November 2021 High Yield Market Insights

- Historically, interest rate and equity volatility have provided insight into the forward path of HY spreads
- The breakdown in correlation between credit spreads and interest rate volatility suggests spreads may not follow volatility higher
- Fundamentals, low defaults, and monetary policy support HY valuations, yet duration risk remains

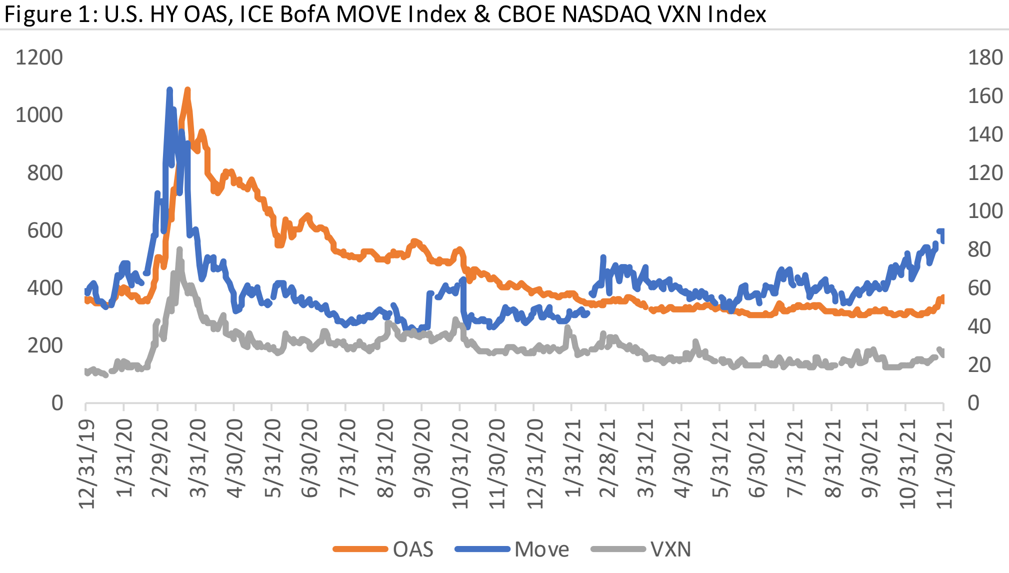
Because of its historically high correlation to equity prices and economic growth, high yield has served as a barometer of investor sentiment. Recently, the high yield market's high correlation to interest rate volatility has become more of a focus.

Since the second quarter of 2021, when the economy hit peak growth, much has been made of the threat of slowing growth and rising inflation on asset valuations. While GDP estimates have begun to increase for 4Q21 and 2022, alleviating some growth concerns, fear of an upward inflation spiral continues to build. Moreover, questions about how the Federal Reserve will combat the risk of non-transitory inflation, even as the Biden administration rolls out additional fiscal policies, remain front and center.

Concern over inflation has fueled interest rate volatility. During the first five weeks of 2021 interest rate volatility, as measured by the ICE BofA Move Index (MOVE), averaged 46.00. By the time the 10-year UST yield hit a 2021 high of 1.75% on March 31st, the MOVE index had jumped 55% to 71.27. While interest rate volatility moderated by June, the MOVE Index remains elevated and is currently sitting at a YTD high of 80.57.

The jump in volatility has caught the attention of high yield investors, given the usual positive correlation with the credit spread. Over the past 20 years the correlation (r-squared) of the U.S. high yield credit spread to the MOVE index has been 55%. Additionally, the high yield market's positive correlation to equity volatility is evident when comparing the HY credit spread to the CBOE Nasdaq Volatility Index (VXN), which has correlated at 51% over the past 20 years.

Figure 1: U.S. HY OAS, ICE BofA MOVE Index & CBOE NASDAQ VXN Index



Source: Bloomberg, Concise Capital

The positive correlations, particularly between interest rate volatility and the credit spread, suggest that high yield spreads are poised to widen materially given the current level of interest rate volatility. At the current MOVE level, HY spreads have historically traded around 600 bp, which is in stark contrast to the current risk premium of 367 bp. However, as illustrated in Figure 1, the historically positive correlation between the credit spread and interest rate volatility has broken down since February, though the emergence of Omicron in late November saw short term correlation increase. Interestingly, the correlation between spreads and equity volatility has largely remained intact.

The breakdown in correlation supports a more constructive view on credit, given a continuation of solid fundamentals and a belief that the Fed will not slam on the brakes too aggressively in the face of inflation.

After posting annualized real growth of 6.3% in Q1 and 6.7% in Q2, followed by a dramatic slowing to 2.1% in Q3, Q4 real GDP is expected to rebound strongly at a median rate of 6.5%. For 2022, the median real GDP estimate is 4.5%. The dramatic rebound in economic activity, fueled by extraordinary fiscal and monetary policy support, has been instrumental in driving an equally strong rebound in EBITDA growth. According to BofA , after a decline in the HY market's LTM EBITDA of -26.0% in March 2020, as of October, the LTM change is up +26.3%.

While the Fed may quicken asset purchase tapering or move up the timeline of rate hikes, monetary policy should remain accommodative throughout 2022. As the yield curve is unlikely to steepen significantly over the next 12 months, the primary HY market should remain open. Consequently, default rates will likely remain subdued in 2022 (~2%), well below the historic LTM rate of 4.5%, which will support historically low HY spreads.

Solid fundamentals, low default rates, and accommodative monetary policy provide the basis for our constructive view on the high yield market. Yet there remains significant duration risk with longer tenor U.S. Treasury rates expected to rise further. Because of its low exposure to rising interest rates, the short duration high yield market should be immune to this risk.

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