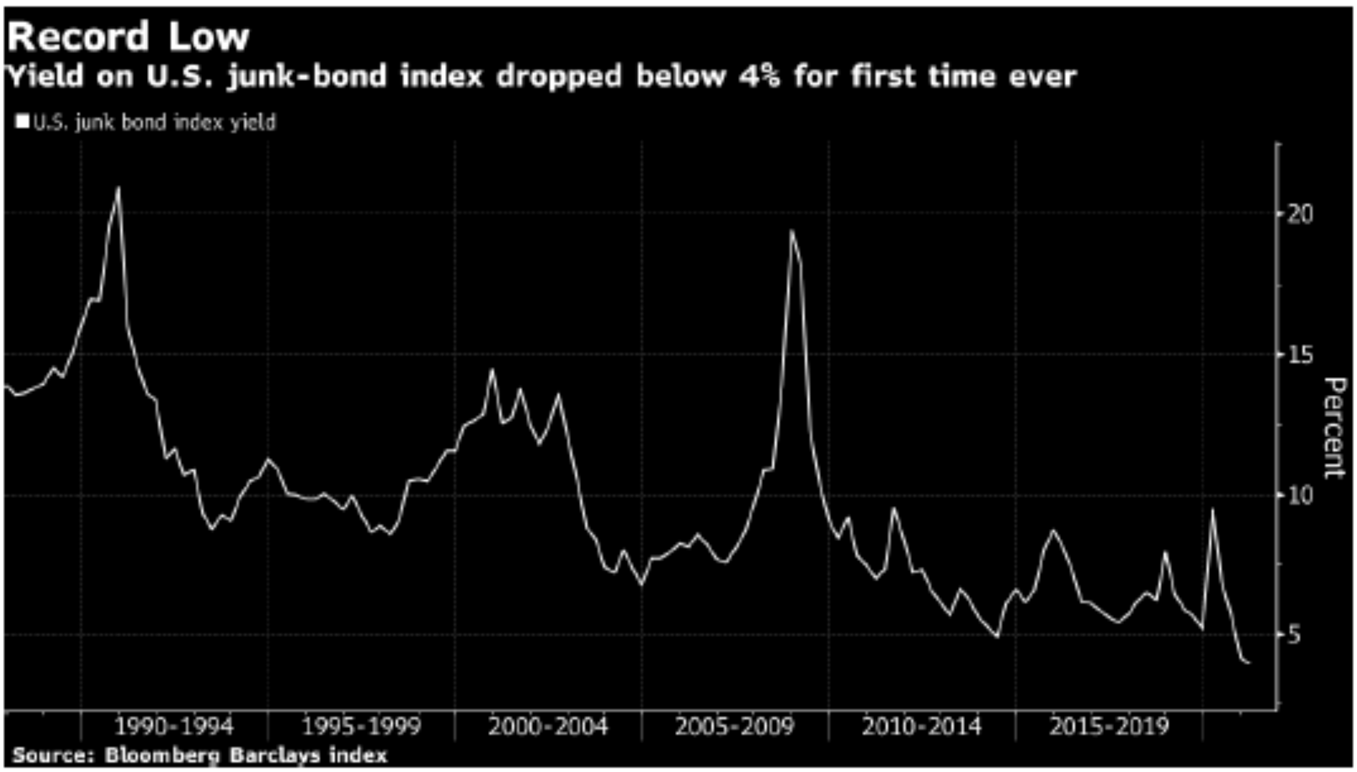
The U.S. High Yield Market Yield is at All-Time Lows, but it's all Relative

A Bloomberg story about the U.S. high yield market yield dropping below 4% for the first time will be fodder for those questioning the high yield market's historical valuation. But, while today's yield is undoubtedly much lower than the level witnessed when Michael Milken started the asset class in the mid-80s (12%), it is not far off from the levels seen during the early part of 2020, before the spread of COVID-19 (5.25%).

Figure 1: U.S. High Yield Market YTW



In the mid-80s, the HY benchmark 5-yr Treasury yield was around 10%. Today, it's 48bp. Inflation is also far lower, where core PCE was 4.25% in 1985 compared to 1.5% as of December.

Since November, when the market received positive vaccine news, we began hearing about an upcoming reinflation trade. This narrative manifested in the form of a rotation into more cyclically oriented sectors at the expense of defensive sectors. The shift in focus to more economically sensitive sectors aided an already climbing trend in inflation expectations. As illustrated in Figure 2, 5Y & 10Y inflation expectation rates bounced off of an unsustainable near-zero level in late March following the CARES Act's passage and the Fed's entry into the market. The ascent of these two measures stalled by late August, even moderating some, before regaining momentum in November as part of the return to positive growth sentiment.

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The boost in inflation expectations, which kicked higher in January, stems from the view that even as the economy shows significant promise in 2021, especially in the second half, the Fed has strongly signaled it was in no hurry to change its dovish policy stance. Federal Reserve Chairman Jerome Powell made the point on several occasions that the Fed would look past any sudden rise in price pressures as transitory.

Figure 2: 5Y & 10Y Breakeven Rates

Inflation expectations have developed into an interesting picture where the 5Y B/E rate (2.33%) is higher than the 10Y B/E rate (2.20%), suggesting the market expects inflation to be higher in 5 years than in 10 years. One could argue this speaks to the market's reaction to the Fed's new mandate of average inflation targeting and the wilingness to allow inflation to run hot where core PCE inflation is running well above 2% for an extended period.

Figure 3: 5Y & 10Y "real" UST Yields

What's noteworthy about this period of building inflation expectations and rising nominal yields is that the 10Y real rate has not changed much (-1.05%) while the 5Y real rate continues to trend lower (-1.90%). The fate of fixed income products is not just a function of rising nominal benchmark yields that shadow rising inflation trends, but asset classes such as high yield also need to be viewed relative to alternatives. And when the 5Y nominal and real yields are 352bp and 600bp, respectively, below the high yield market's YTW, we should not expect broad-based weakness in prices or material widening in spreads.

We remain constructive on the high yield market for 2021 given a thesis of a further 50bp tightening in spreads and declining default rate expectations as part of an improving economic environment fueled by continued support from the Fed and a likely additional dose of fiscal policy stimulus.

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