MacKay Shields: U.S. High Yield Market Update

Valuations

Yields on the ICE BofA U.S. High Yield Index (the “U.S. High Yield Index” or the “Index”) have increased over 3% already in 2022 given the rise in U.S. Treasury rates. The yield on the U.S. High Yield Index now stands at 7.5% vs. 4.3% at the start of the year. Yields at these levels are comparable to what was seen in mid-2018 to 2019 and are now above long-term median levels. Moreover, the average dollar price of the U.S. high yield market as measured by the Index is now approximately $90 – meaning there is now more potential for capital appreciation. Spreads have also recently widened in line with historical median levels of approximately 470bps up from 330bps at the start of 2022. We believe these levels now have the potential to compensate investors for making additional allocations to U.S. high yield.

Investors shaken by the ICE BofA U.S. High Yield Index’s Q1 loss of 4.5% didn’t find any relief in April. The index’s April loss of 3.6% represented to worst monthly performance since March 2020, bringing its year to date decline to 7.99%. Weakness has continue in May, with the index shedding an additional 2.5% through May 12. However, the broader credit risk profile of the U.S. high yield market continues to remain strong. We continue to believe the U.S. high yield market represents a reasonable, lower duration fixed income investment option.
Figure 1: ICE BofA U.S. High Yield Index Yield and Spreads

As of May 12, 2022. Source: ICE Data. It is not possible to invest directly in an index. Please see disclosures for index descriptions. Past performance is not indicative of future results.

Figure 2: ICE BofA U.S. High Yield Average Dollar Price ($)

As of May 12, 2022. ICE Data. It is not possible to invest directly in an index. Please see disclosures for index descriptions. Past performance is not indicative of future results.
Credit Fundamentals

Credit trends have weakened somewhat. First quarter earnings from high yield issuers are showing the effects of cost inflation, strained supply chains, and scarce raw materials.

Cost inflation in Europe is particularly concerning. Even though most U.S. high yield issuers are focused domestically (88% are located in the U.S.), others have manufacturing operations in Europe that are experiencing severe cost shocks; for example, natural gas is almost 7x higher in Europe than the U.S.

The broader credit risk profile of the U.S. high yield market continues to remain strong. The largest high yield issuers are generally large publicly traded companies; S&P 500 companies represent 25% percent of the ICE BofA U.S. High Yield Index. The credit quality of the U.S. high yield market continued to improve in 2021, with 58% of new issues rated BB. The ICE BofA U.S. High Yield Index is now comprised of 54% BBs (on a par value basis), up from 43% at the end of 2011.

Figure 3: U.S. High Yield Has Trended Towards Higher Quality, Public Companies
BB-rated credits have increased as a proportion of the U.S. high yield market, alongside a decrease in CCC-bonds; 25% of the U.S. High Yield Index is now comprised of companies in the S&P 500 Index.

% in Par Value of ICE BofA U.S. High Yield Index

As of December 31, 2021.
Source: ICE Data. It is not possible to invest directly in an index. Please see disclosures for index descriptions.

Default rates remain subdued in this environment given better long-term credit fundamentals. As seen in Figure 4, the U.S. high yield default rate over the last twelve months has decreased to just 0.5% versus a long-term average of about 3%.
Rising Rate Performance

From an interest rate perspective, we believe U.S. high yield is better positioned than most fixed income asset classes to withstand a sharp rise in rates due to its higher coupons and shorter durations. Credit (rather than interest rates) has historically been the more important risk for high yield, and the market has been resilient during previous rising interest rate environments because of the historical correlation between rising rates and economic growth. However, today’s high yield market is more vulnerable than it has been historically. As the overall credit quality has improved, coupons have shrunk.

Please see Figure 5 below that highlights the U.S. High Yield Index’s return in periods during which the 10-Year U.S. Treasury rose more than 100bps since 2000 compared to other fixed income alternatives.

Figure 5: Periods Since 2000 — 10-Year U.S. Treasury Yield Increases More than 1%

<table>
<thead>
<tr>
<th>Rising Rate Period</th>
<th>10-Year U.S. Treasury Yield</th>
<th>Total Return (%)¹</th>
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<tbody>
<tr>
<td></td>
<td>Total Return (%)¹</td>
<td></td>
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<tr>
<td></td>
<td>U.S. High Yield²</td>
<td>U.S. Short Duration High Yield BB-B²</td>
</tr>
<tr>
<td>Sep. 98 - Jan. 00</td>
<td>4.42/ 6.67 225</td>
<td>3.7</td>
</tr>
<tr>
<td>Oct. 01- Mar.02</td>
<td>4.24/ 5.40 116</td>
<td>4.4</td>
</tr>
<tr>
<td>May. 03 - Jun. 06</td>
<td>3.37 / 5.14 177</td>
<td>9.2</td>
</tr>
<tr>
<td>Dec. 08 - Mar. 1.0</td>
<td>2.21/ 3.83 162</td>
<td>49.5</td>
</tr>
<tr>
<td>Jul. 12 - Dec. 13</td>
<td>1.47 / 3.03 156</td>
<td>9.5</td>
</tr>
<tr>
<td>Jul. 16 - Oct. 18</td>
<td>1.45/ 3.14 169</td>
<td>5.8</td>
</tr>
<tr>
<td>Jul. 20 - Mar. 22</td>
<td>0.53/ 2.35 182</td>
<td>4.2</td>
</tr>
</tbody>
</table>

Source: MacKay Shields, as of 3/31/22. It is not possible to invest directly into an index. Please see disclosures for index descriptions. Past performance is not indicative of future results.

1. Total return annualized for periods that are greater than a year.
**Technicals**

Market weakness has caused retail outflows in 2022. Despite heavy retail outflows, the underlying demand for U.S. high yield market has remained stable. Since the start of 2022, the combined assets of the two largest high yield ETFs – iShares iBoxx High Yield Corporate Bond ETF (HYG) and SPDR Bloomberg High Yield Bond ETF (JNK) – have plunged 35% from $31bn to $20bn. However, ETFs only represent 4% of the high yield investor base. As shown in the chart below, U.S. high yield is largely held by long-term, unleveraged investors such as pension plans, insurance companies, and foreign institutional buyers. Generally in the past, investors have looked to manage risk in their overall portfolio by selling equities to fund their U.S. high yield investments as U.S. high yield provides 1.) potential upside equity beta 2.) potential to manage overall portfolio risk compared to equities 3.) relatively attractive income potential and lower historical duration compared to other fixed income alternatives.

**Figure 6: U.S. High Yield Investor Base**

As of December 31, 2021.
Source: JP Morgan. Due to rounding, sum of items may not equal 100% or expressed totals as applicable.
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Past performance is not indicative of future results.

Index Descriptions

ICE BofA Corporates Cash Pay BB-B 1-5 Year Index

A subset of the ICE BofA U.S. Cash Pay High Yield Index including all securities with a remaining term to final maturity less than 5 years and rated BB1 through B3 inclusive. Index results assume the reinvestment of all capital gain and dividend distributions. An investment cannot be made directly into an index.

ICE BofA U.S. High Yield Index

The ICE BofA U.S. High Yield Index tracks the performance of U.S. dollar denominated below investment grade corporate debt publicly issued in the U.S. domestic market. The ICE BofA U.S. High Yield Index tracks the performance of U.S. dollar denominated below investment grade corporate debt publicly issued in the U.S. domestic market. Qualifying securities must have a below investment grade rating (based on an average of Moody’s, S&P and Fitch) and an investment grade rated country of risk (based on an average of Moody’s, S&P and Fitch foreign currency long term sovereign debt ratings). In addition, qualifying securities must have at least one year remaining term to final maturity, a fixed coupon schedule and a minimum amount outstanding of $100 million. Original issue zero coupon bonds, “global” securities (debt issued simultaneously in the eurobond and U. S. domestic bond markets), 144a securities and pay-in-kind securities, including toggle notes, qualify for inclusion in the Index. Callable perpetual securities qualify provided they are at least one year from the first call date. Fixed-to-floating rate securities also qualify provided they are callable within the fixed rate period and are at least one year from the last call prior to the date the bond transitions from a fixed to a floating rate security. DRD-eligible and defaulted securities are excluded from the Index.
ICE BofA High Yield CCC & Lower Index
The ICE BofA High Yield CCC & Lower Index is a subset of the ICE BofA U.S. High Yield Index including all securities rated CCC1 or lower.

ICE BofA U.S. High Yield BB Index
The ICE BofA High Yield BB Index is a subset of the ICE BofA U.S. High Yield Index including all securities rated between BB1 and BB3.

Credit Suisse Leveraged Loan Index
The Credit Suisse Leveraged Loan Index is a representative index of tradable, senior secured, U.S. dollar-denominated non-investment grade loans.

ICE BofA U.S. Emerging Markets External Debt Sovereign & Corporate Plus Index
The ICE BofA Emerging Markets Corporate Plus Index tracks the performance of U.S. dollar (USD) and Euro denominated emerging markets non-sovereign debt publicly issued within the major domestic and Eurobond markets.

The ICE BofA U.S. Corporate Index
The ICE BofA U.S. Corporate Index tracks the performance of U.S. dollar denominated investment grade rated corporate debt publicly issued in the U.S. domestic market.

S&P 500® Index
The S&P 500® Index is widely regarded as the standard index for measuring large-cap U.S. stock market performance.

Yield to worst is computed by using the lower of either the yield to maturity or the yield to call on every possible call date.

Beta is a measure of historical volatility relative to an appropriate index (benchmark) based on its investment objective. A beta greater than 1.00 indicated greater volatility than benchmark.

Spread to worst measures the dispersion of returns between the best and worst performing security in a given market, usually bond markets, or between returns from different markets.

Credit Quality: Percentages are based on fixed-income securities held in the Fund’s investment portfolio and exclude any equity or convertible securities and cash or cash equivalents. Ratings apply to the underlying portfolio of debt securities held by the Fund and are rated by an independent rating agency, such as Standard and Poor’s, Moody’s, and/or Fitch. If ratings are provided by the rating agencies, but differ, the lower rating will be utilized. If only one rating is provided, the available rating will be utilized. Securities that are unrated by the rating agencies are reflected as such in the breakdown. Unrated securities do not necessarily indicate low quality. S&P rates borrowers on a scale from AAA to D. AAA through BBB represent investment grade, while BB through D represent non-investment grade.

About Risk:
Investing in below investment grade securities may carry a greater risk of nonpayment of interest on principal than higher-rated bonds. Bonds are subject to interest-rate risk and can lose principal value when interest rate rise. Bonds are also subject to credit risk in which the bond issuer may fail to pay interest and principal in a timely manner.