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Houston, We Have a Valuation Problem

In our last contribution to this blog four months ago, we described U.S. high yield as a potentially safer middle ground compared to investment grade fixed income and equities. We also made an argument for high yield as one of the safer asset classes for targeting a positive real return in a very uncertain environment. While it is far too soon to draw any firm conclusions, the “safer middle ground” thesis is off to a decent start, but the “positive real return” thesis must make up some significant ground. Still, we continue to believe that U.S. high yield will recover that ground over a reasonable time horizon.

What happened? Higher rates, wider spreads.

The Federal Reserve (Fed) announced its widely anticipated taper in the first week of November. Within days, however, two developments led to higher interest rate and equity volatility along with lower prices for many financial assets.

First, the Fed signaled that its just-announced taper would be accelerated, clearing the way for rate hikes and balance sheet reduction (quantitative tightening or QT) to start much sooner than markets anticipated. While inflation data was hot and getting hotter, the Fed’s move seemed to be more in response to political and public pressure than pressure from the financial markets. Second, a cascading deflation of the most extended financial assets began to pick up steam.

With all the understandable focus on inflation, perhaps the more important dynamic in financial markets has been an increase in real, or after-inflation, yields. Near-term inflation expectations are much higher, but long-term inflation expectations are flat to lower. In the last four months, the yield on the 10-year Treasury Inflation-Protected Security—the 10-year real yield—has increased about 40 basis points.

Since the Global Financial Crisis (GFC), the Fed has almost always been in the “volatility suppression business” as it relates to financial assets. The exception was from late 2017 until the end of 2018. By the end of 2018, the S&P 500 was close to a 20% drawdown, credit spreads had widened materially, and inflation was low. The Fed abruptly got back into the volatility suppression business, and most financial assets did well until the pandemic. It was like Fed Chair Powell delivering Michael Corleone’s line from *The Godfather: Part III*: “Just when I thought I was out, they pull me back in.”

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The Godfather: Part III

The Fed is once again getting out of the volatility suppression business. This time it is because inflation is running high, and the Fed has no choice. A related question is "what is the strike price of the Fed put?" That strike price must be lower—perhaps much lower—when inflation is running so hot. Sometimes, like in the fourth quarter of 2018, markets sell off until they find the strike price of the Fed put. However, that is less likely at the start of a Fed tightening cycle than closer to the end.

When will volatility subside? When interest rate volatility moderates and valuations adjust.

If the Fed is out of the volatility suppression business for a sustained period, we expect volatility in financial assets to be higher than it has been for most of the post-GFC period. However, that does not mean volatility will be as high as it has been since the start of this year.

One condition for volatility to subside will be for the markets to discount "peak hawkishness", and not just for the Fed but for other major central banks, too. Another is for financial assets to find an appropriate valuation level that reflects the new environment.

In the U.S., the market appears to be discounting 6-7 rate hikes this year, plus some significant QT during the second half of the year. At the same time, fiscal policy is turning from hugely stimulative to restrictive. We believe we are in the range of peak hawkishness in the U.S., and in recent days, European and U.K. markets have made a dramatic move in that direction as well.

The valuation adjustment has been appropriately significant for cryptocurrency, meme stocks, unprofitable technology stocks, and SPACs. It has been more modest for the S&P 500. The S&P 500 drawdown this year is consistent with what we have seen for the last 70 years before an initial rate hike. It is not anywhere close to a drawdown that historically has signaled a much higher probability of recession.

What should the U.S. high yield spread be in this context? It was 320 basis points on October 11, 2021, the date of our last blog post. It is about 365 basis points today. Our judgment is that the appropriate high yield spread currently is somewhere between 350-400 basis points. High yield defaults remain near zero, and there are no signs that will change any time soon. The spread is almost entirely compensating investors for volatility and illiquidity rather than expected default losses.

Where is the opportunity in U.S. high yield? Longer-duration BBs and short-duration cushion bonds.

We believe the spike in volatility and reduced liquidity have had a disproportionate impact on U.S. high yield. For much of the last four months, macro and tactical traders have expressed risk-off views via high yield ETFs that then overwhelmed the liquidity of the underlying high yield bonds. In recent weeks, this liquidity challenge has been exacerbated by year-to-date 2022 outflows from high yield mutual funds and ETFs that now exceed the material outflows in all of 2021.

Within U.S. high yield, the greatest impact has been in the highest-rated BB tier. The combination of higher rates, wider credit spreads, and greater interest rate sensitivity led to January 2022 being the fifth worst total return month for BBs in the last 25 years. This decline has continued into February. This year, BB-rated bonds have declined more than Bs and CCCs because they have more interest rate sensitivity and also because exiting "tourists"—investors who are in and out of the high yield market—are concentrated in them. If interest rate volatility settles down and risk assets find their footing, BBs may have more appreciation potential than the lower-rated tiers. If instead the probability of recession must go significantly higher for inflation to be contained, then we would expect BB credit spreads to do much better than lower-rated tiers, and the interest rate sensitivity could actually help.

Longer-duration BBs can then be combined with very low duration, yield-to-call high yield bonds to arrive at a portfolio duration that is well below that of the high yield market, if that is your objective. These are known as "cushion bonds" because the coupons are high enough that they are likely to be called in the next year or so, even in the face of increasing market yields. These bonds can be difficult to source at attractive yields, but when illiquidity causes the market to drop by a few points, they become plentiful.

Compensation for volatility and illiquidity has the potential to be a "free lunch" for long-term investors who do not sell in a volatile and illiquid market. For those investors, volatility and illiquidity may be the most important sources of excess returns. This return potential is the reason why we continue to believe that U.S. high yield is one of the more compelling places to target a positive real return in a very uncertain environment.

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