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 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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Bloomberg 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.

Bond ratings provide the probability of an issuer defaulting based on the analysis of the issuer's financial condition and profit potential. Bond rating services are provided by credit rating agencies currently registered as Nationally Recognized Statistical Rating Organizations ("NRSROs"). Bond ratings start at AAA (denoting the highest investment quality) and usually end at D (meaning payment is in default). Securities not covered by any agency will receive a non-rated (NR) rating.

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.

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

Yield to worst - the lowest potential yield that can be received on a bond without the issuer actually defaulting.

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

Distressed debt exchange - a company that is unable to pay its financial obligations can renegotiate the terms of its debt obligations with its creditors.

The Bloomberg U.S. Aggregate Bond Index represents securities that are SEC-registered, taxable and dollar denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities and asset-backed securities. These major sectors are subdivided into more specific indices that are calculated and reported on a regular basis. You cannot invest directly in an index.

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