HIGH YIELD MARKET

INVESTMENT COMMENTARY & REVIEW

by Michael Yean

First Quarter 2020

The first quarter of 2020 endured historic and vicious market volatility. The COVID-19 pandemic coupled with the untimely dissolution of the three-year Organization of the Petroleum Exporting Countries+ (OPEC+) pact led to the onset of unimaginable human loss and economic damage, resulting in a significant drawdown in the high yield market. The Bloomberg Barclays U.S. High Yield Corporate Index (Index) generated a negative -12.68% total return during the first quarter.

Unlike 2019, the market functioned as expected in a risk-off environment with BB-rated, B-rated, and CCC-rated cohorts posting losses of -10.15%, -12.97%, and -20.55%, respectively. Additionally, issuer size and liquidity were afforded a premium – the top 50 issuers representing nearly one-third of the Index by par value declined by only -7.16%.

The Index option-adjusted spread (OAS) gapped wider by 544 bps in the quarter to +880 bps from +336 bps at the beginning of 2020, while the yield-to-worst (YTW) rose to 9.44% from 5.19%. Intra-quarter on March 23, spreads and yields peaked at +1100 bps and 11.69% respectively. By ratings, BB-rated credits ended the first quarter with an OAS of +654 bps and a YTW of 7.24%, B-rated credits at an OAS of +856 bps and 9.15% YTW, and CCC-rated credits at an OAS of +1704 bps and 17.54% YTW. The average dollar price of the Index at quarter-end was $85.70.

With the U.S. grinding to a virtual halt due to shelter-in-place and social distancing measures, we know the yet-to-be-reported first quarter U.S. economic data and corporate earnings will be unusually weak. Likewise, we anticipate a historic drop in second quarter data. We know high yield defaults will rise substantially from the low levels as of 2019 year-end, as entire swaths of industries are at risk. However, it is also clear that the federal government is willing to do "whatever it takes" to combat the imminent recession and blunt the tail with monetary and fiscal policies being deployed in unprecedented size, scope, and speed. Central bank activity has ranged from two emergency interest rate cuts to asset purchase programs such as the Primary Dealer Credit Facility and the Primary Market Corporate Credit Facility, with indications of further actions. Congress has enacted the CARES Act to support many parts of the economy ranging from individuals to large corporations. An infrastructure spending bill may possibly be next.

While the depth and duration of the economic downturn remains immeasurable at this time, historical data provides evidence that high yield investors have been well compensated at current valuations. We have written and referenced in the past about the attractiveness of the high yield market when yields are greater than 7%. To recap, throughout various conditions over the past 20-plus years, when the average starting yield is greater than 7%, the Index on a 1-year, 2-year, 3-year, and 5-year annualized basis has returned 8.82%, 7.85%, 7.49%, and 7.41%, respectively. Even more profound is historical data supporting the high yield return opportunity when market spreads are above +900 bps, the level breached intra-quarter. The median historical annualized high yield returns over the next 12-, 24-, and 36-months as spreads cross +900 bps is 36.9%, 25.5%, and 20.8%, respectively. In fact, with a time horizon of one year or more for the Index, investors have never lost money (JP Morgan). We're not attempting to call the bottom in this historically uncertain environment, but rather acknowledging that the present opportunity set in high yield is very meaningful and that the total return potential is compelling.

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Bloomberg Barclays U.S. Corporate High Yield Index covers the universe of fixed rate, non-investment grade debt. Eurobonds and debt issues from countries designated as emerging markets (e.g., Argentina, Brazil, Venezuela, etc.) are excluded, but Canadian and global bonds (SEC registered) of issuers in non-EMG countries are included. Original issue zeroes, step-up coupon structures, 144-As and pay-in-kind bonds (PIKs, as of October 1, 2009) are also included. The index includes both corporate and non-corporate sectors. The corporate sectors are Industrial, Utility, and Finance, which include both U.S. and non-U.S. corporations. The Yankee sector has been discontinued as of 7/1/00. The bonds in the former Yankee sector have not been removed from the index, but have been reclassified into other sectors. You cannot invest directly in an index.

The Barclays' Quality sectors discussed above use the following rating methodology. Securities that are rated by three rating agencies, will receive the middle of the three ratings. Securities that are rated by only two agencies will receive the lower of the two ratings. Securities rated by only one agency will receive that rating while securities not covered by any of the three agencies will receive a non-rated (NR) rating. Bond ratings start at Aaa (denoting the highest investment quality) and usually end at D (meaning payment is in default). In limited situations when the rating agency has not issued a formal rating, the rating agency will classify the security as non-rated (NR).

Option-adjusted spread (OAS) is the measurement of the spread of a fixed-income security rate and the risk-free rate of return, which is adjusted to take into account an embedded option. Typically, an analyst uses the Treasury securities yield for the risk-free rate.

Basis point (bp)- A unit that is equal to 1/100th of 1%, and is used to denote the change in a financial instrument.

Par value is the face value of a bond. Par value is important for a bond or fixed-income instrument because it determines its maturity value as well as the dollar value of coupon payments.

Yield to worst - the lowest potential yield that can be received on a bond without the issuer actually defaulting.

Fiscal Policy - The means by which a government adjusts its spending levels and tax rates to monitor and influence a nation's economy.

Monetary - consists of the actions of a central bank, currency board or other regulatory committee that determine the size and rate of growth of the money supply, which in turn affects interest rates.

Default is the failure to repay a debt including interest or principal on a loan or security.

Yield - the income return on an investment, such as the interest or dividends received from holding a particular security.

Spread - The difference in yields between two fixed-income securities with the same maturity, but originating from different investment sectors.

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