High Yields: Halfway There?

The shock was the story in the first quarter, the stimulus was the story in the second—but we're decidedly not yet in the post-COVID era, and the path to economic recovery remains unclear. What does that mean for high yield?

On the one hand, high yield has regained much ground, albeit amid intermittent bouts of volatility, with the asset price rally that began in the second quarter persisting through much of the third.

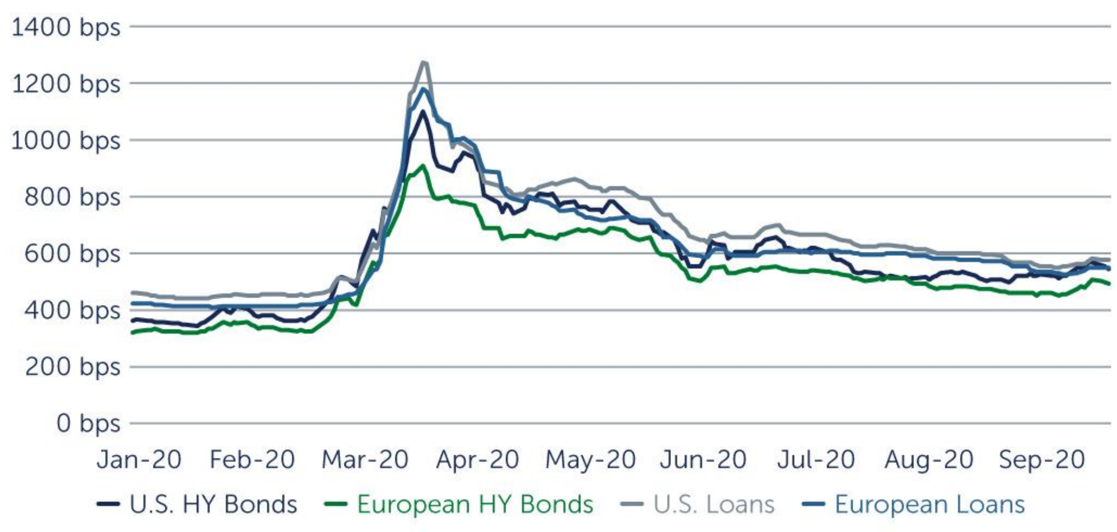
Companies have continued to successfully raise capital, evidenced by another quarter of elevated issuance—particularly in the U.S. high yield bond market, where issuance surged to a near-record $125 billion. While much of that has been in support of refinancing's, there are indications of a growing M&A pipeline, suggesting companies are beginning to once again think longer-term.

Default expectations have accordingly remained in moderate territory, down significantly from peak-COVID forecasts.

Although volatility returned at the end of the third quarter, performance was positive during the period, with U.S. high yield bonds and loans returning **+4.68%** and **+4.13%,** respectively.

The European market also ended the quarter in positive territory, with loans returning **+2.69%,** followed by bonds at **+2.49%.** Spreads have retraced ground as well, though remain elevated relative to pre-COVID levels.

FIGURE 1: U.S. AND EUROPEAN SPREADS (HIGH YIELD BONDS VS. LOANS)

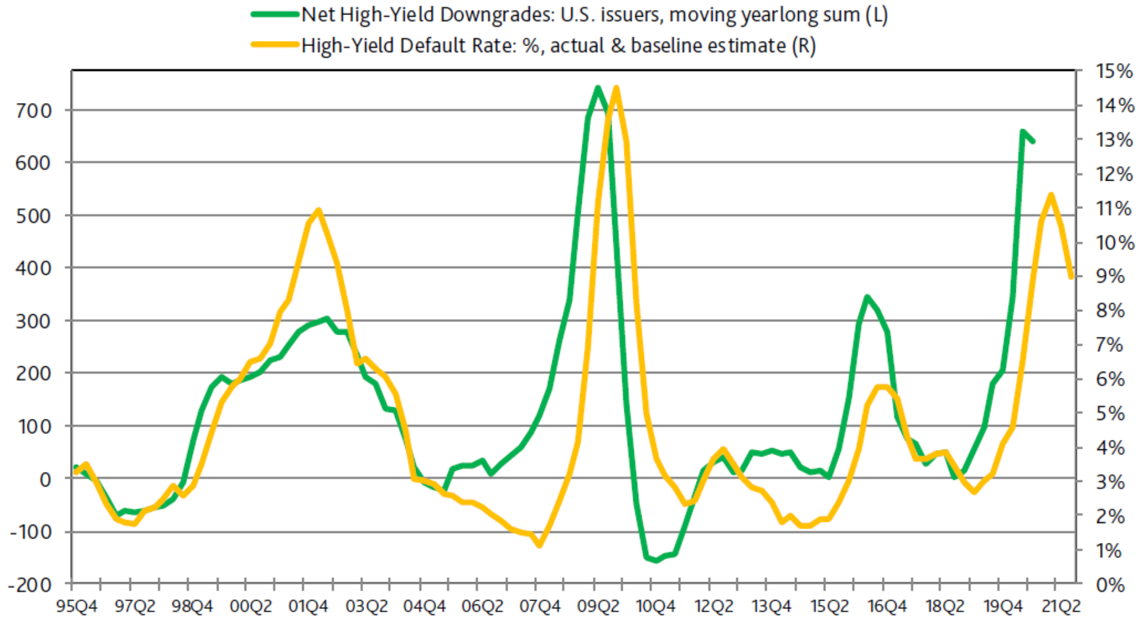


Sources: BAML; Credit Suisse. As of September 30, 2020.

On the other hand, and reflective of the ground left to cover, the rebound in asset prices has not yet extended into a full risk rally. Companies in sectors that have been particularly hard-hit by social distancing trends—such as travel and leisure, entertainment, and aerospace—have continued to trade down, even those that were on stable footing heading into this crisis. Likewise, while higher-rated BB credits have retraced most if not all of their selloff, lower-rated B and CCC parts of the market have yet to fully bounce back.

Where do we go from here?

Overall, high yield still looks like attractive, and will continue to present opportunities. Moody's has lowered their baseline estimates for the U.S. high-yield default rate. The peak baseline estimate for the default rate was lowered from February 2021's 12.1% (as of early August 2020) to March-February 2021's 11.4% (as of early September). From early August 2020 to early September, the average baseline projections for the default rate were lowered from 11.4% to 10.6% for 2020's fourth quarter, from 12.0% to 11.3% for 2021's first quarter, from 10.9% to 10.4% for 2021's second quarter, and from 9.4% to 8.9% for July 2021.



Source: BAML; Moody's Investor Service, Moody's Capital Markets

But the path forward is far from certain making a selective approach as critical as ever. The wave of defaults, while less important than feared after the 1st quarter 2020 is still to come in Q4 2020, Q1 and Q2 2021. We believe that our fund selection is well positioned in this respect with **Lord Abbett (US High Yield) and Barings (Global High Yield)**, being amongst the best credit research houses in our view.

On a relative basis, loans also look like attractive in an increased default rate environment as there may benefits to move higher in the capital structure. We expect to add some new loan funds in our selection in the coming few weeks.

	Return			Spread [6]		New Issuance [7]		Retail Flows [8]		CLO Issuance [8]	
	MTD	YTD	2019	9/30/20	12/31/19	MTD	YTD	MTD	YTD	MTD	YTD
U.S. Loans [1]	0.69%	-0.83%	8.17%	579	461	$42.6	$207.0	($0.6)	($25.4)	$10.4	$59.8
European Loans [2]	1.01%	-0.75%	4.38%	548	423	€ 3.2	€ 42.7	N/A	N/A	€ 1.5	€ 14.7
U.S. High Yield [3]	-1.04%	-0.52%	13.98%	545	367	$47.1	$336.9	($4.3)	$39.3	N/A	N/A
European High Yield [4]	-0.63%	-2.59%	10.74%	491	323	€ 10.2	€ 58.9	(€ 0.1)	(€ 1.9)	N/A	N/A
U.S. CLOs [5]	3.67%	-3.51%	10.86%	910	722	$10.4	$59.8	N/A	N/A	N/A	N/A
EM Corporate Debt [9]	-0.48%	2.58%	13.08%	370	267	$64	$395	$1.3	$1.7	N/A	N/A

1. Credit Suisse Leveraged Loan Index.
2. Credit Suisse Western European Leveraged Loan Index.
3. BAML US Non-Financial High Yield Index (HCNF).
4. BAML European Currency Non-Financial High Yield Index (HPID).
5. JPM Post-Crisis CLOIE BB rating. Spread represented as discount margin (DM).
6. Sources: BALM, Credit Suisse. Loan and bond spreads based on 3-Year discount margin (DM) and option-adjusted spread (OAS), respectively.
7. Source: S&P LCD.
8. Source: JPM.
9. CEMBI Broad Diversified Index.
   EM Corporate Debt issuance data is from BAML and flows data is from JPM.