U.S. high-yield bond market commentary

Executive summary

- The U.S. high-yield bond market, as measured by the Bloomberg Barclays U.S. High Yield 2% Issuer Cap Index, returned 10.14% during the second quarter.
- For comparison purposes, the overall taxable bond market, as measured by the Bloomberg Barclays U.S. Universal Index, returned 3.81% during the second quarter.
- In Western Asset Management’s (“Western”) view, there are clear and identifiable risks that will influence valuations across the high-yield market in the second half of the year.
- Western’s view is that the risk/reward balance for high yield favors “reward.” Technicals are in very solid condition. In addition, the asset class currently offers a high level of current income and greater total return prospects relative to other fixed income asset classes.

Market recap

Markets rallied during the second quarter, after a steep decline during the first three months of the year. Despite COVID-19 (coronavirus) cases moving higher, risk appetite increased as investors appeared to focus on unprecedented monetary policy accommodation by the Federal Reserve Board (“Fed”), substantial fiscal stimulus, reopenings in many states and optimism around a vaccine. Against this backdrop, credit spreads narrowed, after meaningfully widening over the first quarter.

U.S. Treasurys, as measured by the Bloomberg Barclays U.S. Treasury Index, returned 0.48% during the second quarter, boosting its year-to-date gain to 8.71%. Both two- and 10-year Treasury yields moved lower, albeit less so than in the first quarter (yields and prices move in the opposite direction). The spread sectors (non-U.S. Treasurys) also posted positive returns and generally outperformed equal-duration Treasurys.

Looking at the U.S. economy, the Commerce Department reported that first quarter 2020 gross domestic product (GDP) annualized growth was -5.0%. This marked the steepest quarterly decline since the first quarter of 2009. For comparison purposes, the economy expanded 2.1% during the fourth quarter of 2019. According to the Commerce Department, “The decrease in real GDP in the first quarter reflected negative contributions from PCE (personal consumption expenditures), private inventory investment, exports and nonresidential fixed investment, that were partly offset by positive contributions from residential fixed investment, federal government spending, and state and local government spending. Imports, which are a subtraction in the calculation of GDP, decreased.” The initial estimate for second-quarter GDP will be released on July 30.

Weakness in the labor market continued during the quarter, although data were generally better than expected. The unemployment rate fell from 14.7% in April to 13.3% in May, and then moved to 11.1% in June. In addition, the workforce participation rate moved higher, as it rose from 60.2% in April to 61.5% in June.

After contracting during the previous three months, the manufacturing sector expanded in June. According to the Institute for Supply Management’s Purchasing Managers Index (PMI), the manufacturing sector had a reading of 52.6 in June versus 43.1 in May. (A reading below 50 indicates a contraction, while a reading above 50 indicates an expansion.) This marked the strongest reading since April 2019. In addition, 13 of the 18 industries measured by the PMI expanded in June, versus six in the prior month.

The Fed met twice during the second quarter and continued to take aggressive actions to support the economy and keep the financial markets functioning properly. During the Fed’s April meeting it said, “To support the flow of credit to households and businesses, the Federal Reserve will continue to purchase Treasury securities and agency residential and commercial mortgage-backed securities in the amounts needed to support smooth market functioning ... In addition, the Open Market Desk will continue to offer large-scale overnight and term repurchase agreement operations.” The Fed also expanded its credit facilities to include the purchase of individual corporate bonds, which
supported spread tightening. Finally, at his press conference following the June meeting, Fed Chair Jerome Powell said, “We are strongly committed to using our tools to do whatever we can and for as long as it takes to provide some relief and stability … We’re not even thinking about raising rates.” All 17 officials who participated in the rate-setting meetings said they expect to hold rates near zero in 2021, and 15 of them projected rates would remain unchanged through 2022.

As was the case during the previous three months, both two- and 10-year Treasury yields moved lower during the second quarter. When the period began, the yield on the two-year Treasury was 0.23%, and it ended the quarter at 0.16%. The yield on the 10-year Treasury began the quarter at 0.70% and it ended at 0.66%.

The U.S. high-yield bond market, as measured by the Bloomberg Barclays U.S. High Yield 2% Issuer Cap Index, returned 10.14% during the second quarter. For comparison purposes, the overall taxable bond market, as measured by the Bloomberg Barclays U.S. Universal Index, returned 3.81% during the second quarter.

**Outlook**

There are clear and identifiable risks which will influence valuations across the high-yield market in the second half of the year. Issuer fundamentals are typically at the top of the risk list, but given the state of affairs, they don’t crack the top three. The resurgence/retrenchment of COVID-19 cases, the ability of the economy to stabilize, and expectations regarding the November elections are the key factors, and they will continue to drive the market’s direction for the foreseeable future. Our view with regard to COVID-19 is that some of the brightest minds in the world are working on a vaccine. It’s highly likely that it’s a matter of when, not if, a vaccine is discovered and made available. A vaccine would be a game changer and a prerequisite for return to pre-COVID economic growth rates. In an effort to bolster liquidity and extend their runway until economic activity recovers, high-yield companies have tapped the primary market and done so in record fashion. The capital markets remain wide open, providing a wide range of companies, including those in hard-hit industries such as airlines, energy and cruise lines, with cash. In our view, strengthening liquidity should help dampen the default rate. Current valuations imply a 9% default rate over the next 12 months. We do not agree with the broad market assessment. Valuations for the asset class ended June well wide of the average, and spreads have been wider less than 20% of the time over the past 10 years.

In our view, the risk/reward balance for high yield favors “reward.” Technicals are in very solid condition. A significant amount of pent-up demand from institutional and retail investors began being applied to the market as the yield for the asset class moved wide of 6%. In addition, the Fed announced it would buy high-yield ETFs and individual high-yield bonds. Though their purchases to date have been muted, it does provide support. Meanwhile, the new-issue market is open to companies of all industries, many of whom have also utilized their revolving credit lines to help them through the slowdown. A return to pre-COVID valuations will be a challenge in the near future. However, we believe a strong case for meaningful improvement can be made by those who believe a vaccine is on the horizon and default rates for prudent active managers will remain below the historical average rate. The asset class currently offers a high level of current income and greater total return prospects relative to other fixed income asset classes.

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 Aa, 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 measures the market value of all final goods and services produced within a country in a given period of time.

U.S. Treasurys 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. Treasurys when the securities are held to maturity.

The Bloomberg Barclays U.S. 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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