Analysis

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US High Yield – The Law of Supply and Demand

November 2021

An anticipated increase of rising stars in US high yield over the next 12 to 18 months could result in a strong technical backdrop for the asset class.

The impact of the COVID-19 pandemic has been felt across global financial markets as the economic downturn weighed on corporate profitability, leading to a record number of ratings downgrades and an increase in defaults in 2020.[1]

In 2021, as global economies recover from the worst of the economic fallout, corporates have returned to profitability. This has led to a reversal in the ratings fortunes of many high yield companies.

We have seen hardly any fallen angels and around US$25bn of rising stars this year - a trend that looks set to continue alongside the expected ongoing positive global macroeconomic momentum.[2]

How many rising stars could emerge from the high yield universe in the next 12 to 18 months varies, with estimates ranging from US$80bn [3] to over US$200bn.[4]

This trend is surprising in its magnitude, but perhaps expected given the number of companies who bore the brunt of a pandemic-induced downgrade.

Bryan Petermann

Portfolio Manager

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. Credit Suisse, 9 September 2021. Credit Strategy Daily (Rising Stars).
2. IBID
3. IBID
4. JP Morgan, Rising Stars to Burn Brighter, 21 October 2021

For high yield investors, current spreads appear tight.[5] However, we believe they fairly reflect the positive economic situation and are therefore likely to remain tight for some time, in line with the economic backdrop.

Fallen angels are not predicted to increase. At the same time net supply is likely to fall with c.US$5bn forecast for 2022, down 90% from 2021.[6]

As high yield managers sell their bonds following investment grade upgrades, managers may be left with a vast amount of capital they will likely need to redeploy into the high yield market.

We believe this will lead to a very strong demand technical of over US$100bn being recycled into the asset class. Increased demand pitched against falling supply normally drives prices higher.

For investors in US high yield, this could mean further upside potential, even if spreads remain tight as they often do during economic expansions.

5. Bank of America Merrill Lynch US High Yield Index (JC4N) OAS 269bps as of 9 November 2021.
6. Goldman Sachs Global Credit Trader: A Friendlier net supply backdrop for 2022, 4 November 2021

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JC4N - The ICE BofA ML BB-B US Non-Financial Cash Pay High Yield Constrained Index contains all securities in the ICE BofA ML US Cash Pay High Yield Index (J0A0) that are rated BB1 through B3, inclusive, except those of financial issuers, but caps issuer exposure at 2%.