Spreads Have Rallied, But Be Careful Fading High Yield Bonds

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Since our last comment on high yield spreads the market recovered, closing 2020 at a record low yield to worst ("YTW") of 4.25%. Despite low yields, high yield spreads finished the year at +392 bps versus treasuries, below their long-term average but still well above their historic low of +251 bps witnessed in May 2007.

While there is not a large sample set of instances in history we can examine when high yield spreads broke through the +400 bp level, today's setup is reminiscent of the recovery following the 2015 oil price crash. Spreads later broke through +400 in February 2017 and from that point the high yield market went on to produce an extended period of coupon clipping returns.

Forward High Yield Returns When Spreads Last Crossed +400 bps

ICE BofA High Yield Master Constrained Index

Entry Point: 2/28/2017	2/28/2018 (1 Year Fwd)	2/28/2019 (2 Years Fwd)	2/28/2020 (3 Years Fwd)
Total Return (%)	4.12	8.56	14.93
Annualized Total Return (%)	**4.12**	**4.19**	**4.75**

Source: Bloomberg.

Exhibit 1

In addition to support from recent history, high yield bonds currently benefit from an improving economy, demand from crossover buyers, and Fed support. We offer perspective on each below. Investors holding the preconception that high yield is fully valued after the recent run-up should take note.

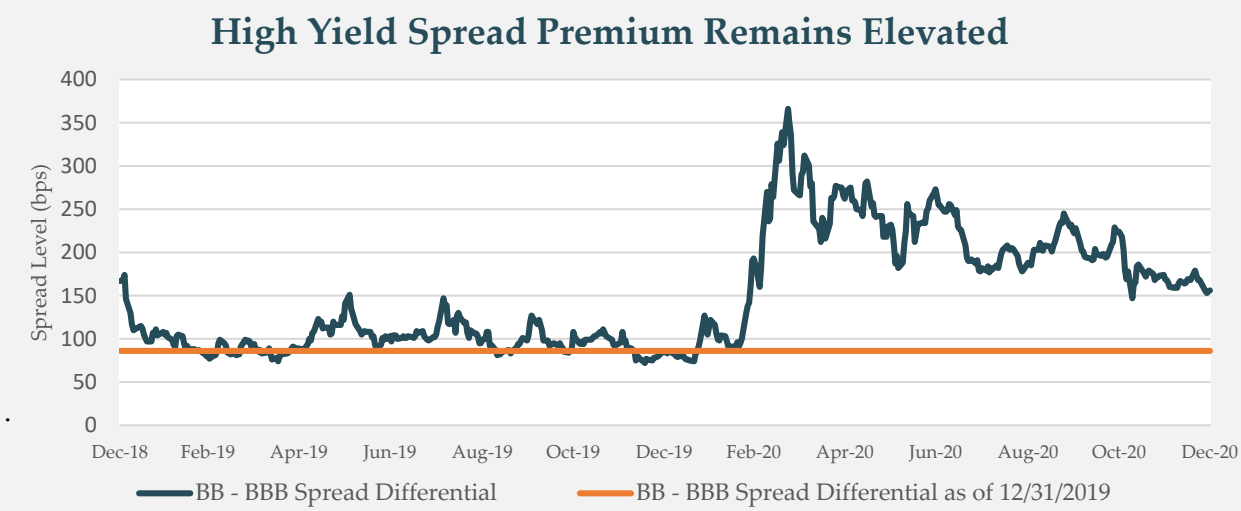
Bouncing Back

The COVID-19 vaccine is a game changer. As the public gains access to this life-saving medicine the global population will soon reach herd immunity, enabling economies to reopen and return to normal function. The US consumer emerges from the last year on lock down with record high net worth and additional fiscal stimulus on the way. This will unleash pent up demand for goods and services.

Meanwhile robust capital market conditions have provided for a record wave of high yield refinancing. Terming out debt and lowering interest expense will remain a prevalent new year theme. We believe this combination of a reopening economy, rebounding consumer spending, and balance sheet repair point to a material decline in credit defaults going forward.

Value is Relative

High yield bonds are an attractive complement to investment grade fixed income portfolios, as evidenced by the elevated spread premium between BB and BBB rated bonds compared with pre-crisis levels. On December 31, 2019 before the market collapse, BB bond spreads traded +86 bps wide of BBB spreads. As of January 11th, the discount is nearly double, standing at +156 bps, or +70 bps greater than it was pre-COVID (Exhibit 2). Furthermore, the effective duration of double B bonds (4.3 years) is roughly half that of triple B's (8.1 years).



Source: Bloomberg – ICE BAML HY Master Constrained Index

Exhibit 2

With triple B bond yields at a meager 2% and treasury rates breaking out post news of a Democratic sweep, this creates strong incentive for investment grade buyers in search of yield and concerned about duration to reach for BBs. This setup also creates a strong catalyst for compression between BB and investment grade spreads.

Whatever It Takes

As Penn previously discussed the Fed's extraordinary measures taken last year proved they would do whatever it takes to prevent a financial system crash. High yield bonds continue to benefit from direct Fed support. As of its most recent disclosure the Fed owns $5.0b in face value of individual corporate bonds, with BBB and BB rated bonds making up 56% and 3% of those holdings, respectively. While the dollar value of bonds purchased is small in the context of the overall corporate bond market, the significance of the central bank's direct support cannot be overstated.

Together with the Fed's more accommodative mandate "to achieve inflation moderately above 2% for some time", the central bank maintains cover to aggressively intervene if the recovery falls off course. As always, we would caution investors *fight the Fed at your own peril*.

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