Building Better Outcomes

Forging Opportunities in a Changing High Yield Market

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Boston – The environment for high-yield bond investing may turn less supportive in 2022, as key macro drivers related to the inflation outlook and COVID-19 virus mutations present challenges. In our view, the three most important factors to watch are liquidity, fundamentals and valuations. Our analysis of these factors, on balance, leads us to favor a moderately under-risked tilt in our portfolios.

Tapering and Tightening

Taking each factor in turn, liquidity may loom largest in the minds of investors, given recent signs that global central banks are generally shifting toward a less accommodative monetary policy stance. In the near term, the U.S. Federal Reserve (the Fed), the most influential global central bank, will begin to taper the asset purchase program used to support markets during the pandemic. The Bank of England is a step ahead, having implemented their first rate hike in three years in December 2021.

That the Fed did a poor job in effectively communicating the difference between tapering (not a direct form of tightening) and rate hikes (a direct form of tightening), has done little to quell market concerns about the move away from pandemic-era stimulus. With tapering, the authorities continue to purchase assets, albeit while gradually reducing the quantity. Interest rate hikes encourage saving and increase the cost of capital, slowing the pace of credit creation.

It is plainly true, in our view, that central bank asset purchases are unnecessary in today's environment of tightening labor market conditions and rising inflationary pressures. It is also plainly true that changes in global liquidity (central bank stimulus and private credit growth) affect asset prices and risk appetite. Thus, with a negative rate of change in global credit creation since early 2021 and with likely increases in short-term rates in the U.S. and parts of Europe on the horizon, it seems clear that liquidity will not be as supportive in 2022.

On interest rates, the market is pricing in an average of 2.5 rate hikes by the Fed in 2022. While rates look set to remain comparatively low or even negative in real terms—and thus, supportive of risk taking—a hawkish turn by the Fed could trigger volatility if the magnitude or speed of rate uplifts surprise the market or lead to a meaningful jump in real rates. Compounding this risk is the possibility of hawkish surprises by more than one, or perhaps several, central banks in close proximity.

Fed action will depend on the inflation data, which may prove stickier than in past years. In the aftermath of the global financial crisis, corporate and household balance sheets were stretched, governments pursued fiscal austerity and corporations continued to globalize through outsourcing. These were all disinflationary.

In contrast, to mitigate pandemic-related risks, governments provided significant stimulus in the form of income support and the global consumer is in comparatively good health, able and willing to spend. De-globalization and supply-chain disruptions have further affected the supply/demand balance. Accordingly, we do not foresee immediate relief to higher inflation, as upward price pressures are unlikely to fully abate in the near term.

Fundamentals Underpinned by Growth

As indicated above, economic activity remains strong in developed markets and the outlook for corporate sector fundamentals appears positive. We expect healthy company cash flows on the back of moderately strong growth to underpin continued improvement in 2022.

Companies should benefit from firm demand and the ability to pass the majority of the rise in input costs onto the consumer. Governments are likely to begin fiscal austerity following their expansive policies of recent years, which should help to reduce risks related to large budget deficits.

We believe that the strong economic backdrop combined with the fact that companies in need have been able to address their capital structure and, on average, are enjoying nearly record high interest coverage, should support an outlook for low defaults from high yield issuers in the coming year.

Higher Valuations for Higher Quality Credits

High yield spreads widened in November, injecting some much needed positive convexity (when duration rises as yields decline) into the market. The average spread in U.S. high yield ended the month in the 32nd percentile, when adjusted to current ratings. That made the market begin to look more interesting. Unsurprisingly, in early December, we witnessed the same phenomenon seen after every brief period of weakness this year: Long-term investors added exposure aggressively and most of the correction was quickly erased.

The net result, in our view, is that spreads remain tight on a historic basis, though appropriate. As we have discussed often over the past year, the high yield market is significantly higher in quality now relative to norms historically. The proportion of BB-rated credits is currently 55%, against typical levels in the mid-40% range. Consequently, the average spread is appropriately somewhat tighter as the proportion of higher yielding lower quality credits has fallen.

The higher quality nature of the high yield market and relatively modest level of credit risk warrants a lower credit risk premium. Historically, the long-term credit risk premium in our market has averaged around 2.5%. Given the current starting point, perhaps approximately 2% might be a more realistic level going forward, as a higher quality market implies lower credit losses.

Bottom line: As we head into 2022, our base-case outlook is for a continuation of supportive growth, improving corporate fundamentals, relatively modest credit risk and valuations that, while not inexpensive at present, appear appropriate.

We absolutely expect intermittent pockets of volatility as the market contends with various catalysts such as evolving monetary policy of central banks or existing and future strains of COVID-19. However, high yield has proven resilient and in lieu of an unforeseen change in the trajectory of the global economic recovery, we anticipate continued resilience in 2022. Demand from U.S. and global institutional investors may provide needed support following episodes of weakness, as many long-term oriented investors will view pockets of volatility as a buying opportunity.

Risk Considerations

Investing entails risks and there can be no assurance that any strategy will achieve profits or avoid incurring losses.

High Yield – About risk An imbalance in supply and demand in the income market may result in valuation uncertainties and greater volatility, less liquidity, widening credit spreads and a lack of price transparency in the market. Investments in income securities may be affected by changes in the creditworthiness of the issuer and are subject to the risk of nonpayment of principal and interest. The value of income securities also may decline because of real or perceived concerns about the issuer's ability to make principal and interest payments. As interest rates rise, the value of certain income investments is likely to decline. Investments involving higher risk do not necessarily mean higher return potential. Diversification cannot ensure a profit or eliminate the risk of loss. Debt securities are subject to risks that the issuer will not meet its payment obligations. Low-rate or equivalent unrated debt securities of the type in which a strategy will invest generally offer a higher return than higherrated debt securities but also are subject to greater risks that the issuer will default. Unrated bonds are generally regarded as being speculative.

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Date-of Data: December 27, 2021

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