High Yield Bond Update

On Monday, March 23rd, the US Federal Reserve (“the Fed”) took unprecedented steps towards calming financial markets, authorizing unlimited purchases of government debt, mortgage backed securities, and for the first time ever, investment grade corporate bonds, including corporate bond ETFs. Unsurprisingly, corporate bond ETFs such as iShares iBoxx Investment Grade Corporate Bond ETF (ticker symbol LQD) surged in response to the Fed backstop.

Left out of the generous Fed bailout was another, much more vulnerable segment of the fixed income market, high yield bonds, also commonly referred to as junk bonds. With no buyer of last resort, high yield bonds diverged further from their higher-rated brethren, as shown in the below chart. As of March 19th, LQD was down -17% year-to-date, while HYG was down -18%. LQD has now trimmed the year-to-date loss to just -4%; while HYG has recovered a bit along with equities, it remains -12% year-to-date.

The Fed comes to the rescue for IG Bonds

10%
5%
0%
-5%
-10%
-15%
-20%
-25%

12/31/2019
1/7/2020
1/14/2020
1/21/2020
1/28/2020
2/4/2020
2/11/2020
2/18/2020
2/25/2020
3/3/2020
3/10/2020
3/17/2020
3/24/2020

HYG
LQD

Figure 1. Divergence in LQD and HYG as Fed Intervenes, as of 3/26/2020

With a recession looking certain as the coronavirus pandemic has halted a large swathe of economic activity in the US, high yield bonds face headwinds unseen since the 2008 global financial crisis. The energy sector, which comprises around 7.7% of HYG will undoubtedly see extreme defaults as oil has fallen to the low $20-per-barrel range. In addition, the 2nd largest sector exposure in high yield is Consumer Discretionary (Non-Cyclicals), a sector likely to experience a sharp uptick in defaults as malls and shopping centers are forced to pause business indefinitely, and consumers cut back on purchases amidst a wave of layoffs unlike any we have seen in recent memory.

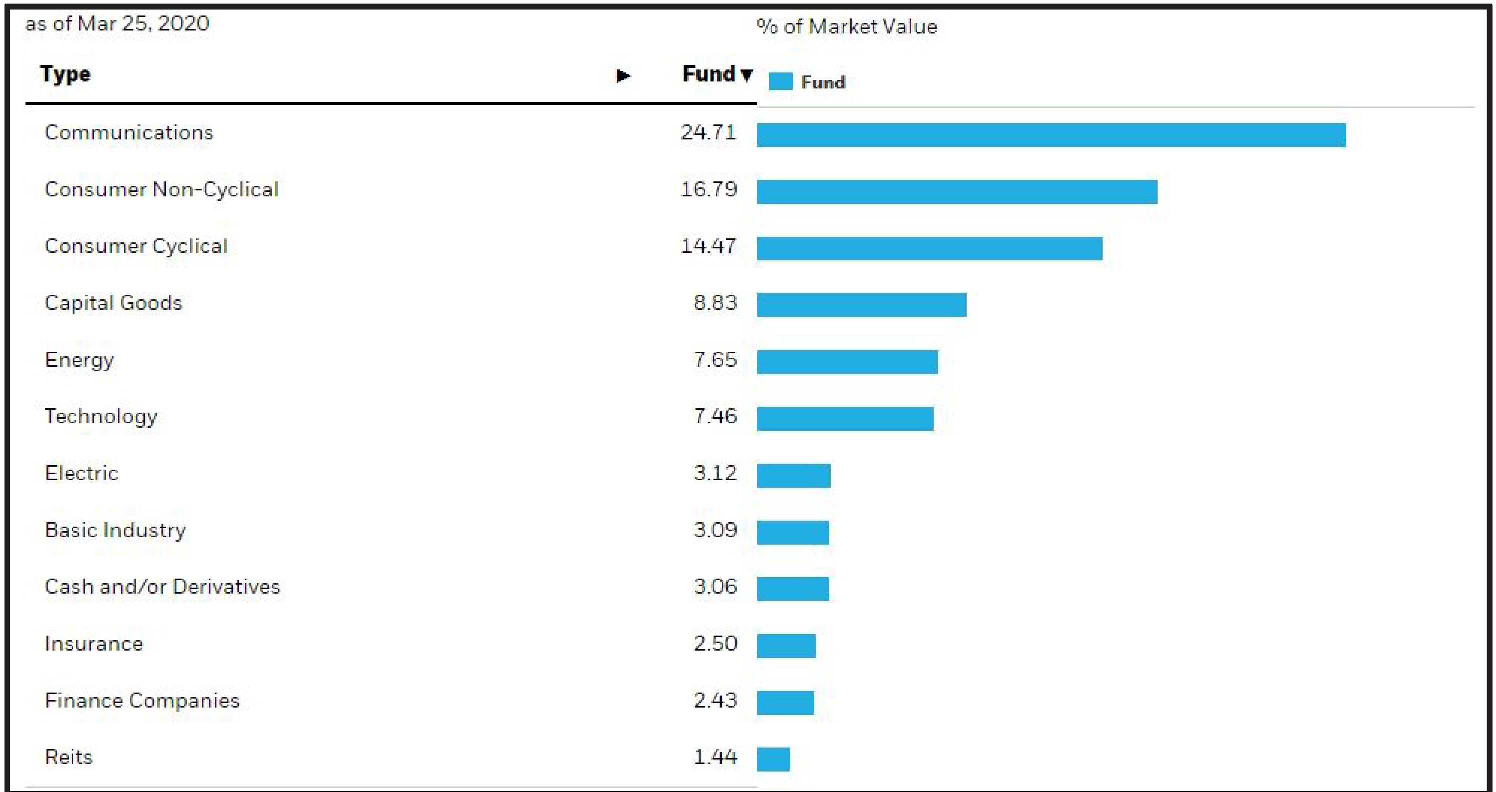

Figure 2. Sector Exposure within HYG, as of 3/25/2020

As of March 23rd, high yield bonds have already endured a -21.3% year-to-date decline. Spreads have continuously risen as the coronavirus outbreak worsens and will likely continue to do so before we reach capitulation. Comparing the current selloff to the 2008 Financial Crisis, spreads have risen to around 10%, a far cry from the 21.8% we saw in 2008. From a price perspective, HYG fell over -34% peak-to-trough in 2008, while the current selloff has brought a -22% decline. After ending last year with a default rate around 3%, S&P anticipates we will see roughly triple that rate, ending the year around 10%.

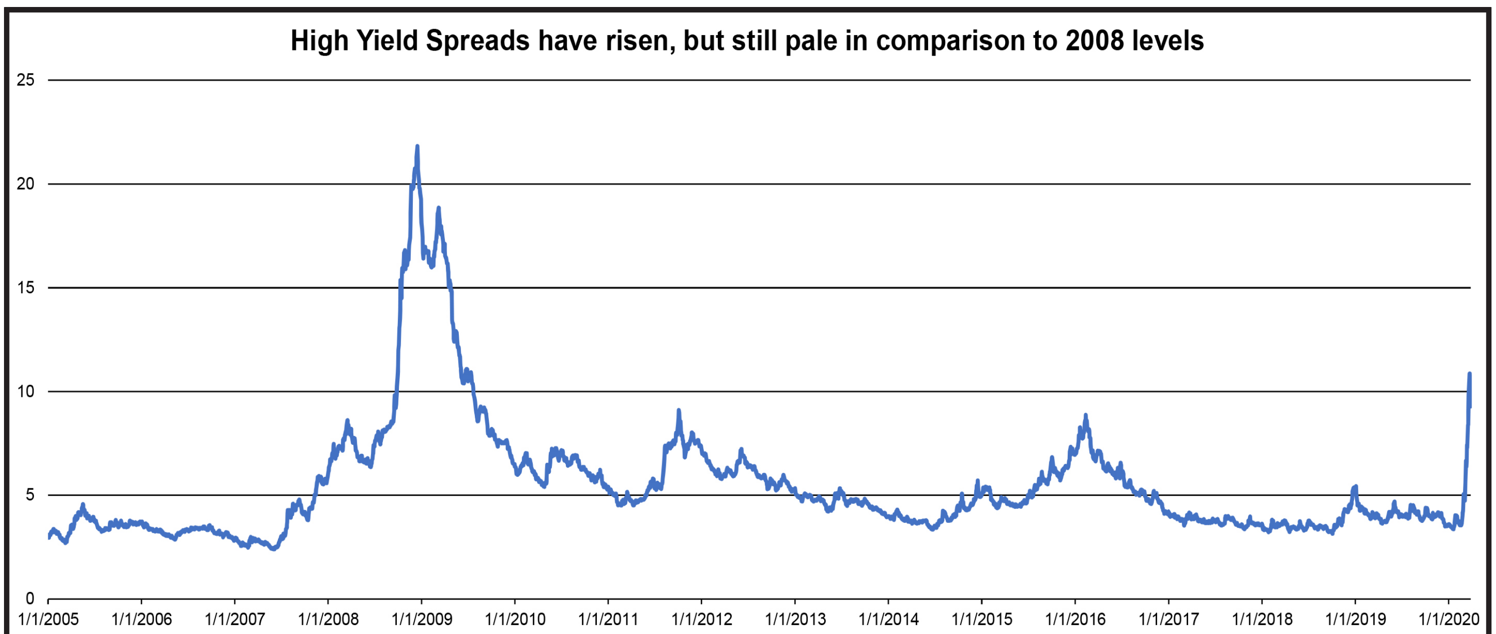

Figure 3. Spread on Bank of America Merrill Lynch US Master II Index, as of 3/26/2020

From the May 1st peak in 2008, it took HYG over a year and a half to fully recover the losses. The (potentially) good news this time is that the economy entered this crisis on relatively strong footing, and assuming the quarantine measures employed are effective, there should be an end date in sight. Furthermore, the government is proposing unprecedented stimulus measures designed to float loans to at-risk businesses. Therefore, once we do bottom out, it is likely that the recovery will occur sooner than last time.

Another potential outcome to consider is that we will see a wave of downgrades from the crowded BBB rating segment, which sits right above junk status. As companies lose their investment grade status, the high yield market could become flooded with these names. Forced selling from investment grade funds will depress prices on the downgraded bonds, however the eventual returns could be rich for buyers of the bonds, if the companies can weather the storm and regain their investment grade status.

In the meantime, there are a multitude of downside risks on the table, and investors should recognize the dangers in attempting to catch a falling knife amidst unprecedented volatility. High yield bonds often behave more like equities than fixed income and are commonly utilized by asset managers that engage in tactical asset allocation using trading strategies such as trend-following portfolio. These strategies allow portfolio managers to tactically exit the asset class. When the market senses the default risk has been fully priced in, the tactical strategist approach is able to move back in and hopefully enjoy upside price action and a healthy interest yield.

The current selloff may be jarring, and the data suggests choppy at best to come, but rest assured the recovery bounce will be rewarding to nimble and patient investors, as it was in 2003 and 2009, and even in 2016 after the oil collapse.

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