Asset Class Insights
High Yield Bonds - April 20, 2020
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The past few weeks have been a rollercoaster ride for investors in both equity and fixed income asset classes. While much has been written about equity market performance, little has been shared about fixed income markets, specifically how central bank policies impact mortgage and corporate markets, in both investment grade and below investment grade space. In this piece, we hope to provide those insights, including what may not be apparent as a result of the most recent central bank intervention into junk bond markets.

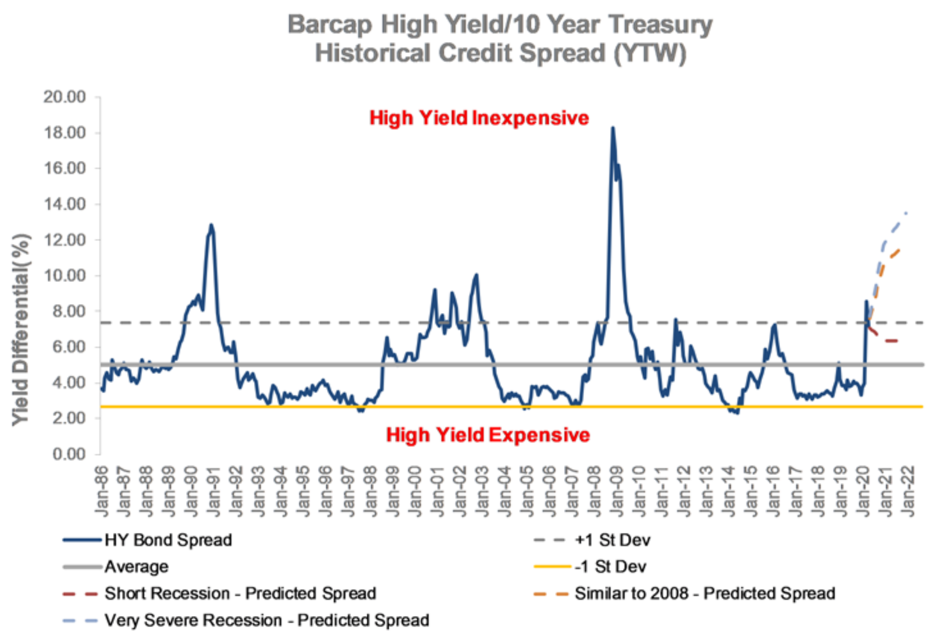
Central bank intervention can occur through a variety of different channels; interest rate cuts, quantitative easing in treasury markets, as well as buying bonds through lending facilities that make purchases of mortgages, municipal, and corporate bonds possible. All strategies have both a direct and indirect impact on bond markets. Monetary policy through changes in the Fed Funds rate impacts the cost of borrowing and generally ripples through all corners of the bond market. Quantitative easing, through treasury markets, has a similar effect, but is more designed to impact the term structure of rates, rather than the overall level of rates, although admittedly they are similar. Intervention through lending facilities is most relevant in our current circumstance.

In non-risk-free market space (everything beyond treasury bonds), the cost of debt is established by the overall level of rates in the economy, influenced by the Fed through Fed Funds or QE, plus a spread (risk premium), or, simply stated, an amount of extra yield (interest rate cost) that must be paid to the bondholder to reflect their risk as a borrower. In municipal bond space, this risk premium is most difficult to see because most municipalities offer their debt tax free, resulting in a yield discount to treasury bonds. Make no mistake though, the spread is there but its presence is not great enough to cause muni yields to exceed treasury yields, except in some very extreme environments. This spread difference is most apparent when you compare low credit quality munis to high credit quality munis. Yields are greater in low credit quality space indicating the presence of a spread that reflects risk. With mortgages, spreads are slightly more apparent, but are typically narrow, indicating the generally low incremental risk involved in investing in most mortgage-backed securities (MBS) vs treasury bonds. The extra cost of being a risky borrower is most apparent in investment grade and below investment grade corporate bond space, as these instruments tend to trade at greater spreads vs. treasuries than any of the others, less once again, some very extreme exceptions.

Recently, the Fed took several actions as it relates to lending facilities. Through the CARES act, borrowers with loans backed by Fannie Mae, Freddie Mac, and Ginnie Mae may skip (or forbear) up to one years' worth of payments on their home mortgages, which must ultimately be paid later. From a homeowner perspective, this is good for Main Street in that it prevents foreclosures for those who have lost their jobs due to COVID-19. From an investor perspective, not so much. The delay in cash flows causes the present value of those bonds to decline (i.e. a dollar received tomorrow is worth less than one today). As a result of the delay in cashflows, prices should decline, and yields should rise. This is what happened leading up to March 18th. On March 18th, the Fed announced that it would intervene in mortgage markets to provide liquidity by buying MBS, which in turn, drove yields back down to, and below, pre-crisis levels.

Similarly, investment grade corporate bonds saw yields spike from 2.21% on March 6th to 4.57% two weeks later. On March 23rd, the Fed announced its intention to offer two credit facilities to support credit markets by making purchases of investment grade corporate bonds on both the primary and secondary markets. The two markets where the Fed can transact are key. On April 9th, the Fed expanded its list of eligible purchases to include fallen angels(investment grade bonds at issue that have since fallen to junk status) and Exchange Traded Funds (ETFs) that invest in junk bonds, regardless of their status as a fallen angel or original-issue junk bond. The goal was the same, provide liquidity to the asset class, restore confidence, and depress spreads, creating a more reasonable borrowing environment for high yield issues with debt coming due that are in need of market-based funding to avoid default. Mission accomplished. Several new issues came to market at reasonable costs to the borrower.

## High Yield Bonds Cheap?




Source: Moody's Investor Services, Bloomberg, iCM Capital Markets Research

It appears as though there may be one key missing ingredient in the HY bond buying Fed strategy, the absence of a primary lending, or bridge loan credit facility. This is not to say that there will not be one, but the language by the Fed does not seem to extend this courtesy to HY bonds, like it did to investment grade credit. Without lending to businesses for operations, real defaults from business closures, not defaults from an inability to roll debt, present a big potential problem. Since many businesses will suffer a real impact to top line revenue, how will organizations service debt by making coupon and principal payments on time? What the Fed has accomplished through its purchases of HY debt has lowering the cost of borrowing, but simultaneously mispricing the risk of lower credit companies defaulting. In order to properly reflect the risk of default, which, even with support from the Fed, could easily extend into double digits, indicating that yields should be much higher than current levels.

When a company defaults on its debt by missing a coupon payment or worse its principal repayment, that absent cashflow will be painfully obvious to an individual holder of the bond. For a high yield ETF, if bonds default in large numbers payments will still be missing from the ETF and will appear in the cashflow produced via a reduced yield and ultimately a lower market price and NAV. When the underlying coupon payments fall from 7% or 8% due to the defaulted coupon payment, investors will no longer want to own the risk without the higher yield as an incentive, especially if that yield is allowed to erode via defaults. Therein lies the gap. Without a primary credit facility available to lower credit quality companies, or at least some mechanism to ensure coupon and principal payments are made, it will soon become painfully obvious how badly mispriced high yield bonds are in the presence of any meaningful default level.

Timing will be key here, the longer businesses are closed, the more likely they are to default. Moody's is forecasting a wide range of default scenarios, ranging from a benign 7.7% by year end in a V-shaped recovery scenario, to as much as 22% by February 2021 in a more protracted recessionary scenario. With a rolling reopening of our economy seeming more likely than a "big bang", something less than full output and revenue potential for businesses is probably the new normal for at least a few months. As such, we continue to believe any opportunity in HY bonds, in the absence of a primary lending or bridge loan facility that deals with actual defaults, needs to begin with double digit spreads, at a minimum. This corresponds to price levels that are 15-20% below today's levels, despite its seemingly inexpensive appearance.



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