# May 2021 High Yield Market Insights

**Summary:**


- The current environment parallels the environment during the 2013 Taper Tantrum
- 2021 could see another episode of tapering and its consequences
- Rising inflation should cause investment performance to moderate and to be volatile later this year
- Despite volatility and wider credit spreads, the HY market generated solid results in 2013
- High yield bonds should remain resilient and out-perform other fixed income assets in 2021


Since the Federal Reserve included corporate bonds in their asset purchase plan, some investors have decried the effect of inflation on valuations and warned of an eventual correction. However, as we have argued previously, what is missing from these doomsday scenarios is a catalyst for a sustained repricing of high yield risk. In addition to Congress keeping the fiscal flood gates open, the Fed has remained resolute in its ultra-accommodative policies.

Following May's high yield performance that saw credit spreads modestly expand, in the first monthly widening since September 2020, some investors will conclude that the high yield market may be losing steam. Such a view could gain traction. May recorded a modest correction in high yield valuations that pushed the MTD returns into negative territory before staging a late-month rebound. While the high yield market was able to eke out a +0.26% total return, (YTD: +2.27%), on a price basis, the market lost -0.17%.

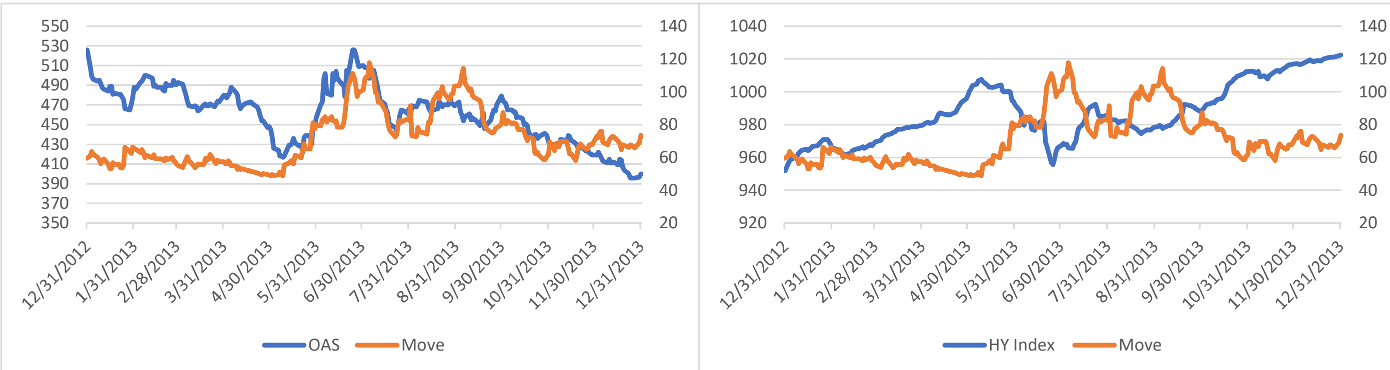
While the rebound corresponded to a pullback in nominal Treasury yields, investors' anxiety surrounding runaway inflation remains front and center. The debate concerns the current run-up in inflation and whether it will be transitory, as the Fed claims, or more sustainable as many believe. If the inflation hawks prove correct, the Fed may need to withdraw monetary accommodation quicker than expected, dampening economic growth, perhaps even causing a recession. Should the Fed signal a change in heart, another taper tantrum could occur and even exceed what we saw in 2013.

In this note, we examine the Bernanke-led taper tantrum that served to increase interest rate volatility, push up nominal yields, and widen credit spreads and what lessons we can apply to the current environment. We believe a tantrum is coming, notwithstanding the high level of guidance from the Fed. With the market so accustomed to the Fed's largess, it will be near impossible to reduce liquidity without some turbulence.

At the start of the 2013 taper tantrum, investors understood that members of the FOMC were becoming uncomfortable with the pace of asset purchases. Soon after the May 1st meeting, three of the governors, including Jay Powell, expressed concern. Their comments sparked the initial bout of volatility in fixed income markets. The run-up in volatility and nominal Treasury yields was on full display by May 22nd when Ben Bernanke, speaking in front of Congress's Joint Economic Committee, stated that the Fed could begin tapering bond purchases "in the next few meetings." That one sentence started the taper tantrum that lasted four months.

A widening in high yield credit spreads accompanied the rise in interest rate volatility. During the first leg up, which lasted until June 25th, the ICE BofA MOVE Index, which measures interest rate volatility, jumped 60 basis points (bps) and high yield credit spreads widened by 109 bps., Please see Figure 1. The jump in volatility and the widening in credit spreads corresponded with a 74 bp increase in the 5-year US Treasury yield. This trifecta of valuation adjustments led to the high yield market losing -5.15% on a total return basis.

Figure 1: ICE BofA MOVE Index vs HY OAS and HY TTR Index vs Move




*Source: Bloomberg, Concise Capital*

Anxiety cooled over the next month with Bernanke making statements that the Fed remained committed to loosening monetary policy. Bernanke's jawboning succeeded in lowering the temperature, dropping volatility, reducing bond yields and narrowing high yield spreads. Over that period spreads tightened by 67 bps, fueling a +3.14% rebound in high yield performance. Unfortunately, the calm didn't last long as volatility increased to near previous highs. Surprisingly, high yield credit spreads ignored this next leg up in volatility that ran through September 5th and tightened by 5 bps, even as bond yields surged. The material weakness in bonds that lifted the 5-year US Treasury yield by 47 bps to a 2013 high of 1.85% pulled high yield lower by -1.60% on a price basis. Coupon income limited the decline in total return to -0.81%.

In addition to taper concerns, the market suffered from another fear. Fed watchers debated who would succeed Ben Bernanke as Fed Chair. The chairmanship was up for grabs between Janet Yellen and Larry Summers. It wasn't until September 16th that Summers withdrew his name from consideration.

By the time the fourth quarter began, the market had gotten over its tantrum to the point where investors greeted the 16-day government shutdown over the Congressional debt ceiling impasse in October with a relative yawn. When all was said and done, the high yield market posted an attractive gain of +7.42% despite the bouts of volatility and surging bond yields. In 2013 the resilience of the high yield market resulted from a 126 bp tightening in credit spreads that offset the 102 bp jump in the 5-year US Treasury yield.

While the broad high yield market, despite heightened volatility, performed well in 2013, the short duration segment performed even better. While outpacing the broad market during periods of stress in 2013, as outlined above, for the full year, the short duration sector outperformed the broad market by 107 bps, posting a total return of +8.49% as short-duration spreads narrowed by 122 bp on the year.

Rolling forward to the current environment, we are again faced with the likelihood of another taper tantrum. And if that isn't enough, we will again see a building debate about who will replace Fed Chair Jay Powell whose term as Chair ends in February 2022 should President Biden not reappoint him. We'll also witness another fight over the debt ceiling as the U.S. fiscal year comes to a close on September 30th. Can you say déjà vu?

There are several important differences between 2013 and today. High yield credit spreads are approximately 100 bps lower than in May 2013. Leverage is one to one and a half turns higher. This combination suggests that a correction could be larger than the turbulence of the 2013 taper tantrum, especially if the market concludes that the Fed will need to aggressively combat non-transitory inflation. And yet, bond yields are not that much different. When the tantrum began in May 2013, 5-year and 10-year nominal Treasury yields were 0.75% and 1.81%, while today they are around

0.80% and 1.60%. Real yields are somewhat lower today with the 5-year and 10-year real Treasury yields of -1.82% and -0.86% vs -1.32% and -0.54% in 2013.

There are varying opinions as to when the Fed will taper. We see the beginning in December. The larger question is to what extent will rates rise in anticipation of the start of tapering. In 2013, the 10-year US Treasury yield reached a high of 3.00% on September 5th with the 5-year US Treasury yield topping out at 1.85%. In our estimation, we are unlikely to realize similar levels by year-end or even by June 2022.

While risky assets, including high yield, may post modest returns due to a future taper tantrum, empirical evidence from 2013 suggests that improving economic fundamentals, fiscal and monetary accommodation, and falling default rates should provide the necessary support for the high yield market to turn in attractive results in 2021. Like in 2013, we expect short duration high yield bonds to continue to outperform the broad high yield market.

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