# 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 basis points (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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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.

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

Cash flow is the net amount of cash and cash-equivalents being transferred into and out of a business.

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

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