March 2021 High Yield Market Insights

Summary:

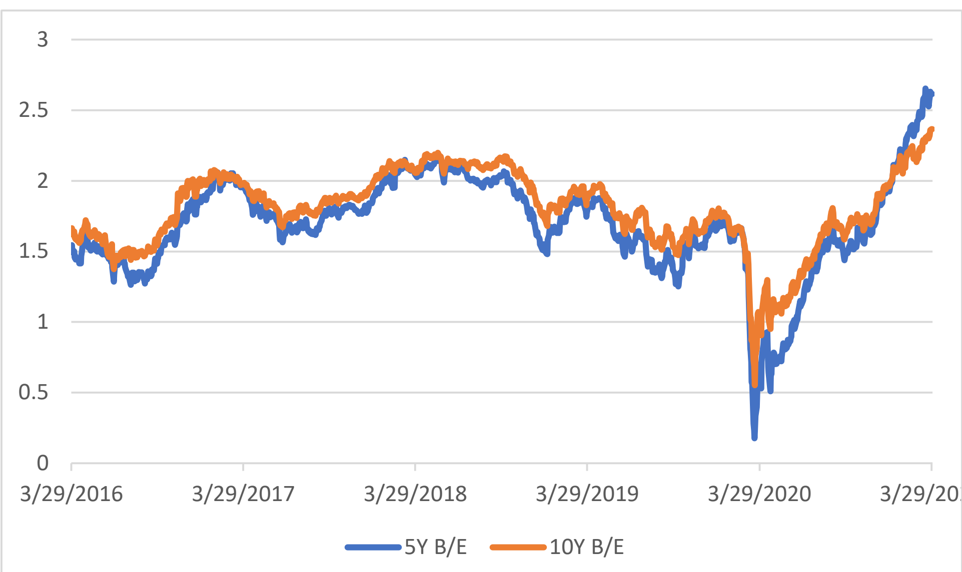
- Divergent expectations between the Fed and investors are pushing up nominal and real yields
- Despite the Fed's transitory view on a pending jump in inflation, markets see things differently
- Recent large-scale fiscal stimulus has markets pricing in Fed tightening sooner rather than later
- The shorter duration of high yield provides a safe harbor within credit; yet an allocation to the short-duration, smaller-cap segment of high yield is even better

The Federal Reserve versus the High Yield Market's Interpretation:

The fixed income market faces an unprecedented dichotomy between the expectations of the Federal Reserve and the views of investors. On the one hand, despite an upside revision to its economic projections, the Fed did not change its monetary policy forecast. It predicts demand and supply pressures on the economy will be transitory. On the other hand, investors see a stimulus-fueled rebound in economic activity, progressively higher supply-side and demand-side driven inflation, and a robust recovery in the labor market, all of which amplify concerns for rising interest rates and higher inflation. That was the takeaway from the most recent Fed policy meeting.

Even before the Fed left many market participants scratching their heads, traders decided to place their bets ahead of the FOMC meeting, increasing nominal and real Treasury yields as well as inflation expectations. In addition, we have seen a rise in commodity and input prices relative to a year ago, in large part due to global supply-chain disruptions.

Figure 1: 5- & 10-Yr Inflation Expectations



Source: Bloomberg, Concise Capital

After dropping to near zero at the start of the pandemic, the market began bidding up its inflation forecast as initial monetary and fiscal stimulus measures eased dire economic conditions. The pick-up in inflation expectations received a boost near year-end powered by positive vaccine news and the passage of round two of fiscal stimulus.

At the same time that inflation expectations began to rise, the market's view on the timing of the Fed's first interest rate hike drew closer, even as Chair Jay Powell indicated that interest rates will remain near zero for years to come. As

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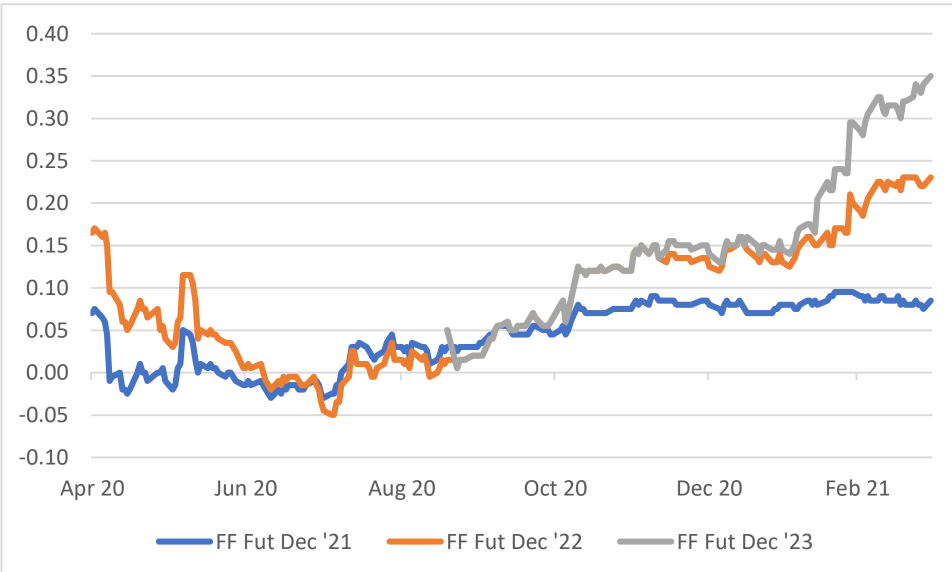
Figure 2 shows, the market believes that the first-rate hike will now come in Q4 ’22, which is in stark contrast to six months ago, when the market was pricing in the first hike in Q4 ’23.

Figure 2: Fed funds futures implied yield

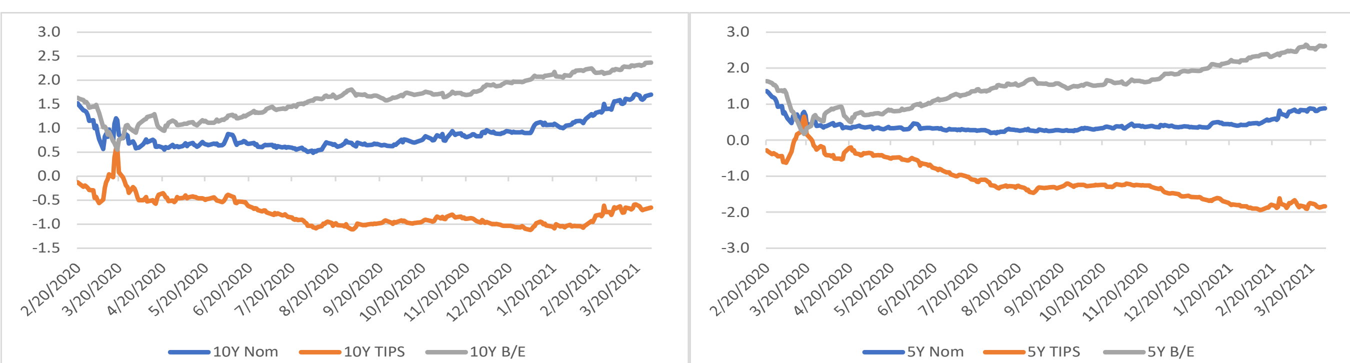


Source: Bloomberg, Concise Capital

Fixed Income Implications

Where the market’s adjustment in Fed policy expectations has impacted the fixed income markets, in general, and the high yield market, in particular, is in “real” rates. The increase in real yields is most notable at the 10-year tenor (Fig 3, left chart, red line) where the real rate has increased by 43 basis points (bp) since early February. The move on the 5-year real rate, (the high yield benchmark), has been much more muted, increasing by 16 bp over the same period. This disconnect has, in part, accounted for the high yield market’s relatively resilient performance.

Figure 3: 5- and 10-year Nominal Ylds, Real Ylds (TIPS) and Inflation Expectations (B/E Rate)



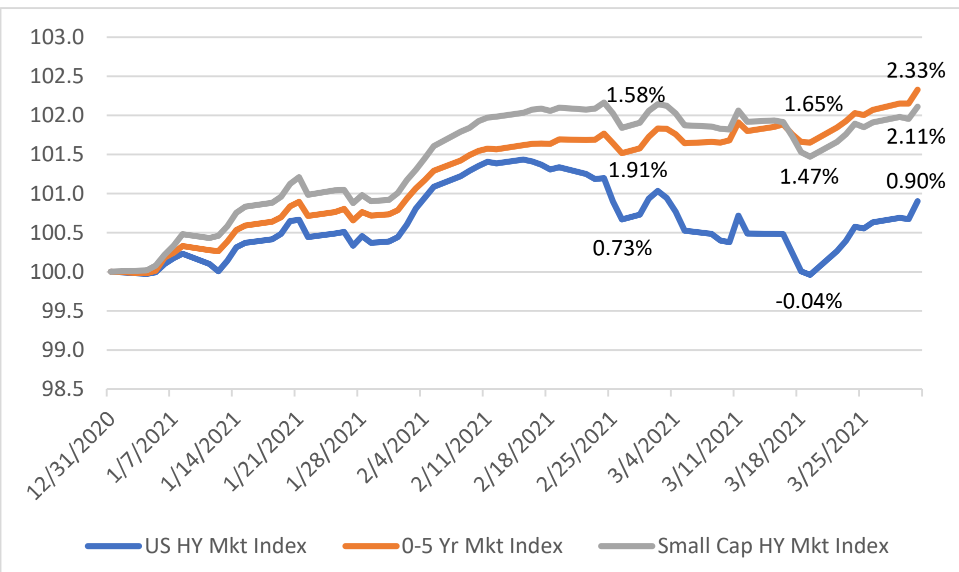
Source: Bloomberg, Concise Capital

The notable runup in longer tenor yields has had an expected negative impact on longer-duration fixed-income assets. The pain has been on clear display within the U.S. investment-grade market where its 7.9-year duration made the asset class vulnerable to the sudden move higher in 10-year Treasury yields. To put a finer point on this dynamic, with the 10Y UST yield jumping +34 bp to 1.74% in March, the U.S. IG market lost -1.39% as spreads widened a mere +2 bp to 97 bp. Year-to-date, the IG market is off -4.50% with the 10Y UST yield up +83 bp.

The high yield market, by virtue of its much lower duration, (DTW: 4.3 years), has fared much better. March saw HY eke out a return of +0.17% even as the benchmark 5Y UST note yield increased +21bp to 0.94%. Noteworthy is the HY market's YTD result of +0.90% as of quarter end, which is in stark contrast to mid-March when the YTD return was underwater (-0.04%). The end-of-month rebound equated to a +0.95% performance boost as investors recaptured their pro-EBITDA growth, procyclical theme after a shaky start to the month.

However, despite the broad HY market's steadfast performance in the face of rising rates, it remains prudent for high yield investors to shorten portfolio duration in the face of an expected rising tide of inflation and corresponding higher nominal yields. As Figure 4 shows, shorter duration HY bonds have notably outperformed the broader HY market throughout the first quarter with the 0-5 yr. duration cohort, (Avg DTW 1.8 yrs.), posting a YTD total return of +2.33% while the broad market returned +0.90%. The short-duration dominance was on full display in mid-March when the broad market dipped below breakeven for the year while short-duration HY bonds were up +1.65%. Moreover, in addition to short-duration bonds generating superior results, the group possesses far lower volatility. Through the first quarter, short-duration volatility is 76% below that of the broad market.

Figure 4: Broad US HY Mkt; 0-5 yr. HY Mkt; Small-Cap HY Mkt Index YTD Returns



Source: ICE BofA, Bloomberg, Concise Capital

In addition to applying a short-duration HY strategy to improve absolute and risk-adjusted results within a high yield portfolio, decreasing issue size not only increases a portfolio's liquidity premium and therefore outperformance potential, but also improves valuation.

Smaller cap issues, as measured by the BofA US Small Cap HY index, have outperformed the broad market by +121 bp for the year. See Figure 4. At 400 bp, the group's OAS is the tightest since October 2018 while at 336 bp, the broad HY OAS is the tightest since 2007. The small-cap HY spread is 140 bp above the historical low while the broad market's spread is only 95 bp above the market's historical low, suggesting small-cap HY's more attractive valuation.

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