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Around THE Curve

U.S. High Yield Offers Safer Middle Ground

September was a difficult month for stocks and interest rates, but U.S. high yield proved to be an exception. For some investors who subscribe to the overly simplistic "tight spreads and low yields" analysis of high yield, the sector's better performance may have come as a surprise—but not to us. We continue to believe it is one of the safest places to target a positive real return in a very uncertain environment. Here is why.

Starting Yield Still Beats Expected Inflation

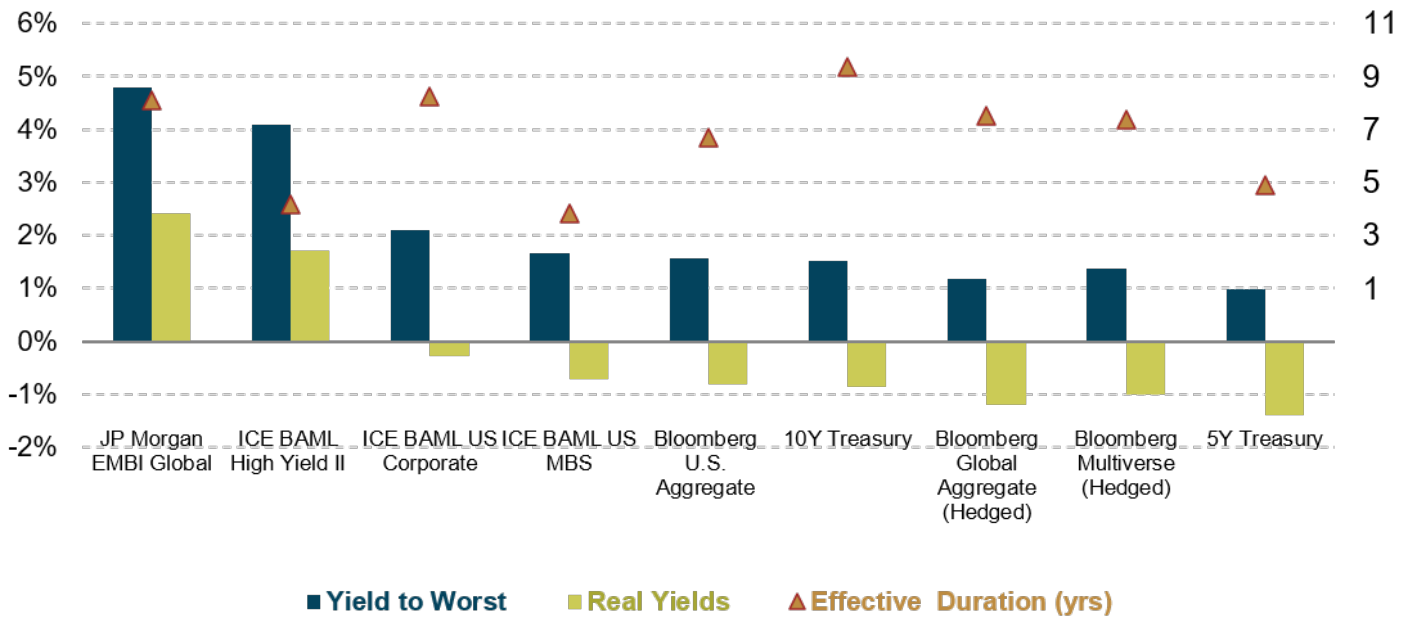
A starting yield well above expected inflation is helpful. U.S. high yield's higher yield stands out compared to most fixed income sectors, and the yield comes with less duration, or interest rate risk. Perhaps "high yield" should be rebranded "low duration."

The negative real yields that plague most fixed income sectors are no accident. Policymakers around the globe want to keep government bond yields below inflation so that debt-to-gross domestic product (GDP) ratios can stabilize and even decline over time. This situation is known as financial repression, and it will be with us for a long time. Investors who want to generate a positive real return are forced to look beyond government bonds (see Chart 1). They are finding that U.S. high yield is one of the best sectors to achieve their objectives in this era of financial repression.

1

Real Yields by Sector

% (left), Years (right), As of 9/30/2021



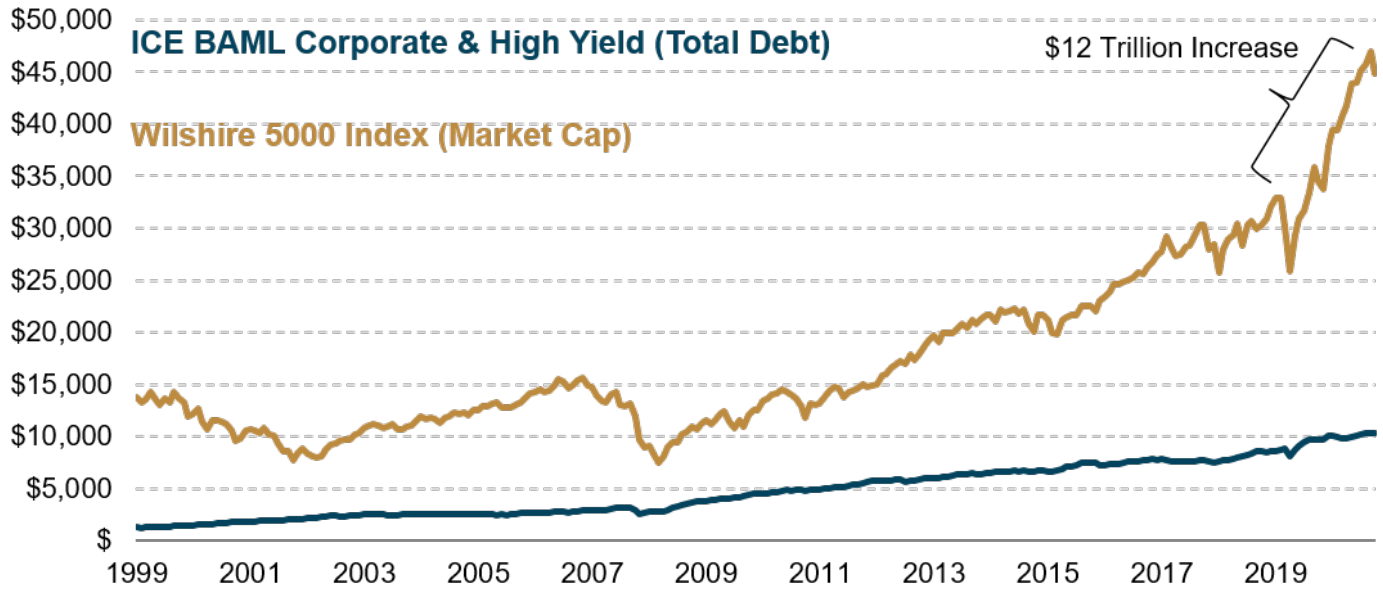
Source: Bloomberg (© 2021, Bloomberg Finance LP)

Corporate Debt-to-Market Value of Equities at Record Lows

A common refrain cites U.S. corporate debt at record levels compared to the size of the economy. Certainly, U.S. corporate debt relative to the size of the economy is above the high end of its historic range. However, the market value of U.S. equities is even farther above the high end of its range. As a result, the value of U.S. corporate debt relative to the market value of domestic equities is at generational lows (see Chart 2). Since the beginning of 2020—before the pandemic meltdown of financial markets—the market value of publicly traded U.S. equities, represented by the Wilshire 5000 Index, has increased by nearly $12 trillion. This gain is more than the value of the entire U.S. investment grade and high yield corporate bond markets, measured by the $10.3 trillion in the ICE BofA U.S. Corporate & High Yield Index. While the overlap between these markets is not perfect the point is clear: the value of the equity supporting U.S. corporate debt is higher than it has been in a long time. This equity cushion provides a critical margin of safety for U.S. high yield bonds. It is also an important reason why U.S. high yield issuers have had wide open access to capital since the pandemic lows in 2020.

2 U.S. Equity Market Capitalization vs. Total Corporate Debt Outstanding

$ Bn , As of 9/30/2021



Source: Bloomberg (© 2021, Bloomberg Finance LP)

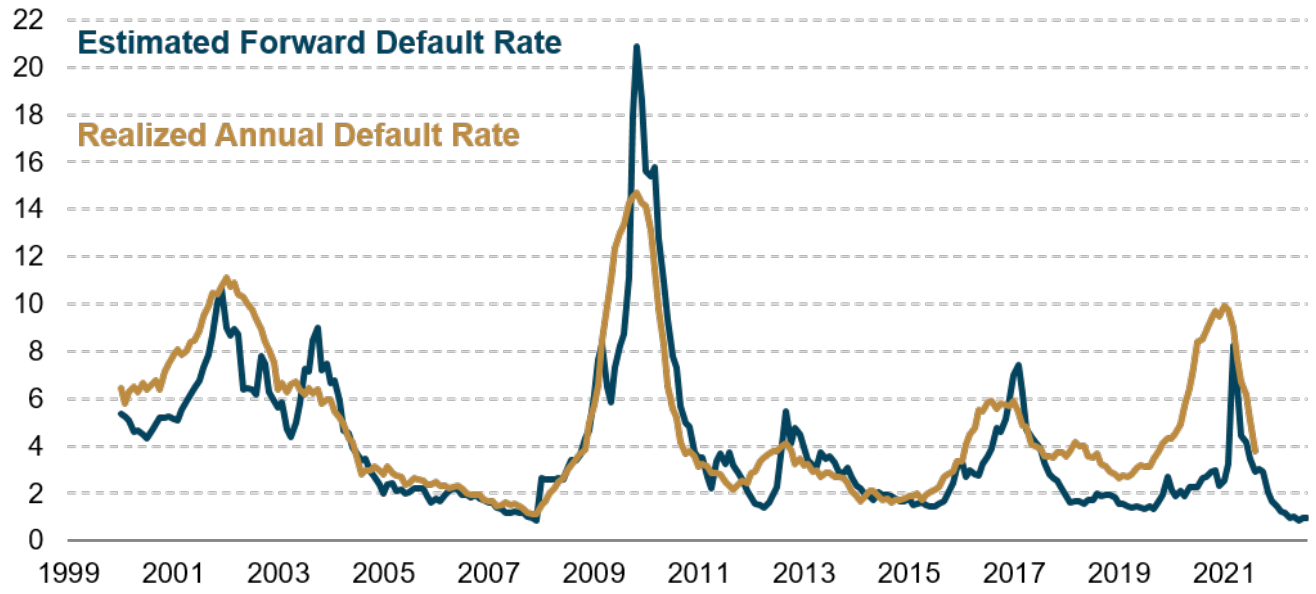
Over the span of about one month at the beginning of the pandemic, the U.S. government and the Federal Reserve (Fed) provided more support to financial markets than they did during 18 months in the 2007-2009 global financial crisis. This pandemic relief included Fed facilities financed by Congress to purchase certain investment grade and high yield bonds and ETFs. We believe this was a regime change that ultimately will lead to structurally tighter credit spreads going forward. Tighter credit spreads also contribute to a lower cost of capital for U.S. businesses and, ironically, may have contributed even more to the move higher in equity valuations. However, the cost of these policies might come in the form of lower growth and efficiency over the long run.

Defaults Are Low, Credit Quality Is High

The factors discussed above, along with high and growing corporate earnings, have brought high yield defaults down to very low levels. We expect defaults to stay well below historic averages for the foreseeable future (see Chart 3).

3 U.S. High Yield Default Rates

%, As of 8/31/2021

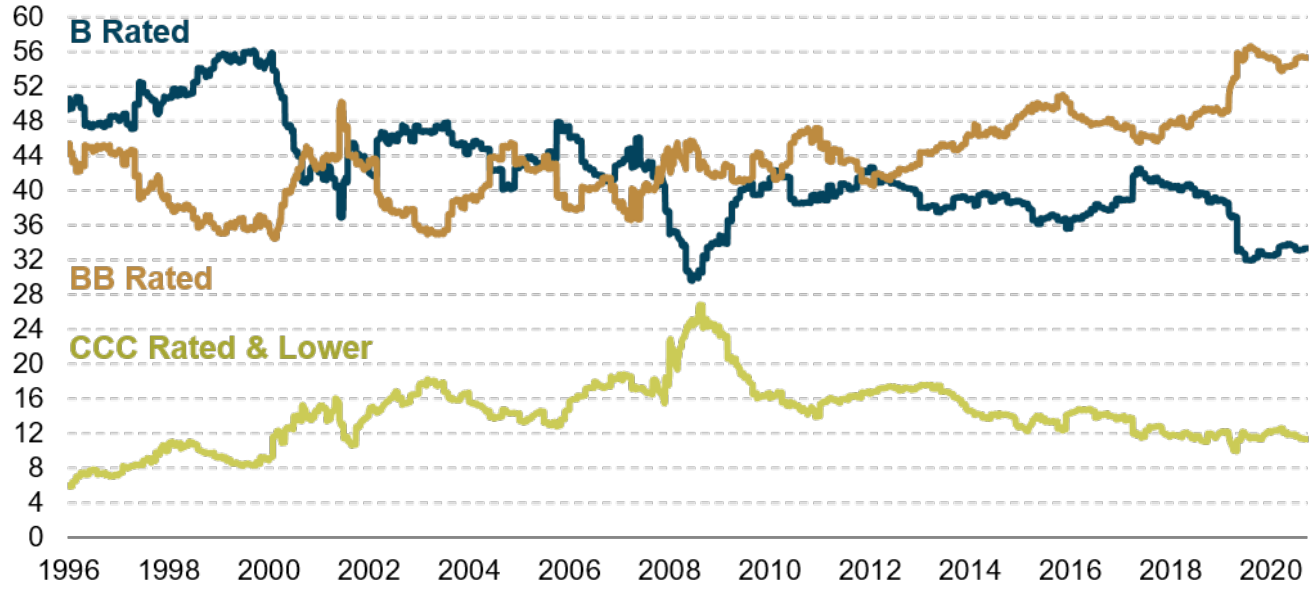


Source: Brandywine Global, Macrobond, ICE BAML

Furthermore, the ratings composition over time highlights significant improvement in the credit quality of the market, with a much higher weighting in BB-rated debt and a lower weighting in CCC-rated debt (see Chart 4).

4 ICE BAML U.S. High Yield, Market Value Weights by Credit Quality

%, As of 9/24/2021



Source: Brandywine Global, Macrobond, ICE BAML

A Coveted Middle Ground

It is always ill advised to analyze any asset class in isolation. Taking that narrow view, high yield might easily be dismissed as having too tight spreads and low yields. However, relative to other asset classes, the appeal of high yield comes into focus. Currently, investment grade bonds often start with negative real or even nominal yields, providing investors with few opportunities. Equities are valued at near peak multiples on near peak profit margins, limiting upside potential. That leaves U.S. high yield in a more attractive middle ground between financial repression on one side and equity valuation risk on the other.

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