Insights
Fixed Income

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Economic Rebound Powers US High Yield

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High yield performance will depend on the economy and the wider market's risk appetite. The resurgence of COVID-19 warrants some caution but, for those looking towards the longer-term resumption of growth, high yield offers the potential for strong returns in a broader environment of low yields.

Despite some wobbles, markets have been comfortable with their risk-on stance since the start of April, supported by substantial fiscal and monetary stimulus, much of which was aimed at protecting the corporate sector. To a large degree, this support has been validated by the rapid rebound in economic activity data, with the Bloomberg US economic surprise index touching its highest level since February 2018 in early October.

While Q2 GDP numbers were understandably dismal, global growth looks like it reverted to a more normal regime during Q3. There are concerns that the re-surgence in COVID-19 will once again hit growth but risk assets have been buoyed by a distinct political will to avoid another economy-wide lockdown.

This environment has resulted in a substantial move in some of the most risky assets, with option-adjusted spreads (OAS) on the US high yield index moving from over 1300bp, at their most distressed levels, to just under 500bp by mid September. Those riding that wave would have made a return of close to 23%.

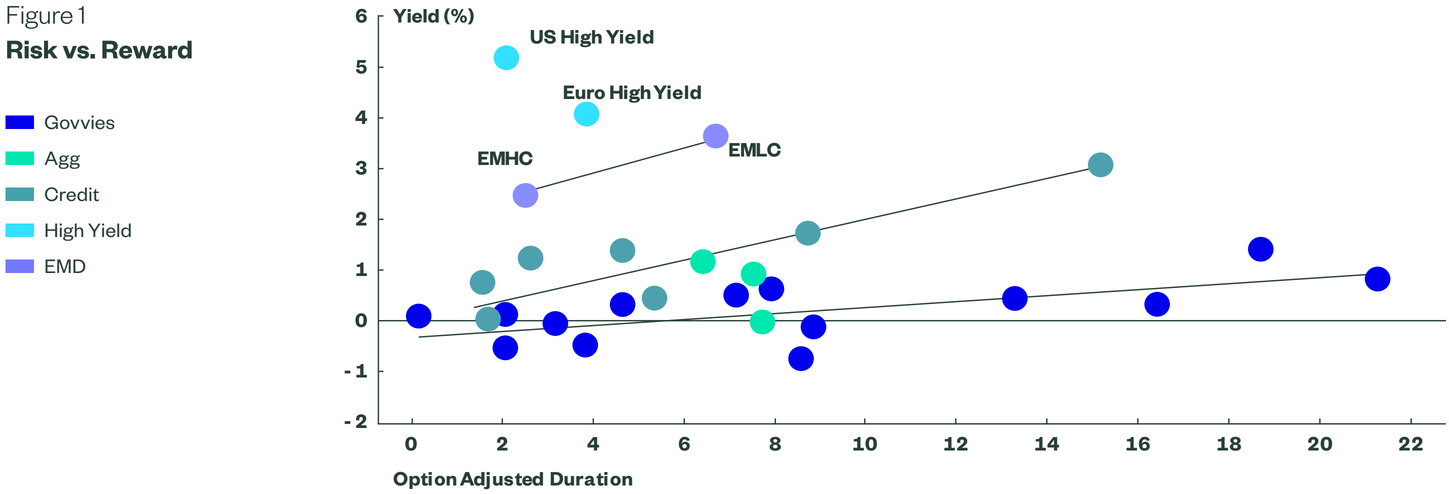
The late summer saw spreads re-widening as a second wave of COVID-19 infections swept Europe and given risk events in Q4 2020 — most notably the US election — there will be questions over the degree to which spreads can continue to narrow. While acknowledging the potential for some volatility into the end of 2020, we see several reasons why high yield investments remain compelling.

Risk vs. Reward Trade-Off Still Favourable

When looked at through the prism of duration risk, returns from US high yield, in particular, remain head and shoulders above the rest. Figure 1 illustrates this clearly, with the yield of close to 5.5% the highest among its peers spite of its relatively short duration.

Low government yields and some fairly relentless spread compression in investment grade credit mean that there are few areas of the fixed income market that yield above 2%. Those areas that do require investors to take on substantial amounts of duration risk. With central bank policy rates likely to remain low for a long time to come, investors will need to increase exposure to higher risk areas, such as emerging market debt and high yield, in order to achieve meaningful returns. This suggests that, as long as risk appetite remains stable, gradual spread compression is likely to continue as investors reach for yield.

Figure 1
Risk vs. Reward



Source: State Street Global Advisors; Bloomberg Finance L.P., as of of 30 September 2020.[1]

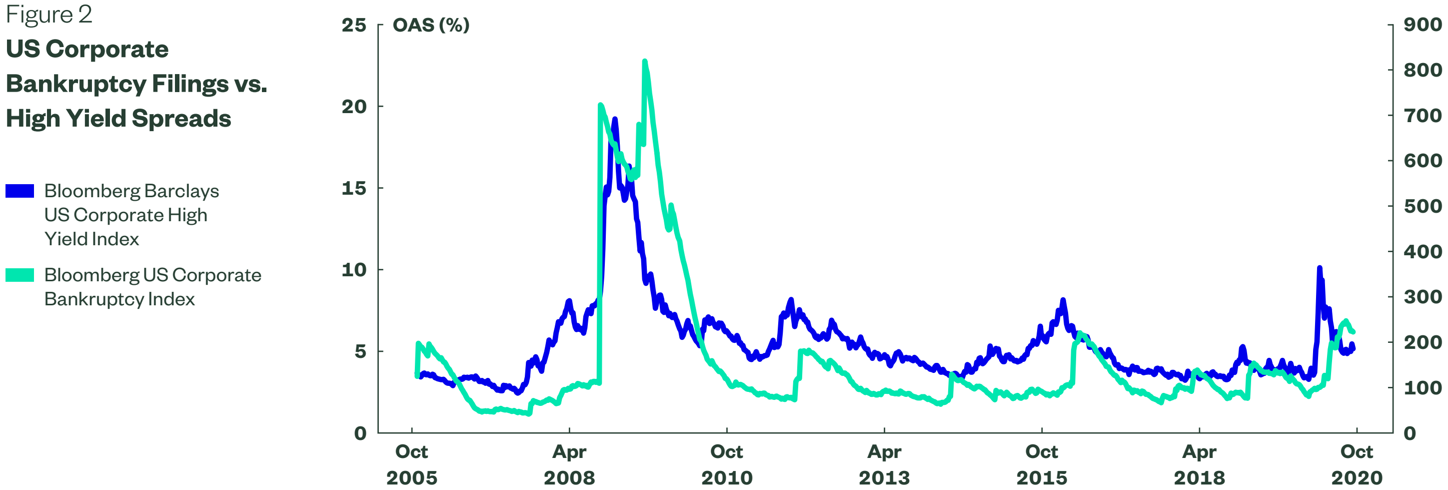
A Forward-Looking Market

Duration risk is just one consideration; credit risks represents the larger concern for market participants. The sudden shutdown of economies globally has hit companies and, despite the measures extended by the government, default rates have been rising. While the economy has put in a meaningful bounce, there remain questions over the degree to which the recovery can continue.

COVID-19 infection rates have started to rise once again, with many countries seeing a resurgence in cases. There are questions over how large the next US stimulus package could be, with the Republicans and Democrats still unable to agree. Lastly, easy financing conditions and government support schemes may merely act to delay the demise of some businesses.

Figure 2 shows that the current level of bankruptcies remains relatively contained compared to what we witnessed in 2009 but, as already mentioned, central bank and government policies may be insufficient to avoid a rise in bankruptcies. However, as can also be seen from Figure 2, it is not unusual for high yield spreads to be on a sustained downtrend well before the peak in bankruptcies. During the 15 years shown, the high yield spread was typically widest 15 weeks before the peak in bankruptcies.

Figure 2
US Corporate Bankruptcy Filings vs. High Yield Spreads



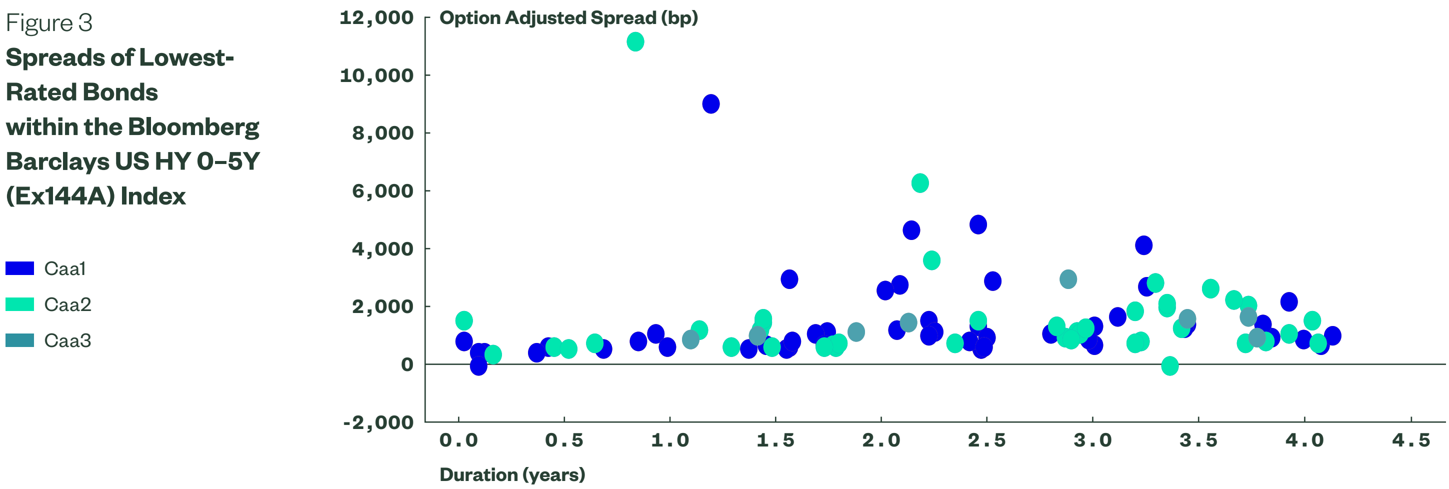
Source: State Street Global Advisors; Bloomberg Finance L.P., as of 2 October 2020.

Things may be a little different this time, and it may take longer for this process to play out, but a second spike in spreads is unusual. Even in 2009, when there was a second wave of bankruptcies, spreads did not widen beyond the initial spike and, in fact, were on a steady decline when the absolute peak in bankruptcies was reached. Spreads are at far tighter levels this time around, possibly reflecting support from the US Federal Reserve, but investors can take some comfort from the fact that the market has, in the past, proved fairly adept at pricing insolvency risk.

Despite the overall compression in spreads, there is still a high degree of price differentiation within the index. Figure 3 shows the option-adjusted spreads (OAS) plotted against duration of the bonds within the index that are rated Caa1 to Caa3. These account for just over 14% of the bonds in the Bloomberg Barclays U.S. High Yield 0–5 Year (Ex 144A) Index (but below 10% of the SPDR ETF tracking that index) and there is already quite a high degree of price differentiation.

The Caa1 bonds are technically the highest rated but it is not unusual that many of them trade at wider OAS than lower-rated bonds. This suggests that the market remains ahead of the rating agencies in downgrading companies associated with specific sectors. For instance, the travel sector has been badly affected by the pandemic so it is no surprise that the market has not waited for formal downgrades but has instead pushed OAS wider to compensate for perceived risks.

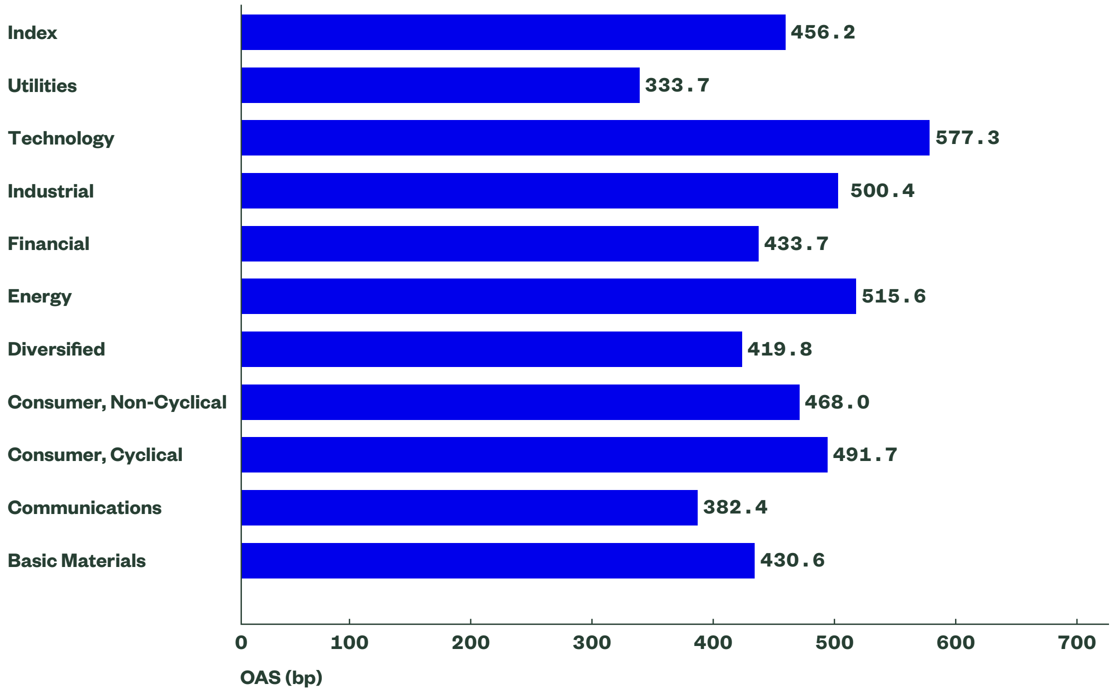
Figure 3
Spreads of Lowest-Rated Bonds within the Bloomberg Barclays US HY 0–5Y (Ex144A) Index



Source: State Street Global Advisors; Bloomberg Finance L.P., as of 30 September 2020.

Energy is one such sector where falling oil prices initially put a large strain on producers. Energy accounts for 12.2% of the Bloomberg Barclays U.S. High Yield 0–5 Year (Ex 144A) Index and was a key reason for our focus on the Euro high yield sector, which is far less exposed (just 1.2% for the Bloomberg Barclays Euro High Yield Bond Index). However, with energy prices having settled well above the April lows, this sector is of less of a concern. In addition, spread pricing remains quite generous with spreads far wider than the index average and second only to the Technology sector (Figure 4).

Figure 4
Option-Adjusted Spreads by Sector for the Bloomberg Barclays US HY 0–5Y (Ex144A) Index



Source: State Street Global Advisors, Bloomberg Finance L.P., as of 30 September 2020.

A Flood of Fallen Angels — a Risk or a Blessing?

The other potential issue for high yield funds has been the prospect of being flooded by Fallen Angels as issuers get downgraded below investment grade (IG). The smaller size of the high yield market means it would struggle to absorb all of the paper. To put this in context, around 2.4% of the $6.75 trillion corporate market[2] rests on the lowest rating rung of the IG ladder, Baa3, and is on negative watch. Adjusting the maturity profile of this group so that it is consistent with the Bloomberg Barclays U.S. High Yield 0–5 Year Index equates to close to $125 billion of paper. This is the equivalent of around 22% of the value of the high yield index, so concerns are reasonable.

Additional pressure comes from the increased issuance seen since May, with June clocking up the highest monthly amount issued ($58 billion, according to Bloomberg). Spread widening in June does hint that the market may have been nearing the limit on what it could absorb but there are two factors that suggest pressure may ease:

- Issuance has been aggressively front-loaded to make the most of buoyant market demand. It has remained heavier than usual over the summer but could diminish substantially by end-October as financing needs are met and as end user demand fades ahead of the US election.

- There was an initial surge of downgrades as ratings agencies re-appraised the fortunes of companies in sectors that were obviously affected by the pandemic. S&P downgraded 1117 companies in Q2 2020 for North America, of which 8 were classified as Fallen Angels. Evidence suggests that the spike in ratings actions may be over for now, with Q3 2020 seeing a more modest 365 downgrades, of which 4 are Fallen Angels.[3]

In short, the pressure from issuance and downgrades looks likely to diminish as a negative factor for the market during the remainder of H2 2020 unless there are a meaningful set of lockdowns and/or a renewed recession.

The Silver Lining

While the spectre of a flood of new paper into the high yield market may be unnerving, there are some upsides to Fallen Angels.

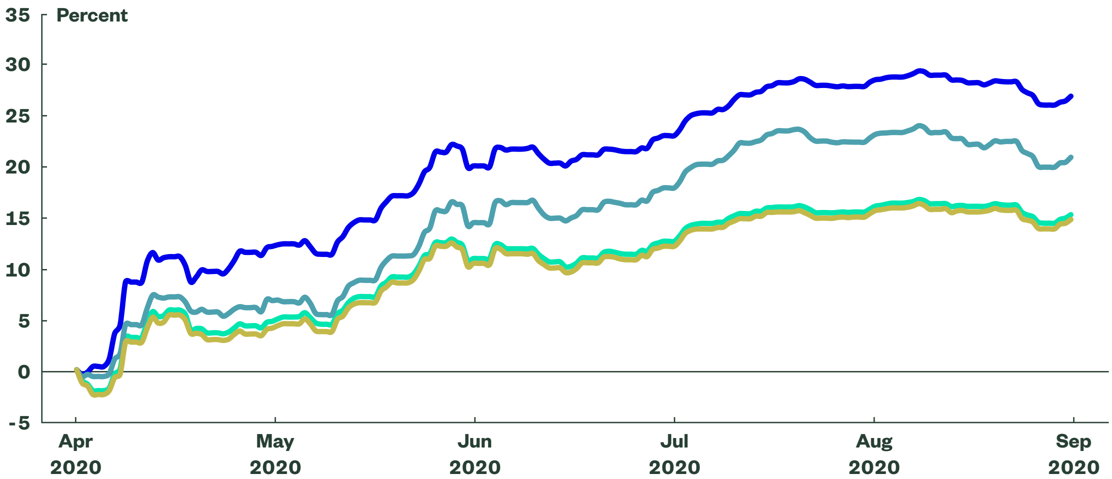
- They provide an opportunity to enhance the credit quality of a portfolio. Having only recently been ejected from the world of investment grade, by their nature they reside at the higher-rated end of the high yield spectrum. While index followers are constrained in the degree to which they can improve an index's rating, they can potentially improve the liquidity of the portfolio by switching out older, less-traded paper for these new entrants.

- A potential second benefit is that returns from Fallen Angels can be above the index average. There is a tendency for bond prices to be depressed when they exit the investment grade space as indices and portfolio managers that are tied into investing only in higher-rated securities are forced sellers. However, once the flush of sellers is past, there is scope for a rebound as High Yield managers start to buy them. There is an element of skill involved in managing this process as not all Fallen Angels will enjoy a bounce, but there is evidence that the group as a whole can enhance performance.

- Figure 5 shows total returns for the Bloomberg Barclays Fallen Angles Index and the ICE Fallen Angels index against their respective standard US high yields indices[4] since the start of April 2020 when the market stabilised. There is a clear outperformance by the Fallen Angels. In this respect, index construction is important as some indices do not allow the immediate inclusion of downgraded bonds, preferring a period of stabilisation.[5]

Figure 5
Fallen Angels Have Posted Strong Returns vs. Wider High Yield Indices

- Bloomberg Barclays US HY Fallen Angels 3% Cap Total Return Index
- Bloomberg Barclays US Corporate High Yield Bond Index
- ICE BofA US Fallen Angel High Yield Index
- ICE BofA US High Yield Index



Source: State Street Global Advisors, Bloomberg Finance L.P., as of 30 September 2020. Past performance is not a guarantee of future returns.

Conclusion

The performance of high yield will be dependent on the economy and the wider market's appetite for risk. It will not be the investment of choice for those expecting a second round of significant lockdowns unless the switch is being made out of small cap equities. However, history suggests that the market has been fairly adept at its initial pricing of default risk and there has been little inclination for dramatic spread widening, even when default rates continue to rise.

The market seems to have coped with other risks, such as the surge in Fallen Angels seen in Q2. This story may have further to play out, but as long as the floodgates do not open, Fallen Angels can actually add to portfolio returns. The low duration of the Bloomberg Barclays 0–5 Year U.S. High Yield Bond Index, coupled with its high yield, does offer some protection to investors against a general rise in yield levels.

Endnotes

1 The chart includes the following indices: Bloomberg Barclays Euro Aggregate Bond Index, Bloomberg Barclays Euro Government Bond Index, Bloomberg Barclays Euro Corporate Bond Index, Bloomberg Barclays UK Gilt Index, Bloomberg Barclays Sterling Corporate Bond Index, Bloomberg Barclays U.S. Aggregate Bond Index, Bloomberg Barclays U.S. Treasury Bond Index, Bloomberg Barclays Emerging Markets Local Bond Index, Bloomberg Barclays 1-3 Year U.S. Treasury Bond Index, Bloomberg Barclays 0-5 Year U.S. High Yield Bond Index, Bloomberg Barclays 0-5 Year Sterling Corporate Bond Index, Bloomberg Barclays 0-3 Year Euro Corporate Bond Index, Bloomberg Barclays 0-3 Year U.S. Corporate Bond Index, Bloomberg Barclays 1-5 Year Gilt Index, Bloomberg Barclays 1-3 Year Euro Government Bond Index, Bloomberg Barclays 15+ Year Gilt Index, Bloomberg Barclays 3-5 Year Euro Government Bond Index, Bloomberg Barclays Euro High Yield Bond Index, ICE BofAML 0-5 Year EM USD Government Bond Index, Bloomberg Barclays U.S. TIPS Index, Bloomberg Barclays 10+ Year U.S. Corporate Bond Index, Bloomberg Barclays 7-10 Year Euro Government Bond Index, Bloomberg Barclays 10+ Year Euro Government Bond Index, Bloomberg Barclays 3-7 Year U.S. Treasury Bond Index, Bloomberg Barclays 7-10 Year U.S. Treasury Bond Index, Bloomberg Barclays 10+ Year U.S. Treasury Bond Index, Bloomberg Barclays U.S. Corporate Bond Index, Bloomberg Barclays 1-10 Year U.S. Corporate Bond Index, Bloomberg Barclays Global Aggregate Bond Index, Bloomberg Barclays 1-3 Month T-Bill Index.

2 Based on the market value of the bonds outstanding in the Bloomberg Barclays U.S. Corporate Index as of 18 August 2020.

3 For Moody's the equivalent numbers were 915 downgrades during Q2 of which 12 were Fallen Angels. For Q3 to date (11 September 2020) the total number of downgrades is 203 of which 5 are Fallen Angels.

4 Bloomberg Barclays U.S. Corporate High Yield Bond index and the ICE BofA US High Yield Index.

5 For instance the iBoxx Liquid High Yield indices enforce a 3-month stabilisation period.

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