HIGH YIELD MARKET

INVESTMENT COMMENTARY & REVIEW

by Michael Yean

Third Quarter 2021

The High Yield market generated modest incremental gains in the third quarter of 2021, with the Bloomberg U.S. High Yield Corporate Index (Index) returning 0.89% during the quarter, increasing year-to-date total returns to 4.53%. The CCC-rated cohort reversed its recent outperformance trend by gaining 0.75% compared to 1.09% and 0.61% for the BB-rated and B-rated cohorts, respectively.

High Yield market spreads drifted higher from their second quarter lows, with option-adjusted spreads (OAS) widening 21 bps in the third quarter to +289 bps, while the yield-to-worst (YTW) rose to 4.04% from 3.75%. By ratings, BB-rated credits now trade at an OAS of +203 bps and offer a YTW of 3.18%, B-rated credits at an OAS of +327 bps and 4.47% YTW, and CCC-rated credits at an OAS of +524 bps and 6.26% YTW. The average dollar price of the Index declined to $104.64 at quarter end.

Investors climbed a wall of worry during the third quarter, with no shortage of wide-ranging economic, corporate, political, and geopolitical concerns. Drama in Washington, missed interest payments by China's Evergrande Group, global supply chain constraints, soaring natural gas prices in Europe, looming Fed taper, ongoing tension between inflation and rates, etc., all contributed to the modest sell-off in risk assets. Of course, the COVID-19 pandemic also continues to rage on.

However, as noted in previous commentary, the high yield market is supported by sound credit fundamentals and anchored by a very low default rate. Aggregate high yield market gross leverage has now declined below pre-pandemic levels and interest coverage has risen above prior levels, with further improvement expected as economic activity continues to recover. The high yield default rate, including distressed exchanges, has declined to below 1%. Distressed bonds at a mere 0.8% of the high yield universe, indicate that the default rate should be expected to remain muted. With these broad pillars in place, we expect a solid positive final quarter to 2021.

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