COMPRESSION IN THE HIGH YIELD MARKET: WHAT DO DIAMONDS AND INVESTING HAVE IN COMMON?

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Like investing itself, there seems to be a lot of misinformation circulating about diamonds. One of the most predominant inaccuracies concerns the origins of the gleaming gemstones. For reasons unclear, (though some blame Superman), many believe that coal turns into diamonds under high pressure. The problem with this? Most diamonds were created billions of years *before* multicellular organisms populated the globe…thus, before coal. No, the vast majority of the diamonds we see were formed in the Earth's mantle under extraordinary pressures and temperatures at least a billion years ago, and then later they were sent to the surface via volcanic activity. Very unique circumstances, no doubt.

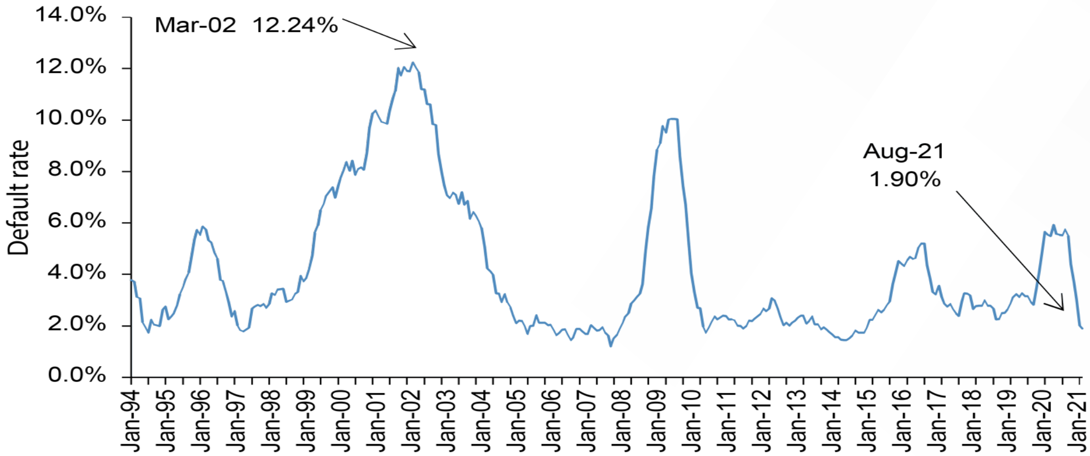
Mass misunderstandings are not limited to rare gemstones – compression in corporate bond markets is driving many investors to reach for yield, looking for home runs, but what they are really doing is picking up pennies in front of a steamroller.

Compression in the High Yield Market

The High Yield (HY) market is trading within 25 basis points of the all-time lows in spreads, per source Bloomberg L.P., an environment where investing feels like picking up pennies in front of a steam roller. But even at these paltry levels, HY offers one of the last remaining pockets of positive real yields for investors. It is also enjoying a dramatic decrease in defaults, now under 2% from over 6% at the end of 2020. And, like most other markets, it benefits from continued Fed liquidity support.

LTM default rate

based on number of issuers

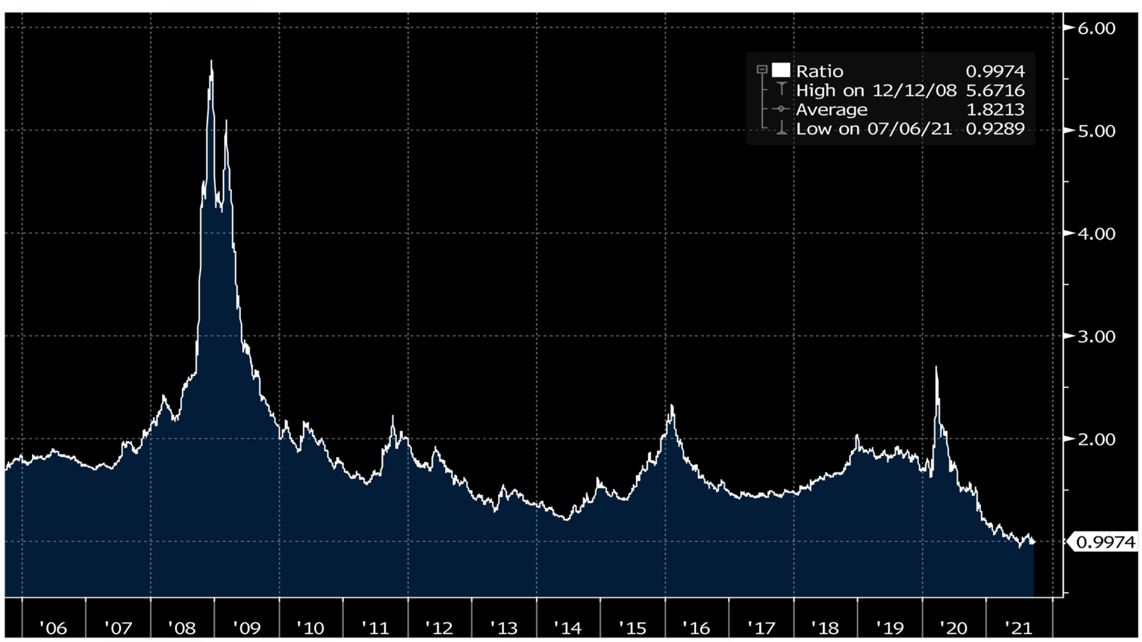


Source: J.P. Morgan
As of August 31, 2021

What does this mean for investors? There are still positives in High Yield; the quality of the market overall has improved with BBs accounting for 52% of the market, an all-time high, per source Bloomberg L.P. The premium over treasury yields in % terms is relatively attractive by historical measures—still close to 300% (debate about artificially low treasury rates is important here but beyond the scope of this note). In short, we believe that focusing on the downside risks in this type of environment is paramount. Bond selection is key and avoiding losers in compressed markets is acutely more important than picking winners.

Importantly, investors are not being compensated for buying longer maturity bonds. Extra yield—that was historically awarded to investors who took on additional duration risk in the High Yield Market—is at all-time lows, as seen below.

This chart shows historical yield divided by duration in the HY market:



Source: Bloomberg L.P., New Age Alpha as of September 28, 2021

Starved for yield, investors may be tempted to take on additional credit risk by increasing lower-rated allocations, particularly to CCCs. The timing of such allocations would be questionable, however. As shown below, CCC spreads are nearly 40% tighter from pre-pandemic levels, while BBs are unchanged and Bs are only slightly tighter

	BB	B	CCC
24-Jun-21	262bp	416bp	628bp
21-Feb-20	260bp	450bp	989bp
2021 High	313bp	486bp	758bp
2021 Low	262bp	416bp	628bp
12 month average (daily)	336bp	525bp	856bp
2021 average (daily)	284bp	449bp	683bp
Decade low	212bp	352bp	628bp
All-time low	162bp	247bp	469bp
20 Yr Median (Monthly)	361bp	545bp	1011bp
%Above Pre Pandemic (2/21/20)	0.6%	-7.4%	-36.5%
% Above 2021 low	0.0%	0.0%	0.0%
% above All-time low	61.0%	68.3%	34.0%
% above decade low	**23.1%**	**18.1%**	**0.0%**

Source: J.P. Morgan as of June 24, 2021

BB-CCC OAS Compression from 2001 thru 2Q21

Over the past 20 years, taking on CCC-rated risk (and the associated increase in compensation) from B-rated risk has provided an additional 476 bps of forward-looking yield. At the end of the second quarter of 2021, that number was a paltry 212 bps, however.

	B-BB	CCC-B
24-Jun-21	155bp	212bp
21-Feb-20	190bp	540bp
2021 High	186bp	277bp
2021 Low	151bp	210bp
12 month average (daily)	190bp	331bp
2021 average (daily)	166bp	234bp
Decade low	124bp	210bp
All-time low	50bp	210bp
20 Yr Median (Monthly)	183bp	476bp
%Above Pre Pandemic (2/21/20)	-18.5%	-60.8%
% Above 2021 low	2.7%	0.8%
% above All-time low	209.4%	0.8%
% above decade low	**24.5%**	**0.8%**

Source: J.P. Morgan as of June 24, 2021

There may well be a couple of more years of Fed accommodation and negligible defaults, but no one will ring the bell when it's over. In the meantime, this unique, yield-compressed environment may last longer than expected. Now is not the time to pick up pennies in front of a steamroller; it is the time to position portfolios to **avoid the losers**.

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