HIGH YIELD MARKET

INVESTMENT COMMENTARY & REVIEW

by Michael Yean

Fourth Quarter 2021

The Bloomberg U.S. High Yield Corporate Index (HY Index) gained 0.71% during the fourth quarter, resulting in a full year 2021total return of 5.28%. Amongst credit-rating cohorts, B-rated credits led with gains of 0.84%, followed by BB-rated and CCC-rated credits returning 0.75% and 0.54%, respectively.

The HY Index option-adjusted spread (OAS) tightened 6 basis points (bps) in the third quarter to +283 bps, while the yield-to-worst (YTW) rose to 4.21% from 4.04%. By ratings, BB-rated credits now trade at an OAS of +195 bps and offer a YTW of 3.30%, B-rated credits at an OAS of +313 bps and 4.57% YTW, and CCC-rated credits at an OAS of +550 bps and 6.82% YTW. The average dollar price of the Index declined to $103.56 at quarter end.

The ongoing and wide-ranging host of economic, corporate, political, geopolitical, and health concerns continued to weigh on the high yield market in the fourth quarter, resulting in two consecutive months of negative returns before rebounding sharply in December.

Looking forward into 2022, our outlook for the high yield market is constructive. Despite a litany of concerns and potentially negative catalysts, only a few prominent factors ultimately matter and drive credit markets. In 2021, the strong U.S. economy and a record-low 0.29% high yield default rate (including distressed exchanges) supported the high yield market and produced coupon-like returns. For 2022, we believe that an improving economy and a very low default rate will once again be positive catalysts for high yield returns.

We should also point out to fixed income investors fearing a rising rate environment that our 2022 interest rate outlook does not portend a meaningful increase in interest rates. Additionally, over the past 25 years, there have been 11 periods where the 10-year Treasury yield rose 100 bps or more (trough to peak). In 10 of those 11 periods, the investment-grade Bloomberg Barclays U.S. Aggregate Index did indeed produce negative returns. However, the HY Index actually generated positive returns during each and every one of those 11 periods of rising interest rates (source: US Department of the Treasury, Bloomberg, Barclays). This dispersion of returns during the aforementioned periods of rising interest rates is largely driven by the high yield asset class' greater correlation to economic activity and growth, than by the movement of interest rates. Strong or improving economic activity typically results in low or declining default rates and anticipated default losses, increasing expected high yield bond cash flows and, thereby, increasing bond valuations. Thus, as economies are typically strong or improving during rising rate environments, this price improvement from appropriately incorporating a low default rate offsets the bond price degradation from rising interest rates. This positive effect on bond prices is particularly impactful in the lower-rated cohorts of the high yield market, which is an area of focus for our high yield strategy.

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