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Keep Calm and Carry On - 10 Reasons to Stay Invested in High Yield

June 2022

Despite the heavy price action we have witnessed in the high yield market since the start of the year, we believe high yield investors should hold firm and potentially consider adding to their exposure at what we believe could be an attractive entry point into the asset class

The high yield market is down over 12%¹ this year due to rising sovereign yields and spread widening associated with slowing economic expectations. Fig. 1 illustrates just how far the market has moved.

However, while the market has been weak, we believe the current environment warrants closer attention.

Fig. 1 - Developed Market High Yield Has Sold Off Year to Date

	H4NC 12/31/21	H4NC 6/16/22
Price	103.35	87.91
YTW	3.66%	7.55%
STW	299 bps	465 bps
DTW	3.82 years	4.40 years
DTM	5.01 years	4.42 years

Source: ICE Index Platform. ICE BofA BB-B Global Non-Financial Developed Markets High Yield Constrained Index (H4NC), as of 16 June 2022. For illustrative purposes only.

1. ICE Index Platform, as of 16 June 2022. Based on the ICE BofA BB-B Global Non-Financial Developed Markets High Yield Constrained Index (hedged USD).

Analysis



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Prior to joining Muzinich, Bryan worked for Pinebridge Investments (formerly AIG Investments) where he served as Managing Director, Head of High Yield for the last five years of his tenure. Bryan started his career in the banking sector. He worked in the media and cable groups at the Union Bank of California and Banque Paribas. Previously, he participated in the start of Société Générale's cable and media group. Bryan received a B.A. from the University of California, Los Angeles where he was a Phi Beta Kappa scholar, and an M.B.A. from the University of California, Berkeley.

1. High Yields

Only 4 times over the last 20 years have yields been higher than now, in the 2002 corporate fraud wave, the great financial crisis (GFC) in 2008-2009, the European sovereign crisis in 2011 and the 2020 Covid crisis.¹ Current yields are consistent with the 2016 high associated with the US energy crisis. Thus, yields are near their 20-year high percentile range.

2. Spreads Above 10-Year Average

Spreads are above their 20-year average at 465 bps versus 448 bps, but they are materially above the 10-year average of 387 bps.¹ The 10-year average is an important focus area given the maturity of the market today versus pre-GFC, and the fact that we consider the GFC to be a 100-year event and unlikely to happen again in the foreseeable future.

3. Low Dollar Price

Dollar prices have only been lower than the current level 3 times over the last 20 years: the 2002 corporate fraud scandal, the GFC and 2020 Covid era.¹

4. Higher Rating than pre-GFC

The asset class now carries a BB3 rating versus B1 pre-GFC; we are higher rated than before the largest correction.¹

5. Strong Credit Metrics

US high yield leverage is less than 4.5x gross with a net of almost 3.5x. This is a function of a US market that is at a 20-year high in BBs and a 20-year low in CCCs as well as issuers maintaining large cash balances in the post-Covid era.² Interest coverage is approaching 6x in the US and may decline to 4.75-5.00x in 2023 in a slowing economy/rising rate environment.³ Liquidity and leverage are not an issue right now because the weak companies failed in 2020-2021, while the strong issuers became leaner.

6. No Wall of Maturities

The market is **NOT** exposed to near-term maturities. The coupon can cover US maturities through 2024.⁴

7. DTW and DTM aligned

The market DTW is in-line with the DTM (See Fig 1.); in our opinion the changing duration picture of the market is behind us. Convexity is now in our favor.

8. Further Spread Widening Would Result in a Flat Return on a 1-Year Basis

The current average yield of the market is 5.69%.¹ We believe if spreads widened 130bps from current levels the asset class would post a flat return over 1 year. Spreads only exceeded 600 bps during the Covid peak from March-May 2020 and the US energy crisis from December 2015-March 2016 over the past 10 years.¹

9. Default Rates Near Historic Lows

While default rates will rise as the economy slows, in our view they are unlikely to hit GFC levels given the low CCC percentage in the market, the low level of large leveraged buy outs (LBOs) in the market, and the recent 8%+ US default rate peak.² Based on the current market, we believe a 3-5% rate could be achieved over the next 12-18 months, and this is likely already priced into current broad market spreads where CCCs are approaching 1,000 bps.

10. Less Liquidity in a Bear Market Makes Tactical Trading Challenging

Tactical trading in high yield can be challenging since not every issuer trades every day. Buying after a clear upturn will be challenging since brokers no longer carry inventory and everyone will be trying to buy. We believe the best time to buy in high yield is when managers are selling, and prices are going down while the best time to sell is when prices are going up and everyone is buying.

The global economy is slowing and there are potential recessionary clouds on the horizon. While it is impossible to say where the market will trade on any given day, it is clear that investors have taken pain in 2022 and the potential returns at this point are actually skewed more towards the positive than they were at the end of 2021.

In our opinion, longer-term investors with strong capital positions could consider the following options.

1. Ride out these levels and let the power of the coupon overcome short-term volatility.
2. Begin **ADDING** to positions and dollar-cost average down and YTW average up their holdings.

1. ICE Index Platform, as of 16 June 2022. Based on the ICE BofA BB-B Global Non-Financial Developed Markets High Yield Constrained Index (hedged USD).

2. ICE Index Platform, as of 31st May 2021. ICE BofA US Cash Pay High Yield Index (JOA0), ICE BofA CCC and Lower US Cash Pay High Yield Index (JOA3) and ICE BofA BB US Cash Pay High Yield Index (JOA1).

3. BofA Securities. Market Outlook HY Credit Strategy, 14 June 2021.

4. ICE Index platform. ICE BofA US Cash Pay High Yield Index (JOA0), as of 31st May 2022.

We believe selling today at current low dollar prices is locking in losses. In our view, high yield investors make almost all of their return over time due to the carry of being invested, if not over 100% due to default losses. This is in direct contrast to equities where investors make almost all of their total return from price movements.

We believe investors with a long-term perspective and stable capital are best positioned to achieve the long-term total return potential of the asset class offered by today's levels. Time in the high yield market is more important than timing the high yield market over the long run.

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Index Descriptions

JOA0 - The ICE BofA ML US Cash Pay High Yield Index tracks the performance of US dollar denominated below investment grade corporate debt, currently in a coupon paying period that is publicly issued in the US domestic market. Qualifying securities must have a below investment grade rating (based on an average of Moody's, S&P and Fitch), at least 18 months to final maturity at the time of issuance, at least one year remaining term to final maturity as of the rebalancing date, a fixed coupon schedule and a minimum amount outstanding of \$250 million.

JOA1 - The ICE BofA ML BB US Cash Pay High Yield Index is a subset of the ICE BofA ML US Cash Pay High Yield Index (JOA0) including all securities rated BB1 through BB3, inclusive.

JOA3 - The ICE BofA ML CCC & Lower US Cash Pay High Yield Index is a subset of the ICE BofA ML US Cash Pay High Yield Index (JOA0) including all securities rated CCC1 or lower.

H4NC- H4NC - The BofA BB-B Global Non-Financial Developed Markets High Yield Constrained Index is based on securities in the The ICE BofA Global High Yield Index that have risk exposure to countries that are members of the FX-G10, Western European territories of the US and Western Europe. The FX-G10 includes all Euro members, the US, Japan, the UK, Canada, Australia, New Zealand, Switzerland, Norway and Sweden. The index includes the debt of all non-financial issuers rated BB1 through B3, inclusive, but caps issuer exposure at 2%.

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