



HIGH YIELD MARKET

INVESTMENT COMMENTARY & REVIEW

by Michael Yean

Fourth Quarter 2020

The high yield market closed out 2020 on a strong note, with the Bloomberg Barclays U.S. High Yield Corporate Index (Index) gaining 6.45% during the fourth quarter, resulting in a 7.11% total return for the year. Lower rated credits led the fourth quarter rally, with the CCC-rated debt returning 9.91%, while B-rated and BB-rated debt returned 5.83% and 5.69% respectively. The Index option-adjusted spread (OAS) tightened by 157 basis points (bps) to +360 bps, while the yield-to-worst (YTW) declined to 4.18% from 5.77%. By ratings, BB-rated credits now trade at an OAS of +265 bps and offer a YTW of 3.21%, B-rated credits at an OAS of +379 bps and 4.43% YTW, and CCC-rated credits at an OAS of +658 bps and 7.12% YTW. The average bond dollar price of the Index increased to \$104.96 by year-end. By 2020 year-end, the high yield market had added another notch in its belt, reinforcing its historically-proven tendency to rapidly recover from significant market drawdowns.

Accelerating post-holiday rates of COVID-19 cases coupled with the discovery of additional coronavirus variant(s) elevated the ongoing risks of a global pandemic. Meanwhile, prior to year-end the Congress passed a second relief package in an effort to combat the growing economic fallout. On balance, our outlook remains optimistic for the high yield market in 2021. The primary pillars of our outlook, as detailed in previous quarterly commentaries, continue to be highly accommodative monetary policy, ample fiscal policy, and effective delivery of COVID-19 vaccines. All of which combined should set the stage for a durable economic recovery and a constructive environment

for credit. However, the high yield market is not without headwinds; which include tight valuations, low absolute yields and below historical average spreads. Nonetheless, while absolute market yields are at historic lows, the U.S. high yield market offers the greatest yields globally outside of Emerging Market High Yield. In regards to credit spreads, research has shown there is no discernable historical pattern to one year holding period returns when starting spreads range between 300 bps to 700 bps. With 396 monthly spread observations over the past 34 years, the high yield market offered a spread between 300 bps to 700 bps greater than 76% of occasions. When spreads begin a period between 300-399 bps, one year annualized returns averaged 6.7%. Starting spreads from 400-499 bps result in average returns of 6.9%, 500-599 bps return 5.4%, and 600-699 bps return 6.4% (Bloomberg L.P., Credit Suisse). In short, while an OAS of +360 bps is below historical averages, there is no pre-determination of poor returns when investing in the high yield at current "tight" levels.

All told, while low yields and tight spread combined with a market trading above par may serve to limit potential total returns for 2021, we believe the progression of the simultaneous global economic recovery from the pandemic-induced recession will result in a positive year for high yield.

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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 Policy - 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.

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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