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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High Yield Portfolio Manager

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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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