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High Yield's Wild Year

FEBUARY 2021

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Snapshot

- The high-yield market has a history of transformation. Credit quality has improved over the past year due to an influx of former investment-grade companies.
- The outlook for defaults has improved sharply since last March, and forecasts show a steady decline in the default rate over the next 12 months.
- As the high-yield market hovers near all-time low yields, we believe active management is essential to identifying opportunities for outsized returns and avoiding credit mistakes.

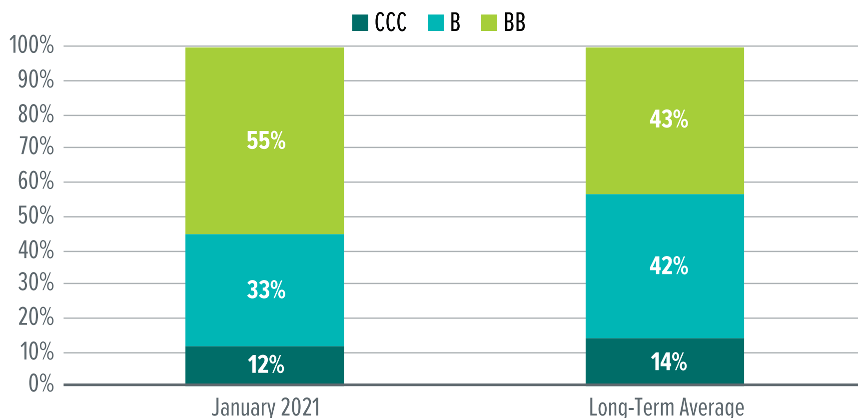
The high-yield market has a history of transformation, whether it's during the technology-media-telecommunications phase of the early 2000s, the Great Financial Crisis or the current COVID-19 pandemic.

Today, we're setting records or revisiting milestones that we haven't encountered in years. The high-yield market, as measured by the ICE BofA US High Yield Constrained Index, breached a 4% market yield in February for the first time, falling to a record low of 3.96% on 11 February. The average price in 2021 exceeded $105 for the first time since July 2014[1].

High-yield credit quality has also improved over the past year (Exhibit 1). BB rated bonds hit an all-time high Index share of 57% during July 2020 (and were holding at 55% in January) compared to a long-term average of 43%[1].

The investment-grade market's loss has been the high-yield market's gain. An influx of fallen angels (investment-grade companies that have been downgraded to high yield) has been the primary contributor to the migration toward higher quality. This shift has been mostly at the expense of B rated bonds, while the impact on CCC rated bonds has been a bit more muted.

Exhibit 1: Investment Grade's Loss is High Yield's Gain



Long-term average is based on the period from December 1996 through January 2021. Source: ICE. Past performance is not a reliable indicator of future results.

[1] Based on the net performance, price and yield characteristics of the ICE BofA US High Yield Constrained Index dating back to its inception on 31 December 1996 as provided by ICE.

Turning back the clock

At the time, January 2020 seemed like an unremarkable month. The high-yield market had returned 14.41% in 2019, ending the year with a 5.41% yield, and was more or less unchanged in January.

Then COVID-19 began to cross borders, and its anticipated economic impact spilled over into financial markets. The high-yield market was down by 1.55% in February 2020—starting a massive selloff that finally hit bottom on 23 March 2020. The damage through the March low was stark[1]:

- High-yield market performance was down by 20.57% year to date
- The market yield climbed to 11.40%—the highest level since August 2009
- The market spread reached a towering 1,087 basis points—the highest since June 2009
- The average price had fallen to $78.60—the lowest since June 2009

The Federal Reserve's (Fed) quick action in resurrecting the playbook from the Great Financial Crisis—with some important modifications—succeeded in flooding markets with liquidity and avoiding a financial catastrophe[2]. This time, the Fed acted quicker than it did in 2008. It also went further, buying high-yield corporate bonds and exchange-traded funds (ETFs) for the first time.

Financial markets were receptive to the Fed's actions. The high-yield market rallied by 9% in the final six trading days of March, shrinking the year-to-date loss through 31 March 2020 to 13.13%. Markets continued to regain confidence over the last three quarters of 2020: the high-yield market registered positive returns in every month except for September (-1.04%), finishing with a full-year return of 6.07%.

Issuance and investor demand

Corporations took full advantage of the opportunity to access capital markets following the Fed's interventions. $72.9 billion came to market during the first quarter of 2020; then, the new-issue market exploded during the final three quarters of the year. 2020 was the first calendar year to exceed $400 billion in new issues, with total new issuance of $450 billion[3]. Refinancing was the primary use of proceeds (66.1%), followed by general corporate purposes at 24.7%, which was the highest share since 2000 (39.1%).

Investors had fled high yield in a significant way during the first quarter of 2020, with $15.4 billion of outflows. As the market rebounded, investors—in their constant search for yield, and now for total return as well—jumped back into high yield with $44 billion of inflows during the second quarter of 2020 alone. Another $15 billion of inflows during the second half of 2020 resulted in a net inflow of $43.6 billion for the calendar year.

Default rate environment

In March 2020, Moody's baseline forecast for the U.S. speculative-grade default rate was pegged at 14.4% by March 2021[4]. Fortunately, the default-rate environment didn't deteriorate to that degree, and never surpassed 9% per Moody's January 2021 report. Moody's U.S. speculative-grade default rate stood at 8.3% in January 2021.

The outlook for defaults is decidedly better today than it was last March. Moody's forecasting model shows a steady decline in the default rate over the next 12 months, falling to 5.6% by January 2022. While this decrease is a welcome improvement, the default rate remains high relative to the average default rate of 3.7% over the past 10 years and 4.5% over the past 25 years.

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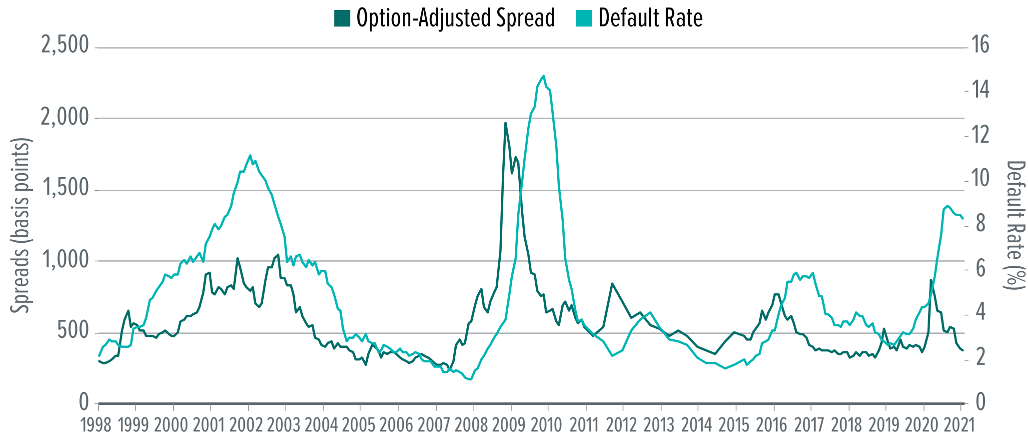
[2] "Fed support fuels corporate debt spree in April." Reuters. 29 April 2020.
[3] Blackstone Credit Insights: December 2020 Market Commentary
[4] Moody's is a credit-rating agency that assesses the risks associated with individual bond issuers as well as market-wide credit-default risks.

Exhibit 2: Spreads and Default Rates Follow a Similar Path



Monthly data from January 1998 through January 2021. Sources: Moody's for U.S. Speculative Default Rate data; ICE for spread data on the ICE BofA US High Yield Constrained Index. Past performance is not a reliable indicator of future results.

The energy sector

Energy has been a focal point of the high-yield market for quite some time. If an investor had stepped away from the market at the end of 2019 and came back today, the sector's weight would not look much different, although its composition has changed.

The intervening period, however, was volatile. Energy began 2020 as high yield's long-serving top sector, but then shrank to its fifth-largest sector by the end of the first quarter of 2020 after plunging by nearly 40%.

A wave of defaults, an influx of fallen angels, a pick-up in the new-issue market, and a nearly-55% return over the final three quarters of 2020 re-established energy as the largest sector in high yield. Despite this roundtrip, it is notable that energy was the only primary sector in negative territory for full-year 2020 (-6.55%).

Exhibit 3: The Energy Sector's Round Trip

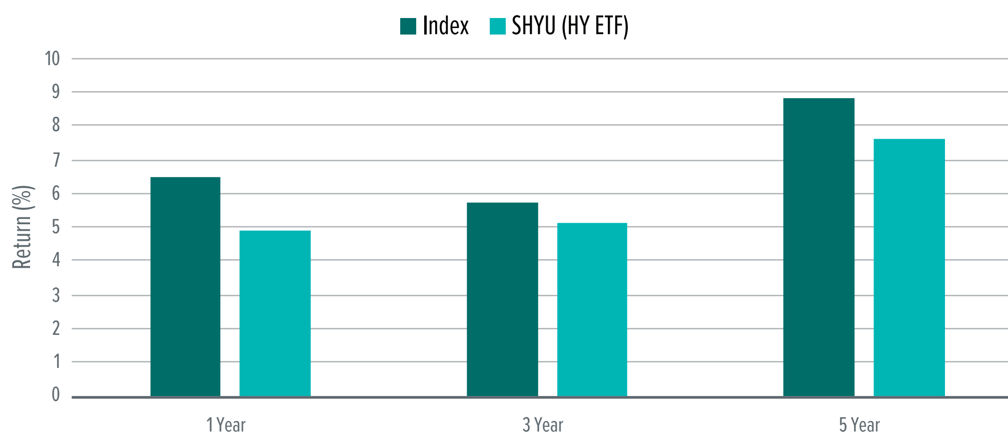
Change in Weights for the Top Five Sectors in the ICE BofA US High Yield Constrained Index					
Weight as of	**Dec 31 2019**	**Weight as of**	**Mar 31 2020**	**Weight as of**	**Jan 31 2021**
Energy	12.5%	Media	11.4%	Energy	13.2%
Media	10.8%	Healthcare	10.8%	Media	9.3%
Telecommunications	10.5%	Telecommunications	10.7%	Healthcare	8.9%
Healthcare	10.4%	Basic Industry	10.3%	Basic Industry	8.6%
Basic Industry	10.4%	Energy	8.8%	Telecommunications	7.3%

Source: ICE. Past performance is not a reliable indicator of future results.

SEI's view

As the high-yield market hovers near all-time low yields, we believe active management and our manager-of-managers structure are essential to navigating a challenging environment for alpha generation. In our view, the passive ETF approach has produced unimpressive results for long-term investors (Exhibit 4 on the next page).

Exhibit 4: ETF Relative Performance



Performance measured through 31 December 2020. Index = ICE BofAML US High Yield Constrained Index (USD); SHYU = iShares $ High Yield Corp Bond UCITS ETF. Sources: Blackrock and ICE. Past performance is not a reliable indicator of future results.

Looking ahead, it will be important to avoid credit mistakes. Corporate default rates have continued to decline, but are expected to remain above historical averages. There should also continue to be positive opportunities for both rising stars (high-yield companies that are upgraded to investment-grade status) and acquisition candidates—two events that typically lead to outsized returns.

The energy sector—once again the largest within high yield—was the largest underweight in our strategy for a long time, but that is no longer the case. Our managers identified value in select sub-sectors and credits as energy underwent substantial turnover.

We believe the bank-loan market remains an enduring source of relative value. Furthermore, our manager-of-managers framework provides flexibility in balancing capacity constraints that larger single-manager strategies may struggle to offer.

Index Definitions

The ICE BofA US High Yield Constrained Index tracks the performance of below-investment grade, U.S. dollar-denominated corporate bonds publicly issued in the U.S. domestic market, but caps exposure to individual issuers at 2%.

Glossary of Financial Terms

Credit quality is an assessment of the creditworthiness, or risk of default, of a company or country. Credit quality is typically measured with a credit ratings system: the higher the rating, the lower the perceived risk of default. Moody's rating system employs a scale that generally ranges from AAA (highest) to D (lowest).

Option-adjusted spreads estimate the difference in yield between a security or collection of securities and comparable Treasurys after removing the effects of any special features, such as provisions that allow an issuer to call a security before maturity.

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