DUCENTA SQUARED
ASSET MANAGEMENT

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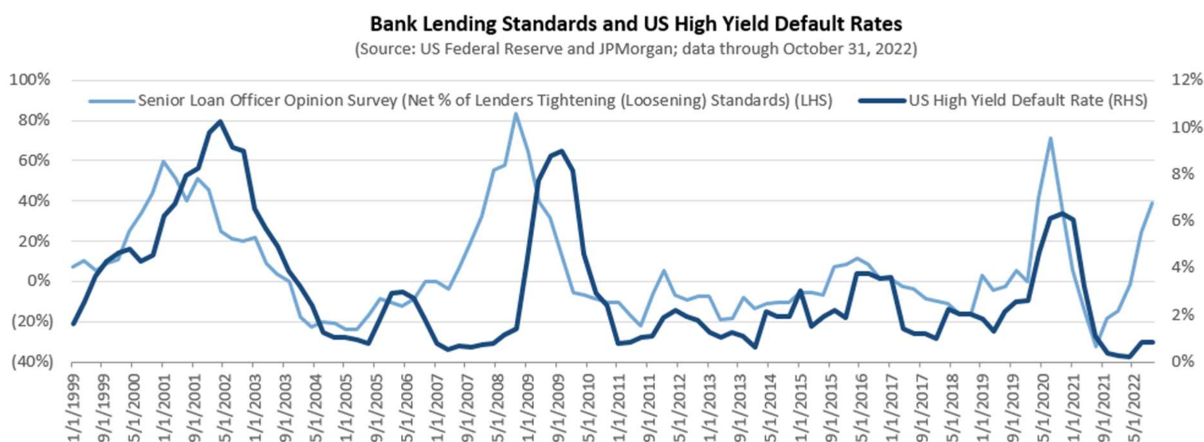
Do High Yield Valuations Reflect Current Economic Risks?

The year 2022 has proven to be a challenging period for US fixed income markets. The high yield sector, historically viewed as one of the least rate-sensitive fixed income sectors, returned -12.5% year-to-date through the end of October (per the Bloomberg US High Yield Corporate Bond Index (the "High Yield Index")). The sharp move higher in US Treasury rates contributed a meaningful portion to that return figure, with 5-year Treasury rates climbing nearly 300 basis points from 1.27% at the end of 2021 to 4.23% at the end of October. Additionally, high yield spreads widened approximately 180 basis points year-to-date to 463 basis points as of October 31, 2022. At their widest point year-to-date, in early July, spreads nearly reached 600 basis points, approximately 100 basis points wider than current levels. The combination of higher US Treasury rates and wider spreads pushed the average yield on the High Yield Index to 9.12% as of the end of October 2022.

Narrowing Path to "Soft Landing"

Since the early July peak in high yield spreads, the case for the Federal Reserve's ability to achieve a "soft landing" with its current tightening cycle appears much less convincing. Despite 375 basis points of cumulative increases to the federal funds rate since March, economic data has held up remarkably well. Notably, most labor indicators suggest that the job market remains robust, with the US unemployment rate still just 3.7% (down from 3.9% at year-end 2021). Meanwhile, inflation continues to run at near 8%, with the latest CPI reading coming in at 7.7% year-over-year in October. Consequently, these trends have forced Federal Reserve Chairman Jay Powell and his FOMC colleagues to continue talking tough, indicating that they'll have to press down even harder on the breaks. The market currently expects the FOMC to raise federal funds rate another 100 basis points to nearly 5.0%, up significantly from the 3.5% terminal rate that was expected in early summer.



While the US labor market data are holding strong, investors are beginning to see initial signs of cracks in credit fundamentals. The outlook for corporate earnings continues to dim, the massive wave of post-Covid ratings upgrades is quickly slowing, and high yield defaults are starting to pick up again. On the latter point, the US high yield default rate hit a record low level of 0.23% at the end of the first quarter but has since climbed to 0.83% at the end of October (per JPMorgan data). While this remains well below the historical average of approximately 3.5%, we expect defaults to continue to move higher in 2023, a view that is supported by Federal Reserve's Senior Loan Officer Opinion Survey on Bank Lending Practices. This survey tracks the percentage of banks that are tightening / loosening lending standards, and on a historical basis the data track extremely well with high yield default rates. In the most recent

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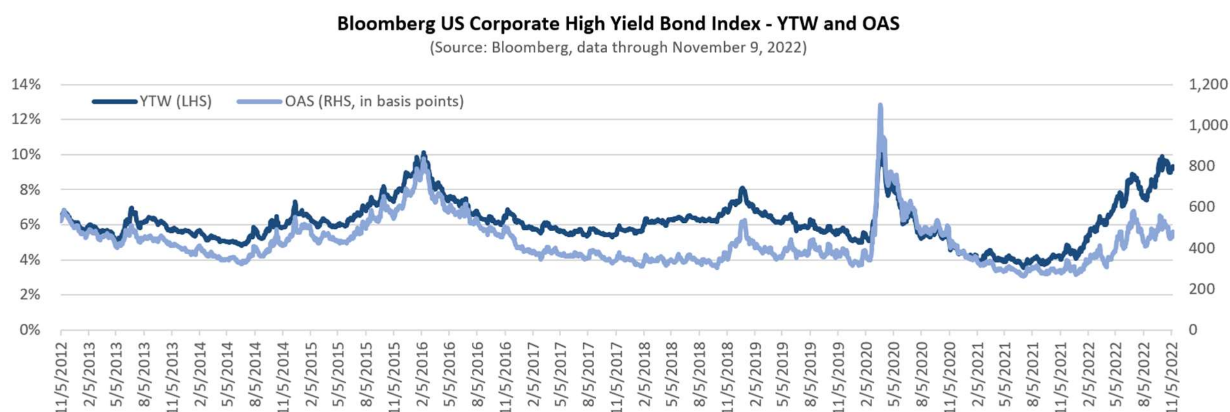
October report, the net percentage of banks tightening lending standards spiked to 39.1% from 24.2% last quarter and -1.5% (i.e., loosening) back in April. A jump of this magnitude is similar to readings recorded during the recessionary periods (and default peaks) of 2001-2002, 2008-2009, and 2020-2021 (see chart above).

Yields vs. Spreads

While each economic and credit cycle is different, the Federal Reserve's Senior Loan Office Survey should give investors reason to pause. We are certainly not alone in anticipating an economic recession next year, but for high yield investors that have already experienced historically weak performance in 2022, is the negative outlook already priced in? On this point, there appear to be two camps forming, one argues that all-in yields of approximately 9% appear attractive, and the other that believes spreads remain too tight. During prior downturns, high yield spreads peaked around 800-1,100 basis points (with the 2008 peak of 1,971 basis points during the Great Financial Crisis representing a major outlier). With spreads currently inside of 500 basis points, the bear case asserts that high yield spreads could go significantly wider in 2023.



Our investment process focuses on relative value across fixed income sectors, and on that basis, we believe that high yield spreads currently appear unattractive. One relative value metric – the ratio of high yield spreads to investment grade spreads – is currently just over 3x, which is below the long-term average of approximately 3.5x and the 3.6x level reached earlier this year. Additionally, yields and spreads in the leveraged loan market exceed their high yield equivalent by more than 100 basis points, and represent another relationship that seems out of line with historical ranges. With the cracks in credit fundamentals just beginning to emerge and the FOMC set to continue tightening financial conditions in 2023, we anticipate that high yield investors will have more attractive entry points in the next few quarters.

Past performance is no guarantee of future results.

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The Bloomberg US Corporate High Yield Bond Index measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1 / BB+ / BB+ or below. Bonds from issuers with an emerging markets country of risk, based on Barclays EM country definition, are excluded.