FIXED INCOME

Is High Yield in a Sweet Spot?

BARINGS INSIGHTS

High yield continues to benefit from supportive tailwinds—from an improving default picture to lower sensitivity to rising rates—and may be poised for strong performance as the recovery takes hold.

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The post-pandemic high yield market is coming into focus. While it will take time for economic activity to return to normal, particularly given rising COVID cases in some parts of the world, expectations remain for a strong recovery in the months and year ahead.

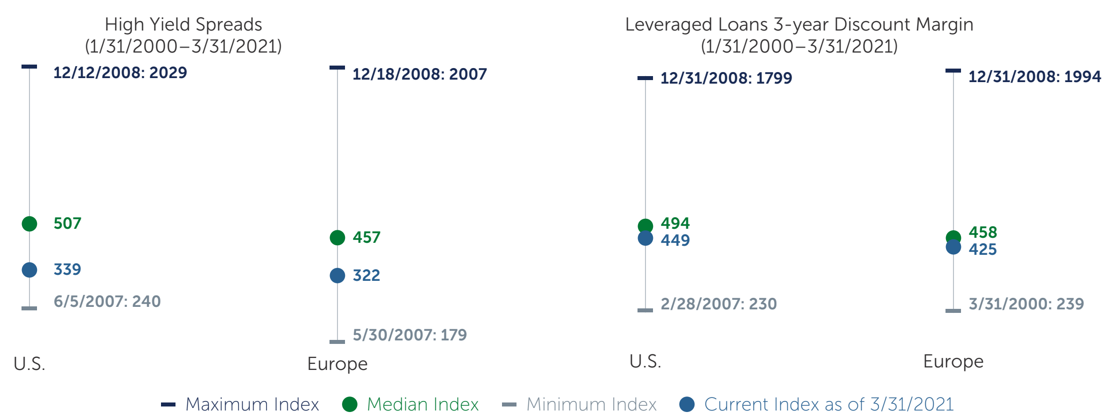
Rising rates continue to dominate headlines, and it is perhaps no surprise that loans have outperformed bonds to start the year, returning roughly 2% in both the U.S. and Europe.[1] However, while there are certainly benefits to floating rate assets like loans in a reflationary environment, high yield bonds also look relatively well-positioned, particularly in Europe, where returns reached 1.6% for the quarter given the market's insulation from U.S. Treasury yield volatility. U.S. high yield bonds, despite lagging the broader high yield market, have shown resilience relative to some other fixed income asset classes, returning 0.95%.[2] This is due in part to the asset class' shorter duration profile—whereas investment grade corporates, for instance, have an average duration of slightly more than seven years, high yield bonds have a duration of roughly four.[3]

Early Signs of Recovery

From a fundamental standpoint, default expectations continue to improve. Given that distressed ratios are at multi-year lows and both the bond and loan markets are awash with liquidity, we believe defaults this year could fall in line with historical averages of between 2–3%. For comparison, high yield bond and loan defaults ranged from 3–5% last year—much lower than the double digits some initial forecasts were calling for, thanks in large part to the massive global stimulus measures.[4] At the same time, earnings, revenues and cash flows are expected to surge higher this year and into 2022 as consumer demand returns.

Given the positive performance of the asset class and improving default expectations, spreads have tightened significantly in recent months, leading to questions around valuations. While bond and loan spreads do appear tight relative to historical averages, the question of valuations is more nuanced—for a few reasons. For one, while spreads have tightened recently, they remain favorable relative to higher-rated corporates, some of which are trading at or near record tights. High yield bonds continue to trade wider than 2017/2018 market cycle lows, for instance, while loans continue to trade wider than both pre and post-GFC tights (**FIGURE 1**).

FIGURE 1: High Yield Spreads Appear Tight Relative to History...

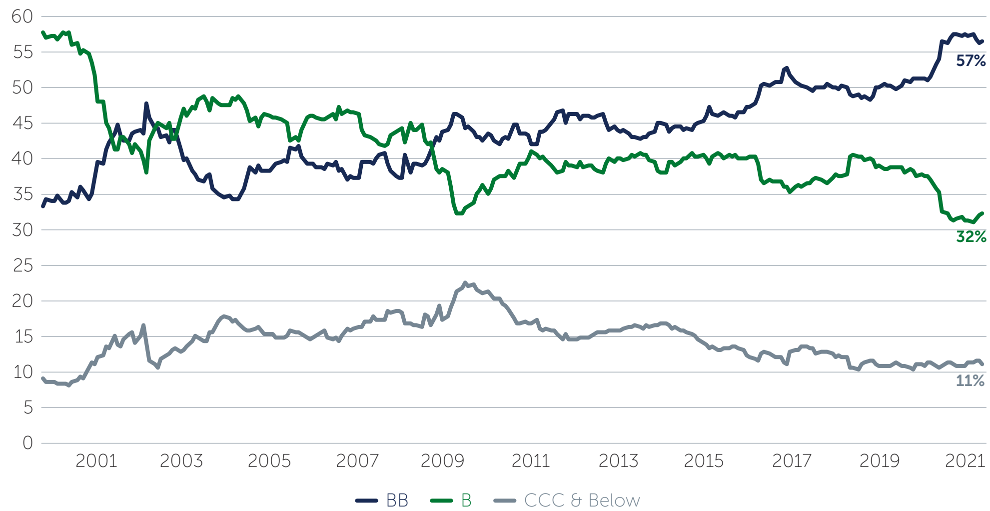


SOURCES: ICE BAML; Credit Suisse. As of March 31, 2021.

1. Source: Credit Suisse. As of March 31, 2021.
2. Source: Bank of America Merrill Lynch. As of March 31, 2021.
3. Source: Bank of America Merrill Lynch.
4. Sources: S&P; Credit Suisse. As of December 31, 2020.

In addition, the quality of the high yield market has improved significantly. BBs now account for 57% of the global high yield bond market, for instance, up from 35% in 2000. Single-Bs, on the other hand, currently make up 32% of the market, down from 56% (**FIGURE 2**). While CCCs are up slightly, they remain well-below the 2009/2010 peak. Over the last year, the notable uptick in quality came on the back of strong new issuance and record fallen angel activity, as a number of investment grade-rated names were downgraded into high yield following the initial onset of COVID.

FIGURE 2: ...But the Market is Much Higher-Quality



SOURCES: ICE BAML. As of March 31, 2021.

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Looking ahead over the next 12–24 months, the economic outlook remains supportive for the asset class as a whole. While expectations for GDP growth vary by country—with U.S. forecasts significantly improved following progress on the $1.9 trillion stimulus package, and parts of Europe lagging due to extended lockdowns—the global economy appears to be on a positive trajectory overall. Against this backdrop, and given the higher quality of the market, we believe valuations remain in reasonable territory. In fact, even if interest rates move higher going forward, we believe there is room for spreads to tighten further and possibly re-test historical tights. In essence, this combination of improving financial conditions and economic growth has created a sweet spot for high yield credit—and in our view, the asset class looks very well-positioned as a result.

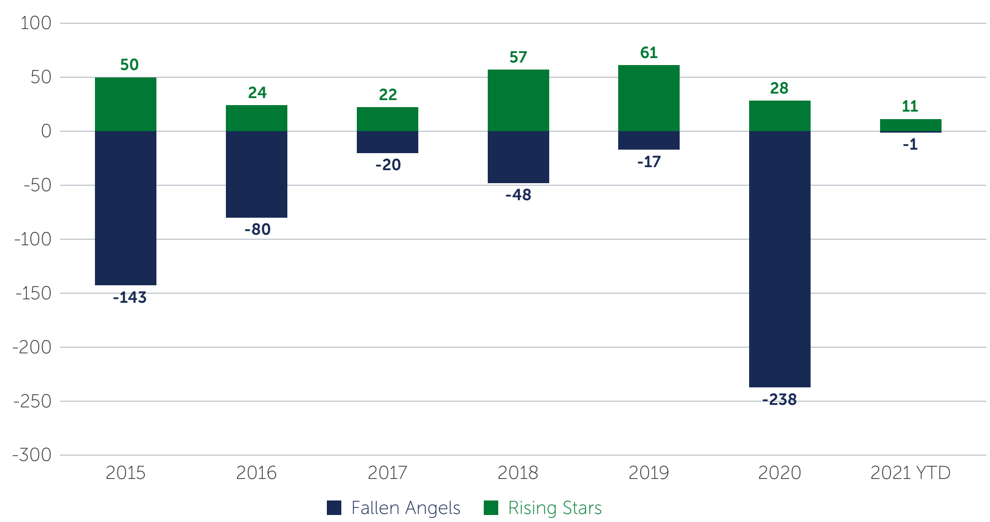
Three Opportunities to Consider

As we look across the high yield markets today, there are a number of opportunities that could materialize in the coming months.

RISING STARS

Whereas fallen angels made headlines in 2020, rising stars—or high yield companies that are upgraded to investment grade status—may be the story of the next 12–24 months. As mentioned, fallen angel activity reached a record last year as the pandemic took hold, with roughly $238 billion falling into the high yield market from investment grade—including large names like Ford, Kraft Heinz and Occidental Petroleum (**FIGURE 3**). In addition to contributing to the up-tiering of the market, these fallen angels presented unique opportunities to invest in large, well-diversified companies with significant operational and financial flexibility. In the U.S. high yield bond market in particular, many of these downgraded companies now look poised for further spread tightening as they migrate back to the investment grade market over the next several quarters.

FIGURE 3: Volume of Fallen Angel and Rising Star Activity ($B)



SOURCE: J.P. Morgan. As of March 31, 2021.

While fallen angel/rising star activity is primarily a U.S. phenomenon, there are also a number of BB credits outside of this universe with the potential to move up in rating as the markets go through the next major upgrade cycle—as has often happened during historical recovery periods. For instance, over 8% of the U.S. high yield market was upgraded following the 2001/2002 economic downturn. In the years following the 2007/2008 global financial crisis, nearly 9% of the market moved into investment grade territory. This year, $11 billion has already been upgraded, while there have been very few downgrades. And we expect to see a similar trend in Europe given the market's significant growth and issuance over the last several years. Of course, the activity for the remainder of the year will depend in part on rating agencies, and their confidence that improvements in companies' leverage and earnings growth are sustainable. But given the improving economic backdrop, we believe there may be an opportunity for many of these companies to generate excess returns as they are upgraded over the next several years.

CYCLICAL AND COVID-DISRUPTED SECTORS

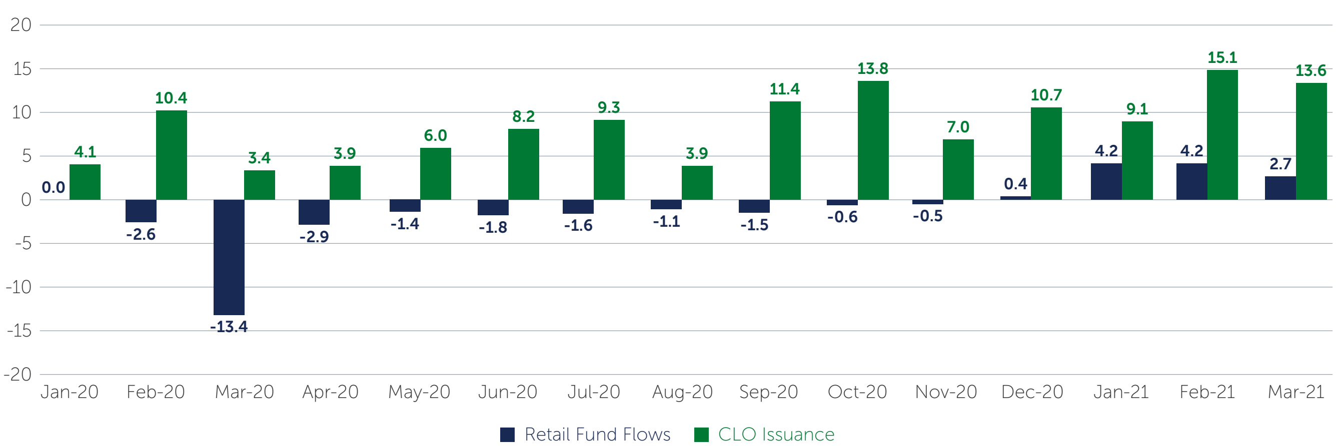
We also see potential opportunities in cyclical sectors that were hit particularly hard over the last year. While a number of these names have already begun to rally, the potential exists for some issuers in these sectors to outperform the broader market as the recovery gains momentum. Energy is an example—one of the biggest laggards in recent years, the sector entered 2021 with some of the widest spreads in the market. In the last several months, however, energy has reversed course and is now outperforming across both high yield bonds and loans. While volatility has crept back in very recently amid heightened COVID concerns in parts of Europe, the sector nonetheless looks well-positioned for further recovery going forward.

There are also potential opportunities in a number of COVID-disrupted sectors that continue to trade wide relative to a year ago, and below what fundamentals would suggest. Retail is one example, although selectivity is key given the secular challenges facing the sector. As global lockdowns limited activity over the last year, household savings skyrocketed, with consumers in the U.S., U.K., China and Japan estimated to have saved nearly $3 trillion.[5] When storefronts re-open and activity begins to normalize, the unleashing of this pent-up spending power could provide a strong tailwind to retail issuers—particularly those that were able to take advantage of the market over the last year and shore up liquidity.

LOANS

As interest rate expectations have gone up in recent months, investor sentiment has shifted notably toward loans, which are floating rate, and away from fixed rate assets. This is perhaps most apparent from the increase in demand across both the U.S. and Europe. Following roughly two years of outflows, retail fund flows—a key demand driver in the U.S.—have turned notably positive, reaching roughly $11 billion by the end of March (**FIGURE 4**). At the same time, collateralized loan obligation (CLO) issuance, another key demand driver for loans, has increased in both the U.S. and Europe. Balancing the strong demand picture, supply also has remained healthy and may be on track to outpace the last couple of years—with issuance reaching $181 billion in the U.S. at the end of the first quarter, and €36 billion in Europe.[6] This supply/demand dynamic has effectively created a technical tailwind for global loans, suggesting there may be room for further spread compression going forward and potentially resulting in an attractive total return opportunity from here.

FIGURE 4: U.S. Monthly Retail Flows and CLO Issuance ($B)



SOURCE: J.P. Morgan. As of March 31, 2021.

5. Source: Bloomberg Economics.
6. Source: S&P. As of March 31, 2021.

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This is within the context of loans being senior in the capital structure, meaning they are typically paid back ahead of subordinated debt and equity. Loans are also secured by some or all of a borrower's assets—ranging from real estate and equipment to intangible assets like software and trademarks—providing additional credit risk protection.

Travel & Leisure

While loan prices in both the U.S. and Europe have recovered significantly since their decline roughly a year ago, there are pockets within the market with further room for recovery. Travel & leisure, for instance, was hit particularly hard by the pandemic and subsequent lockdowns, and continues to lag in its recovery relative to the broader market. However, many of the companies in this space have been able to raise a significant amount of capital over the last year, which should help bridge them through to the reopening of the economy. While the capital-raising activity and high leverage levels in the space do suggest the need for rapid deleveraging going forward—and raise questions about whether companies will be able to manage higher debt levels—we believe most companies proactively managed their maturity profiles leading up to the crisis. Further, many issuers will not face impending maturity walls for another several years.

Key Takeaway

High yield has come back strongly since the onset of the pandemic, and continues to benefit from a number of supportive tailwinds at its back—from a more manageable default picture to expectations for improving economic growth and financial conditions. While rising rates could continue to impact high yield bonds in the near-term, the asset class, given its short duration, remains fairly well-positioned relative to other fixed income markets. As a result, we believe high yield could be poised for further strong performance going forward, particularly as the economic recovery takes hold and consumer demand begins to return. That said, with risks still on the horizon—including around rising COVID cases—credit selection and active management will be key to identifying those issuers that can withstand bouts of short-term volatility and potentially offer attractive upside as we continue on the road to recovery.

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