HIGH YIELD MARKET UPDATE – FED UP?

YTD PERFORMANCE

Coming into 2020, we observed that 2019 was a very unusual year. Little did we know what 2020 would have in store. The arrival of COVID-19 brought shelter-in-place orders, travel bans, and job furloughs that wreaked havoc on financial markets. Equities sold off, credit spreads widened significantly, default rates rose, and credit downgrades rapidly accelerated.

High Yield (HY) performance suffered in March as option-adjusted spreads (OAS) blew out to over 1,100 basis points (bps), resulting in the largest drawdown in HY since the energy-related junk bond collapse in 2015/16. In response to the virus-related market chaos and taking cues from lessons learned during the Great Financial Crisis, the Federal Reserve (Fed) quickly stepped in to help stabilize markets while Congress passed a $2.2 trillion stimulus package to help provide relief for companies and individuals most impacted by the growing pandemic.

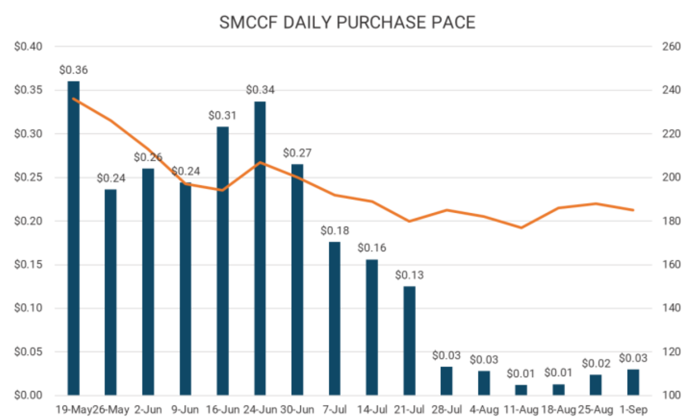
FED INVOLVEMENT

We believe the Fed did what they thought best to curb deterioration in credit fundamentals resulting from the exogenous shock that plunged the economy into recession. Cutting interest rates to near zero while injecting massive amounts of liquidity into an array of government, corporate, and money market credit facilities will be written about in textbooks for years to come. While the initial steps taken by the Fed will be looked upon favorably, the unintended consequences of their Corporate Credit Facilities (CCFs) will surely be debated.

As the spread of COVID-19 deepened, its impact on communities, economic activity, and financial markets, the Fed established both the Primary Market Corporate Credit Facility (PMCCF) and Secondary Market Corporate Credit Facility (SMCCF). The PMCCF is designed to provide access to credit by purchasing bonds of "Eligible Issuers" at the time of issuance as defined by the Fed. In short, PMCCF provides investment grade companies and those considered investment grade as of March 22, 2020, access to credit to maintain business operations during the pandemic-related market dislocation.

The more impactful of the two programs—SMCCF—is designed to provide liquidity by purchasing individual corporate bonds and exchange-traded funds (ETFs) in the secondary market. However, the breadth of this program appears somewhat limited. Recent research by Jon Rather of BofA Securities points out that 428 distinct issuers have benefitted from SMCCF bond purchases. However, the top 40 issuers by purchase amount represent approximately 30% of total purchases.

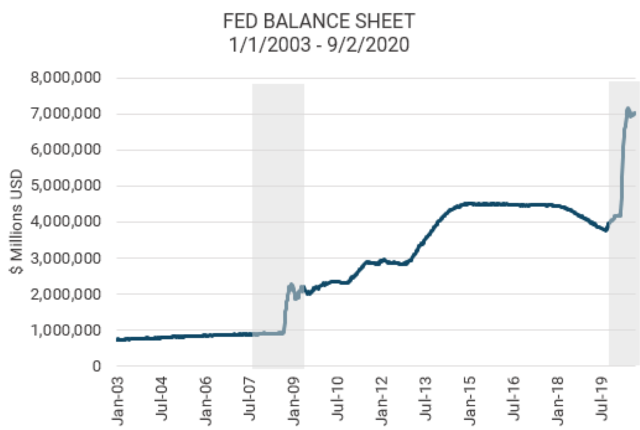
Chart 1: SMCCF Bond Purchases



Questions related to this unprecedented market intervention by the Fed are primarily concerned with its independence and functioning of free markets. Namely, has the Fed overstepped its role by creating "zombie companies?" Periods of market dislocation are often accompanied by liquidity issues for highly levered companies with subpar management teams which often leads to bankruptcy. The bankruptcy process is designed to allow such companies to run smoothly as they restructure their debt burden. When the Fed steps in to buy ETF's that hold distressed bonds of poorly run companies, the normal restructuring process presumably fails to occur.

While the normal functioning of credit markets has been altered, the Fed provided a necessary backstop to get through the current crisis. Millions of jobs were saved as the Fed's unprecedented balance sheet expansion provided attractive bridge loans to circumvent what could have been a significant wave of credit defaults.

Chart 2: Fed Balance Sheet Tops $7 Trillion

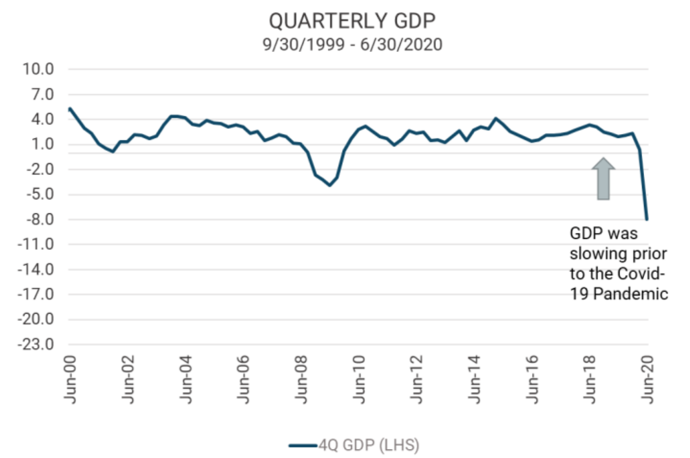


In addition to CCF implementation, Fed Chairman Jerome Powell recently announced a major policy shift toward inflation targeting and, therefore, employment. The Fed will now target an "average" inflation rate instead of its previously stated 2% inflation target. In theory, this will allow inflation to run a little hotter as employment trends improve. Furthermore, Chairman Powell recently provided forward guidance that suggests interest rates will stay near zero through the end of 2023 as the Federal Open Market Committee strives to meet the Fed's mandate of promoting maximum employment and stable prices. As Cameron Crise, a macro strategist for Bloomberg, noted after the September 16th FOMC announcement, "We'll need unemployment at or below 4.1% AND headline PCE inflation of 2% or higher." Crise went on to note, "Since the start of the 1970s there have only been 23 months in which these two conditions have been met." The odds clearly do not look good for the Fed meeting their dual mandate, likely resulting in a continued chase for yield.

ECONOMIC IMPACT

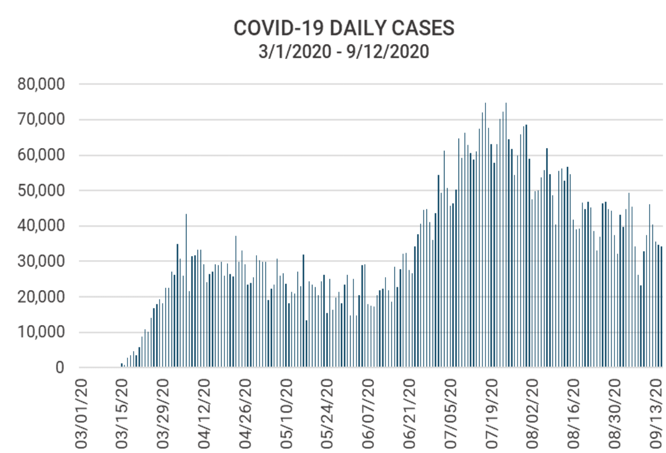
Shelter-in-place orders that brought business activity to a halt during much of April and May resulted in the U.S. Gross Domestic Product (GDP) tumbling nearly 8% during the second quarter. While Q2 was the worst quarterly decline on record, unprecedented monetary and fiscal stimulus unleashed by central banks and governments around the world appears to have staved off an even deeper recession. However, unemployment remains at twice the pre-pandemic level and is particularly acute in industries like hospitality and travel that remain significantly depressed.

Chart 3: GDP Hits Levels Last Seen During Great Depression



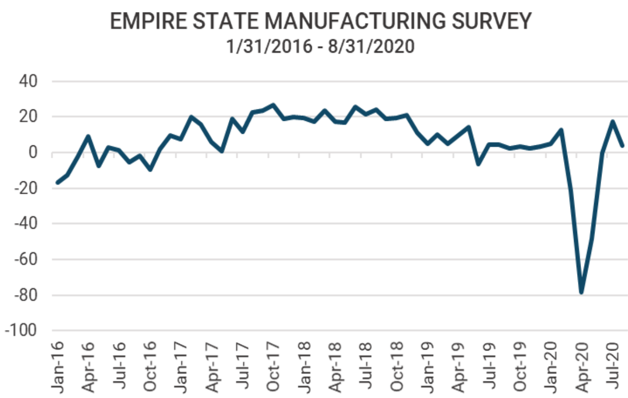
The rebound in economic activity in recent months has been impressive despite COVID-19 cases being elevated through the summer months after shelter orders were broadly lifted. However, case counts are trending in the right direction in recent weeks, leading to increased optimism in further reopening efforts.

Chart 4: COVID-19 Daily Cases Showing Improvement After July Peak



While we believe the worst is behind us, it is too early to declare victory as future growth prospects hinge on the development of a vaccine that is safe, effective, and broadly distributed. Some sectors such as housing are doing quite well, but recent data from regional manufacturing surveys suggest general business conditions may be losing momentum after a sharp rebound in July, as illustrated in Chart 5.

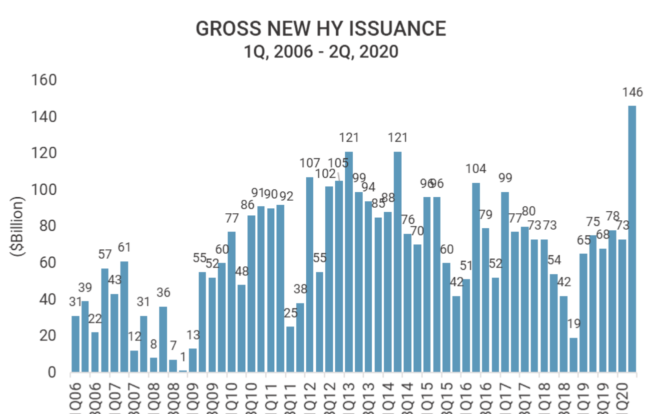
Chart 5: Waning Economic Momentum?



BOND ISSUANCE

A reinvigorated need for funding, combined with support provided by the Fed's lending program, has been an important driver of HY new issuance this year. Approximately $150 billion of Fallen Angels have entered the HY market since February this year (nearly 40% of the YTD new issue volume). This 120% increase in Fallen Angel content within the HY market represents by far the largest downward migration from the Investment Grade (IG) market in the last 10 years. This migration, however, has been relatively orderly and provided more opportunity than chaos due mainly to the fact that while large, the migration has been somewhat more muted than some strategists had expected. We think the rapid pace of economic improvement off the bottom of the pandemic-driven contraction has modulated the migration. The implied overhang of low-quality IG paper remains an issue, particularly if the economy begins to faulter.

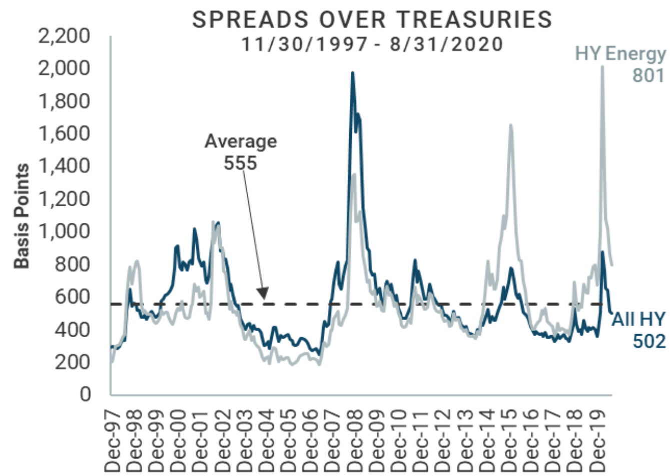
Chart 6: High Yield Bond Issuance (Quarterly)



CREDIT SPREADS

Credit spreads have tightened significantly from April highs. Within HY, yields and spreads continued to tighten in August, with the Yield to Worst (YTW) and OAS closing at 5.36% and 502 basis points, respectively.

Chart 7: Credit Spreads Falling



Lower-than-average HY spreads has resulted in certain areas of the market appearing less attractive than others. The Fed has been heavily involved in the BB cohort, compressing this cohorts yields and spreads. However, in our view the tightness of BB spreads relative to history limits upside.

Chart 8: BBs Share of the Broad HY Index

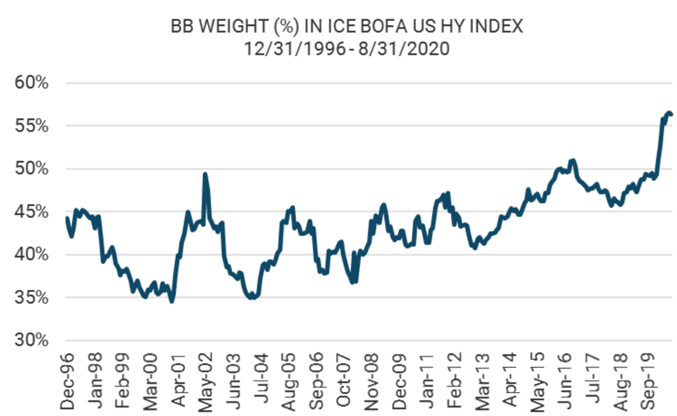
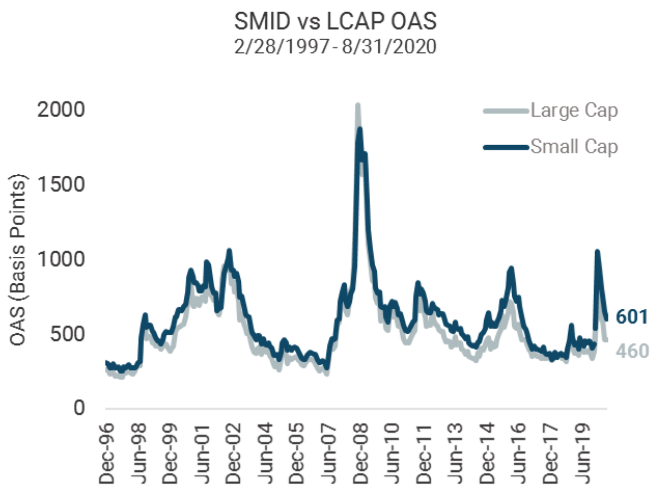


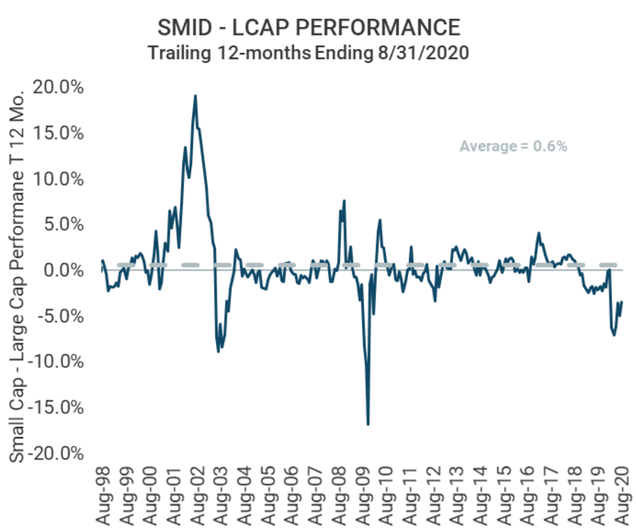
Chart 9 exhibits how Small- and Mid-Cap (SMID) spreads continue to stand near record wides relative to their Large-Cap (LCAP) counterparts. This creates an interesting opportunity for investors seeking exposure in cyclical areas of the market should economic conditions improve.

Chart 9: Small Cap Spreads Still Wide Relative to Large Caps



Wider spreads have naturally led to a lag in SMID performance as shown in Chart 10. The ICE BofA U.S. Small Cap Cash Pay High Yield index has lagged its large cap counterpart by around 450 basis points YTD. With SMID spreads elevated relative to LCAP, we believe there will be plenty of opportunity in the months to come to take advantage of this disconnect.

Chart 10: Small Cap Performance Rebounding of Late

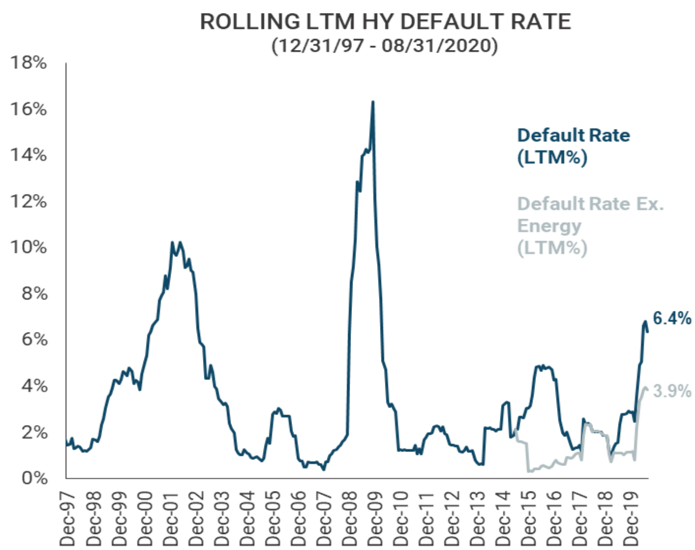


DEFAULTS

Bond defaults have moderated of late after surging during Q2. The latest twelve-month (LTM) default rate now stands at 6.4%, roughly double the long-term average.

Chart 11 shows Par-weighted default rates for HY bonds and leveraged loans. Over the past 20 years, the Par-weighted default rate for both asset classes averaged just over 3.0%. As has been the case for the better part of the last 12 months, Energy-related bankruptcies or restructurings have been the largest contributor to rising default rates.

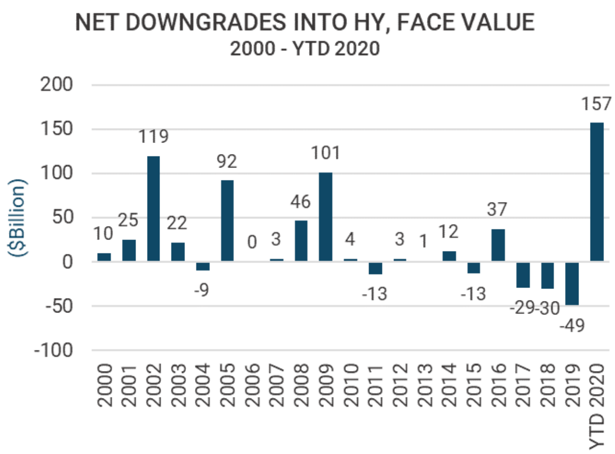
Chart 11: High Yield Par-Weighted Default Rates



FALLEN ANGELS

The ICE BofA U.S. Fallen Angel High Yield Index has outperformed other areas of the HY market, delivering a return of 6.13% YTD as of August 31st. This strong performance is likely to continue albeit at a slower pace over the balance of the year. The combination of rebounding fundamentals and supportive Fed policy has driven the strong relative performance. Our baseline view is for both tailwinds to continue. We also think there will be more Fallen Angel issuance to come this year. The level of Fallen Angel new issuance could easily surpass $200 billion by year-end. This level of migration will continue to be a bottom-up opportunity depending on individual names rather than a systematic risk. That said, a double-dip recession could reaccelerate concerns for a new surge in Fallen Angels beyond what the current market could absorb in an orderly fashion.

Chart 12: Downgrades at a Multi-Year High



Strong performance and spread tightening are likely to continue as over $150B of investment grade bonds have been downgraded so far in 2020. We think the level of Fallen Angels could easily surpass $200B by year-end, providing additional opportunity for our strategy to capitalize on the relative attractiveness of this space.

CONCLUSION

So, are we Fed up? Hardly. In fact, we are cautiously optimistic about the evolving approach the Fed has taken during these unprecedented times. Investors are clearly hopeful as well, with over $58B in new flow into HY since March, according to data compiled by JPMorgan. As a result, yields have fallen and spreads have largely normalized, leaving LCAP, non-cyclical BB's looking rich as their above HY market duration leaves them vulnerable to rising interest rates. Conversely, we are finding value in B's, SMID credits, and within cyclical sectors whose spreads have not fully normalized and duration profile is more benign.

We continue to focus on executing our fundamental-driven investment process, leveraging the expertise of the H&W research team within Fallen Angels and SMID's. We remain committed to identifying attractive liquidity opportunities within workout credit holdings and maintaining adequate portfolio liquidity.

All investments contain risk and may lose value. Investing in high yield securities is subject to certain risks, including market, credit, liquidity, issuer, interest-rate, inflation, and derivatives risks. Lower-rated and non-rated securities involve greater risk than higher-rated securities. High yield bonds and other asset classes have different risk-return profiles and market cycles, which should be considered when investing.

Data sources: Chart 1: Federal Reserve, BofA, HWCM; Chart 2: Federal Reserve Bank of St. Louis FRED database; Chart 3: Bloomberg, HWCM; Chart 4: Centers for Disease Control and Prevention, HWCM; Chart 5: Federal Reserve Bank of New York; Charts 6,11,13: JPMorgan, HWCM; Charts 7-10: ICE BofA, HWCM; Chart 12: BofA Global Research, HWCM.

Market Disruption: The recent global coronavirus pandemic has caused and continues to cause disruption in the global economy, unprecedented business and travel disruption and extreme fluctuations in global capital and financial markets. H&W is unable to predict the consequences of the upheaval caused by coronavirus pandemic, which, depending on the severity and the length of the outbreak, has the potential to negatively impact the firm's investment strategies and reduce available investment opportunities.

Past performance is not a guarantee or a reliable indicator of future results.