What a difference a year makes: High yield opportunities in 2021

As yields and spreads have returned to pre-Covid levels, and in light of recent interest rate volatility, many investors have asked us whether high yield bonds can continue to generate attractive returns and whether they should maintain an allocation to them within their fixed income portfolios. Given the continuation of strongly pro-cyclical policies in 2021 and beyond, high savings rates, vaccine optimism and the relatively low level of nominal and real yields, we believe fixed income asset allocation should continue to be oriented toward cyclical assets and away from high quality and highly interest rate sensitive bonds. As a result, we feel that high yield bonds remain one of the most appealing investment options available in fixed income, and that an actively managed portfolio of high yield bonds can be a sensible part of a client’s overall portfolio.

At the same time, the ever-changing market conditions mean that investors should remain nimble and strategic with their high yield allocations. We believe investors need to pay particular attention to manager selection and find those who can navigate less-liquid markets with the ability to handle increased idiosyncratic risk. With this approach in mind, we believe that the U.S. high yield market presents a tactical opportunity to earn attractive returns for those investors comfortable with the additional risks of investing in high yield. In this paper, we explore potential opportunities and risks we see for this asset class.
Over the past 12 months, high yield credit spreads, as measured by the Bloomberg Barclays U.S. High Yield Index, have made a complete round trip from the March 2020 wides of 1100bps back to pre-COVID tights of 310bps thanks in large part to unprecedented monetary relief measures. Over the course of 2020, Fed policy was clearly a direct driver of credit spreads as the Fed, for the first time ever, started to buy corporate bonds (both IG and HY). While the Fed purchased just $14bn in total credit assets versus the initial program size potential of $750bn, the very announcement of these corporate credit facilities fueled a sharp rally that continued through 2020. However, this powerful technical that drove spreads tighter over the course of last year will only continue to decelerate. Going forward we believe returns will be driven by fundamentals, in contrast to market beta driving everything tighter. This will likely lead to further diversification of issuer and sector performance, creating opportunities for active managers.

One of the biggest questions for 2021 is how much the returns from 2020 borrowed from 2021—the year when the world is supposed to “return to normal”. While high yield valuations are currently at less-compelling levels than were available in most of 2020, we believe there is still good reason to be constructive on high yield bonds. Given the backdrop of ongoing monetary and fiscal policy support, robust GDP growth, improving fundamentals, the rollout of vaccines and declining default rates, we think high yield credit can perform well. In fact, we believe high yield will be a beneficiary of improving trends. However, looking ahead, we believe returns will be more idiosyncratic and successful alpha generation will rely on security selection and relative value. As a result, we believe active managers are poised to outperform, lower quality high yield will outperform higher quality, smaller issuers will outperform larger issuers, and portfolios should lean in to the ‘reflation trade.’ Interest rate volatility now has investors focused on duration, and we think this is the key downside risk in the near term, though we are reminded that high yield credit has historically performed well in periods of moderate rate increases.

Though markets appear to have recovered fully from the March 2020 drawdown, there is still dispersion across sectors and ratings categories, creating opportunity for investors. While the Fed’s purchasing of eligible Fallen Angels and HY ETFs via its corporate credit facilities has been remarkably effective, it has also stretched valuations for these names to record tights. As a result, we believe spread compression opportunities for these names are limited. This has made lower quality credit (B and CCC rated bonds) excluded from ETFs, look increasingly attractive and we think investors should consider positioning for further spread tightening in lower rated segments of high yield.

Similarly, smaller capital structures in the high yield universe, which we refer to as “middle market,” appear to offer value, as most of these credits were not eligible to be included in the Fed’s corporate purchases and therefore have not directly benefited from the Fed bid in the same way larger ETF-eligible bonds did. In addition, these smaller “middle market” names tend to be overlooked and under-researched due to a number of reasons including their smaller issuance size and limited publically available financial data. Given this, middle market credits have typically offered investors a yield premium of 100 to 150 basis points (bps) over larger issuers, while exhibiting similar credit risk. Display 1 shows this yield premium over time. It is important to note that in the depths of COVID, the yield premium on these named gapped out as wide as 350bps, largely because

“After the beta rally in 2020, we believe returns will be more idiosyncratic and successful alpha generation will rely on security selection and relative value.”

**DISPLAY 1**
Quantifying the Middle Market Yield Premium
Yield to Worst (%) Data as of March 31, 2021

<table>
<thead>
<tr>
<th></th>
<th>Jun-17</th>
<th>Mar-18</th>
<th>Dec-18</th>
<th>Sep-19</th>
<th>Jun-20</th>
<th>Mar-21</th>
</tr>
</thead>
<tbody>
<tr>
<td>Δ Middle Market HY vs Large Cap HY</td>
<td>0.0%</td>
<td>0.5%</td>
<td>1.0%</td>
<td>1.5%</td>
<td>2.0%</td>
<td>2.5%</td>
</tr>
<tr>
<td>Δ Middle Market HY vs Index</td>
<td>3.0%</td>
<td>3.5%</td>
<td>4.0%</td>
<td>4.0%</td>
<td>3.5%</td>
<td>3.0%</td>
</tr>
</tbody>
</table>

Source: Bloomberg, MSIM. Yield to Worst shown for Bloomberg Barclays U.S. High Yield Index. The index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. Past performance is no guarantee of future results. See Disclosure section for index definitions.
they were not eligible for Fed’s corporate credit facilities.

Amid improving economic expectations, we also think investors should consider increasing exposure to cyclical sectors most levered to the economic recovery to potentially capitalize on the strong global growth and the “reflation” trade. Lastly, we believe selectively increasing exposure to credits in COVID-impacted sectors may provide compelling returns. While we believe the market is correctly pricing in some real risk to investors in some of these stressed sectors, some stronger credits in these “bad neighborhoods” have been able to bolster liquidity and look particularly attractive.

Key Risks

While attractive opportunities remain, a keen eye on some key risks should also inform positioning in 2021. Recently, interest rates and inflation have come into focus, which has driven volatility and a more bearish outlook on bonds in general. While we believe the Fed is going to maintain its zero interest rate policy in 2021, the perception that there is clearly more room for rates to rise then there is for them to fall, coupled with the rise in treasury yields, likely means that interest rates will remain a key focus going forward. In rising rate environments, it is generally assumed fixed income returns to diminish considerably if rates rise by a meaningful amount, and many fear fixed income returns will be negative given the inverse relationship between bond prices and interest rates. However, history tells us that high yield bonds can generate positive returns during this type of environment. In fact, when looking at high yield returns during periods of rising rates over the last 20 years, high yield provided investors compelling returns in each of those periods. (Display 2)

This is because high yield bonds have large coupons and this, combined with spread contraction due to economic growth, can offset some of the impact of rising rates. Additionally, many high-yield bonds are callable years before their maturity, which helps provide high-yield bonds with some of the lowest durations found in the fixed income market. For example, as of March 31, 2021, the duration of the Bloomberg Barclays U.S. Corporate High-Yield Index is 4.07 years, compared with 8.24 years for the Bloomberg Barclays Investment-Grade Corporate Index. Smaller “middle market” credits tend to have even less duration than the broader high yield market. Thus far, in 2021, high yield has shown it’s resiliency amid increased rate volatility and inflation concerns. On a year-to-date basis, the US HY index is providing a gain of 0.85% despite record issuance and outflows from the asset class. By comparison, US IG bonds are now down -4.65% year-to-date.

Given the increase in fallen angels in 2020, BBs now represent 58% of the high yield index, which is an all-time high. This also means interest rate risk is higher than normal for the broad high yield market; since of all the high yield rating segments, BB rated credits tend to be the most sensitive to a back-up in rates. This further bolsters our down-in-quality view, as lower quality credit is less sensitive to rates, albeit with greater risk of default. We believe underweighting low coupon, long duration BB credit should help mitigate the risk from a move higher in rates. For investors particularly concerned with rate risk, short duration high yield strategies may make sense. Given the asset class has improved in quality over the long-term and, especially, since the

DISPLAY 2
Median Quarterly Total Returns Given Change in 5-Yr Treasury Yield
Data from 1993 – December 2020

Source: MSIM, Bloomberg. The index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. The index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. Past performance is no guarantee of future results. See Disclosure section for index definitions.
beginning of the pandemic, it is not unreasonable to think that spreads could reach and trade through the all-time tights of 238bps in of May 2007. When you consider this evolution, we believe there is a compelling case to be made for investing in high yield.

As we look out further in the year, we could see a ramp up in debt-funded shareholder-friendly activity. Management teams that were prudent to raise ample liquidity in the depths of COVID could look to return capital in the form of dividends and buy backs, which would be clearly negative for bondholders. With primary markets wide open, M&A seems likely to pick up as well and we could see companies continue to lever up to make acquisitions. Anecdotal comments suggest that investment-banking teams are very busy and there is renewed focus on how companies can opportunistically take advantage of the expected economic rebound given the low cost of debt. This also supports our bias for smaller capital structures because they are less likely to be the acquirer, and bondholders could benefit from a larger company acquiring the business.

We believe there is good reason to be constructive on high yield in 2021. Continued positive sentiment from vaccine announcements, strong equity markets, central bank support, prospects for further fiscal stimulus and higher commodity prices all converged to help drive high yield spreads tighter to start 2021. In the current market environment, we feel that high-yield bonds remain one of the most appealing investment options available in fixed income, and that an actively managed portfolio of high-yield bonds can be a sensible part of a client’s overall portfolio.

Although spreads have tightened significantly, we expect continued risk on sentiment and the global backdrop to support moderate spread compression. Additionally, we expect default rates to decline as the record setting new issue calendar has provided companies access to capital to shore up liquidity and push out maturities. Lastly, in our experience, there are a number of compelling reasons to consider investing in the high-yield market and these reasons become even more pronounced when rates begin to rise.
**INDEX DEFINITIONS**

The Bloomberg Barclays Global Aggregate Credit Index is the credit component of the Bloomberg Barclays Global Aggregate index, which provides a broad-based measure of the global investment-grade fixed income market.


The Bloomberg Barclays Pan-European High Yield Index covers the universe of fixed-rate, sub-investment-grade debt denominated in euros or other European currencies (except Swiss francs). This index includes only euro- and sterling-denominated bonds, because no issuers in the other European currencies now meet all the index requirements. To be included, the bonds must be rated high-yield (Ba1/BB+ or lower) by at least two of the following ratings agencies: Moody’s, S&P, and Fitch. If only two of the three agencies rate the security, the lower rating is used to determine index eligibility. If only one of the three agencies rates a security, the rating must be high-yield. Bonds must have at least one year to maturity and an outstanding par value of at least EUR50 million. The index does not include non-rated bonds, and it excludes debt from entities in countries that are designated as emerging markets.

The Bloomberg Barclays U.S. Corporate High-Yield Index measures the market of USD-denominated, non-investment grade, fixed-rate, taxable corporate bonds. Securities are classified as high yield if the middle rating of Moody’s, Fitch, and S&P is Ba1/BB+/BB+ or below. The Index excludes emerging market debt.

The Bloomberg Barclays U.S. Mortgage Backed Securities (MBS) Index tracks agency mortgage-backed pass-through securities (both fixed-rate and hybrid ARM) guaranteed by Ginnie Mae (GNMA), Fannie Mae (FNMA) and Freddie Mac (FHLMC). The index is constructed by grouping individual TBA-deliverable MBS pools into aggregates or generics based on program, coupon and vintage. Introduced in 1985, the GNMA, FHLMC and FNMA fixed-rate indexes for 30- and 15-year securities were backdated to January 1976, May 1977 and November 1982, respectively. In April 2007, agency hybrid adjustable-rate mortgage (ARM) pass-through securities were added to the index.

The Bloomberg Barclays U.S. Treasury Index includes public obligations of the U.S. Treasury.

The Bloomberg Barclays U.S. Corporate Index is a broad-based benchmark that measures the investment grade, fixed-rate, taxable, corporate bond market.

The JP Morgan CEMBI Broad Diversified Index is a global, liquid corporate emerging markets benchmark that tracks U.S.-denominated corporate bonds issued by emerging markets entities.

The JP Morgan Emerging Markets Bond Index Global (EMBI Global) tracks total returns for traded external debt instruments in the emerging markets, and is an expanded version of the EMBI+. As with the EMBI+, the EMBI Global includes U.S dollar-denominated Brady bonds, loans, and Eurobonds with an outstanding face value of at least $500 million.

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