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 6.44% during the fourth quarter.

- For comparison purposes, the overall taxable bond market, as measured by the Bloomberg Barclays U.S. Universal Index, returned 1.29% during the quarter.

- Given the regulatory approvals of various vaccines and significant ongoing policy support as evidenced by the recent $900 billion relief package, along with clarity over U.S. elections, Western Asset Management (“Western”) has become more constructive on the economy’s ability to clear any remaining hurdles sooner than initially expected.

Market recap

The fourth quarter of 2020 was ultimately a strong one for risk assets, which rallied despite a number of short-term headwinds, including a sharp rise in COVID-19 (coronavirus) cases. Ultimately, investors chose to remain forward-looking, as a number of significant breakthroughs occurred in the final two months of the year, which provided some measure of relief from key macro risks.

The event that had the largest impact on investor sentiment was the announcement of several successful COVID-19 vaccine trials. In December, some of these vaccines achieved regulatory approval and began to be distributed to higher-risk segments of the global population. Despite the spike in COVID-19 case counts, the vaccine breakthrough brought some clarity as to the likely timing of when economic activity should normalize. Also supporting investor sentiment were continued monetary policy accommodation by the Federal Reserve Board (“Fed”), the resolution of the November presidential election, the approval of a $900 billion stimulus package in the U.S., and the long-awaited Brexit agreement.

U.S. Treasurys, as measured by the Bloomberg Barclays U.S. Treasury Index, returned -0.83% during the fourth quarter, bringing the index’s year-to-date gain to 8.00%. Two-year Treasury yields fluctuated, but they were unchanged overall, while 10-year yields moved higher over the quarter (yields and prices move in the opposite direction). The spread sectors (non-U.S. Treasurys) posted positive returns and generally outperformed equal-duration Treasurys.

Looking at the U.S. economy, third quarter 2020 gross domestic product (GDP) annualized growth was 33.4% – the sharpest quarterly ascent on record. This followed a -31.4% reading during the second quarter, the steepest quarterly decline on record. According to the Commerce Department, “The increase in real GDP reflected increases in personal consumption expenditures, private inventory investment, exports, nonresidential fixed investment, and residential fixed investment that were partly offset by decreases in federal government spending and state and local government spending. Imports, which are a subtraction in the calculation of GDP, increased.” The initial estimate for fourth quarter GDP will be released on January 28, 2021.

Unemployment remained elevated amid the pandemic, but there were some signs of improvement. That said, the U.S. lost 140,000 jobs in December, ending seven consecutive months of job growth. The unemployment rate fell from 7.9% in September to 6.9% in October, and it was 6.7% in both November and December. The workforce participation rate was little changed, as it was 61.4% in September and 61.5% in December.

After contracting for much of the second quarter, the manufacturing sector continued to expand over the third and fourth quarters. According to the Institute for Supply Management's Purchasing Managers Index (PMI), the manufacturing sector had a reading of 59.3 in October, 57.5 in November and 60.7 in December (the best reading since August 2018). (A reading below 50 indicates a contraction, while a reading above 50 indicates an expansion.) Sixteen of the 18 industries measured by the PMI expanded in December, versus 14 in September.

The Fed met twice during the fourth quarter, and it maintained its highly accommodative monetary policy stance. In the minutes...
from the Fed's November meeting, 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 continued to recover but remain well below their levels at the beginning of the year." At the Fed's meeting in December, it said, "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."

The U.S. high-yield bond market, as measured by the Bloomberg Barclays U.S. High Yield 2% Issuer Cap Index, returned 6.44% during the fourth quarter. For comparison purposes, the overall taxable bond market, as measured by the Bloomberg Barclays U.S. Universal Index, returned 1.29% during the quarter.

Outlook

Given the regulatory approvals of various vaccines and significant ongoing policy support as evidenced by the recent $900 billion relief package, along with clarity over U.S. elections, we have become more constructive on the economy’s ability to clear any remaining hurdles sooner than initially expected. We are ultimately optimistic about fundamentals; however, valuations already largely reflect that optimism in many industries. Overall high-yield spreads, which had widened to over 1,100 basis points (bps) over U.S. Treasuries during the depths of the crisis, are near completing a round trip back to where they began 2020 (at +336 bps). Overall valuations are, therefore, less attractive than in the recent past. The technical backdrop, despite the expiration of the Fed’s explicit backstop, remains very positive. New-issue supply is expected to trend lower than 2020’s pace, while demand is expected to remain robust in a world starved for yield (the market value of the Bloomberg Barclays Global Negative Yielding Debt Index surpassed $18 trillion in December).

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