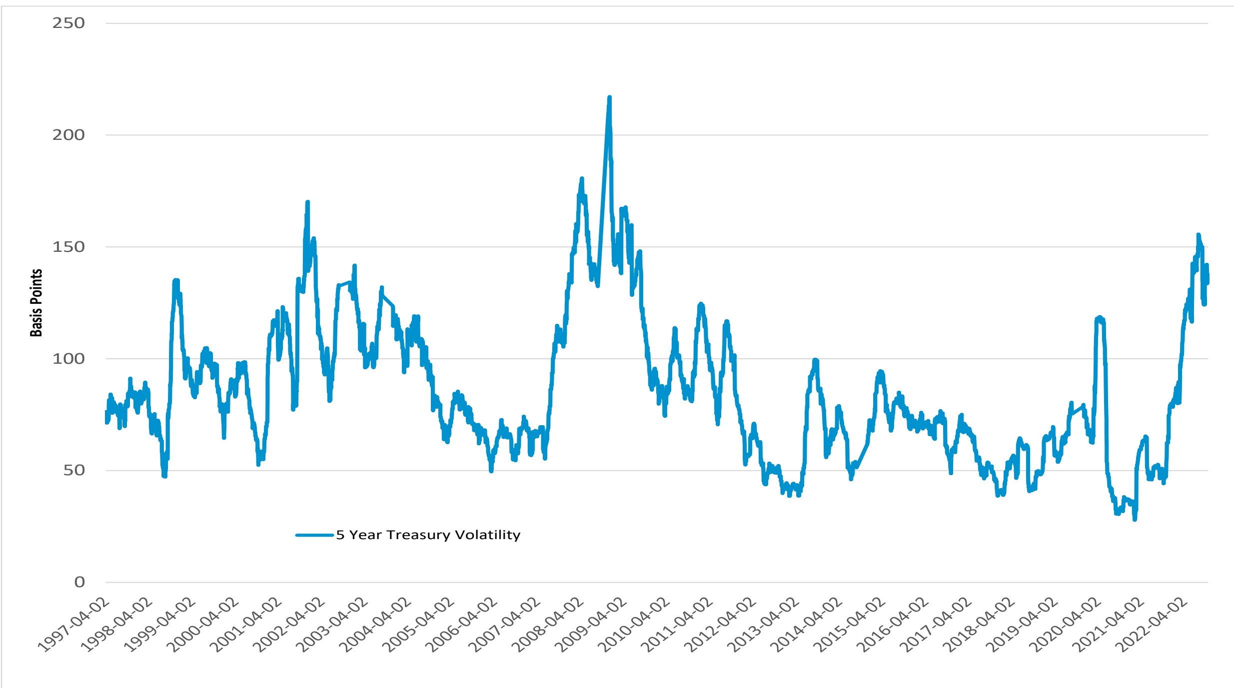
October 2022 High Yield Market Insights

- Treasury yields have been rising and volatile this year
- Interest rate rises and volatility have been reflected in high yield bonds
- Short term high yield offers a good trade-off in this environment: higher yields with lower volatility

Bonds become volatile when the Federal Reserve tightens, or some other crisis injects uncertainty into markets. This time is no exception. Judging from the five-year treasury, we are in an episode of great uncertainty and, hence, great volatility. The five-year, conveniently, is the spot on the US yield curve closest in duration, or interest rate sensitivity, to the high yield (HY) bond market.

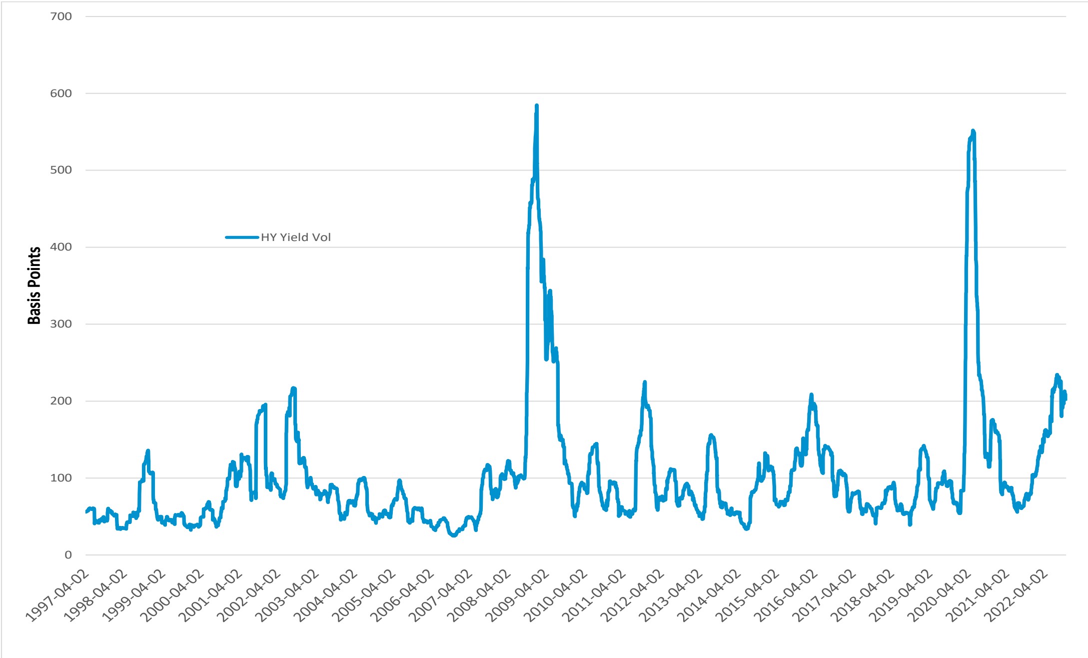
Figure 1: Annualized US 5 Year Treasury Volatility



Treasury volatility is telling us a story, if you know how to read the runes. It is a tale of uncertainty surrounding Fed policy, the great unknown overhanging the markets, but not a tale of systemic risk as we saw during the financial crisis of 2008-2009 or during the COVID crisis of 2020.

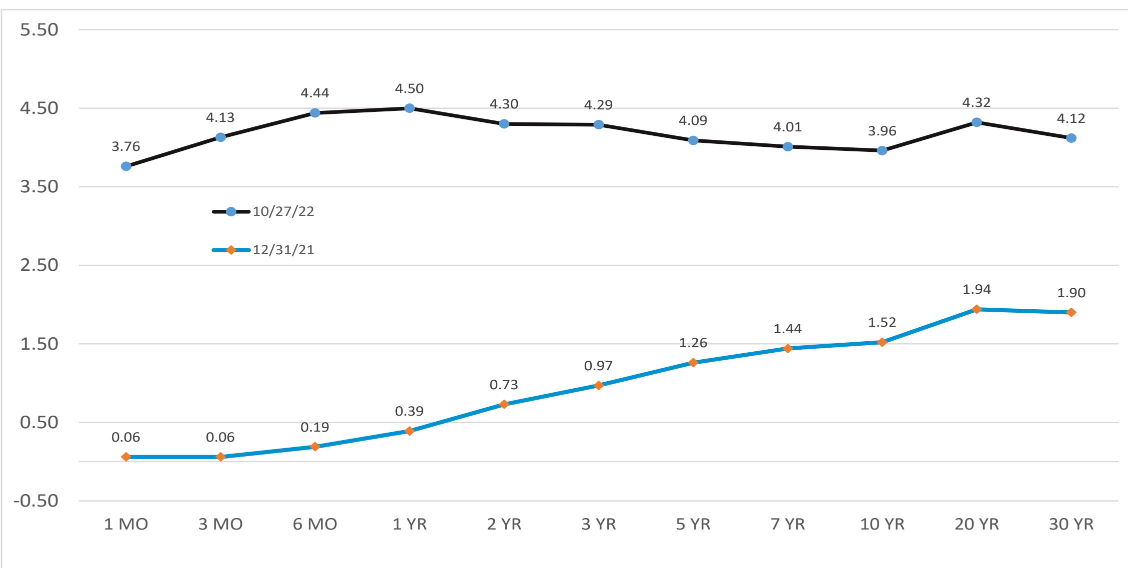
Volatility in the high yield market is elevated too. As with treasury volatility, it has not attained the levels of the global financial crisis or the inception of COVID. There is neither a systemic crisis nor a high yield centered crisis like the telecom defaults of 2003 or the shale oil defaults of 2016.

Figure 2: Annualized HY Yield Volatility



Volatility is not all that has risen in 2022. US treasury yields have risen as the Fed has tightened. The effect of tightening has been uneven across the yield curve, a measure of yields relative to time to maturity. The Fed affects short term rates directly as it changes the Fed funds rate, an overnight rate. This has a higher impact on shorter maturity instruments like three, six and twelve month T-bills. T-bill yields have risen over 4% in 2022 compared to seven to thirty year bonds, whose yields are up between 2.2% and 2.6%.

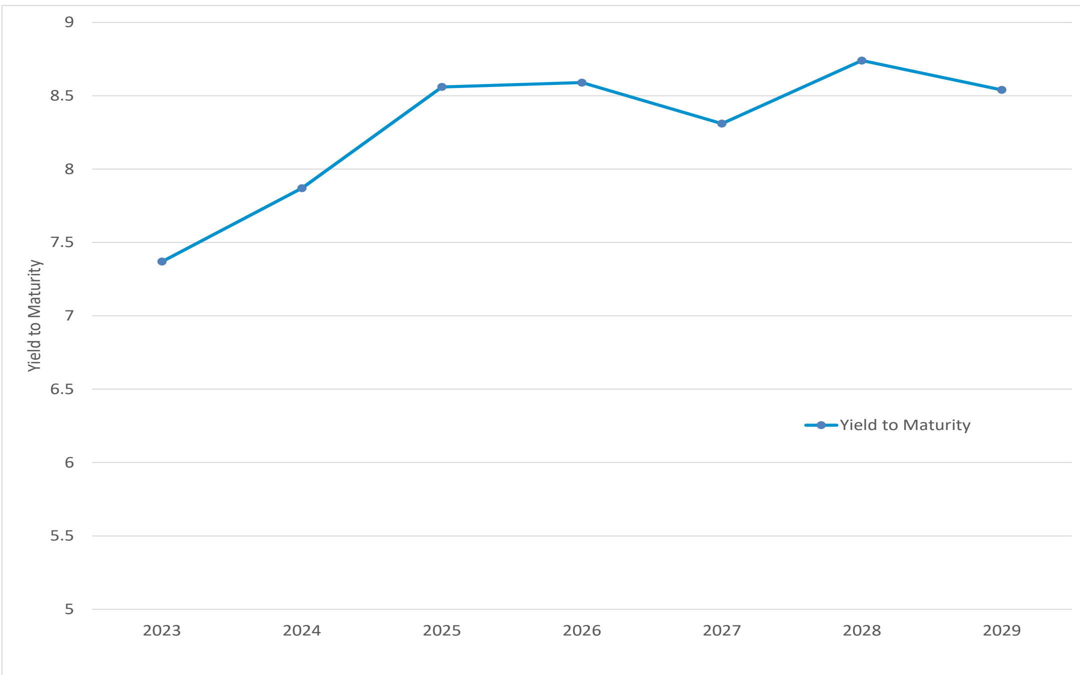
Figure 3: US Treasury Yields in 2022



Market participants expect the Fed to keep raising rates through year-end. Currently, another 0.75% of Fed funds increases are priced into futures. While inflation could suddenly turn lower, obviating the need for further rate increases, this is unlikely. Inflation tends to persist once it gets rolling. So, what sort of strategy would work best in this environment? If this isn't a systemic crisis or a credit crisis, the significant rise in HY yields might present an opportunity.

High yield has sold off with the treasury market. Its spread, or premium over treasuries, has increased, but not to levels that signal distress. That tells us that markets do not currently anticipate a credit crisis. HY yields, at over 8%, are above inflation. Shorter term HY bonds are yielding as much or more than longer term HY bonds.

Figure 4: HY Bond Yields October 31, 2022



Source: Concise, Invesco

Concentrating on short term HY bonds looks like the strategy best suited to take advantage of the surge in yields while protecting against a volatile environment. Let us count the ways:

1. Short HY bonds yield about as much as long term HY, but have far less duration risk, or sensitivity to treasury rate changes. Treasury rate changes have been the story of this cycle. If there is further upside in government yields, the short end is the place to hide.
2. HY issuers do not have much debt to refinance over the next two years. It is likely the Fed tightening cycle and its accompanying volatility will subside over a 2-3 year timeframe.
3. HY rates slope downward in the shorter part of the curve. This produces a natural rise in prices as bonds move toward maturity and their yields fall.
4. Double digit short term HY yields will blunt the impact of further rate rises. The higher and shorter term yields are, the less impact yield changes have on prices.