High Yield Bonds: That Was Then, This Is Now

After many years of mostly supportive conditions, fixed income assets today appear to be pinned in a vise of expectations—of persistently high inflation, of more restrictive monetary policy, of slower economic growth, of mounting debt piles, of ongoing geopolitical discord. Bond yields ascended steadily in response, punishing duration-heavy assets like Treasuries, investment grade corporates, emerging markets debt and agency paper during the first half of 2022. However, the generationally low yields that preceded the selloff left even high yield bonds vulnerable to duration risk for the first time in their brief history.

Though the pain has been acute across markets, there are signs that we may be in only the early stages of the credit cycle's turn. Decades of monetary accommodation along with fiscal permissiveness created the financial market equivalent of serene weather, suppressing market volatility and preventing the cathartic cleansing of failed business models that accompanies the end of a credit cycle. With policymaking agility now hamstrung by multidecade-high inflation rates, it seems that the bill for this period of relative calm may be coming due.

"In fair weather, prepare for foul," advised seventeenth century English polymath Thomas Fuller, and we've long been inclined to agree with this sentiment. Rather than searching for a port in the storms that inevitably arise, we continually underwrite our portfolio exposures in an effort to maintain appropriate levels of risk based on the fundamental backdrop and spread compensation available in the market.

KEY TAKEAWAYS

- The sharp rise in interest rates has punished duration-heavy fixed income assets, but even high yield bonds were not spared thanks to generationally low yields.
- Long a source of comfort for investors, the "Fed put" may not be as readily available as it has in the past as the central bank battles inflation levels not seen since the early 1980s.
- Central bank intervention over the years has blunted the peaks and valleys of the credit cycle, denying markets of the cleansing catharsis and reallocation of capital that characterizes a cycle's bottom.
- If history is any guide, the multiple inversions of the yield curve this year augur ill tidings for both the economy and the high yield bond market, though there are potential mitigating factors.
- While such an uncertain environment encourages downside risk mitigation, in our view, idiosyncratic opportunities may emerge should markets punish bonds indiscriminately.

Views expressed are as of July 15, 2022.

For Auld Lang Syne

January 2022 began with a bang, as it appeared investors had resolved to shed duration risk in the face of unrelenting inflation pressures and financial conditions that had already begun to tighten. Unlike most New Year's resolutions, however, this one has had staying power. The 4% loss posted by long government bonds in January, for example, was just the start of a first-half rout that sent the Bloomberg US Long Treasury Index 22.3% lower amid a broad repricing across asset classes.[1] Treasury yields surged across maturities, as shown in Exhibit 1, but pulled back a bit in the back half of June as focus shifted to downside economic growth risks.

While duration-heavy fixed income assets bore the brunt of the selloff, generationally low yields also left the high yield market susceptible to duration risk for the first time in its short history, and the Bloomberg US Corporate High Yield Index fell -14.2% in the first half of the year even as credit fundamentals remained generally supportive.[2] Volatility in rates and spreads—the index gapped more than 150 basis points in June alone, its second-largest monthly widening since 2008[3]—has weighed on new high yield bond issuance. With borrowers given pause by higher rates and investors seeking to preserve liquidity, new issuance totaled only $69 billion in the first six months of 2022 compared to $288 billion over the same timeframe last year.[4] A very active primary market has been a key support of high yield performance in recent years, and continued weakness here could become a more systemic concern should issuers find their access to the capital markets limited when it comes time to refinance maturing paper.

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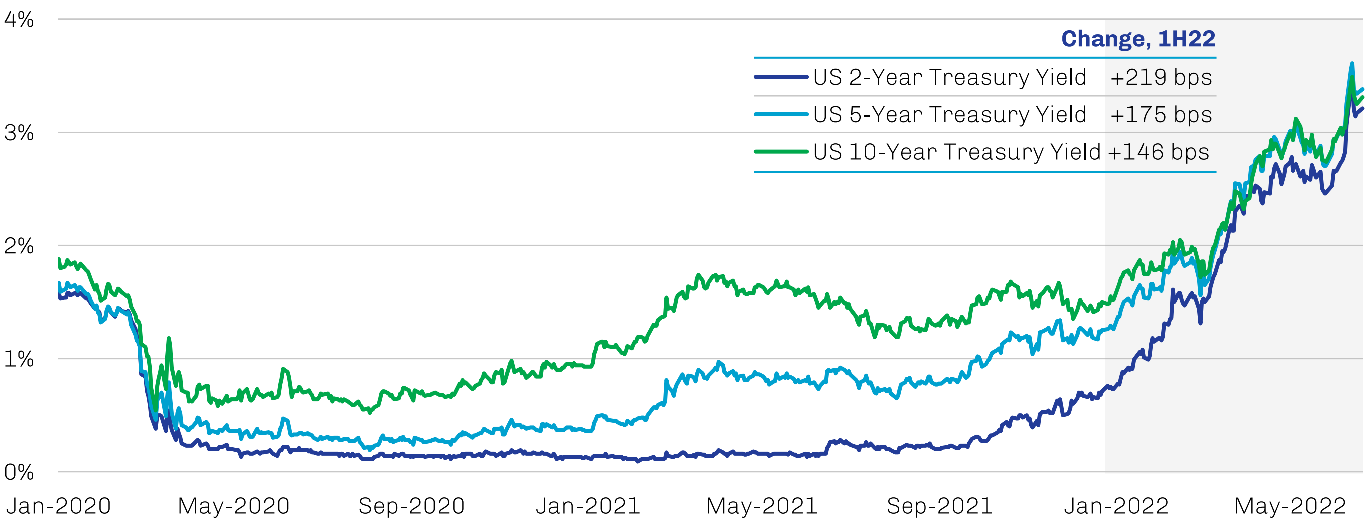
Exhibit 1. Expectations of Fed Tightening Have Driven Interest Rates Higher and the Yield Curve Flatter



Source: Federal Reserve; data as of June 30, 2022.

Is the "Fed Put" Kaput?

In recent decades, market participants for all intents and purposes have been able to delegate risk management responsibility to the monetary authorities, confident that the Fed and other central banks would intervene as necessary to temper any threats to financial and/or market stability. Though most often referred to in the context of equities, the so-called "Fed put" also bolstered risk tolerance in the fixed income space and pushed yield-seeking investors into lower-rated and longer-maturity bonds. Such a strategy was not unreasonable; the benefits of the central bank's implicit backstop were demonstrated repeatedly over the years, as the Fed has extinguished episodic market flare-ups caused by such disparate factors as economic slowdowns, a bloated banking system, geopolitical discord and a global pandemic.

Historically, the Fed put was slightly out of the money; that is to say, the central bank's tolerance for market dislocations was fairly low, and it could be counted on to intervene before the damage was too severe (the put's strike price in this analogy). Much of

1,2,3. Source: FactSet; data as of June 30, 2022.
4. Source: Wells Fargo; data as of June 30, 2022.

the Fed's willingness to act and act quickly could be traced to persistently low inflation; with minimal concern that its actions would interfere with the pursuit of its dual mandate of steady prices and full employment, the central bank was free to provide the liquidity necessary to calm volatility. Permissive monetary policy, meanwhile, was complimented by accommodative fiscal policy, as the same low inflation enabled ever larger and more frequent interventions at the federal level.

Given the need to get very high inflation levels under control, the strike price of the Fed put seems likely to be lower than it has been during previous instances of market tumult. The uncertainty surrounding this has caused an enormous amount of anxiety for bond market participants—especially those "yield tourists" who continued to search for higher rates despite the mounting risks—and represents a likelySource of ongoing volatility, in our view.

Bent Spokes in the Credit Cycle

While policy intervention has helped smooth off the rough edges of financial stressors and asset price volatility, persistently repressed yields also have warped typical credit cycle dynamics, denying markets the healthy end-cycle catharsis that sheds failed businesses and reallocates scarce capital to its most productive uses.

Though each has its own idiosyncratic characteristics, credit cycles generally have followed similar paths. They begin with extreme pessimism as the market emerges from a period of rationed credit, high levels of distress and defaults, and pronounced risk aversion among investors. While post-trough bond issuance typically is well-structured, attractively priced and cemented by strong covenants, investors tend to become increasingly permissive as the credit cycle unfolds; with more money chasing finite investment opportunities, bond structures offer limited protections, prices tighten, and covenants weaken or disappear. This market ebullience ultimately results in the broad misallocation of capital, forcing the Fed to rein in financial conditions to avoid overheating the economy. With credit less appealing to investors and less available to borrowers in an environment of tighter liquidity, spreads widen and expected defaults spike as capital flows only to the most creditworthy businesses, and the market achieves the aforementioned healthy catharsis before the whole thing starts over again.

While in past cycles one could point to certain areas within credit markets where the misallocation of capital was greater than others—if only in hindsight—it can be argued that the persistent repression of yields in the aftermath of the global financial crisis led to a wide range of distortions impacting rates, credit, sovereign, emerging debt and global equity markets. At the same time, the Fed may be trapped in a monetary straitjacket. The vigor needed to slay the inflation dragon will slow the economy and likely push it into recession; a more timid approach may sidestep recession but risks anchoring inflation expectations at a higher level, resulting in years of below-potential economic growth and the continued erosion of Americans' real wealth. Either scenario suggests the Fed's ability to intervene in markets as freely as it has in the past may be compromised, which in the high yield market may translate into an extended period of distress and default—catharsis, yes, but maybe not the healthy one we want.

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Are We There Yet?

Though it may seem like we already have had a massive correction in leveraged credit, the option-adjusted spread of the Bloomberg US Corporate High Yield Index widened only 269 basis points in the first half of 2022. At 587 basis points, high yield spreads are only slightly above the long-term average near 530 basis points.[5] While our ultimate destination is unknown and the timing is uncertain, we think it is safe to say that we aren't "there" yet. Given the somewhat limited spread widening thus far, we see the potential for additional downside from here, especially if the Fed's inflation-fighting fervor prompts a recession. Inflation alone would weigh on margins and pressure credit metrics, and inflation plus slow economic growth would amplify these effects.

Such fears may be well-founded if recent signals from the Treasury market are any indication. Fueled by persistently high inflation prints and aggressive Fed rhetoric, market estimates of the terminal federal funds rate have evolved rapidly since the Fed launched its rate-hike cycle in March, and the 10-year/two-year Treasury curve inverted for a short period in both April and June and appears to have begun a lengthier inversion in early July. This historically has been a classic precursor for both future

5. Source: Bloomberg; data as of June 30, 2022.

recessions and high yield bear markets; each of the past 11 recessions in the US since 1950 was preceded by an inversion of the yield curve (the inversion of 1965–66 was the lone false signal during this period) as was each of the four bear markets in the short history of high yield bonds.[6]

In past credit cycles, high yield issuers—particularly those that combine high financial leverage with high operating leverage—were often the first to feel the effects of tightening financial conditions. Compared to their investment grade peers, high yield companies tend to inhabit weaker market niches and have narrower businesses, less-focused management teams and greater financial leverage. Lacking an advantaged market position, such businesses are likely to have thinner margins and a limited ability to pass along higher input costs to their customers. As the cost of capital increases, high yield issuers may be particularly susceptible to cash flow volatility and thus have the greatest need for credit forbearance or access to incremental capital. Of course, such companies—particularly those on the smaller end of the EBITDA spectrum and with narrow product lines in more commoditized industries—likely will have the fewest options in world of tight financial conditions.

A potential mitigating factor is that the high yield index is as highly rated as it has been at any time in the past 30-plus years; as shown in Exhibit 2, bonds rated BB comprised about 52% of the index at end-June. All other things being equal such bonds can be expected to have greater capacity to withstand slower economic growth and higher inflation than lower-rated bond cohorts. Relative to B and CCC rated bonds, companies with BB rated paper tend to have better management teams, more diverse and stable business lines, and stronger balance sheets. If coupled with moderating inflation and a shallow recession, the high yield index's strong credit quality could drive a less-bad outcome. This scenario, however, is dependent on the market remaining orderly and two-way price discovery continuing to be ample, conditions not guaranteed in the event of panicked liquidation and erratic price movements.

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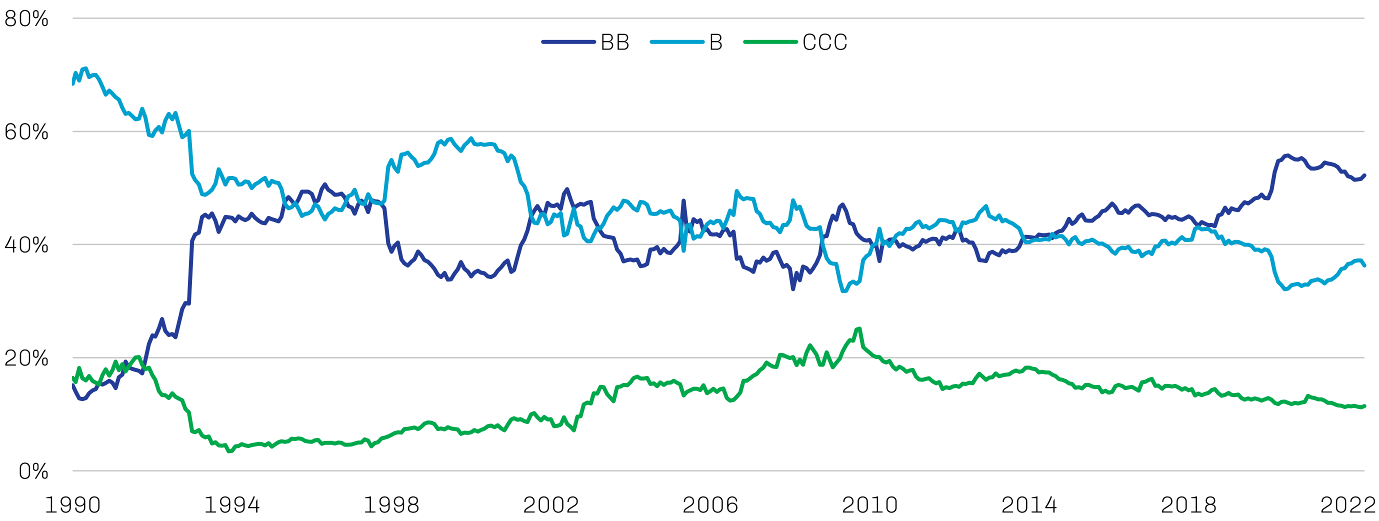
Exhibit 2. While Relatively Strong Credit Ratings May Cushion the High Yield Market in a Downturn...

Percentage of Bloomberg US Corporate High Yield Index by Credit Rating, January 1990 through June 2022



Source: Bloomberg, Morgan Stanley Research; data as of June 30, 2022.

While a measured increase in policy rates can be absorbed by the credit markets, things could get messy if markets lose faith in the Fed's ability to control inflation and the bond vigilantes step in to drive up rates. More pessimistic scenarios see spreads approach levels seen during the global financial crisis. The conditions that produce these darker timelines also entail increased risk that fallen-angel paper floods the high yield market. There are approximately $3.5 trillion worth of bonds in the US BBB credit tier compared to only $1.3 trillion in the entirety of the US high yield market.[7] As the economy all but shut down in early 2020, only well-conceived Fed programs to support the primary and secondary bond markets prevented several hundred billion dollars worth of paper from losing its investment grade status.

6. Source: Global Financial Data, Federal Reserve Bank of St. Louis, FactSet; data as of June 30, 2022.
7. Source: Morgan Stanley Research; data as of June 30, 2022.

Exhibit 3. ...The Large Share of BBB Paper Points to a High Risk of "Fallen Angels"

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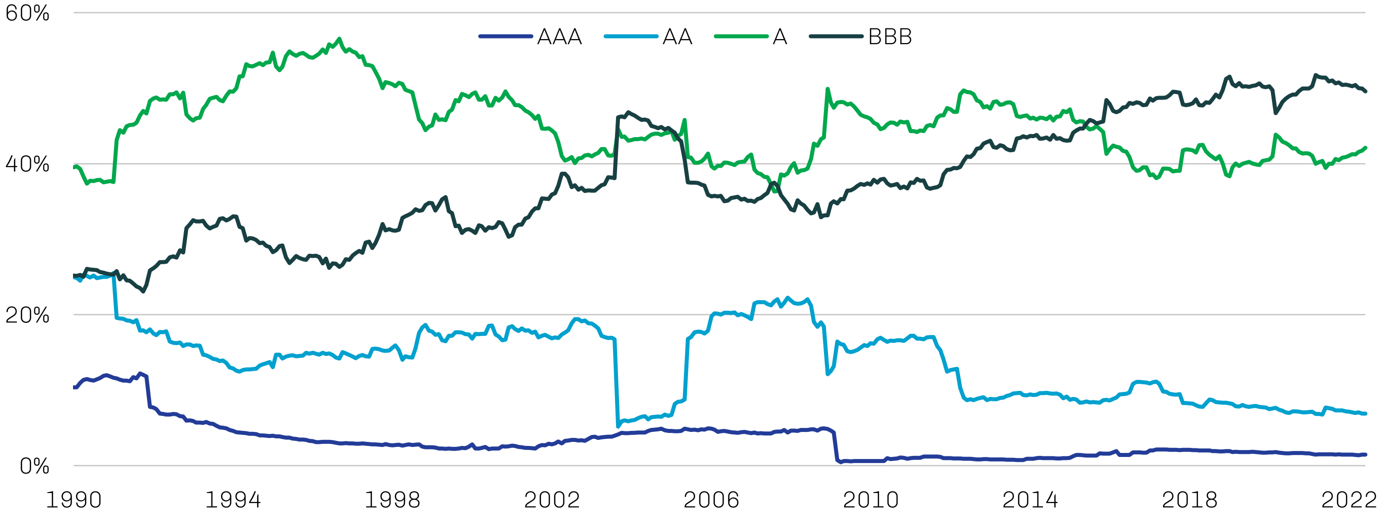

Source: Bloomberg, Morgan Stanley Research; data as of June 30, 2022.

Conclusion

"There are decades when nothing happens; and there are weeks when decades happen." So (supposedly) wrote Vladimir Lenin as he was living in exile in 1917. It certainly seems as if the pre-Covid, pre-inflation, pre-Russia/Ukraine world was decades ago. Though much has changed in a fairly short period of time, as with the Russian Revolution in the wake of WWI, these developments were many years in the making, rooted in the decades-long lengthening of global supply chains with just-in-time inventory precision to the deepening involvement of government and monetary authorities in financial markets.

While these factors have provided an unprecedented tailwind for leveraged credit and risky assets in general, we may be witnessing the beginning of the end of this period of uber-supportive financial conditions. In such an environment, we believe it is wise to focus on minimizing downside risk through shorter-duration, higher-quality, more-liquid issues, while also looking to countercyclically allocate capital as spread widening presents idiosyncratic opportunities.

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"Duration" is a measure of the sensitivity of the price of a bond to changes in interest rates.

"Bear market" refers to a period during which a market experiences a prolonged decline in price.

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Bloomberg US Long Treasury Index includes fixed income securities issued by the US Treasury (not including inflation-protected bonds) and US government agencies and instrumentalities, as well as corporate or dollar-denominated foreign debt guaranteed by the US government, with maturities greater than 10 years.

Bloomberg US Corporate High Yield Bond Index is composed of fixed-rate, publicly issued, non-investment grade debt, is unmanaged, with dividends reinvested, and is not available for purchase. The index includes both corporate and non-corporate sectors. The corporate sectors are Industrial, Utility and Finance, which include both US and non-US corporations.

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