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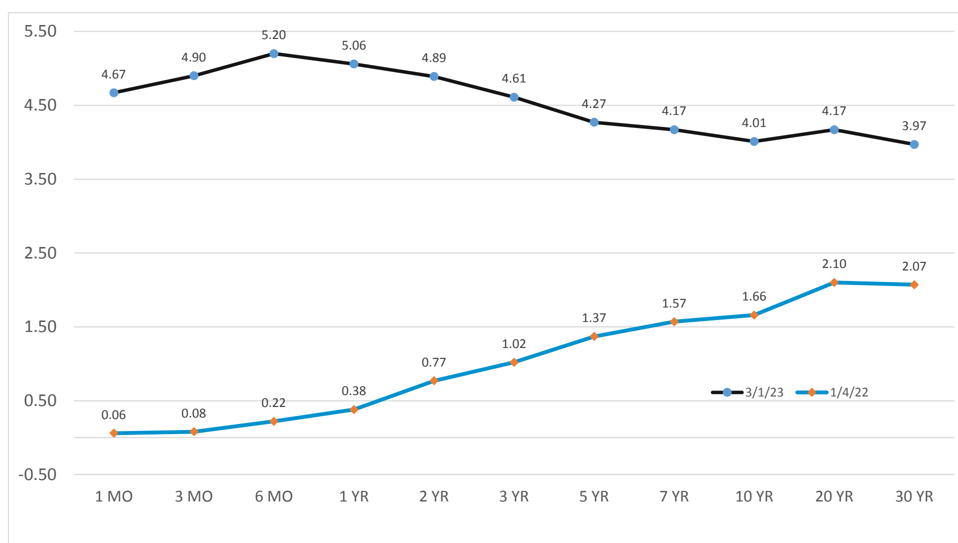
February 2023 High Yield Market Insights

- The high yield curve is upward sloping, unlike the US treasury yield curve
- Its positive slope gives investors the potential to generate rolldown gains
- Elevated short term HY yields protect investors against the risk of Fed tightening

The US treasury yield curve has inverted. Short term rates are higher than long term rates. Short rates followed as the Fed raised the Funds rate, whereas long rates have not increased as much. Long rates never do when the Fed tightens. Longer bond yields are only partially affected by tightening cycles that run a year or two; their longer maturities allow them to take longer run inflation and growth into account.

Figure 1: US Treasury Yield Curve; March 2023 vs one year ago



Treasury yield curve for Jan 4th, 2022, chosen because the S&P 500 hit its cycle high that day.

As with treasuries, short term high yield (HY) bonds have risen more in yield than longer maturities. Unlike the treasury curve, they have not inverted. This implies HY spreads, the premiums to treasury yields, have become narrower in short maturities relative to longer maturities. This is sensible, because credit risk typically increases with time, e.g., companies may have enough cash to pay off a short term bond but not the remaining maturities.

Even without inversion, given the outsize move in short term treasuries, short term HY yields have risen more than long term yields. At the two year horizon, BB bonds yield approximately 6.6% and B rated bonds around 7%.

Lack of inversion gives HY investors an advantage over treasury investors. Upwardly sloping yield curves allow for gains from rolldown, the passive decline in yields as bonds move closer to maturity. Remember that bond prices rise as yields fall.

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If you hold a 3-year 7.5% coupon B rated bond with a current yield to maturity of 7.5%, its price will be 0.9% higher a year later if the 2-year yield is still at 7%, as it is today. If the coupon of the bond is lower, like most bonds issued over the last several years, the gain will be more, over 2.2% for a 6% coupon bond as in the example below.

Figure 2: The Value of Rolldown

	2 Year	**3 Year**	**Rolldown Gain**
Maturity	3/2/2025	3/2/2026	
Coupon	6.00%	6.00%	
Price	**98.17**	**96.05**	**2.21%**
Yield	7.00%	7.50%	

Source: Concise Capital, using current B yields

One further point is that the BB curve (Figure 3) is much flatter than the B curve (Figure 4). At the front end of the curve (<4Y maturities), the rolldown of B rated bonds is approximately double that of BB rated bonds. It is at this sweet spot, both in terms of duration and credit quality that you will find Concise's portfolio positioned.

You will also be better protected from rising rates the shorter the exposure you have. Further good news is that current high yields provide much better protection against losses from rising rates than two and three year BB and B rates of about 4% and 4.6%, respectively, a year ago. The low yields and coupons we have had over the last decade or so did little to cushion selloffs in rates. Bonds starting with higher coupons and lower prices can insulate against still higher yields.

There is little reason to be longer out on the curve for the moment in HY bonds. The Fed is still tightening policy. Such a course risks further price deterioration from higher treasury rates or from widening of the unusually narrow credit spreads in HY for this part of the cycle. The best course at this time is to stay short on the curve, given the high available yields and the relative protection of less rate and spread sensitive short term bonds.

BB and B yield curve comparison on next page.

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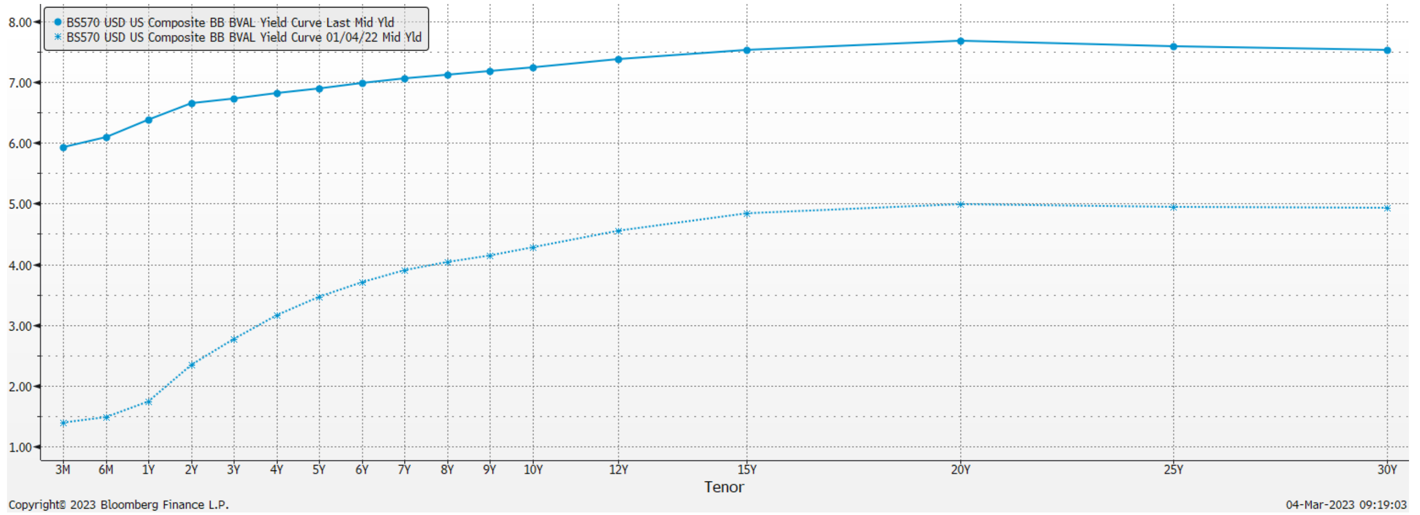
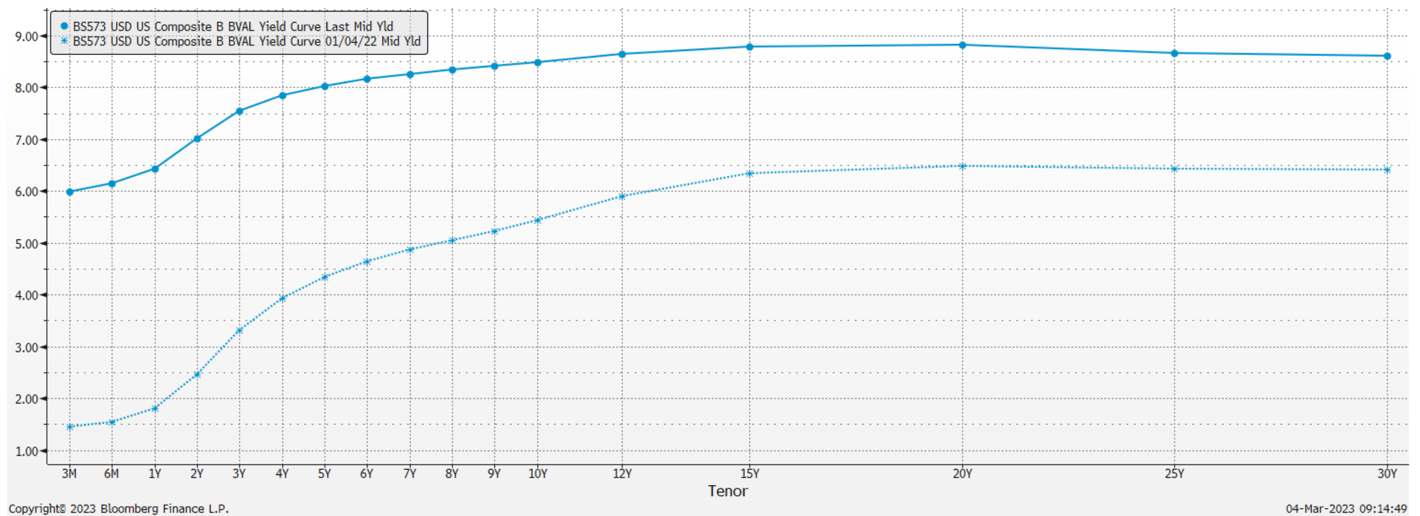
Figure 3: BB yield curve, March 2023 vs one year ago



Source: Bloomberg

Figure 4: B Yield Curve, March 2023 vs one year ago



Source: Bloomberg