CRESCENT

FINDING VALUE IN FIXED INCOME WHEN RATES RISE

Credit has been resilient in 2021. Since the beginning of the year interest rates have risen and spreads have tightened. Investors have been comfortable reaching for yield in a world of accelerating growth and dovish Fed policy. As job growth slows and inflation accelerates how should investors be positioned within fixed income? John Fekete, Crescent Capital Group's Head of Capital Markets, discusses the state of the US economy and the outlook for debt markets.

John Fekete
Managing Director

John Fekete is Head of Capital Markets and is the lead Portfolio Manager of Crescent Capital Group's High Yield Bond, High Income and Syndicated Credit Solutions strategies. He is a member of Crescent Capital Group's Management Committee.

Q: After a historic recovery in 2020 few people were expecting continued strong returns in 2021. How has the US High Yield asset class fared so far this year?

Investors who maintained exposure to below investment grade credit within their overall portfolio have, once again, been rewarded. Year-to-date returns have been strong, with the ICE BAML US High Yield Index ("Index") returning 2.35% through May 10. This is in sharp contrast to the -2.53% year-to-date return for the Bloomberg Barclays US Aggregate Bond Index and -3.40% return for the Bloomberg Barclays US Corporate Bond Index. High Yield's superior return comes amid a backdrop of accelerating revenue and earnings growth and declining downgrade and default activity.

Q: Has the rally gotten ahead of itself?

The US economy appears to be on a path of sustained recovery. The risk to consensus 2021 GDP growth may be to the upside, supportive of value-oriented asset classes like credit, leading to additional spread tightening. While spreads are fairly valued in light of the expected low future default rate, there is no historical precedent for the current market. Fixed income investors have never before seen this level of fiscal and monetary support for the US economy. One risk facing fixed income assets is a potential increase in inflation. Accelerated consumer spending coming out of the pandemic could quickly put upward pressure on prices. The April core CPI reading was up 0.92% over March (3.0% annualized), the largest seasonally-adjusted increase in core CPI since September 1981. The greatest increases were seen in sectors tied to the reopening of the economy such as used car prices, airfares, lodging and car and truck rentals. While spreads are low by historical standards we believe asset allocators are poised to add risk should there be spread widening. We expect any pullback would be short and shallow, met with increased demand.

Q: The April jobs report was a big disappointment. Does this suggest the recovery is slowing?

Mass vaccinations, easing lockdowns and rising wages have boosted spending on goods and services. At the same time, businesses can't seem to find enough people to hire. Employers added 266,000 jobs in April, about 75% below expectations and nearly 500,000 below the March level. There are about 8.5 million fewer workers today compared to before the pandemic, yet employers report difficulty in attracting workers. There has been speculation that enhanced jobless benefits and challenges with respect to child care are discouraging some Americans from returning to the workplace. Automation and efficiencies implemented during the Coronavirus pandemic may also be a factor in less robust hiring. The U.S. Bureau of Economic Analysis estimates 1Q 2021 GDP at $19.09 trillion. On a pre-pandemic basis, 1Q 2020 GDP was $19.01 trillion. Despite 8.5 million fewer workers American businesses created $80 billion more in goods and services. This suggests firms that laid off a portion of their workforce may not need to bring every job back as demand returns to normal. Maintaining the momentum of jobs recovery could become more challenging and the labor force participation rate may not return to pre-pandemic levels. No doubt the Fed is watching closely, and this may be why there's little handwringing over inflation in the Eccles Building.

Q: Are there signs the Fed is considering withdrawing market support?

Chairman Powell's April FOMC press conference made clear tapering is not planned at this time. There was no change to the monthly bond buying pace and no new guidance for when those policies might change. It seems safe to say the Fed is going to keep its foot on the accelerator until substantial further progress is made towards its employment and inflation goals. During the press conference Chairman Powell reiterated his view that the recent uptick in inflation is attributed to transitory factors and he provided an unwavering display of confidence that Fed officials are not worried about sustained inflation above the 2% target. The earliest we would expect hints of a policy change would be late 2021.

Q: Are you seeing increased demand for floating rate loans and any other pockets of value?

We believe fund flow data supports the premise that a rotation out of fixed coupon bonds and into floating rate loans occurred in 1Q 2021. According to UBS, we saw outflows of $2.9 billion in US High Yield Bonds and $1.6 billion in European High Yield in 1Q 2021. By contrast, US floating rate loan fund inflows totaled $11.7 billion, the largest since 1Q 2017. This makes sense as bank loans typically do not face the same interest rate headwinds as bonds. As a result of this rotation and the corresponding sell-off in select interest-rate sensitive high yield bonds we see a sweet spot today in BB-rated bonds. This is for two reasons: 1) Ratings upgrades are expected to outpace downgrades in 2021, particularly for "rising stars" or former high yield bonds that are upgraded to Investment Grade ("IG"). With the upgrade you typically see credit spread compression, leading to capital appreciation on top off attractive coupons; 2) IG managers rebalancing into BB-rated High Yield bonds for extra yield. IG investors can reduce duration risk and increase yield by selling triple-Bs (yield: 2.4%, duration: 8.0 years) and buying double-Bs (yield: 3.3%, duration: 4.8 years). We believe the rotation into double-Bs is in the early innings, with UBS estimating about 3.5% of IG portfolios are now allocated to BB-rated bonds. This compares to a cycle high of 6% in March 2015 when interest rates last spiked in the US. We think double-Bs are favorable from a risk-reward perspective.

Q: What is your outlook for below investment grade credit?

The worst of the pandemic's economic impact is behind us. The fundamental outlook is firmly positive, with US GDP expected in the high single-digit range this year. The worst of the pandemic's economic impact is behind us. The fundamental outlook is firmly positive, with US GDP expected in the high single-digit

range this year. The pace of vaccinations has been critical to reopening businesses and normalizing economic activity. Credit investors have grown confident that a dovish Fed combined with a growing economy can sustain the credit market rally into its second year, fueling demand for higher-yielding assets. Corporate defaults have peaked and are declining, and credit rating upgrades are expected to outpace downgrades, providing a path for credit spreads to tighten further. High yield bonds and bank loans also benefit from offering more spread and lower interest rate sensitivity than IG corporates and five and 10-year US Treasury bonds and have historically outperformed when interest rates rise.

Q: How would you describe the overall quality of the US High Yield market?

The quality of the US High Yield market has improved as defaulted debt exited and fallen angels entered the benchmarks. January was the biggest month in two years for rising stars and became the first month where rating upgrades outpaced downgrades since the Covid-19 pandemic began, with $19 billion of net upgrades within US High Yield and $7 billion net upgraded to IG. At the same time, credit quality has never been higher, with a record 54% of the US High Yield market rated double-B and only 13% rated CCC+ or lower, the smallest percentage in 20 years according to Bank of America.

Q: Where are valuations today?

The Index spread of 345 basis points as of May 1, 2021 is slightly lower than pre-Covid levels (372 basis points on Jan 1, 2020), while the Index yield-to-worst was close to a record low of 4.12% on May 1, 2021. Spreads look attractive relative to IG, especially given US High Yield bonds and bank loans are much more resilient when interest rates rise. The High Yield to Investment Grade spread ratio continues to look wide at 4:1, the second-highest reading in the last four years. We would expect to see additional inflows into below investment grade credit given negative real yields in the IG market.

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About Crescent

Crescent Capital is a global credit investment manager with $30+ billion of assets under management. For nearly 30 years, the firm has focused on below investment grade credit through strategies that invest in marketable and privately originated debt securities including senior bank loans, high yield bonds, and private senior, unitranche, and junior debt securities. Crescent Capital is headquartered in Los Angeles with offices in New York, Boston, and London and more than 180 employees globally.

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