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Short Duration High Income Q&A

By US Short Duration High Income Investment Team

Summary

- The US short duration high yield market is well-positioned to benefit from the structure of the Federal Reserve Board (Fed) corporate bond purchase programmes.
- Against the backdrop of low coupons and long duration risks in traditional, core bonds, US short duration high yield may offer a potentially better risk/return alternative.

Q: The Fed has gone "All in", deploying a range of tools including lending programmes and corporate bond purchase programmes to support the private sector. What are the implications for the bond (or credit) markets under these circumstances?

A: Over the last several weeks the Fed has taken extraordinary steps to support credit markets. The policy response started with repos and expanded to include commercial paper and money markets, all of which were in the existing playbook. Then policy expanded further to support public market corporate debt by making 5-year and investment grade credit eligible for investment, as well as broad market high yield ETFs. These programs have helped sentiment, enabling investors to look beyond the very near term. US high yield bonds traded significantly higher in reaction to these measures. Since the Fed announcement on 9 April, the ICE BofA USHY index tightened from 881bps to reach 731bps on 17 April. The index returned 5.8% during the same period[1]. The primary market had also seen a significant pickup in activity month-to-date with a total of 21 deals priced for $10.2bn[2].

With the Fed supporting both investment grade and sub investment grade credits in the United States, the US short duration high yield market is well-positioned to benefit from these Fed actions, given its focus on US issues with shorter-term maturities in the US high yield credit market.

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Q: What do you expect from credit spreads in the US high yield market going forward?

A: The near-term outlook for the global economy and corporate profitability is uncertain and evolving due to the headwinds associated with COVID-19 outbreak. The situation continues to move very rapidly and requires close monitoring, especially in light of the massive confluence of central bank intervention and government stimulus.

While the duration and severity of the economic downturn is unknown, the extraordinary monetary and fiscal policy measures instituted by the Fed and the US government aim to not only help stabilise financial markets but also accelerate the recovery and the Great Restart.

Upcoming economic reports should reflect materially slower activity resulting from the government-imposed shutdown. Data points are unlikely to rebound in the short term. First-quarter corporate earnings are likely to come in below expectations and most outlooks are expected to be downbeat with reduced visibility.

While the near-term outlook for the high-yield asset class is less certain, the intermediate- and long-term outlooks are constructive. At quarter-end, the high-yield market's price was 85.8 cents on the dollar and spread was 877bp (down from nearly 1100bp intra-quarter)[3]. According to JP Morgan, a spread of 800bp has historically led to attractive return opportunities, but the case is even more profound above 900bp[4]. The median annualised returns over the next 12-, 24-, and 36-months for high yield as spreads cross 900bp are 36.9%, 25.5%, and 20.8%, respectively. In fact, with a time horizon of a year or more, the asset class has not produced a negative return when spreads crossed 900bp. This backdrop may offer an attractive entry point for long-term investors with significant total return potential given the market's discount to par.

Q: Although the Fed intervention has been decisive, not every sector is as well-placed to weather this storm. How do you differentiate the winners from the losers, in an environment of rising credit defaults?

A: The COVID-19 pandemic is expected to impact all high-yield issuers and cause defaults to increase. However, the asset class remains well diversified across many industries. Healthcare, energy, telecommunications, cable & satellite TV and technology are among the top industries in the universe. Energy industry issuers are likely to face a higher rate of default, but risk should be concentrated in the most distressed credits within the E&P and oil field equipment & services subindustries.

Q: After the liquidity squeeze in March, do you see any signs of the market stabilising?

A: The Fed and fiscal response to support the orderly flow and stabilisation of credit continues to work with further evidence of healing in the investment grade and high-yield markets. Investment grade issuers have continued to access the capital markets following record new issuance in March. After going dormant for most of March, the high yield primary market got tested – successfully – heading into month-end. By mid-April, the new issue market was wide open. Most issues were characterised as secured deals with maturities of five years and a few tack-on offerings to existing notes, using the proceeds to raise liquidity and bridge operations through the COVID-19 pandemic.

Q: Zero interest rates are back. What is the investment edge offered by the short duration high yield market, compared with core bond solutions?

A: Depressed interest rates in conjunction with an abundance of negative-yielding debt globally will make it difficult for investors to find attractive income and compelling total returns. Traditional, or "safe," bonds generally have low coupons and long durations and offer zero or ultra-low returns. The danger of taking duration risk when interest rates are low is that principal values will decline when interest rates rise. Indeed, traditional core bonds are no longer delivering the risk/reward outcomes investors are used to.

With yields at historic lows, now may be a good time to look to US short duration high yield market, which may offer investors an alternative to traditional core bonds.

Source:
[1] ICE Data Services,; 17 April 2020.
[2] JP Morgan; 17 April 2020.
[3] ICE Data Services; ICE BofA US High Yield Index; 31 March 2020.
[4] JP Morgan; 31 December 2019.