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## Positive outlook for high-yield market in 2021

By: Will Reardon | December 17, 2020

**Boston** - Over the past several weeks, clarity on US election results and news of efficacious vaccines from both Pfizer and Moderna have been decidedly bullish for US high-yield and risk<sup>1</sup> markets. The FDA's recent emergency approval of the Pfizer vaccine, with the first US vaccinations occurring this week, has reassured investors that recovery is on the way.

We've seen tremendous market returns and tremendous yield and spread tightening, despite the continued aggressive spread of the pandemic and a record number of virus-related hospitalizations in the US. The lower-quality, higher-beta segments of the high-yield market and sectors hardest-hit by the coronavirus —such as entertainment/film, air transportation, energy and leisure — are among the top-performing sectors following positive vaccine developments.

### **Political gridlock may moderate outcomes**

Under a Biden presidency and at least a relatively balanced Senate, a less-aggressive stimulus package is likely to emerge than was expected with a "blue wave" scenario. However, we think the smaller tailwind from less stimulus is outweighed by the likelihood that corporate tax hikes and regulatory changes will be more measured, a positive for the credit sector.

In our view, the energy and health care sectors faced significant risks in the event of a Democratic-controlled government. Under a split government, the political backdrop for both sectors now appears more favorable and valuations in those sectors, on the margin, now appear more attractive.

### **Positive outlook for 2021**

Overall, we have a positive outlook for high yield in 2021, largely due to US election results, vaccine rollouts that started in December, and a consistently accommodative Federal Reserve. High-yield issuer fundamentals have improved and default rates appear to have peaked. Moreover, we expect the volume of "fallen angels" — the total of issues downgraded from investment-grade to high yield — will be significantly lower in 2021 than this year. On the technical side, we saw record issuance in 2020 and expect this to moderate somewhat while demand for the asset class should remain supportive as investors globally continue to search for yield.

It's worth noting that currently there is approximately \$17 trillion of negative-yielding debt globally.<sup>2</sup> In terms of global corporate-bond supply, the US represents about 13% of the overall supply, while accounting for more than 40% of the yield. The bottom line is that US corporate bonds are one of the only remaining "games in town," and that fact will likely underpin continued support for our asset class.

### **Post-pandemic positioning**

In anticipation of successful vaccine development, we had been adding risk to our portfolios with pandemic-exposed names where we saw upside potential, specifically in areas such as air transportation, leisure and automotive. Importantly, we looked for issuers with sufficient liquidity to weather a longer stretch of uncertainty if necessary. Further, the high-yield market stands to benefit from a likely cyclical rebound should widespread vaccination occur by mid-2021.

The road to recovery, however, will not be without bumps. The implied backstop from the Fed in the form of its Corporate Credit Facilities (CCF) proved critical in providing much-needed stability to risk markets in 2020. The CCF is not being renewed past year-end; however, it would not take much for these programs to be reinstated if needed. Additionally, a lot of the "pop" in the hardest-hit COVID sectors has already been harvested.

In sum, while we are optimistic about high-yield market prospects for 2021, we are not out of the woods and valuations, in aggregate, are not cheap. The pandemic is spreading aggressively and the timing for widespread vaccination remains a key risk. While we are always looking to add risk in discounted, high-conviction names, this winter will be pockmarked with periods of heightened volatility and we believe a prudent amount of caution is warranted.

We will look to ensure our high-yield strategies have sufficient core ballast in several of the more defensive sectors, such as utilities, cable/satellite TV and the environment, and a risk-adjusted focus remains as critical now as ever.

**Bottom line:** We believe prospects are bright for high-yield assets in 2021 and will seek to add portfolio risk in high-conviction names that offer positive convexity. On the flip side, we believe caution is warranted and will maintain sufficient ballast in the more defensive sectors.

1. Risk asset is a term broadly used to describe any security that is not a risk free asset like a high quality U.S. government bond. A risk market refers to these securities.

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