Growing Dispersion in Credit

December 2019

OVERVIEW

- **Lower-rated credit has been a notable laggard in an otherwise rewarding year-to-date environment for investors**
- **BB-rated high yield has been very well bid, with yields recently reaching extremes on both an absolute and relative basis**
- **Disciplined portfolio construction helps resist the impulse to reach for yield in order to accomplish near-term income or return goals**

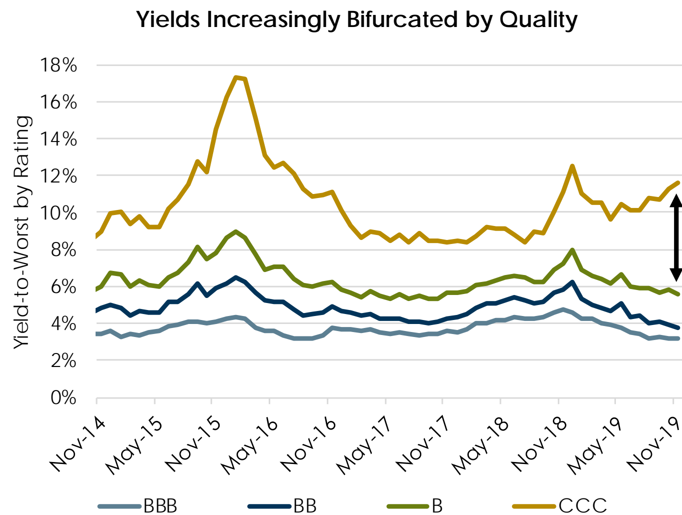
Background

Following a difficult 2018, where owning cash was superior to almost any other investment, year-to-date results have provided a mirror image in that practically everything within a diversified portfolio has worked well. High quality government bonds, credit sensitive fixed income, global equities, and public real estate have all provided returns well in excess of historic averages. That said, one segment of the market that has struggled to keep pace in 2019 is CCC and lower-rated credits, across high yield and related categories such as bank loans and Collateralized Loan Obligations (CLOs).

Evolving Compensation for Credit Risk

The chart below illustrates market yields for various rating sub-categories within US corporate credit. Although yields are universally low by historical standards, it's still appropriate for dispersion to exist across the credit spectrum as investors rightfully demand higher compensation for assuming incremental risk. What we've seen since early May, as US-China trade tensions escalated and global growth concerns came to the fore, is the growing divergence between the CCC-rated basket and the higher quality segments of the market. While the spreads and yields for more highly rated issues continue to compress, there has been a notable increase in spreads and yields for the lowest rated benchmark constituents. This heightened divergence creates potential opportunity for active managers as security selection and the careful avoidance of idiosyncratic situations with elevated default risk can result in excess return. That said, a cautious approach to perceived value is warranted, as the CCC-rated category includes a higher concentration to Energy and other cyclical sectors that have proven to be particularly vulnerable to the later stages of an economic expansion.

Yields Increasingly Bifurcated by Quality

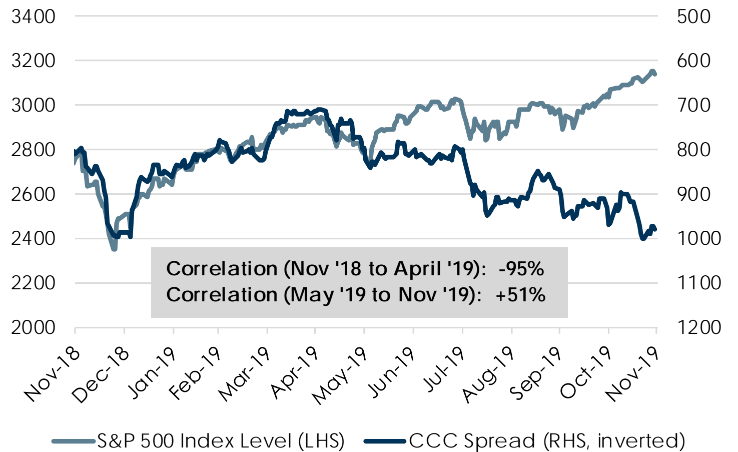


Source: ACG Research, Bloomberg Barclays (5-years ending 11/29/19)

Investors Flocking to High Quality Junk

In an effort to preserve income amid low yields, investors have shown a willingness to venture beyond investment grade and into the upper tiers of high yield. Given strong technical demand, the all-in yield for the BB-rated basket has recently dropped to a historic low of just under 3.8%. Not only has this marginalized the advantage relative to BBB-rated securities, which now stands at its tightest level since early 2005, it means that most high yield investors are far from capturing the benchmark's overall yield of around 5.6%. In the more bifurcated environment that currently exists, less than 10% of high yield bonds trade within +/- 50 bps of the average yield for the index. To fully obtain the benchmark's yield, it is thus required that investors own the full spectrum of risk, all the way down to the CCC and lower-rated credits. Over the past seven months, the correlation between CCC-rated credit and equities has broken down. Investors (perhaps with the exception of those in high yield ETFs) appear to have lost their appetite for higher levels of risk within corporate credit, even as stocks have dealt more effectively with global uncertainty.

Riskiest Bonds Fall While Stocks Rise



Source: ACG Research, Bloomberg Barclays, S&P Dow Jones Indices (12-months ending 11/29/19)

ACG's Position

With a "muddling through" backdrop largely defining the post-crisis environment, the domestic economy has produced growth and inflation of around 2% while market yields for US Treasury bonds have frequently failed to match even these muted levels. Understandably, this setting has caused a reach for yield across the credit spectrum, such that the compensation received for incremental risk has diminished materially. The recent dispersion observed in the lower rungs of high yield and related credit categories is evidence of a push-back by investors that may well signal further stress on the horizon. Despite the more sanguine equity markets setting all-time highs, it's prudent to pay attention to your risk appetite within credit more than prevailing yields, and to combat any impulses that may jeopardize longer-term goals.

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231 South Bemiston Avenue ♦ 14th Floor ♦ Saint Louis, Missouri 63105
www.acgnet.com
314.862.4848