

» *High yield bonds
and inflation:
Certainly not a
deal-breaker*

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High Yield Corporate Bonds
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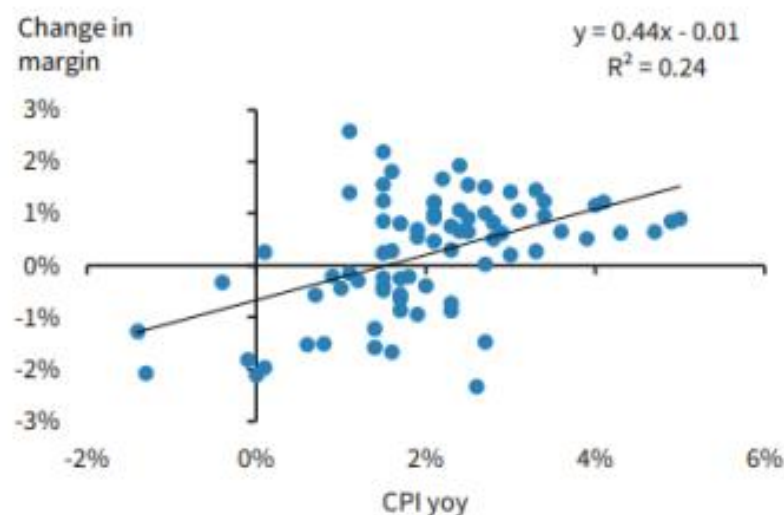
Inflation may be transitory – it is still worth knowing what it means

Talk about inflation and the potential implications for financial markets is all the rage. Money supply has exploded due to deficit spending as well as central bank policies. Real asset prices have certainly seen strong price gains, especially over the last 12 months or so, in most corners of the world, ranging from commodity prices to equities to real estate. Wage growth has so far been contained, but there are signs that an increased tightness in labor markets in certain areas and sectors could be developing, and the next shoe to drop. Nonetheless, for the most part, central banks have convinced market participants that any inflation surge will only be transitory, and not have a meaningful impact on market prices. As far as we are concerned, we will leave the opening on whether inflation will pick up in a lasting manner to macroeconomists. Instead, we will confine our thoughts a bit about the direct experience of the high yield market with inflation. We will then focus on the effects of higher interest rates on the high yield market, which we would also assume happens in the event of higher inflation.

The impact of inflation on corporate earnings

A good place to start is the development of corporate earnings. Corporate margins have generally increased in times of inflation in the past as companies have had an easier time of increasing prices, and have been able to more than offset the inflation on input costs. The graph below shows that in periods where the CPI is above 2%, corporate profit margins tend to increase.

Chart 1: Corporate profit margins increase with inflation



Source: Bloomberg, Barclays Research

This development has been aided by globalization, with global trade more than doubling its share of GDP, from 27% in 1970 to 60% in 2019¹. However, it is clear that this trend will not continue at the same pace, so we may not have the same deflationary force in the future. Nonetheless, profit margins are at least one item where we can be somewhat more relaxed if the past is any guide.

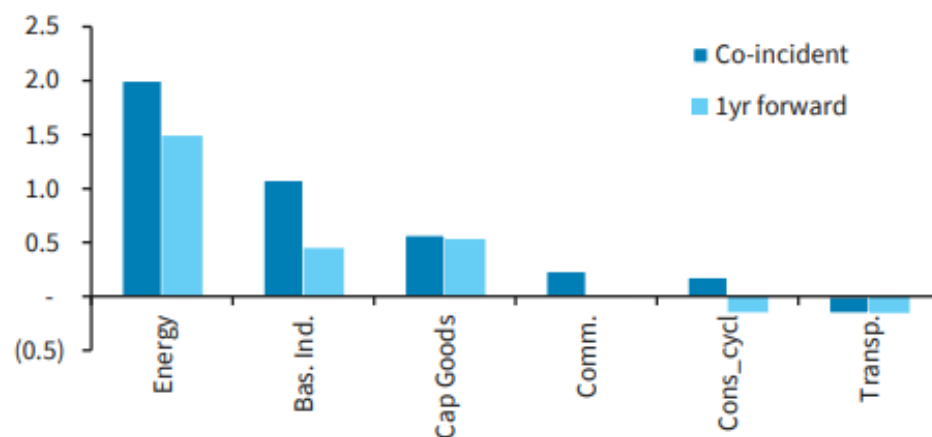
¹ Source: Deutsche Bank "What's in the tails?" 7 June 2021 David Folkerts-Landau et al

Also, if we look at margins by sector, energy, basic industry, and capital goods all show a positive correlation, both concurrently and one year forward, to increases in CPI. These sectors represent 14%, 9%, and 5% respectively of the global high yield index. Furthermore, due to the high beta nature of energy, this bodes well for the margins of the high yield universe. We see greater potential for negative margin development in sectors with labor costs as a high percentage of costs, such as restaurants and some retailers. However, since these are relatively small sectors in the high yield universe, we believe this risk is contained. Consequently, margin pressure and a consequent deterioration in credit profiles as a result of inflation is not a huge area of concern for us.

Nonetheless, as credit investors it is imperative to remember that we have asymmetric return profiles skewed to the downside. This means that owning losers hurts us a lot more than owning the winners. Therefore, even if on aggregate margins increase, there are certainly issuers which suffer from higher inflation. Many issuers that have large exposure to commodity prices have pass-through agreements but often there is a time-lag (in many cases three months). We need to ensure that the company can survive that time period until the pass-through takes effect, as avoiding those types of losers is key, as it is very difficult to offset those losses by picking the winners.

Chart 2: Margins vs. CPI by sector

Margin chg (pp) for 1% CPI incr.



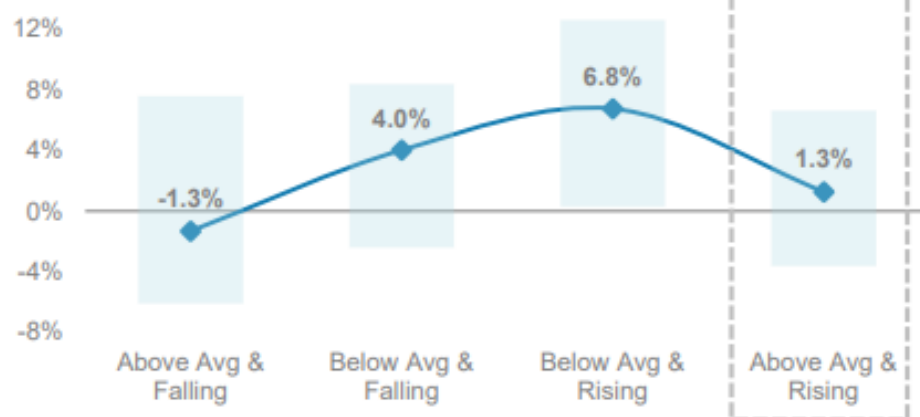
Source Barclays "Tuesday Credit Call" 20 April 2021 Shobhit Gupta, Duoduo Chen

Impact of inflation on the global high yield asset class

Taking a different perspective, and just looking at historical excess returns (excess returns are the returns after stripping out the return component due to interest rate changes) broken down by different inflation scenarios, rising inflation also seems manageable for the high yield market. Admittedly, excess returns decline when inflation is above average and still rising, but the worst excess returns are by far when inflation is already above average and then falling. We will later explore why we think that is the case.

Chart 3: Above trend and rising inflation weighs on credit returns too

US HY XS Fwd 12m Rtns By Inflation Bucket

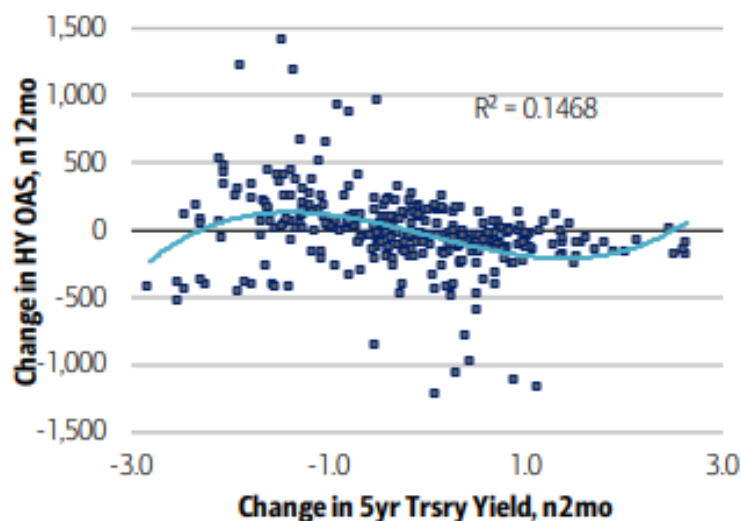


Source: Bloomberg, Morgan Stanley Research; Note: We use excess returns from 1970 or whenever history begins. Blue dot shows average while blue bars show interquartile range.

Source: Morgan Stanley "Cross Asset Playbook" 19 April 2021 Andrew Sheets et al

In other words, the historical record gives us good reason to believe that the high yield market can withstand higher inflation. However, an important and related question is whether we need to fear higher interest rates that often occur during periods of high inflation. We will start by looking at the sensitivity of spreads to interest rates. As the graph below shows, the correlation between spreads and changes to interest rates is quite low.

Chart 4: HY OAS sensitivity to changes in interest rates (monthly changes since 1993)

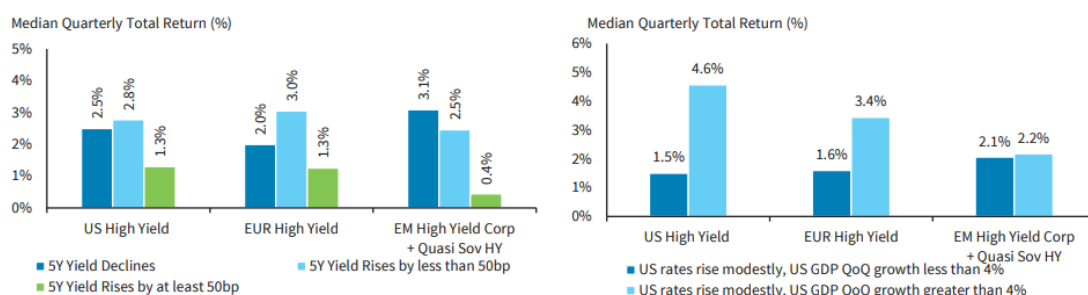


Source: B of A Securities "High Yield Strategy" 28 May 2021 Oleg Melentyev, Eric Yu

With an r-squared of only 0.15, there is only a modest tendency for spreads to tighten when yields rise. Looking at the correlation between government bond yields and total returns in high yield, the correlation over time is very close to zero. Consequently, we would argue there is not a huge risk to the high yield market directly from higher inflation leading to higher interest rates. Nonetheless, while the correlation over time is close to zero, during periods where spreads are relatively narrow, the correlation does increase. As spreads are currently rather tight versus historical averages, the correlation may likely be currently higher so that the indirect effect from inflation harms returns.

Looking at total returns under different interest rate scenarios², returns in high yield (the exception is EM HY) are actually higher in cases where interest rates rise in a quarter by less than 50 bps than when interest rates decline in a quarter (see chart). However, returns dip in the event that interest rates rise more than 50 bps in a quarter, although they are still positive. Finally, overlaying moderate rate rises with different growth scenarios, we can also see that returns are also better in an environment where growth is higher.

Chart 5: How interest rates changes influence HY returns



Source Barclays "Tuesday Credit Call" 25 May 2021 Shobhit Gupta, Duoduo Chen

Looking at history more granularly shows a similar picture: Three-month total returns are negative in only two of 14 instances of rising rates for both the US and European HY markets. Even in those cases, the negative returns were only modestly negative. However, as investors do not often know when exactly interest rates rise, we believe it is also important to understand returns in the subsequent period after the interest rates rise. In this instance, we have two negative periods for US HY and three for European HY. An important consideration, though, is that the only substantial negative occurrence was in the midst of the Global Financial Crisis, which had little to do with rising interest rates in the face of rising inflation.

² Source: Barclays "Tuesday Credit Call" 25 May 2021 Shobhit Gupta, Duoduo Chen

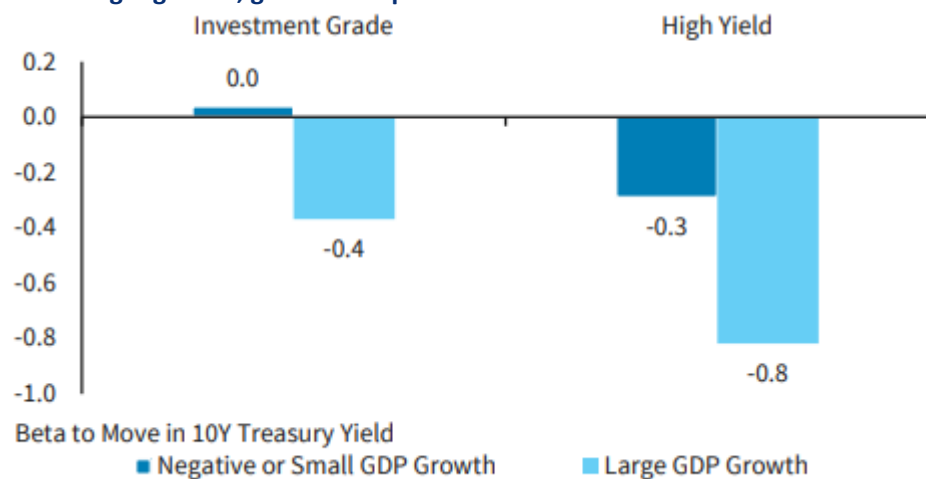
Table 1: Returns during and after periods of rising interest rates

Date	Total return over 3 months of rising rates (%)		Total return over subsequent 3 months (%)	
	USD HY	EURO HY	USD HY	EURO HY
Jan-03	9.16%	10.60%	9.09%	6.14%
Sep-03	3.06%	2.71%	5.85%	2.99%
Jun-04	-0.29%	1.25%	4.20%	3.84%
Dec-05	0.74%	-0.09%	2.87%	2.58%
Apr-06	2.37%	1.92%	0.45%	0.78%
Jun-07	0.56%	0.39%	0.11%	-1.30%
Jun-08	1.73%	1.01%	-7.97%	-9.73%
Jun-09	22.42%	27.09%	14.96%	19.47%
Feb-11	5.65%	6.41%	2.35%	2.09%
Jul-13	-1.09%	0.36%	3.00%	4.51%
Dec-16	2.57%	2.27%	2.47%	1.44%
Jan-17	3.35%	1.91%	2.33%	1.66%
Feb-18	0.26%	-0.36%	-0.10%	-0.72%
Mar-21	1.40%	1.84%	NA	NA
No of negative returns	2	2	2	3
Median	2.05%	1.87%	2.47%	2.09%
Average	3.71%	4.09%	3.05%	2.60%

Source JP Morgan, April 2021

Looked at slightly differently, we can see that high yield is quite sensitive to higher growth generally, as can be seen in the graph below.

Chart 6: Larger growth, greater compression



Source: Barclays "Tuesday Credit Call" 9 February 2021 Shobhit Gupta, Duoduo Chen

Why high yield suffers as inflation declines

Going back to the point about high yield performing poorly when inflation is above average and falling, we believe that the explanation is tied up with the point that high yield is very sensitive to economic growth. High growth generally means lower defaults, and as long as the outlook for the default rate remains low, then high yield is likely to perform well. However, when the outlook for growth falls, and consequently, default expectations increase, high yield suffers. In the case of high inflation, but falling, we believe that is usually the case when central banks have stepped on the brakes and tightened monetary policy. That harms the growth outlook and leads to spread widening. In other words, higher inflation and even higher interest rates are not directly a big concern for participants in high yield. However, if those factors lead to and/or reflect central bank tightening, leading to lower growth, then we do have to worry at some point.

One other concern from higher yields is that the high yield market suffers from retail outflows and non-traditional investors shifting away from the asset class. Non-traditional investors may take advantage of the higher yields to achieve their needed return targets in less risky debt, and retail investors often overestimate the impact of interest rates on the high yield market. We view both of these as generally a shorter-term effect, but nonetheless, we believe it is important to keep them in mind.

Conclusion

Inflation, in and of itself, is not at the top of list of concerns for the high yield asset class. Even if the result is higher interest rates, that is not our primary concern. We must remain vigilant though, and avoid the companies that suffer from inflation. We also need to understand whether higher inflation poses a risk to tighter monetary policy, which can choke economic growth. Growth and its impact on defaults remains one of the most important factors for the development on the high yield market, and as investors in high yield, keeping your focus on that and sidestepping any mines is the key to success.

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