HIGH YIELD MARKET

INVESTMENT COMMENTARY & REVIEW

by Michael Yean

Third Quarter 2020

The high yield market rally continued, with the Bloomberg Barclays U.S. High Yield Corporate Index (Index) gaining 4.60% during the third quarter, and bringing year-to-date total return into positive territory at 0.62%.

In traditional risk-on fashion, lower rated credits outperformed during the quarter, with the CCC-rated cohort returning 7.35% compared to 4.53% and 4.02% for the B-rated and BB-rated cohorts, respectively. The Index option-adjusted spread (OAS) tightened by 109 bps during the quarter to +517 bps from +626 bps, while the yield-to-worst (YTW) declined to 5.77% from 6.87%. By ratings, BB-rated credits now trade at an OAS of +382 bps and offer a YTW of 4.39%, B-rated credits at an OAS of +540 bps and 6.05% YTW, and CCC-rated credits at an OAS of +951 bps and 10.10% YTW. The average dollar price of the Index increased to $99.58 by quarter end.

High yield default rates steadied as various degrees of recovery took hold across global economies. At quarter-end, the last-twelve-month par-weighted U.S. high yield default rate was 5.80%, compared to 6.19% at the end of June, 2.63% at the beginning of the 2020, and 2.54% during the prior year period. Including distressed exchanges, the default rate was 6.36% compared to 6.61% at the end of June. With a record-breaking primary market allowing high yield issuers to refinance and extend maturities, we do not expect a further spike in the default rate. We do, however, expect defaults to remain elevated as economic activity remains well below prior year levels and continues to hinder companies' earnings, cash flows, and ability to service debt.

The near-term outlook for the final quarter of 2020 warrants caution given the lack of agreement on further fiscal stimulus in U.S., the upcoming U.S. election, and concerns regarding the prospects of an uptick in coronavirus infections coinciding with the traditional flu season in the Northern Hemisphere, amongst other headline risks. However, despite the potential for transitory volatility, we have a favorable outlook for the high yield market entering 2021.

Reviewing past election cycles since 1984, which includes all political party combinations of the Presidency and Congressional chambers, in every instance the high yield market has posted positive total returns for the 6-month period following the election with median and average returns of 5.3% and 6.3%, respectively. Over the 12-month period following elections, high yield has generated median and average returns of 8.9% and 13.6%, respectively (source: Wells Fargo Securities).

Beyond the election, the ongoing zero interest rate policy, the likelihood of at least one safe and effective vaccine in 2021 along with more effective treatments for COVID-19, and the prospects of continued fundamental recovery should result in a constructive environment for credit. Combined with current spreads above the historical median for the overall HY Index as well as within each ratings cohort, we are confident in our longer-term positive outlook.

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