Why Headwinds for Equities Could Be a Tailwind for High Yield

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When storm clouds form over the stock market, like after the dotcom crash in 2000, high yield bonds actually have an opportunity to outperform, history says.

Conventional wisdom says that since high yield bonds are somewhat correlated with equities—particularly in periods when the equity-risk premium is rising—difficulties for stocks are likely to spill over into the high yield market. That was certainly the case in 2000, when the internet bubble burst. That year, the S&P 500 fell more than 9% while high yield lost more than 5%, on average.

Yet investors often forget that 2000 also ushered in a multi-year period of high yield outperformance, with non-investment grade bonds returning roughly 40% from the end of March 2000 through the end of 2005, versus a loss of 9% for U.S. equities.

Fast forward to today:
Market volatility is climbing again on global slowdown fears. And the bull market is now nearly 11 years old, more than twice the age of the typical cycle. Given these circumstances, it's understandable that investors are worried that equities and related risk assets are likely to fare poorly in the coming years.

What's important to remember is that even if high yield takes a hit early on in a stock downturn, owing to its correlation with equities, that relationship often wanes after the initial scare. This is particularly true as imbalances in the equity market are exposed by short-term sell offs, and interest rates begin to fall as a slowdown unfolds, forcing investors to search for new sources of income. That was the case after the dotcom crash in early 2000. It was also the true after the start of the 2007-2009 bear market, when high yield returned roughly 50% from October 2007 through the end of 2012 while stocks were largely flat in the wake of the global financial panic.

SEEMS LIKE OLD TIMES

Today's market has a lot in common with the dotcom bubble, which could be good for high yield in the long run.

	2000	TODAY
Shiller P/E Ratio	44	30
Market Cap/GDP	141%	148%
10YR/2YR Yield Spread	0.07%	0.20%

The question: Is this market the type of environment in which high yield is likely to outperform equities again?

It's Another Mania

Few associate this stock bull market with the irrational exuberance of the late '90s, but there are similarities. In the late '90s, most of the market's gains were driven by the Four Horsemen of Tech: Microsoft, Intel, Cisco Systems and Dell. Today, the FAANGs—Facebook, Apple, Amazon, Netflix, and Google-parent Alphabet—are just as dominant and are collectively valued at nearly $4 trillion. That rivals the gross domestic product of Germany. In some parts of the market, speculation has reached Pets.com levels, with profit-less WeWork having been valued at nearly $50 billion—before being repriced below $5 billion.

Stocks Have a Valuation Problem

The past two periods in which high yield outpaced stocks have had something else in common: record-high valuations for equities.

Historically, the S&P 500 index's median price/earnings ratio, based on 10 years of normalized (or averaged) earnings, has been approximately 16. In 1999 and 2000, that figure climbed above 40 for the first time ever. And in 2007, the market's P/E approached 30 for only the third time in history (the lead-up to the Great Depression being the other). The situation today? The cyclically adjusted P/E for U.S. stocks is again above 30.

It's not just P/E ratios that are signaling an expensive market. The so-called Warren Buffett Indicator is rather simple: It compares the total value of equities against U.S. GDP. Whenever overall stock market capitalization exceeds the size of the entire U.S. economy, history says it's time to worry. That happened in 2000, when stock values rose to more than 140% of U.S. GDP. Today, it's back above 140%.

High Yield Is Less Frothy Than Equities

To be fair, high yield hasn't looked like a screaming bargain either lately. As of the end of the third quarter, spreads between what high yield bonds are paying and the yield on 10-Year Treasuries was approximately 4.2 percentage points. That is more than a full point below the 20-year average spread of around 5.6 points. It's also well below the 9-percentage point spread between non-investment grade bonds and Treasuries at the end of 2000, in the early stages of the tech stock crash.

Still, high yield spreads today aren't nearly as tight as they've been in recent years, when the gap shrank to historic lows of 2.5 percentage points in early 2007 (just before the financial crisis), to 3.4 percentage points in 2017, and to 3.2 percentage points in 2018.

Should the financial markets experience a scare from macroeconomic or geo-political forces, investors can expect spreads to widen out rapidly. In 2000, spreads flared out to more than 9 points after the Internet bubble popped. In 2008, amid the global financial crisis, high yield spreads ballooned to more than 21 points before recovering rapidly. That type of quick correction in valuations is rarely seen in stocks.

Low Rates Give High Yield an Advantage

A recession is by no means guaranteed in the next year or two simply because parts of the yield curve flattened or inverted this year. To be sure, a flat curve has historically foreshadowed economic troubles ahead. That was the case at the start of 1999 and again in 2007.

But even if a recession does not materialize, the mere fear of a pending slowdown is likely to cause investors to reassess their tolerance for risk. At the same time, though, a decline in rates across the curve is likely to shine a light on high yield, as investors will be driven to seek out income at a time when it's difficult to find.

High Yield Could Get a Value Bump

Market corrections don't simply change the direction of the stock market, they also shake up what types of equities are likely to outperform going forward. The late 1990s, for instance, were dominated by high-flying tech stocks until the internet bubble burst in 2000, at which point fearful investors finally started to care about the prices they paid for assets. At that point, out-of-favor and overlooked value stocks started getting noticed. Not coincidentally, it was during this period when high yield also began to outpace the broad stock market.

This shouldn't come as a surprise. Many market sectors that dominate high yield—think energy, industrials, telecommunications, consumer staples, and financials—are value-leaning groups. It stands to reason that as markets recover from any momentary dislocation, the relative outperformance of value stocks relative to growth is likely to boost the issuers of high yield debt.

Is value guaranteed to snap back anytime soon? No, but value has badly lagged growth stocks for more than a decade. And a recent survey by Bank of America Merrill Lynch found that only 7% of investors think value will break out in the coming year. History says this may be a contrarian indicator that value—and possibly high yield—are ready to get some attention.

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