

High Yield commentary

Market commentary

The high yield market declined by 1.03% during September, as measured by the Bloomberg Barclays High Yield Index. For the third quarter as a whole, the index return was 4.60%. Year to date, the benchmark is barely positive at .62% after declining by almost 21% in the first three weeks of March.

The slow relative recovery of Caa issues continued in Q3, as Caa bonds rose by 7.35%, while B bonds rose 4.53% and Ba bonds rose 4.02%. Year to date, Ba performance is +4.25%, B performance is -1.16%, and Caa bonds still lag badly at -6.95%.

September marked the fourth time in the last five months that small bonds (\$200-500mm outstanding) significantly outperformed, rising by .29% while midsize bonds (\$500mm - \$1 billion) fell by .81% and large bonds (over \$1 billion) fell by 1.12%. Over the quarter this has amounted to small bonds returning +5.29%, midsize bonds returning +5.05% and large bonds returning +4.65% (Credit Suisse). We believe this continuing mean reversion among size cohorts has room to continue. During the early days of the recovery in late March and April, spreads on small bonds relative to large ones exploded to 590bp, six times their long-term average, in a single week. Currently, large bonds trade at spreads equal to their long-term average, while midsize bonds continue to trade 113bp wide to the average and small bonds trade 124bp wide to their average.

A notable area of outperformance over the last month was second lien and Caa loans, as CLO issuance hit a 17-month high in September. While the broad loan market returned +.69% in September, second lien loans returned +3.63% and Caa rated loans returned +4.63%.

Retail fund flows in September were negative: \$7.6 billion from mutual funds and \$5.8 billion from ETFs. Total such inflows to funds since March 25th, however, remain at a record \$61.2 billion, or 25% of the AUM of high yield mutual funds at that date. Additionally, Bank of America estimates that institutional net inflows since March total about \$130 billion.

One conspicuous non-flow is from the Fed. On April 9, the Fed announced that it would buy up to \$750 billion in corporate bonds, including some high yield ETFs and recently downgraded individual bonds. This was an enormous fund, about 9% of the total size of the corporate (combined high yield and investment grade) bond market. As of September 30, the Fed owns just \$1.1 billion of high yield ETFs and \$100 million of individual high yield bonds, which is less than .1% of the total market. It is the most successful market manipulation we can recall. With investors flooding the market with new money to front-run the purchases by the Fed, bond prices regained their huge losses in just four months, during a severe recession, which we believe was the Fed's hope and intention all along.

Default activity appears to be reaching its peak. The LTM gross par-weighted default rate for high yield (including distressed exchanges) is 6.36% and for loans it is 4.23%. Excluding energy, which has experienced a 18% LTM default rate and accounts for a massive 46% of all LTM defaults, both bond and loan default rates are within 100bp of their long-term average, a small fraction of the default rate that was implicit in credit spreads during March. Retail, cable, and communications industries have together accounted for another 38% of defaults, confirming the historical tendency

of defaults to be highly clustered by industry during times of distress. JPMorgan again reduced its forecast of 2020 and 2021 gross default rates to 6.5% and 3.5% for bonds, 4% and 3.5% for loans. Recoveries on defaulted bonds, however, are at historic lows: 15% for bonds (versus a long-term average of 40%) and loans at 47% (versus a long-term average of 66%). As a reminder, these recoveries are bond prices measured at the date of default. In the energy sector, recoveries are just 10%. Although market-wide average high yield net leverage has increased by .7x during 2020 (JPM) as cash flows have shrunk, the resilience of industries has been much better than anticipated, sustained in part by massive aid to both companies and their employees.

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