High Yield Bonds – Time to Buy?

By David Ellis, CFA

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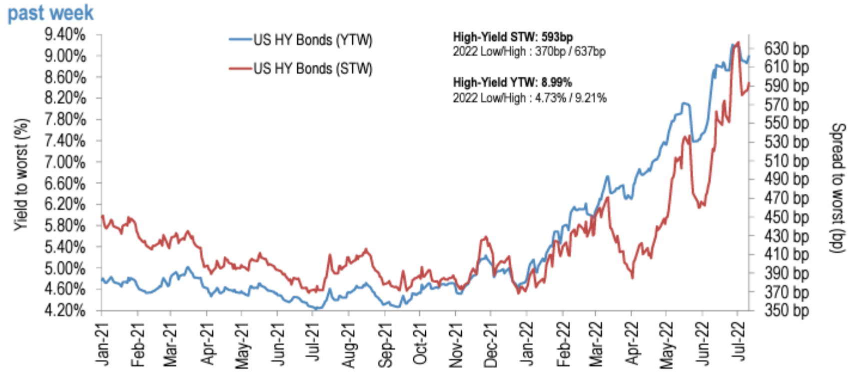
How did we get here?

With the transition of Covid to its endemic stage this year, U.S. consumers, with trillions of dollars in savings, were ready to get back to their old lives, travel, eat at restaurants, buy new cars, and basically make up for lost time. Despite anticipation, many service industries were not ready for the sudden onslaught of demand, having cut their labor forces dramatically during the pandemic. This demand, on top of the supply chain problems caused by the pandemic, and the shocking invasion of Ukraine by Russian forces, led to a dramatic increase in inflation, most recently registering at 8.6% in May and 9.1% in June. As prices began to rise in 2021, the Fed believed inflation was going to be "transitory," and they projected a gradual rise in the Fed Funds rate and a slow but steady reduction in their massive treasury and mortgage portfolios. When it became clear high inflation would persist longer and at higher levels, the Fed's message quickly shifted to a hawkish tone, and they made lowering inflation their top priority. Having raised the Fed Funds rate by 50 b.p. in May and 75 b.p. in June, analysts expect them to raise it another 75 b.p. in July, and 50 b.p. in September with a target of 3-3.5% by year end. The Fed's now forceful actions and commitment to slow the economy abruptly altered the economic outlook from moderating growth to recession. The first half of 2022 was a brutal time for investors in almost every asset class, and HY was no exception. Having outperformed investment grade bonds for most of the year, HY declined -6.81% in June as recession fears took hold, extended the YTD loss to 14.04% and ultimately exceeded IG corporates' 13.67% loss for the same period.

Where are we now?

The HY Index ended the second quarter with a yield of 8.83%, and a spread of 585 b.p. BB spreads were 396 b.p., Bs were 619 b.p. and CCCs were 1,170 b.p. The yield at the beginning of the quarter was 5.93% and spreads began the quarter at 371 b.p. To put this into perspective, average spreads during non-recession periods are 519 b.p., but they are 971 b.p. during recessions.

Figure 1: High yield bond yields and spreads were volatile but essentially unchanged over the past week



Source: J.P. Morgan.

The HY default rate (including distressed exchanges) is now rising after finishing 2021 at a 14 year low of 0.35%. As we go through the process of reducing the amount of liquidity in the system through the Fed's Quantitative Tightening (QT) programs, and investors pull money out of HY mutual funds and ETFs, HY companies that would most likely have been able to refinance last year are running into trouble in 2022. Still, default rates remain low: the long-term average default rate is 3.2% and we ended June at a 1.08% rate. We expect defaults and distressed exchanges to increase especially if access to the HY market remains challenging, but the question is how high will it go? JPM analysts who are currently not expecting a recession, predict the rate will rise to 1.25% by the end of 2022 and 1.75% at the end of 2023. However, Bank of America analysts say the market is already pricing in a recession which would suggest a 5.5% default rate! We believe how high the rate goes depends on 1) liquidity and 2) will those companies that must refinance get access to the HY market.

HY liquidity became more stressed. The HY market experienced $43.4 billion in outflows this year as of July 6, and banks and brokers reduced their exposure to the market. As Jamie Dimond, CEO of JP Morgan, said in June, the bank is bracing itself for an economic "hurricane" with rates rising to combat inflation and a slowdown in the economy. Consequently, getting trades executed in the HY market is much more difficult now than earlier in the year. Adding to the illiquidity is the dramatically lower new issue supply in 2022. During the first six months of 2022, the market saw just $71 billion ($32 billion of that in January) of new issuance versus $339 billion in 2021. Issuers are reluctant to pay the higher rates necessary to clear the market, or, especially in the case of CCC issuers, the market is closed to them. Investors dislike uncertainty and given the economy's transition (with the Fed embarked on a rate raising cycle, inflation at 4-decade highs, the economy slowing, and an unsettled war), they are reluctant to invest new money.

Outlook

Economic and monetary policy shifts force investors to reassess their outlooks and asset valuations. We have experienced credit crises and large spread widening episodes in the past, and each time underlying conditions have reasonably dictated the magnitude and duration of the sector's malaise. Always an interplay of factors, driven by underlying creditworthiness, initiates a recovery. When the market does recover, the same illiquidity that contributed to the negative performance propels prices higher. As an example of this, on July 5th spreads were at their highs for the year (599 b.p.), but by the end of the week they had tightened an impressive 51 b.p. as the new quarter brought an inflow of funds to the market and there were not enough bonds to buy. Our conclusion is that in illiquid, yet fundamentally sound markets it is preferable to "remain invested" rather than to try to enter at a market bottom or pre-determined spread level.

After the June CPI print of 9.1% on July 13th, we believe spreads may widen further, and anticipate more opportunities to find investment opportunities in the HY market. We think selectively buying bonds rated in the B and BB range that navigated the pandemic successfully and took advantage of low rates to refinance near-term maturities will generate compelling longer-term returns. Companies rated CCC had a receptive audience while the Fed flooded the market with liquidity. While spreads for those companies moved wider than the rest of the HY market, recession concerns may limit their refinancing options. Despite the anticipated economic slowdown, JP Morgan expects the HY default rate will increase over the next two years yet remain well below the historical average of 3.2%. In separate analysis, Bank of America's HY model estimates the sector will generate returns between 10-12% over the next 12 months using the following assumptions: spreads as of July 8th of 576 b.p., a 12-month spread target of 452 b.p., a higher default rate of 5.5% with a recovery of 44.5%, and a starting yield of 8.79%. The same analysis at wider spreads of 750 b.p. produces estimated returns in the 18-20% range!

Unlike prior transitions to slower growth, most HY companies are entering the current one in strong financial condition. Companies were able to take advantage of pandemic-related spending and low interest rates to solidify their capital structure. The unique features supporting the current economy, which are also behind the Fed's efforts to contain inflation, suggest a recession, if it does occur, will be brief and shallow. We agree with JP Morgan's assessment of the default rate and believe the financial damage of the slowdown will be modest. For this reason, we recommend investors direct part of their portfolio into the HY market. An often-followed adage in financial markets holds investors should wait for the Fed to complete its tightening cycle before venturing into riskier asset classes. Given the unusual circumstances driving the current cycle, we believe waiting to initiate an investment program may erode the achievable gains in the sector. By starting early, investors can also earn absolute yields that are actually "high" again, for a change.

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