HIGH YIELD MARKET

INVESTMENT COMMENTARY & REVIEW

by Michael Yean

Second Quarter 2021

The rally in the high yield bond market continued through the second quarter of 2021, with the Bloomberg Barclays U.S. High Yield Corporate Index (Index) gaining 2.74% during the quarter and bringing total returns for the first half of the year to 3.62%. The CCC-rated cohort outperformed once again, returning 3.49% compared to 2.16% and 2.86% for the B-rated and BB-rated cohorts, respectively.

With the grind higher, the Index option-adjusted spread (OAS) ended the quarter at +268 bps, the tightest level since the 2007-08 global financial crisis, while the yield-to-worst (YTW) reached a record low of 3.75%. By rating category, BB-rated credits now trade at an OAS of +200 bps and offer a YTW of 3.04%, B-rated credits at an OAS of +294 bps and 4.06% YTW, and CCC-rated credits at an OAS of +462 bps and 5.65% YTW. The average dollar price of the Index rose to $105.35 at quarter end.

With elevated bond prices, call constraints, and local and record tights for spreads and yield, total returns will be limited. Based on historical data (source: Jefferies), twelve-month forward returns for the high yield market are only modestly positive when beginning spreads are less than +350 bps or YTW is below 4.5%.

However, in a market environment where we envision rate risk to be greater than credit risk, we believe investment in the high yield market is still warranted, particularly when alternative asset classes are nearly all at similarly tight/high valuations and more exposed to rising interest rates. The high yield market is well-supported by current macro-economic and credit fundamentals, most notably very low default rates and estimated losses. Asset prices and bond valuations are theoretically anchored by estimates of default losses and expected default-adjusted returns, and with default rates trending to less than 1% for 2021 and expectations of similar levels for 2022, the high yield market is appropriately pricing in minimal credit risk.

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