HIGH YIELD MARKET

INVESTMENT COMMENTARY & REVIEW

by Michael Yean

Second Quarter 2020

Following the dramatic first quarter drawdown that produced high yield market losses of nearly 20% by late March, the market staged a sharp recovery driven by unprecedented fiscal and monetary relief and stimulus. The Bloomberg Barclays U.S. High Yield Corporate Index (Index) rallied nearly 20% from the low reached on March 23, 2020, generating a 10.18% second quarter return, and ended the first half of 2020 at negative 3.80%.

With direct support from Federal Reserves' Secondary Market Corporate Credit Facility, BB-rated credits returned 11.54%, outpacing B-rated and CCC-rated credits that produced 8.64% and 9.10% respectively. The Index option-adjusted spread (OAS) tightened by 254 bps in the quarter to +626 bps from +880 bps, while the yield-to-worst (YTW) declined to 6.87% from 9.44%. By ratings, BB-rated credits now trade at an OAS of +456 bps and offer a YTW of 5.18%, B-rated credits at an OAS of +643 bps and 7.09% YTW, and CCC-rated credits at an OAS of +1209 bps and 12.60% YTW. The average dollar price of the Index increased to $95.89 at quarter end.

Economies across the globe experienced a severe economic downturn, leading to higher high yield default rates. As of mid-year, the last-twelve-month par-weighted U.S. high yield default rate climbed to a 10-year high of 6.19%, up from just 2.63% at the beginning of the year and 1.46% the prior June. Including distressed exchanges, the default rate was 6.61%. We expect default activity to increase throughout the year, as the ongoing recessionary environment further hinders companies' earnings, cash flows, and ability to service debt. However, with a receptive primary market, issuers that can demonstrate the likelihood of a viable business model on the "other side" of the downturn have successfully bridged liquidity gaps into 2021.

Although the specific trigger of any recession, the depth and duration of such recession, and resulting government support may be difficult to predict beforehand, the subsequent recovery of the high yield market, thus far, is ultimately not surprising. Historical precedents have provided some guideposts for the magnitude of forward returns, even the rapidity of achieving such returns when high yield valuations approach the +1,100 bps spread and 11.69% YTW peak witnessed in March. We had written about the compelling opportunity present in high yield in our first quarter commentary.

Our outlook for the second half of 2020 remains positive, albeit more cautious. The current dramatic level of government relief and stimulus should continue to provide an effective backstop for asset prices. However, current market valuations are no longer as compelling given the uncertain outlook for the COVID-19 pandemic or the pace and level of economic recovery.

Within the high yield market we believe the greatest potential for total return remains in the smaller issue, B-rated and CCC-rated cohorts. We believe our focus on these credit buckets, while navigating through unexpected defaults, will result in durable relative performance.

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