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High Yield | Volatility

High yield market gets help from the Fed

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Boston - On April 9, the Federal Reserve took another swift step to help backstop the US economy as the fight against the spread of COVID-19 continues to take a toll on businesses big and small.

Fed takes job as lender of last resort seriously

Over the past few weeks, the US central bank has revealed many new programs to support markets and now surpasses the European Central Bank in terms of effort. The Fed's program is directionally beneficial for all credit, as it will likely manage default expectations lower, increasing investors' appetite for risk.

The programs will particularly support the BBB and BB-rated portions of the investment grade and high yield markets. The eligible issuers who can participate in the Primary Market Corporate Credit Facility (PMCCF) and the Secondary Market Corporate Credit Facility (SMCCF) were expanded to include recent fallen angels[1] that were investment grade as of March 22 and maintain BB-ratings at the time of purchase. Citi estimates that 8% of the Bloomberg Barclays Ba Index is from fallen angels that met the Fed's March deadline. This could be a material positive for issuers, as it removes the risk of fallen angels overwhelming the high yield market, which has been a potential problem for a while.

There is also language regarding the purchase of high yield ETFs. The "preponderance" of ETF exposure will remain investment grade, but the "remainder" can be allocated to ETFs "whose primary objective is exposure to US high yield corporate bonds." High yield ETFs performed well as a result of the announcement and witnessed over $1.2 billion in inflows on April 9. Actions supportive of the high yield ETFs should aid trading levels across the entire high yield ratings spectrum. And the Main Street Lending program may also help supply certain issuers with additional liquidity to manage through the crisis.

Fed's new programs may lead to modest increase in dispersion

The breadth of the Fed's efforts are broadly constructive for high yield and other credit markets as a whole. However, we anticipate that this will likely lead to a modest increase in dispersion between the CCC-rated cohort of high yield bonds and those rated BB. Although we believe investor appetite for risk will be boosted as a result of the Fed's actions, we are still hesitant to increase our exposure to lower quality (CCC-rated) high yield issues. In our view, it is still too early in the cycle, and we expect additional volatility as the market contends with weak first quarter earnings reports, disappointing guidance and growing unemployment.

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Bottom line: Our focus has been concentrated on more defensive businesses or more structurally senior bonds of companies that are suffering as a result of the current economic environment, but that we assess as having a high likelihood of surviving. The contraction in spreads as a result of the Fed's announcement seems premature from our perspective. Depending on the duration of the current health crisis, the economic pain will continue to be substantial.

[1] Fallen angels are bonds that were initially given investment grade ratings but have since been downgraded to non-investment grade status because of the issuers' deteriorating financial conditions.

Bloomberg Barclays Ba Index is the Ba-rated component of the Bloomberg Barclays US Corporate High Yield Index.

Bloomberg Barclays US Corporate High Yield Index is an unmanaged index of non-investment grade corporate bonds traded in the US.

It is not possible to invest directly in an index. ***Past performance is not a reliable indicator of future results.***

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