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June 2021 High Yield Market Insights

Summary:

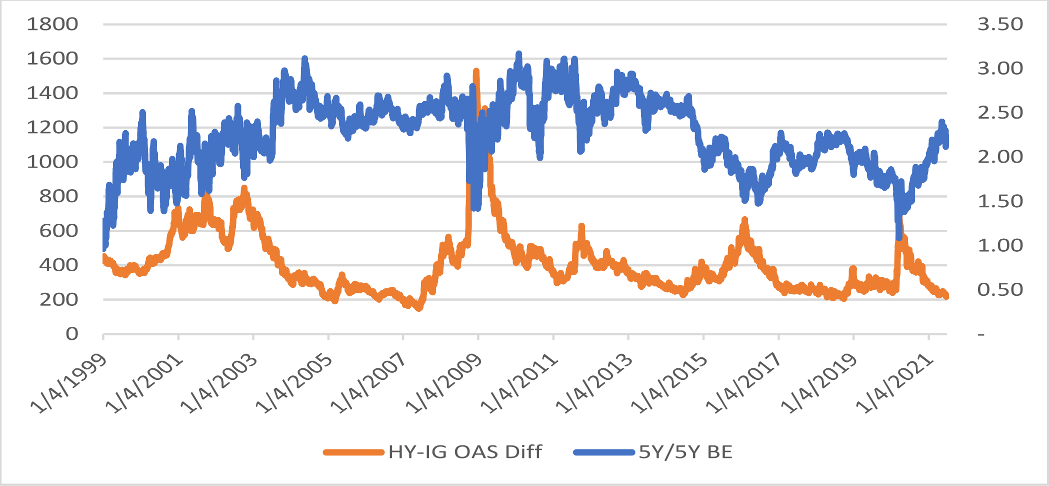
- Optimism about transitory inflation has lowered breakeven rates
- The decline has fueled a bid for longer duration assets
- Lower inflation expectations could result in a widening of the HY-IG OAS
- A focus on longer duration assets led to HY underperforming the IG market in June
- Given its higher breakeven yield, HY should regain momentum as inflation expectations increase

The one topic that has dominated corporate America and financial markets alike has been inflation. The number of companies citing inflation during their conference calls has hit a 10-year high. The debate surrounding whether the run-up of inflation is transitory or permanent has divided the economic community. The eventual answer will impact asset price valuation. With equities trading near all-time highs, and corporate bond spreads trading at decade tights, much is riding on the outcome.

Fixed income market participants are keenly interested in the inflation debate, given the spill-over on nominal sovereign yields and, by extension, on real yields. Throughout much of 2021, investors have sought to buffer a fixed income portfolio's exposure to duration in the face of rising yields, fueled by the strong rebound in economic activity, fiscal expansion, and dovish monetary policy. During the first five months of 2021, shorter duration assets outperformed longer-duration assets. June, however, witnessed a reversal of sorts as inflation concerns moderated, with the Fed regaining control of the inflation narrative, which in turn allowed longer tenor bond yields to decline notably during the month.

When it comes to gauging the path of future rates and therefore fixed income valuations, a key indicator is inflation expectations. While survey and market-based measures of inflation expectations do not strongly correlate to future rate paths, they do correlate strongly to risk premiums across the corporate bond market.

Figure 1: U.S. High Yield – Investment Grade OAS Differential vs 5Y/5Y Forward Breakeven Rate

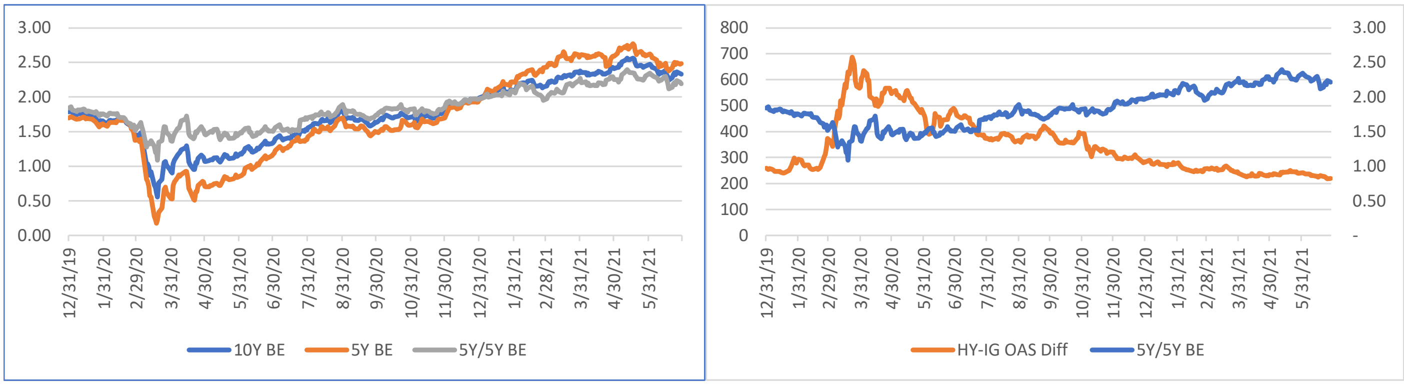


Source: Bloomberg, Concise Capital

When judging relative value and risk sentiment within the corporate bond market, investors often consider the difference between U.S. investment grade and high yield credit spreads. The larger the difference between the two groups, the greater is the level of perceived risk and vice versa. Comparing inflation expectations (as measuerd by 5Y5Y breakevens) against this relative spread measure delivers a correlation coefficient of -82% (see Figure 1, which shows a 20-year history of the six-month change). As inflation expectations fall, signaling a decline in duration risk, the spread differential between the IG and HY market widens.

Historically, the inflation breakeven rate declines when the market begins pricing in a slowdown in economic growth. In Figure 2 (left chart) you'll note the collapse in inflation expectations at the onset of the pandemic. This collapse reflected a concern among investors that slowing growth portends a decline in EBITDA and narrowing EBITDA margins. That in turn resulted in a rotation up in credit quality. The right chart shows this rotation to higher quality via a widening credit spread differential between high yield and investment-grade.

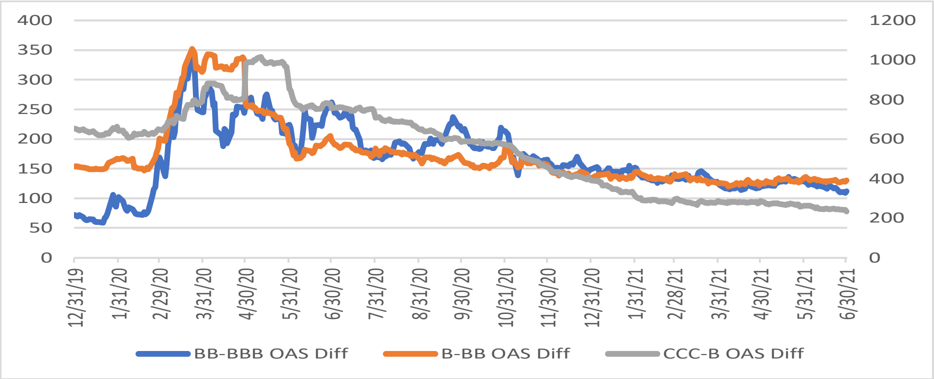
Figure 2: Market Based Inflation Breakeven Rates & HY-IG OAS Differential vs 5Y/5Y Forward B/E Rate



Source: Bloomberg, Concise Capital

The step-up in credit quality from high yield into investment grade is also evident across credit segments within the high yield market. Figure 3 illustrates the relative widening in spreads between credit cohorts at the start of the pandemic. The jump in spread differentials corresponded to reduced sentiment for riskier bonds.

Figure 3: OAS Differential between BBB, BB, B, and CCC Credit Cohorts



Source: Bloomberg, Concise Capital

The current easing of inflation expectations has nothing to do with concerns of a slowing economy and related credit cycle weakening, but instead reflects reduced concern about transitory inflation becoming permanent.

With the spread between high yield and investment-grade spreads near all-time lows and with inflation expectations moderating since mid-May, lower quality and shorter-duration corporate bonds are vulnerable to a period of underperformance over the near term as the HY-IG OAS differential widens to 300bp from the current 218bp.

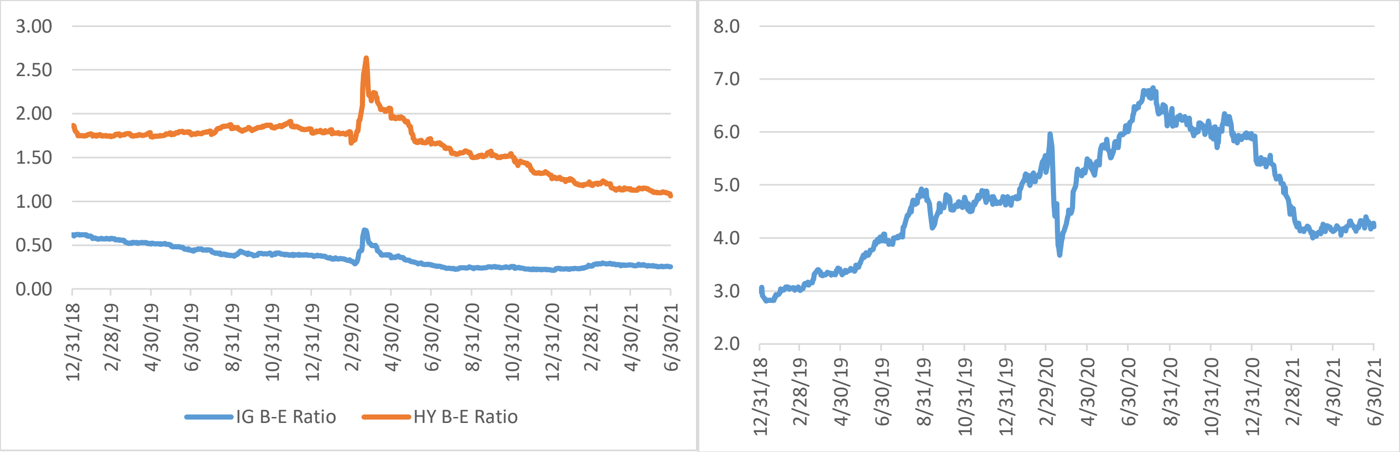
Any potential near-term weakening of lower credit corporate bonds, however, is likely to be short-lived. While many like to frame the inflation debate as a binary argument, in fact, the situation is more nuanced. While some of the current inflationary trends will likely ease as supply bottlenecks are addressed, price pressures could persist well into 2022. Consequently, we would expect inflation expectations to return to an upward trajectory during the third quarter. The return of inflation concerns coupled with the pricing of a taper in monetary policy late in the fourth quarter should lift longer tenor nominal yields. We would expect the 10Y/2Y US Treasury curve to increase toward 2021 wides of 160bp by year-end with the 10Y/5Y curve widening to 75bp.

The ensuing bear steepening of the Treasury curves will accompany a pullback of duration exposure and a narrowing of the HY-IG OAS differential back toward current levels.

Another determinate to an expected return of positive sentiment toward shorter-duration credit markets is the superior breakeven yield. The breakeven yield is a measure of how much a fixed income market can absorb a backup in nominal yields. Historically, the high yield market's median breakeven yield is 185bp based on a yield-to-worst measure (194bp via YTM), meaning the market can absorb a 185bp increase in the benchmark 5Y UST yield before it realizes a capital loss. The historic median for the IG market is 77bp (78bp via YTM). The HY rate has historically been 2.4x that of the IG market, giving the high yield market a lot more runway.

Currently, the HY B/E rate is 106bp vs the IG market's 25bp (see Figure 4, left chart). While the HY rate is well below its historic median level, it is 4.2x that of the IG market (see the right chart). Furthermore, another argument for rolling down the credit spectrum within HY, should we see the short-term move to longer duration assets reverse as we expect, is the superior breakeven rates of Bs (150bp) and CCCs (272bp) compared to BBs (71bp).

Figure 4: HY & IG B/E Ratio (left) & HY/IG Ratio (right)



Source: Bloomberg, Concise Capital

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