SKY HARBOR
CAPITAL MANAGEMENT

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# US High Yield – 2021 Outlook Summary

*The following is a summary of our larger, in-depth 2021 Outlook report, which is available upon request.*

## Executive Summary

2020 has been a unique and highly tumultuous year. The coronavirus pandemic brought about an abrupt end to the relatively benign risk environment enjoyed early in the year, leading to one of the most dramatic contractions in economic output on record. High yield spreads widened over 700 bps amidst the first US and European lockdowns, with weakening economic and market conditions necessitating central bank intervention and various government stimulus programs to prevent a downward spiral. Despite a third wave of coronavirus cases, we view renewed policy support and positive developments on the vaccine front as another step toward a sustained re-opening. And, cognizant of lingering risks, we remain optimistic about the high yield market as we head into 2021, underpinned by our expectation that positive EBITDA growth, credit metric improvement, a reduction in the default rate, and the continuation of technical tailwinds should bring about further spread compression. The following outlook report represents our analysis of the state of the US high yield market, with a focus on both the risks and opportunities inherent to the asset class as we enter a new year.

Key takeaways are as follows:

- Broad US high yield market returns of ~ 4.2% in 2020 (YTD through November 30) are approximately 43rd percentile relative to the last twenty years, and represent the 2nd weakest performance in the last five years
- Short duration US high yield market returns of ~ 2.2% in 2020 (YTD through November 30) are approximately 22nd percentile relative to the last twenty years, and also represent the 2nd weakest performance in the last five years
- BB credits outperformed on both an absolute and beta-adjusted basis YTD through November 30 (+7.0%), followed by Single-Bs (+1.9%); CCC credits significantly underperformed for a second year in a row (-1.2%) despite a late-year rally
- Energy (-11.0%) was the only sector generating negative total returns; the sector has underperformed the index in 9 of the last 12 years
- In contrast to 2019 - when rating and sector returns were driven largely by duration – sensitivity to the coronavirus and issue size were the key determinants of performance in 2020
- Large issues (> $1bn in size) outperformed small issues (< $350mm in size), likely driven by ETF inflows and their preference for holding the most liquid securities in the index
- The high yield market saw record-levels of primary market activity in 2020, with issuance of ~ $420bn through November 30 up 52% vs. the same period in 2019
- Despite elevated high yield issuance, use of proceeds remained quite conservative; refinancing constituted 64% of primary market volumes in 2020, above the trailing 15yr average of 53%; aggressive issuance (debt-funded dividends, LBOs) made up 7% of volumes in 2020, below the 15yr average of 28%
- Virus-related lockdowns caused abnormally weak Q2 and Q3'20 EBITDA generation, pushing index net leverage to ~ 4.6x; this is approximately 1 turn above long-run averages, and a level not observed since the early 2000s
- Despite EBITDA erosion, index interest coverage of 4.1x is still above the long-run average of 3.7x, buoyed in large part by the low interest rate environment
- Corporate earnings growth turned negative in 2020, but is expected to rebound significantly in 2021, albeit off a weak base; for FY21, we expect EBITDA growth of ~ +9.5%
- We forecast the high yield default rate will decrease to ~ 5.0% in 2021 and ~ 3.5% in 2022 after reaching nearly 10% by FYE 2020
- We forecast recovery rates on defaulted issuers will increase to ~ 35% in 2021 and ~ 44% in 2022, up from ~ 30% on a trailing 12-month basis
- At November 30, 2020, broad market and short duration HY spreads were 433 bps and 385 bps, respectively, historically 2nd quartile and wide of spreads at the start of 2020
- We estimate excess spreads at the end of 2021 will be ~ 150 bps, below the long-run average of 300 bps due to low interest rates on a global basis
- Premiums paid to hold smaller/less-liquid issues are well above cycle averages; spread duration compensation is below cycle averages
- Index spreads have compressed toward pre-lockdown levels, but several sectors (Real Estate, Leisure, Financial Services, Healthcare, and Media) have lagged the H2'20 recovery
- We expect issuance to remain elevated in 2021, but below record-setting levels in 2020; in our view, reduced fallen angel volume and less issuance for general corporate purposes (used to bolster balance sheets during COVID lockdowns) should offset modestly higher acquisition funding needs
- We expect high yield demand to be robust in 2021, driven by less onerous FX hedging costs and a glut of negative/low yielding debt on a global basis
- For broad market US high yield, we expect year-end spreads of 345 bps, 5yr Treasury yields of 0.58%, a 5.0% default rate, and a 65% loss given default estimate to lead to 2021 returns of ~ 6%
- For short duration US high yield, we expect year-end spreads of 305 bps, 3yr Treasury yields of 0.40%, and a 5.0% ratings migration rate to lead to 2021 returns of ~ 6%
- We modestly prefer US over EUR high yield, and think there could be attractive total return opportunities in dual currency capital structures
- Key downside risks to our thesis include 1) failure to achieve trade war resolution, 2) additional lockdown measures should deployment of coronavirus vaccines be delayed or treatments prove ineffective, 3) a rise in policy uncertainty stemming from a new administration, 4) heightened post-rally convexity that could limit further spread compression within some parts of the HY market, and 5) shareholder friendly initiatives undertaken by management teams once business conditions normalize
- Key opportunities supporting our thesis include 1) exceptionally strong corporate EBITDA growth upon a full re-opening of the economy, 2) liquidity premium normalizations that lead to small issue outperformance, 3) technical tailwinds that reduce supply and increase demand for US HY, supporting secondary market spread compression, 4) rotation into cyclical credits as we emerge from recessionary conditions, and 5) outperformance of CCCs via the combination of positive EBITDA growth, a reduction in net downgrades, and a halving of the default rate

*For inquiries regarding the underlying analyses and full report, please contact your SKY Harbor representative or email info@skyhcm.com.*

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