U.S. High Yield: What Does History Tell Us about Elevated Spreads?

During the past few decades, U.S. high yield spreads have rarely stayed above 800 basis points for very long. What are the implications for investors?

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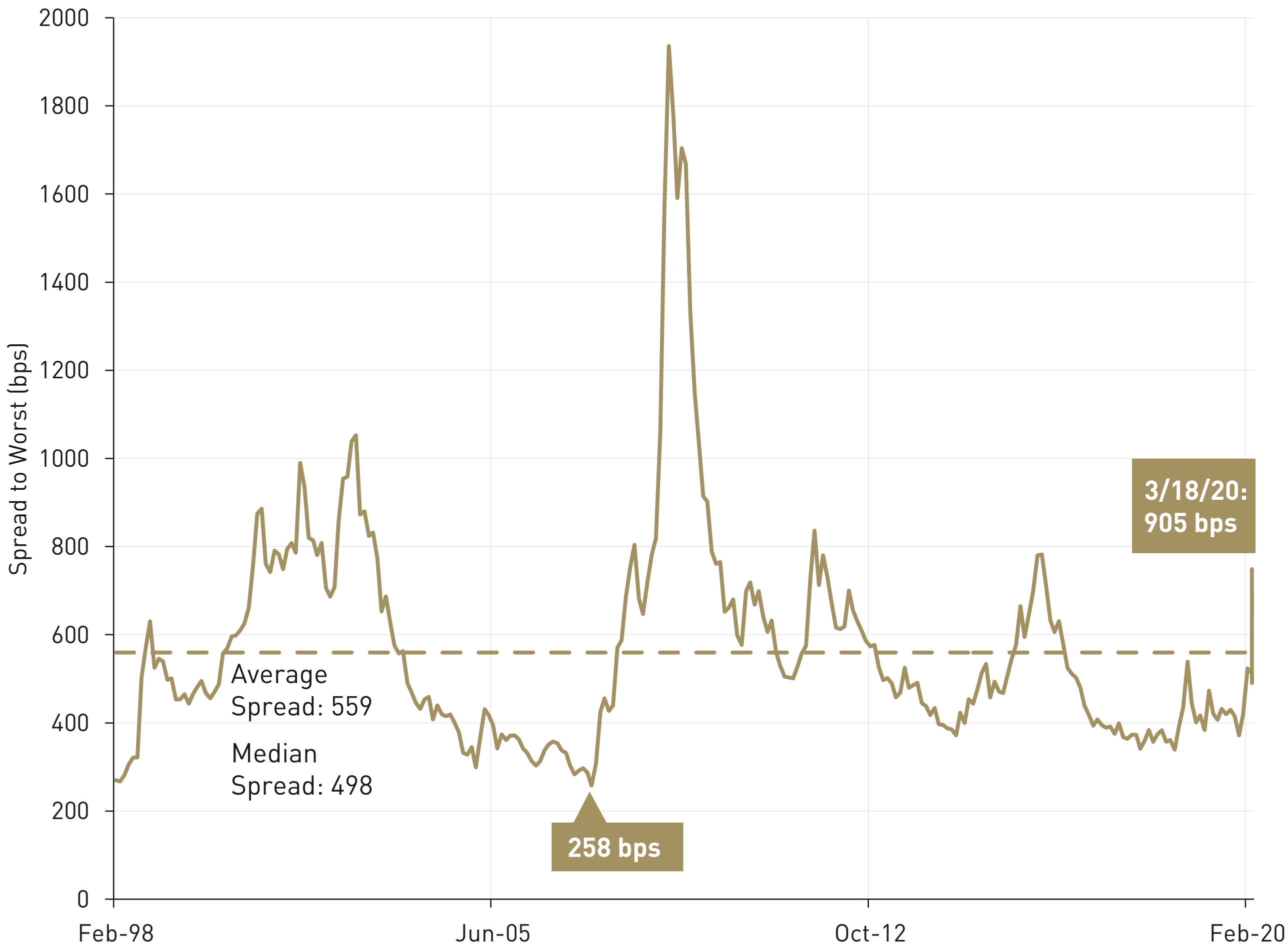
Chart 1. Historically, U.S. High Yield Spreads Have Rarely Remained Above 800 Basis Points

U.S. high yield spreads, February 28, 1997–March 18, 2020



Source: ICE Data Indices, LLC. Data as of March 16, 2020. Yield spreads represented by the ICE BofA U.S. High Yield Constrained Index. Past performance is not a reliable indicator or guarantee of future results. It is important to note that the high-yield market may not perform in a similar manner under similar conditions in the future. The historical data shown in the chart above are for illustrative purposes only and do not represent any specific portfolio managed by Lord Abbett or any particular investment. Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment. Bps represents a basis point. One basis point equals 0.01%.

Elevated

In Brief

- The recent market volatility has led to elevated spreads for U.S. high yield bonds, which recently exceeded 900 basis points (bps).
- But history shows that in prior periods where spreads topped 800 bps, they did not remain above that level for very long.
- Further, in the one-, two-, and three-year periods following instances where the spread crossed 800 bps since 2000, the high yield market posted positive returns in 17 of 18 observed periods.

As the COVID-19 coronavirus has expanded across the globe, there have been some dramatic moves in the financial markets. While once unthinkable daily swings of 5-10% in the equity markets, either positive or negative, are happening almost every day, equally historic moves have been occurring in the credit markets.

In the U.S. high yield bond market, for example, of the 10 largest one-day spread widening moves that have occurred since the inception of the benchmark high yield index—the ICE BofA U.S. High Yield Constrained Index--three of those have happened in the past seven days (as of March 16, 2020). As a result, the average index spread has widened from a low of 338 basis points (bps) as of mid-January to over 900 bps basis points as of March 18—a change of over 550 bps in just a few weeks. Spreads are now well above long-term averages. (Lord Abbett Investment Strategist Riz Hussain offers additional insights on the high yield market.)

What Has Happened after High Yield Spreads Have Widened?

This has pushed average credit spreads on the benchmark high yield index to rarely seen levels. In a typical recessionary environment, high yield spreads historically have risen to a range of 800-1,000 bps. In the depths of the Global Financial Crisis in 2008, when tangible concerns over the solvency of the financial system paired with excessive leverage in the market to magnify default concerns, spreads widened to double prior market peaks. But as illustrated in Chart 1 (front page), those periods when spreads have remained about 800 basis points have been relatively short-lived.

Adding to high yield at elevated spread levels historically has led to strong returns for investors who can look out over longer holding periods. But when you have such periods of elevated volatility, investors are naturally hesitant to add risk to their portfolios, thinking that things can get worse before they get better. That can be true, and this environment is likely no different. However, Table 1 on the following page summarizes historical returns of the high yield index in the first month spreads crossed 800 basis points.

Chart 1. How Has U.S. High Yield Performed After Instances When Spreads Topped 800 Basis Points?

Average Annual Returns over the periods following the initial month spreads crossed 800 bps

Initial month crossing 800 bps	1 year		2 year		3 year	
	High Yield	S&P 500	High Yield	S&P 500	High Yield	S&P 500
November 2000	7.7%	-12.2%	1.7%	-14.4%	9.5%	-5.5%
June 2002	22.2%	0.3%	16.0%	9.3%	14.2%	8.3%
March 2008	-20.3%	-38.1%	12.0%	-3.7%	12.7%	2.4%
August 2008	5.9%	-18.3%	13.6%	-7.4%	11.8%	0.5%
September 2011	18.9%	30.2%	12.9%	24.7%	11.0%	23.0%
January 2016	21.0%	20.0%	13.6%	23.2%	9.5%	14.0%
Average	**9.2%**	**-3.0%**	**11.6%**	**5.3%**	**11.4%**	**7.1%**

Adding to high yield when spreads first cross 800 bps, even if they widen further, historically has led to strong long-term returns

Source: ICE BAML and S&P Dow Jones Indices. Table depicts performance of the ICE BAML US High Yield Index and the S&P 500 Index in the periods following the initial month that the high yield index spread exceeded 800 basis points.

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In some cases, spreads continued to widen, but looking out over 12 months, returns were generally positive, and over 24 or 36 months, the high yield index averaged double digit returns, well ahead of the S&P 500® Index. The one exception was the 12-month period ending March 2009, which would have meant selling right near the depths of the financial crisis. But even in this case, if you invested in U.S. high yield bonds right before the financial crisis, looking out to a two- or three-year holding period could have led to double-digit returns, well ahead of equity market returns.

A Final Word about High Yield Bond Spreads

It is difficult to predict what may happen in the days and weeks to come – we believe it is likely that volatility will be with us for some time. No one can be sure when things will settle down. But if history is any guide, current valuations would suggest that taking a closer look at U.S. high yield could be worthwhile.

A Note about Risk: The value of investments in fixed-income securities will change as interest rates fluctuate and in response to market movements. Generally, when interest rates rise, the prices of debt securities fall, and when interest rates fall, prices generally rise. High-yield securities, sometimes called junk bonds, carry increased risks of price volatility, illiquidity, and the possibility of default in the timely payment of interest and principal. Bonds may also be subject to other types of risk, such as call, credit, liquidity, interest-rate, and general market risks. Longer-term debt securities are usually more sensitive to interest-rate changes; the longer the maturity of a security, the greater the effect a change in interest rates is likely to have on its price. Lower-rated bonds may be subject to greater risk than higher-rated bonds. No investing strategy can overcome all market volatility or guarantee future results.

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A **basis point** is one one-hundredth of a percentage point.

Spread is the percentage difference in current yields of various classes of fixed-income securities versus Treasury bonds or another benchmark bond measure. A bond spread is often expressed as a difference in percentage points or basis points (which equal one-one hundredth of a percentage point).

Spread-to-worst measures the dispersion of returns between the best and worst performing security in a given market, usually bond markets, or between returns from different markets.

The **ICE BofAML U.S. High Yield Index** is a capitalization-weighted index of all US dollar denominated below investment grade corporate debt publicly issued in the U.S. domestic market.

The **ICE BofAML U.S. High Yield Constrained Index** is a rules-based index consisting of U.S. dollar-denominated, high yield corporate bonds for sale in the U.S. The index is designed to provide a broad representation of the U.S. dollar-denominated high yield corporate bond market. The index is a modified market value-weighted index with a cap on each issuer of 2%.

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