U.S. high-yield bond market commentary

Executive summary

• The U.S. high-yield bond market, as measured by the Bloomberg Barclays U.S. Corporate High Yield 2% Issuer Capped Bond Index, returned 4.58% during the third quarter.

• For comparison purposes, the overall taxable bond market, as measured by the Bloomberg Barclays U.S. Universal Index, returned 0.99% during the third quarter.

• In Western Asset Management’s (“Western”) view, the pandemic crisis will pass but, in the meantime, it sees a lot of damage done to the fundamental credit condition of the average high-yield bond.

• Western points out that credit defaults are a lagging indicator and the downgrade spree has recently tapered off. Meanwhile, S&P earnings are forecast to show meaningful improvement next year.

Market recap

Markets rallied during the third quarter, albeit to a lesser extent than the second quarter. COVID-19 (coronavirus) continued to drive the markets and the economy. Investor risk appetite was initially robust, supported by continued monetary policy accommodation by the Federal Reserve Board (“Fed”) and optimism around a vaccine. However, concerns over an uptick in COVID-19 infections, political gridlock in Washington, and uncertainties over the upcoming November elections negatively impacted investor sentiment in September.

U.S. Treasuries, as measured by the Bloomberg Barclays U.S. Treasury Index, returned 0.17% during the third quarter, bringing its year-to-date gain to 8.90%. Two-year Treasury yields moved marginally lower, while 10-year yields edged modestly higher over the quarter (yields and prices move in the opposite direction). The spread sectors (non-U.S. Treasuries) also posted positive returns and generally outperformed equal-duration Treasuries.

Looking at the U.S. economy, the Commerce Department reported that second-quarter 2020 gross domestic product (GDP) annualized growth was -31.4%, marking the steepest quarterly decline on record. For comparison purposes, first-quarter annualized GDP was -5.0%. According to the Commerce Department, “The decline in second quarter GDP reflected the response to COVID-19, as ‘stay-at-home’ orders issued in March and April were partially lifted in some areas of the country in May and June, and government pandemic assistance payments were distributed to households and businesses. This led to rapid shifts in activity, as businesses and schools continued remote work and consumers and businesses canceled, restricted, or redirected their spending. The full economic effects of the COVID-19 pandemic cannot be quantified in the GDP estimate for the second quarter of 2020 because the impacts are generally embedded in source data and cannot be separately identified.” The initial estimate for third-quarter GDP will be released on October 29.

Unemployment remained elevated amid the pandemic, but there were further signs of improvement. That said, the pace of new hires decelerated in September. The unemployment rate fell from 11.1% in June to 10.2% in July and 8.4% in August. The unemployment rate then declined to 7.9% in September, the lowest rate since March 2020. However, the workforce participation rate edged lower, as it fell from to 61.5% in June to 61.4% in September.

After contracting for much of the second quarter, the manufacturing sector expanded over the third quarter. According to the Institute for Supply Management’s Purchasing Managers Index (PMI), the manufacturing sector had a reading of 52.6 in June, 54.2 in July and 56.0 in August. The PMI then moved to 55.4 in September. (A reading below 50 indicates a contraction, while a reading above 50 indicates an expansion.) Fourteen of the 18 industries measured by the PMI expanded in September versus 13 in June.

The Fed met twice during the third quarter and maintained its highly accommodative monetary policy stance. In the minutes...
from the Fed’s July meeting it said, “Additional accommodation could be required.” While the minutes didn’t offer a definitive time for such a move, the Fed said that more explicit guidance would be “appropriate at some point.” At its meeting in September, projections from individual members of the Federal Open Market Committee indicated that rates could stay anchored near zero through 2023. In the Fed’s statement it said, “The COVID-19 pandemic is causing tremendous human and economic hardship across the United States and around the world. Economic activity and employment have picked up in recent months but remain well below their levels at the beginning of the year. Weaker demand and significantly lower oil prices are holding down consumer price inflation… The path of the economy will depend significantly on the course of the virus. The ongoing public health crisis will continue to weigh on economic activity, employment, and inflation in the near term, and poses considerable risks to the economic outlook over the medium term.”

Two-year Treasury yields moved lower during the third quarter, whereas 10-year yields edged slightly higher over the period as a whole. When the quarter began, the yield on the two-year Treasury was 0.16% and it ended the quarter at 0.13%. The yield on the 10-year Treasury began at 0.66% and it ended the quarter at 0.69%.

The U.S. high-yield bond market, as measured by the Bloomberg Barclays U.S. High Yield 2% Issuer Capped Index, returned 4.58% during the third quarter. For comparison purposes, the overall taxable bond market, as measured by the Bloomberg Barclays U.S. Universal Index, returned 0.99% during the quarter.

Outlook

In our view, some of the greatest minds in the world are working on treatments and vaccines to fight the pandemic, and those efforts will ultimately be successful. It is also our opinion that there will be a fourth round of stimulus, providing support for individuals and businesses. Over the long term, we believe this crisis will pass but, in the meantime, we see an awful lot of damage done to the fundamental credit condition of the average high-yield bond. We believe leverage metrics will undoubtedly show a spike, and cash flow and interest coverage will show steep declines when second quarter earnings results are compiled. While companies have taken prudent actions in gaining increased liquidity, it has come at a cost to the average firm’s risk profile. The rating agencies have taken note. Moody’s has downgraded roughly 600 issuers since the beginning of March, a record for a four-month period that easily surpasses any four-month period during the Great Recession. However, it is not all doom and gloom. Defaults are a lagging indicator and the downgrade spree has recently tapered off. Meanwhile, S&P earnings are forecast to show meaningful improvement next year. Current valuations are as wide as they were pre-COVID. In our view, we won’t be returning to those levels anytime soon, as they are not consistent with current fundamental conditions. At a spread of 517 bps, high-yield valuations appear fair, but they also imply expected improvement. Progress in fighting COVID-19 and improving economic conditions are both consistent with our expectations.

All investments involve risk, including loss of principal. Fixed income securities involve interest rate, credit, inflation and reinvestment risks, and possible loss of principal. As interest rates rise, the value of fixed income securities falls. High-yield bonds are subject to greater price volatility, illiquidity and possibility of default.

Glossary

High-yield bonds possess greater price volatility, illiquidity and possibility of default.

Investment-grade bonds are generally rated BBB and above.

Spread refers to the difference between Treasury securities and non-Treasury securities of similar maturity but different credit quality.

Credit quality is a measure of a bond issuer's ability to repay interest and principal in a timely manner. The credit ratings discussed are based on a security's rating as provided by Standard and Poor’s, Moody’s Investors Service and/or Fitch Ratings, Ltd., and they typically range from AAA (highest) to D (lowest), or an equivalent and/or similar rating. The credit quality of the investments in a fund’s portfolio does not apply to the stability or safety of the fund. These ratings are updated monthly and may change over time. Please note that the closed-end funds have not been rated by an independent rating agency. Investment-grade bonds are bonds that are rated Aaa, Aa, A and Baa by Moody's Investors Service and AAA, AA, A and BBB by Standard & Poor's Ratings Service, or that have an equivalent rating by a nationally recognized statistical rating organization or are determined by the manager to be of equivalent quality. A below-investment-grade bond or high-yield security has a rating of BB or lower; it pays a higher yield to compensate for its greater risk.

Gross domestic product (GDP) is an economic statistic that
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measures the market value of all final goods and services produced within a country in a given period of time.

**U.S. Treasuries** are direct debt obligations issued by the U.S. government and backed by its "full faith and credit." The U.S. government guarantees the principal and interest payments on U.S. Treasuries when the securities are held to maturity.

The **Bloomberg Barclays U.S. Corporate High Yield 2% Issuer Capped Bond Index** is a component of the U.S. Corporate High-Yield Bond Index, which covers the universe of fixed-rate, non-investment-grade corporate debt of issuers in non-emerging market countries. It is not market capitalization-weighted; each issuer is capped at 2% of the index.

An investor cannot invest directly in an index. Unmanaged index returns do not reflect any fees, expenses or sales charges.

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