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How Will the High Yield Market Handle a Recession?

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The probability that the US and European economies will enter a recession has been increasing, based on several capital market indicators, economists' statements, and market prognosticators.

Analyzing how the leveraged debt market will react in a recession based on history has several issues:

- There have only been four US recessions since 1990, therefore the sample set is relatively small,
- Each recession has been driven by unique characteristics, and drawing conclusion from past cycles can be risky,
- The make-up and structure of the leveraged debt market has changed dramatically over time.

If the economy enters into a recession (or already is in one), there are many possible outcomes for the leveraged debt markets. Some of the key considerations are:

- What type of recession occurs,
- The quality of today's High Yield Bond market as opposed to the past,
- How much the High Yield Bond market has already repriced year-to-date.

Given all the bear cases that have been suggested in the press and investment reports, we thought it would be healthy "food for thought" to consider a scenario where specific circumstances around a recession could benefit High Yield Bonds.

The Potential Recession Scenario

- The US enters a recession in the next 12 months (while debt maturity walls are still low),
- The current strength of the corporate and household balance sheets keeps the recession short and shallow[1],
- The lack of debt maturities from 2020-21 refinancing[2] keeps defaults low. Currently, the default rate is 0.7%.[3]
- Investors' concerns recede over central bank hawkishness as the economy slows,
- A pause by the Fed would likely create stability in the High Yield Bond market.

The Relative Quality of the High Yield Bond Market Makes a Difference in the Recession

- The High Yield market has more BBs and less CCCs than in the last three recessions (Exhibit 1).
- The maturity wall for bonds and loans for the next two years is approximately 6.2% of the amount outstanding, well below historical averages.[2]

Exhibit 1

ICE BofA US High Yield Index - Par Weighted			
As a % of Index	BB	B	CCC and Below
12/31/2000	29.6	55.5	15.0
9/30/2007	41.0	40.5	18.5
12/31/2019	47.2	38.3	14.5
5/31/2022	50.9	37.0	12.1

[1] International Monetary Fund data retrieved from the St. Louis Fed shows Household debt /GDP near 80% vs 100% in 2008.
[2] JP Morgan, High-yield bond and institutional loan maturity schedule, June 2022
[3] JP Morgan Default Statistics

Has the High Yield Market Already Repriced for the Economic and Rate Concerns?[5]

During the last three recessions, the High Yield Bond market initially posted negative quarterly returns (as it has year-to-date), but in each case, began to post meaningful gains prior to the recession ending (see Appendix)[4]

- Year-to-date the average price has declined from 103.3 to 85.6.
- The average YTW has increased from 4.4% to 8.9%.
- The average STW has increased from 330 bps to 592 bps.
- If one focused on the higher quality portion of the market and avoided CCCs, the average YTW has increased from 3.9% to 8.1% for the BB-B Index.
- A 8.1% yield would compare favorably to the average annual return on the High Yield Bond market for the last decade of about 4.4% and the recent yield on the investment grade market of 4.7%[5].
- Given that the Investment Grade market has about 2X the duration that High Yield Bond market has on average, if rates start to decline meaningfully Investment Grade market would likely rally more than High Yield. However, in an environment in which rates continue to climb or stay stable the excess yield in High Yield Bond market would likely outperform.

Closing Comment

Despite the uncertain outlook, what we do know is maturity walls have been pushed off, defaults are near historic lows, and yields are elevated - making the High Yield asset class more attractive on a relative basis than it has in several years.

APPENDIX:

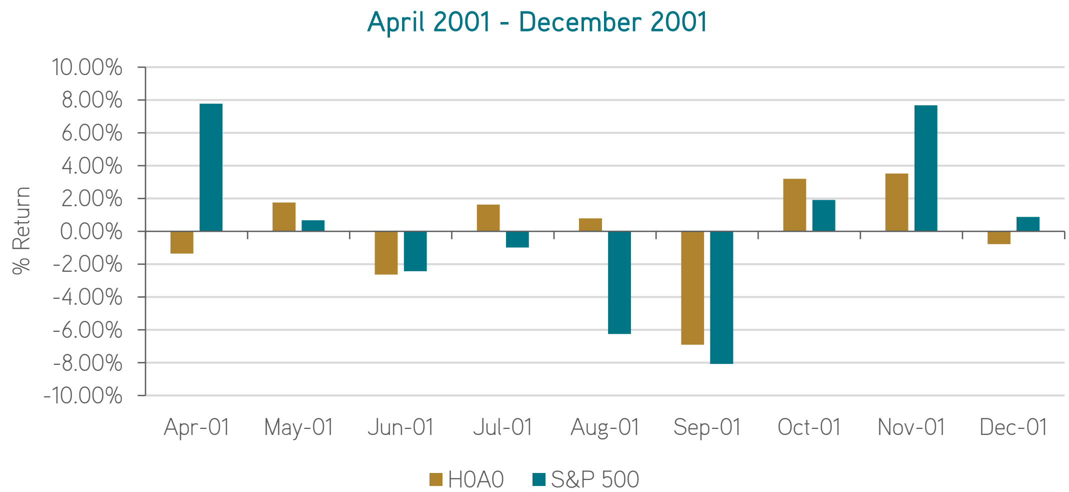
ICE BofA US High Yield Index

Recession Q1 2001-Q4 2001 Inclusive	
2001	**Return**
Q1	5.783
Q2	-2.269
Q3	-4.651
Q4	5.987

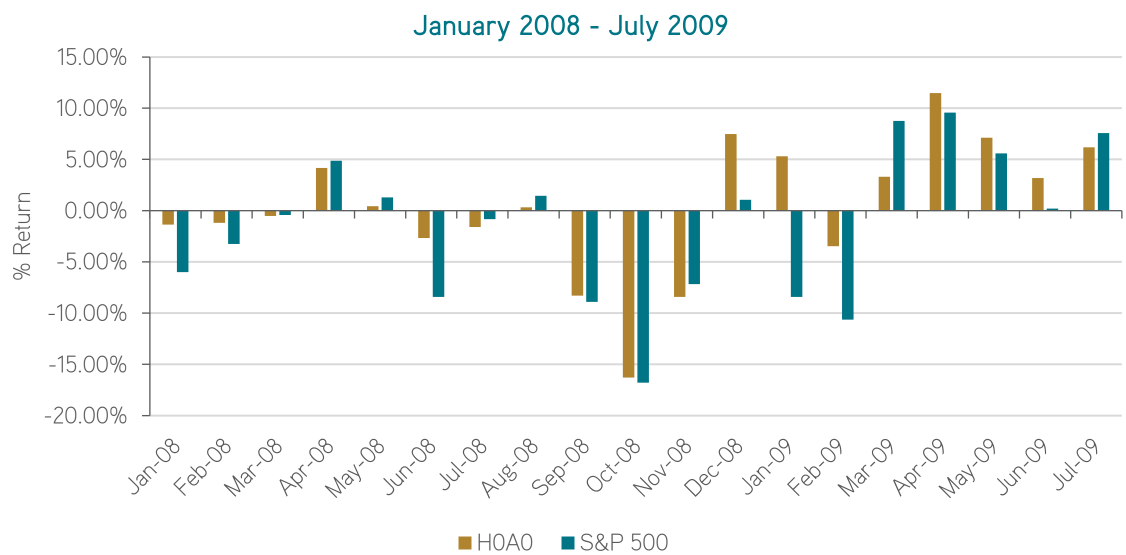
Recession Q4 2007-Q3 2009 Inclusive	
2007	**Returns**
Q4	-1.164
2008	
Q1	-3.036
Q2	1.809
Q3	-9.476
Q4	-17.628
2009	
Q1	5.016
Q2	23.191
Q3	14.817

Recession Q1 2020-Q3 2020 Inclusive	
2020	**Returns**
Q1	-13.123
Q2	9.606
Q3	4.706

[3] JP Morgan Default Statistics
[4] ICE BofA US High Income Index
[5] ICE BofA US Corporate Index



Source: Bloomberg. Added to Appendix on October 13, 2022



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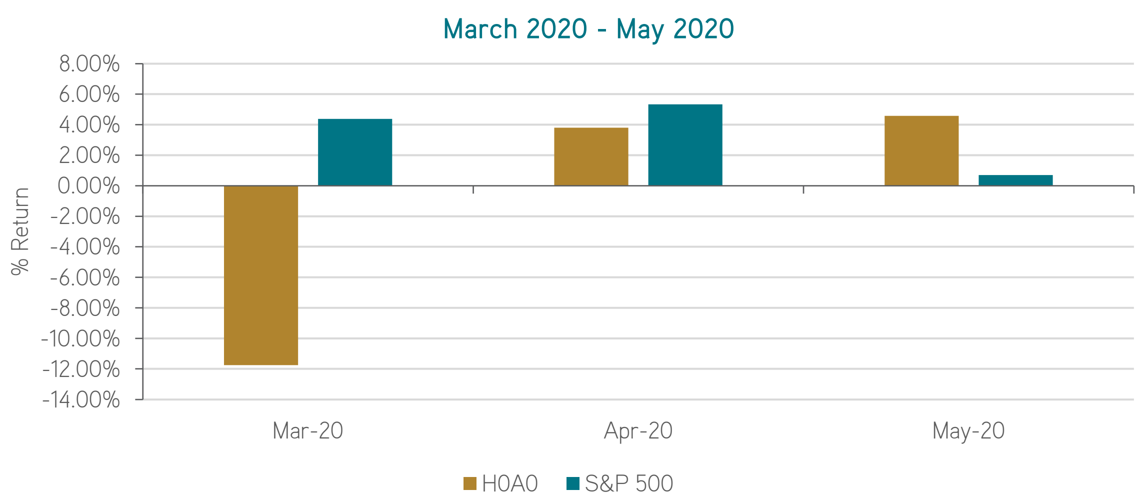

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ICE BofA US Corporate Index tracks the performance of US dollar denominated investment grade corporate debt publicly issued in the US domestic market.

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