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Fixed-Income Insights

U.S. High Yield: Assessing Opportunities in 2021

Valuations have recovered significantly since the tumult of March 2020, but we remain constructive on high yield credit for the coming year.

by Riz Hussain, Investment Strategist

KEY POINTS

- Despite the recovery of risk assets of all stripes in 2020, we still see U.S. high yield as attractive when compared to investment grade corporate credit, particularly when considering compositional and duration changes over time for both markets.
- The potential for an increase in "rising stars" (high yield issues that move to investment-grade status) reflects upside in high quality high yield. Meanwhile, signals on distressed debt and corporate default rates suggest easing pressure on issuers in the lowest credit tiers of high yield.
- We think an unconstrained approach that draws from all credit tiers within high yield is poised for outperformance versus a strategy focused on BB- and B-rated issues alone.

On the surface, the full-year performance of U.S. high yield in 2020 would seem like an ordinary year of solid returns without knowing anything else. The benchmark ICE BofA U.S. High Yield Constrained Index started the year with a yield-to-worst of 5.44% and a market-weighted coupon of 6.29%—and ended with a total annual return of 6.07%. Of course, the 12 months in between were anything but ordinary. Credit spreads widened out by nearly 1400 basis points (bps) before retracing basically all that move, the default rate more than doubled to 6.2%[1] and yields on bond-market benchmarks (that is, U.S. Treasury securities) plummeted, all courtesy of the COVID-19 pandemic.

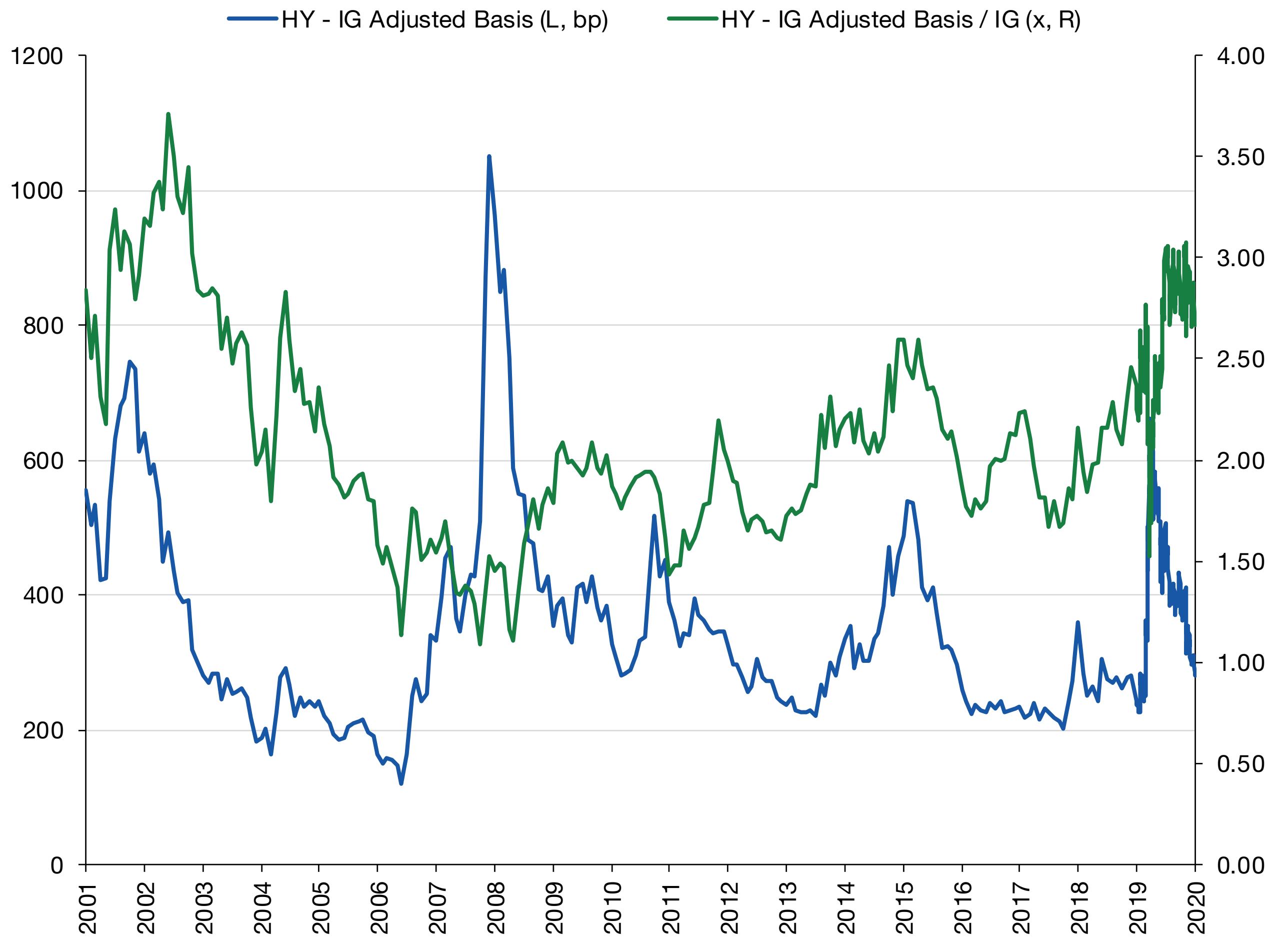
So how does that set up the potential opportunity for high yield investors in 2021? While the pandemic has accelerated the secular struggles of segments of the U.S. economy, it has also produced structural changes with new beneficiaries. And of course, valuations are far less dislocated than they were for much of last year, and that reality has implications for returns expectations and portfolio positioning. But in assessing relative valuations of key asset classes, we still favor the U.S. high yield asset class, seeing a continuation of positive performance driven by spread tightening and fading default losses through the coming year, arising from a prospective U.S. economic recovery that could be quite different than what we've seen coming out of past recessions.

Putting the High Yield Rally in Perspective

One of the points we've made repeatedly over the last year has been that the duration and quality of the U.S. high yield market has shortened and improved (as gauged by the persistent upward shift in ratings weights), respectively over the past 20 years. On the flip side, investment grade (IG) credit has become longer in duration and of lower quality as most of the notional amount of investment grade corporate credit sits in the lowest rung of the BBB rating cohort. And that influences how we consider the relative value picture of credit spreads in both markets today against the historical record.

Figure 1. Adjusting for Compositional Changes, the Spread Pickup Into High Yield Looks Particularly Attractive versus Investment Grade

Data for the period December 31, 2001–December 31, 2020



Source: ICE BofA US Corporate Index (IG), ICE BofA US High Yield Index (HY), and Lord Abbett. The chart shows adjusted spread differential on an absolute basis (in basis points) on the left axis and as a multiple on the right. The spread histories of both the IG and HY indexes have been adjusted for changes in underlying index credit ratings, maturity breakdown, and industry composition over time, so that the historical spreads are more directly comparable to today.

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In Figure 1, courtesy of our Quantitative Research team, we incorporate these contrasting evolutions in duration and quality of both asset classes to adjust the reported spread history of each market. Specifically, we adjust the spread histories of both the ICE BofA U.S. Corporate Index (IG) and the ICE BofA U.S. High Yield Index for the changes in ratings, maturity breakdown and industry as they have evolved, so that the historical spreads are more directly comparable to today. Prior to this cycle, the last time this ratio of adjusted spread pickup into high yield to adjusted IG index spreads was this high was in 2005 in the wake of the sizeable downgrades of Ford and General Motors that led to high volatility and market dislocations in the first half of the year. Every cycle is different, but it's worth noting that in the 12 months that followed the 2005 episode, high yield outperformed investment grade by 8.4%. Of course, any thoughts on outperformance to follow have to reflect that yields across fixed income are meaningfully lower today, but we expect high yield outperformance nonetheless in the year ahead.

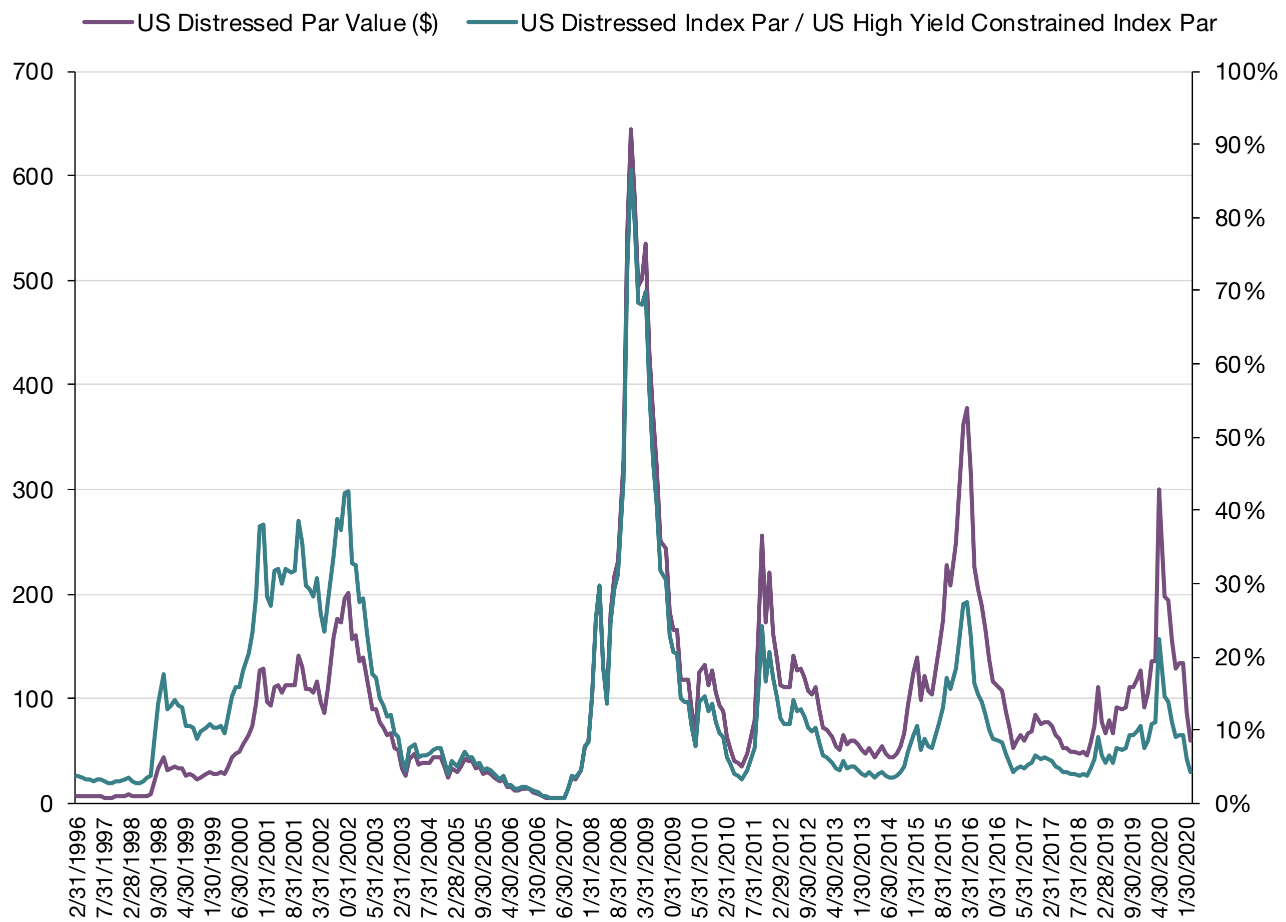
We should also note that many investors see the potential for benchmark yields moving higher in 2021 as a headwind to fixed income returns. As of January 5, 2021, interest-rate forwards show that investors expect the five-year and 10-year U.S. Treasury yields to move higher by approximately 25 and 20 bps, respectively, over the coming year. And on that measure, high yield has far more carry to offset any price declines arising from those projected increases in benchmark yields. For example, the breakeven yield[2] change for high yield over the coming one year is approximately 125 bps versus just 21 bps for investment grade, all else equal.

The (Backward Looking) Default Rate Is Poised to Turn Lower

But how should we think about this relative attractiveness of high yield in the context of defaults still to come? As of December 31, 2020, the trailing 12-month speculative default rate sat at 6.2% per JP Morgan data, far below the typical 10%-15% peaks we've seen in prior default cycles in recessions over the last 30 years. And the pace of defaults (and for that matter, volumes of debt that has moved into the "fallen angel"[3] category and downgrades within high yield) has also slowed materially to suggest a peak in the default rate may be visible on the horizon. In Figure 2, we track the absolute and relative size (by par value) of the ICE BofA U.S. Distressed Index, which considers any performing issues trading at an option-adjusted spread over 1000 bps as "distressed." Think of this segment of the market as the pool of potential default candidates. And here we show it at the lowest levels (when scaled by the overall market size) since late 2018 when the default rate was much lower than it is today. Indeed, while the par value

Figure 2. The Percentage of the U.S. High Yield Market That is "Distressed" Is the Lowest Since September 2018

Par value of U.S. distressed debt (left axis; billion US$) and ratio of distressed debt to the broad U.S. high yield market (right axis) for the period December 31, 1996–December 31, 2020



Source: ICE BofA US High Yield Index and ICE BofA US Distressed Index. In this context, "distressed" refers to issues with an option-adjusted spread of 1,000 basis points (each basis point is one-one hundredth of a percentage point).

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of high yield debt considered distressed recently hit a higher absolute total than we had in the early 2000's recession, as a portion of the outstanding market size, it's been significantly smaller; this distressed debt gauge also made a much quicker recovery from cycle highs this time around.

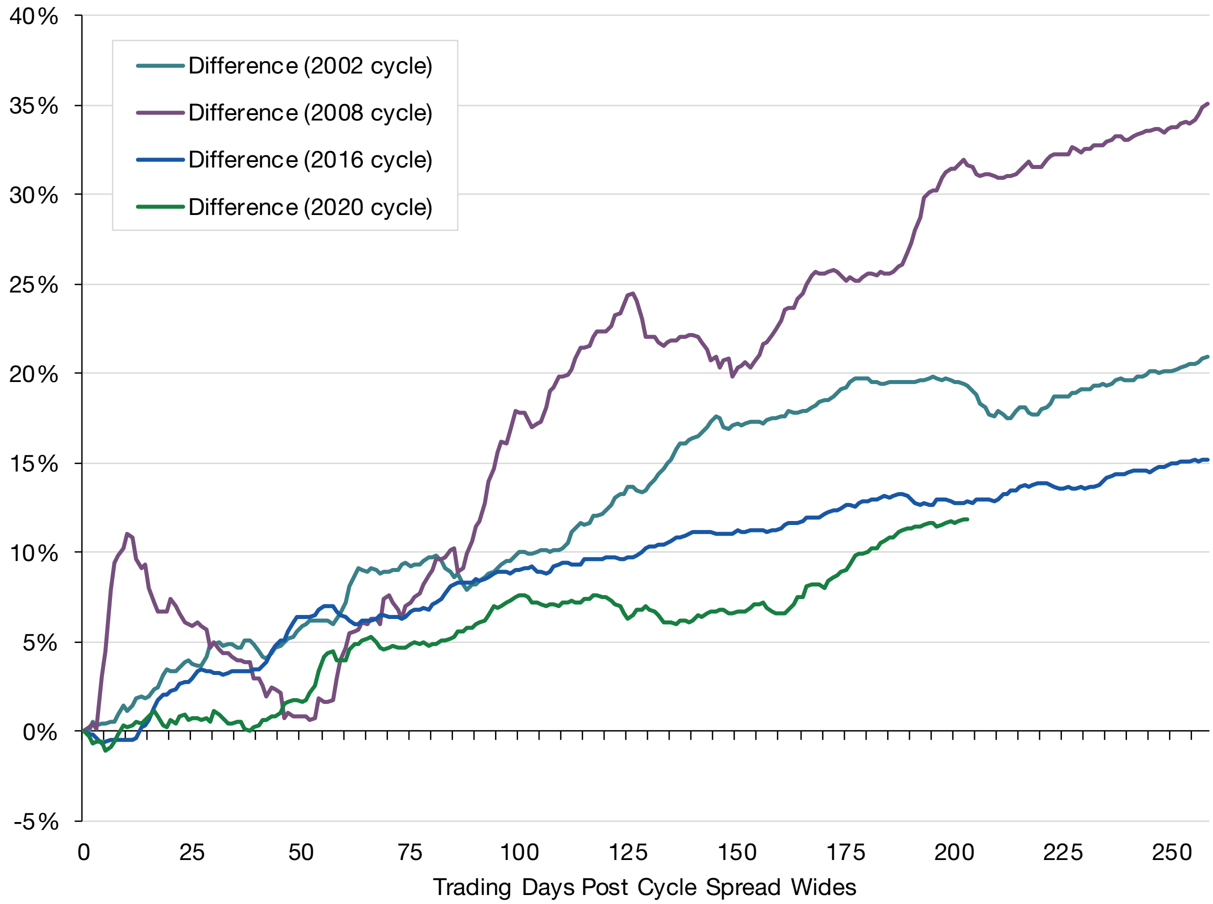
Why is the aggregate par value of securities identified by the market as at risk of default shrinking? First note that we had a "mini-default cycle" in 2015–16 that witnessed the demise of some of the weaker credits in sectors similarly at risk this year (like Energy and Retail) default or restructure. So, the starting cohort of names entering this cycle was arguably more durable in a downturn. More importantly, the high yield primary market has been buoyant with a record amount of new issuance in 2020. This has been very different than the experience of prior recessions where capital rationing through a far less active new issue market has proven to be a procyclical driver of defaults. This time around, companies have been able to build cash on hand to offset current cash burn and otherwise push out maturities beyond 2021, effectively building a durable liquidity bridge to the other side of the pandemic.

Can "Fallen Angels" Regain Their Wings?

With the prospect of a slowing pace of defaults, we expect a reversal in another trend over coming years as we believe many fallen angels from earlier this year will rise again. To be sure, some fallen angels likely will struggle under idiosyncratic and secular challenges, as we noted earlier. But as with other recoveries, we expect "rising stars" (upgrades from high yield to investment grade) to be a positive contribution to returns in the year to come. In Figure 3, we track the cumulative outperformance of an index of fallen angels relative to the ICE BofA U.S. High Yield BB Index after the turn in the credit cycles of 2002, 2008 and 2016, as well as 2020. As shown, the outperformance can continue past just an initial recovery, and the 2020 recovery in fallen angels may have room to run if history is any guide. For some further context, consider that the ICE BofA Fallen Angel

Figure 3. Fallen Angels Have Potential to Outperform If History Is a Guide

Cumulative return difference between "fallen angels" (as defined) and entire BB-rated issue category for indicated periods



Source: ICE BofA US Fallen Angel High Yield Index and the ICE BofA BB US High Yield Constrained Index. T=0 is defined as spread wide for each respective cycle: October 11, 2002; December 19, 2008, February 11, 2016 and March 23, 2020.

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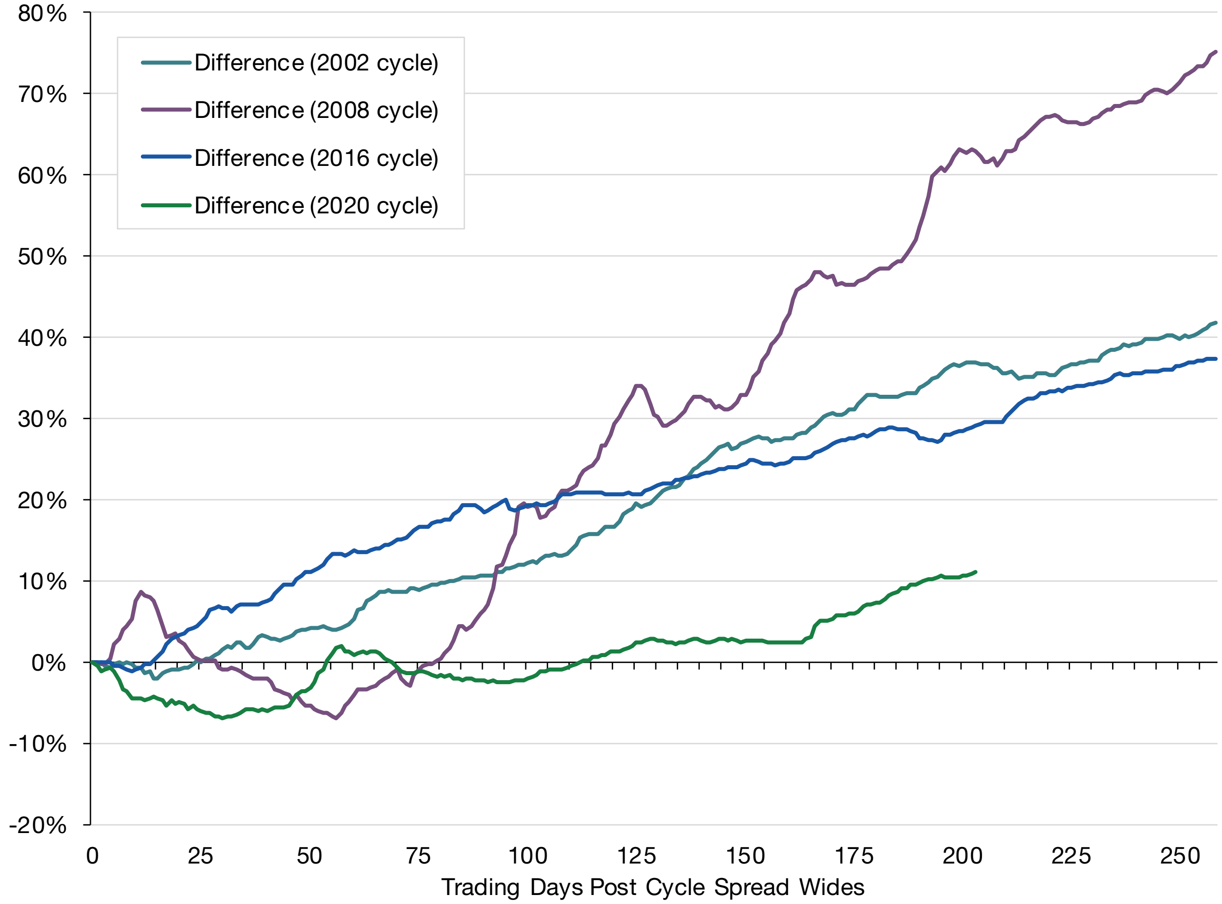
Figure 4. There May Still Be Some Room for CCCs to Catch Up to BBs

Cumulative return difference between CCC- and BB-rated issues for the indicated period



Source: ICE BofA CCC US High Yield Constrained Index and the ICE BofA BB US High Yield Constrained Index. T=0 is defined as spread wide for each respective cycle: October 11, 2002; December 19, 2008, February 11, 2016 and March 23, 2020.

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Index ended 2020 at a price of $107.62, largely in line with the BB High Yield Index at $107.36. Meanwhile the BBB Corporate Index trades at a price of $115.48, suggesting material price upside in those fallen angels that can regain BBB ratings in the year(s) ahead.

More CCC Compression to Come?

As noted earlier, the CCC segment of the high yield market has shrunk over time, reflecting the general uplift in composite rating of the high yield market. Again, mindful of the secular challenges many issuers and sectors will face given the structural changes accelerated by the pandemic, we've taken a more selective approach to underwriting credits in this cohort than just broadly overweighting CCCs. But a simple look to the recovery of prior periods of distress in Figure 4 suggests an index of CCC-rated issues can compress to the broader market (admittedly partially through an exit of defaulted candidates, but also as default fears subside).

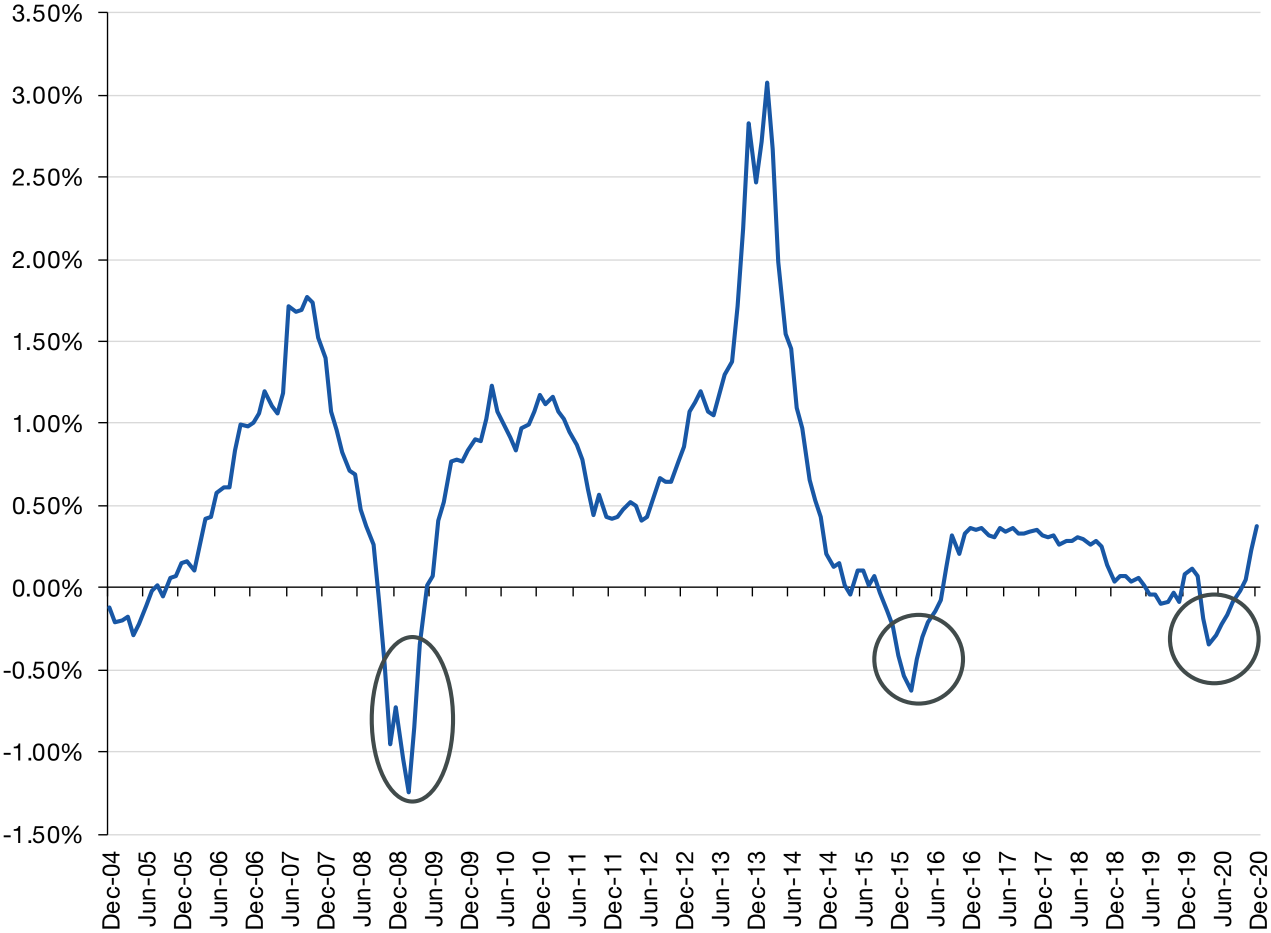
Note that the recovery of CCCs in this cycle is thus far lagging what the historical record would suggest (as we saw with fallen angels earlier), even with the outsized recovery of CCCs in November and December. It wasn't until well into the recovery that started in March that CCCs started to rebound. We believe this reflects the defensive positioning that remains in much of the marketplace today as many investors have been braced for a far stronger wave of defaults than has occurred. And of course, absolute total returns in this cycle are somewhat constrained by the reality that yields on benchmark U.S. Treasuries themselves are close to zero. But the more important takeaway is that if other cycles are any guide, the outperformance we have seen in lower rated high yield potentially could continue, even if gains accumulate at a slower pace.

An Unconstrained and Flexible Approach

Finally, with the ICE BofA BB US High Yield Constrained Index reaching a price of $107.36 compared to a pre-pandemic 2020 high of $105.16, we argue that limited upside remains in legacy high yield BBs given call constraints.[4] So, while a BB/B oriented high yield strategy has fared well during much of 2019 and 2020, we believe Figure 5 supports the argument for outperformance of a strategy that considers the full opportunity of high yield over one restricted to BBs and Bs. Specifically, we track the difference between the annualized return of the high yield index over a five-year period versus the similar return measure of a BB/B index. We note that over our period of study, the full high yield market outperforms nearly 80% of the time over a rolling five-year period.

Figure 5. The Broad High Yield Index Is Once Again Poised to Outperform BB/B Rated Issues Alone

Return difference of rolling 5-year annualized return of the broad high yield index to the BB/B index (both as defined), December 31, 2004–December 31, 2020



Source: Bloomberg Barclays U.S. Corporate High Yield Index and Bloomberg Barclays U.S. High Yield Ba/B 2% Issuer Cap Index.

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Summing Up

While investors in U.S. high yield are catching their breath after the remarkable market action of 2020, we still see the asset class as attractive when compared to investment grade corporate credit. Adjusting for the evolution of quality, duration and industries across both markets, we see the pickup into high yield credit when scaled by investment grade spreads as attractive as it has been in 15 years.

Meanwhile, our reading of distressed debt levels and default rates indicates that pressures are easing on issuers in the lowest credit tiers of high yield. We also see rationale for fallen angels to continue to outperform in 2021 given the potential ability for many issuers to regain investment grade ratings in the year(s) ahead, just has occurred in prior economic recoveries.

In a wild and unpredictable 2020, a high yield strategy tilted toward high quality worked well. But a look at the return data in other segments of high yield suggests that an unconstrained approach—one that considers the full high-yield market opportunity—may potentially be is poised for outperformance in the coming year versus an approach focused on BB/B-rated credits.

[1]Trailing 12-month basis, based on data from JP Morgan.

[2]Here is how a breakeven yield would come into play in this context: Assuming a static credit spread, U.S. Treasury yields could rise as much as 125 bps and a high yield investor would get a "breakeven" 0% return (offset by the starting yield), whereas with the investment-grade index, U.S. Treasury yields only have to rise 21 bps to offset the starting yield.

[3] "Fallen angels" is a term for bonds whose credit ratings have moved from investment grade into the high yield category. Conversely, "rising stars" are those bonds that have moved from below investment grade to investment grade.

[4] Some corporate bonds have an embedded call option that allows the issuer to redeem the debt before its maturity date. Call-constrained bonds are those trading above their current call price.

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Glossary of Terms

Carry represents the return (or premia) accruing to an investor from holding a higher yielding security over a lower yielding security, assuming underlying prices remain constant.

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). The 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.

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