Donald Phillips: How is the high yield market coping with the invasion of Ukraine, soaring energy prices and the spectre of stagflation?

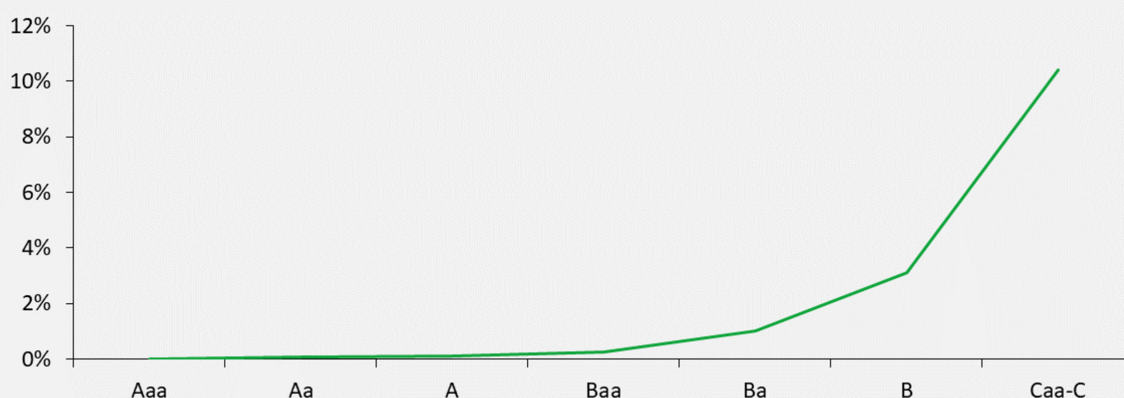
There is a lot to unpack in this question. The short answer is, quite well.

Major equity indices are, as I type, still reeling, with the Eurostoxx and growth-heavy Nasdaq both down 15% year-to-date. The global high yield market is down close to 6.3% year-to-date in sterling terms. Drilling into this, the US market is down 4.8%, whilst European high yield is 5.8% lower. Given the proximity to the conflict and European reliance on Russian commodities, this difference is unsurprising.

Indeed, the US high yield market remains much more concerned about rising interest rates and duration risk than about aggregate demand in the economy and the potential for rising defaults. An illustration of this point is the continued outperformance of low-quality, CCC bonds. High yield market commentators have been discussing for months, nay years, that CCC bonds are a good place to hide from rising interest rates. The high coupons on offer are naturally more resilient to rising interest rates than the lower coupons you typically get from, for example, BB-rated bonds.

Of course, with commodity prices going through the roof, the large cohort of commodity sector bonds in the US CCC-rated part of the market are benefitting. With the fixed, limited upside in bonds, particularly when the market has already largely priced in their current good fortune, we don't believe this is a theme that bond investors should embrace too readily. We must always remember the skew of defaults towards the lowest quality parts of the market, shown in Chart 1 below. If an investor wants to bet on thematic, cyclical companies, they are better doing so in the equity market.

Chart 1: Mean default rate 1920 to 2020



Source: Liontrust, Moody's, as at 31.12.20

There is no such outperformance from CCCs in Europe, where the spectre of stagflation is arguably greater. Stagflation is when you have both inflation and a shrinking economy. Inflation was already proving itself frustratingly persistent before the explosion in commodity prices and will, of course, be exacerbated if commodity prices remain elevated. Meanwhile, European manufacturing and

consumer discretionary spending will likely both take a hit. The inflation part of this issue means central bankers will be reticent to cut monetary policy as they normally do in a slowdown.

To a significant extent, such fears are playing out in European high yield spreads, the risk premium we are paid for the default risk that comes with high yield bonds. The European high yield spread – as illustrated in Chart 2 – has now risen to 4.8%, well above the long-term average of 4.1%, and we view this as attractive compensation for the risks.

Chart 2: European high yield credit spreads

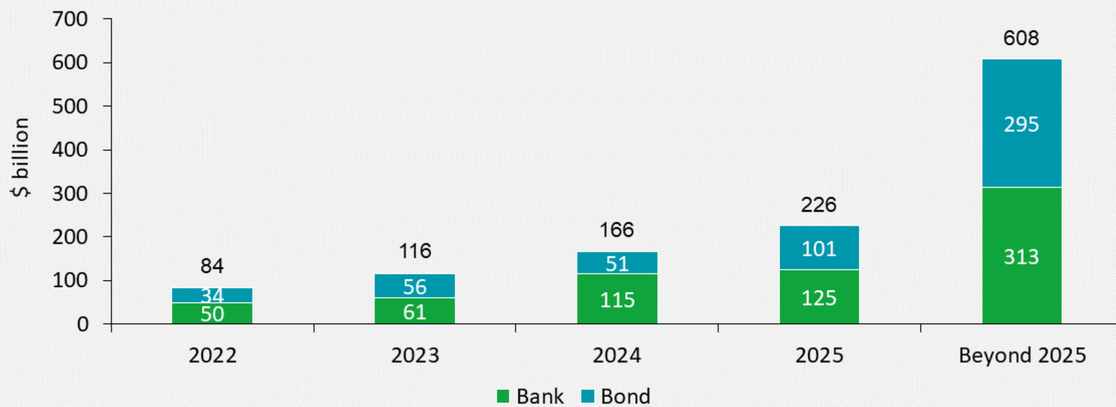
Source: Bloomberg, data as at 07.03.22

Note that US high yield spreads are still below the long-term average, but with the number of interest rate hikes priced into US government bonds, the overall yield is in line with the long-term average. We therefore also like US high yield, particularly when we consider the likely resilience the US has against continued escalation in Ukraine. In our view, there is much less of a chance of a default spike in the US.

Our high yield exposure is currently split fairly evenly between the US and Europe (including the UK). We have light exposure to cyclicals and companies with high energy costs of production. We have zero airlines, which are so exposed to fuel costs. The quality bias we have within our process means we are very light on CCC risk and we don't have any notable emerging market risk. Moreover, our quality bias means we also seek companies with pricing power and resilience, two operational qualities that are the best defence in more difficult economic periods. With these characteristics, our high yield holdings have an average gross redemption yield of around 6.7%.

Some may counter that if you're sanguine on defaults, as we are, why not own more CCCs and boost your yield? The main reason we are generally sanguine on defaults is that a low proportion of global high yield debt is due in the near term: 7% in 2022 and 16% in 2022 and 2023 combined, as shown in Chart 3. Although, if you're old enough, you can remember the high yield market closing to new issuance for 18 months during the global financial crisis! To be clear, we don't believe this event will cause that level of market stress. Looking back at Chart 1, we still believe a quality bias is the best way to approach the high yield market for the long term.

Chart 3: Global high yield maturity profile



Source: Moody's Investors Service, data as at 10.11.21

Many clients ask about liquidity. The honest answer is during times like this, liquidity is more difficult when trying to access a bid. Often the price to sell is lower than indicated on our Bloomberg screens (and therefore factored into the pricing across the market). We often see more liquid, large company bonds indicating greater volatility than parts of the market with, in our view, greater default risk.

During longer periods of market stress, these pricing dynamics tend to play out and the lower quality, less liquid parts of the market catch up in terms of mark-to-market pricing. Our mantra of 'large, liquid, listed' means we expect to be less impacted than many during such periods.

The corollary is that longer periods of market stress bring about valuation opportunities, as the compensation for future defaults – the spread – often overreacts. We do not believe this time is any different.

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