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Four Reasons High Yield is More Resilient Today

INSIGHTS

The high yield bond market has undergone a fundamental shift over the last decade, with today's higher-yielding, higher-quality market looking particularly resilient in the face of a potential downturn.

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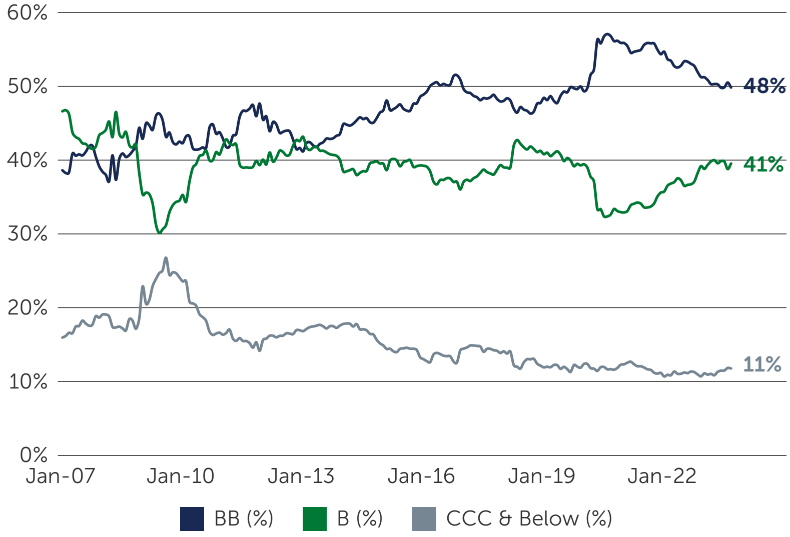
There is clearly no shortage of challenges shaping the investment landscape today. Optimism around the prospect of an economic soft landing seems to be fading, and a potential recession looms in what may be the not-so-distant future. The path of interest rates also remains uncertain, although consensus seems to be for a prolonged 'higher-for-longer' environment going forward. At the same time, geopolitical tensions continue to escalate around the globe.

While all these factors have the potential to weigh on markets in the months ahead, high yield bonds look particularly well-positioned to weather the impending storm—for four key reasons.

1. The Market is Higher-Quality

There is a common interpretation that high yield means high risk. But that is not necessarily the entire case—in fact, the quality of the market today is higher than it has been historically. More specifically, while Europe has historically been more of a BB-rated market, **most U.S. high yield issuers today are BB-rated**—a seismic shift from a decade ago **(Figure 1)**. At the same time, the lowest-rated CCC issuers account for only 11% of the U.S. market today, versus over 19% 10 years ago and 17% 20 years ago.[1] The companies in the U.S. high yield market today are also larger and more globally diversified relative to history, and include global well-recognized names.

Figure 1: A Higher Credit Quality Profile vs. History



Source: ICE BofA, please note the above data refers to U.S. market. As of September 30, 2023.

1. Source: ICE BofA. As of September 30, 2023.

"Given the combination of a higher credit quality profile, low leverage, ample cash cushions and limited near-term maturities, default rates are unlikely to increase significantly in the near to medium term."

Encouragingly, many of these companies have been **shoring up their financial positions** over the last few years, leaving them well-prepared, from a fundamental standpoint, to weather a possible downturn. Corporate net leverage is healthy in both the U.S. and Europe, at roughly 3.6x and 4.8x, respectively.[2] Interest coverage also looks manageable, at 5.3x in the U.S.[3] And corporate profits, in the form of Earnings before interest, taxes, depreciation, and amortization (EBITDA), are back to or better than pre-Covid levels for much of the high yield universe—in fact, average EBITDA in the U.S. recently reached US$1 billion, underscoring the larger size and scale of borrowers.[4]

That high yield issuers have, so far, been able to maintain their balance sheet credit quality amid slowing growth and higher marginal funding costs, suggests that most are in a position to continue servicing their debt, even through a period of economic weakness. At the same time, **near-term maturities remain limited**. Over the next 18 to 24 months, for instance, 7% of the U.S. market is coming due.[5] The majority of that debt is BB-rated, suggesting the issuers will have access to the capital markets and are less likely to face refinancing risks.

Given the combination of a higher credit quality profile, low leverage, ample cash cushions and limited near-term maturities, default rates—although inching up due to some idiosyncratic cases—are unlikely to increase significantly in the near to medium term. Even if a recession arrives in the coming months, we expect defaults in the U.S. high yield market to remain around 3%, in line with historical averages.

2. Yields & Prices Look Attractive vs. History

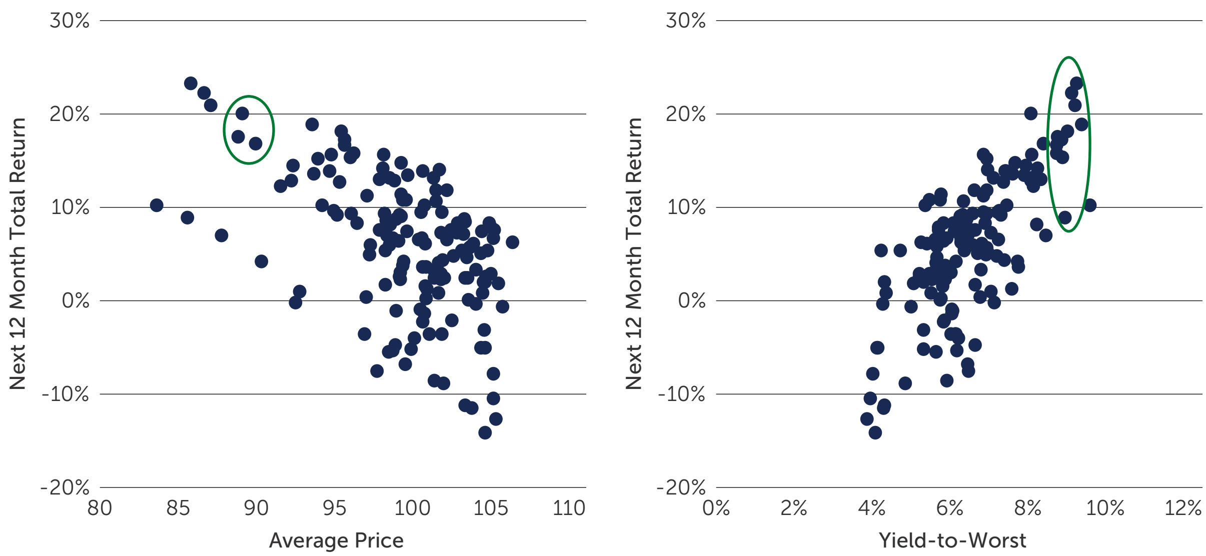
High yield is in a unique position relative to the last several years. The last 18 months, of course, posed challenges for the asset class in the form of rising rates, which ushered in broad-based losses across most fixed income markets, high yield included. The very low interest rate environment of the years prior also created difficulties, as returns across the asset class rarely exceeded low double-digits.

More recently, following the sizeable repricing of the U.S. market in 2022, bond yields have doubled to near double-digit levels. BB rated U.S. high yield bonds, for instance, are currently yielding around 7.5%, while yields on the rest of the high yield market are above 9%.[6] While yields are trending higher, prices in some cases are trading at discounts of 10–15%.[7]

2. Source: Bloomberg. As of September 30, 2023.
3. Source; Bloomberg. As of September 30, 2023.
4. Source: ICE BofA.As of October 2023.
5. Source: ICE BofA. As of September 30, 2023.
6. Source: Bloomberg. As of September 30, 2023.
7. Source: J.P. Morgan; Bank of America. As of September 30, 2023.

This unique combination of high yields and discounted prices not only provides a cushion against potential credit losses, but also reflects capital appreciation potential as the market re-prices back toward par. Historically, yields and prices near these levels have also led to strong double-digit returns on average over the following 12 months **(Figure 2)**.

Figure 2: Yields/Prices Near Current Levels Have Historically Led to Double-Digit 12M Forward Returns



Source: Barings and ICE BofA, please note the above data refers to U.S. market. As of September 30, 2023. PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS.

Coupled with high yield's relatively short duration—currently less than four years[8]—these characteristics add to the overall defensiveness of the asset class in a downside scenario. In fact, given the heightened uncertainty around economic growth and mounting geopolitical tensions, some investors have already begun shifting away from assets such as equities, where valuations look fairly high, in favor of the attractive yields and durable positioning of the high yield market—a trend we expect to continue as rates normalize.

3. High Yield Doesn't Require Strong Economic Growth

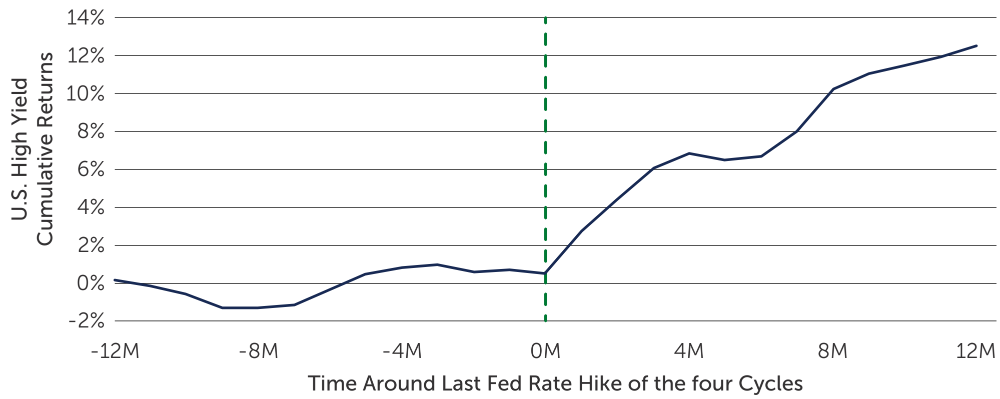
There is much speculation around whether the U.S. Federal Reserve will be able to preemptively cut rates before the labor market is materially affected. A successful soft landing would, of course, be a positive outcome for high yield, with the combination of declining inflation and an (even slowly) growing economy likely to result in spread compression and the potential for attractive total returns.

Even if a soft landing isn't achieved, however, the outlook for high yield isn't all negative. As an asset class, high yield bond is different than equities in that it doesn't necessarily require strong economic growth to perform well. Rather, what matters most in high yield is an issuer's ability to continue to meet the interest payments on its outstanding debt obligations. Slow gross domestic product (GDP) growth, or even a short period of mildly negative growth, is less likely to drive a significant increase in defaults—particularly given the more defensive elements of the asset class today.

8. Source: ICE BofA. As of September 30, 2023.

It is also worth noting that 75% of the negative return outcome for the U.S. high yield bonds in 2022 was driven by the Fed's unprecedented rate increases[9], which look poised to moderate as inflation falls. In fact, previous periods of peak rates have been followed by positive U.S. high yield bond market returns. Specifically, the last four U.S. rate-hiking cycles have led to 12-month cumulative returns of almost 12% on average **(Figure 3)**.

Figure 3: Previous Periods of Peak Rates Have Been Followed by Positive Returns

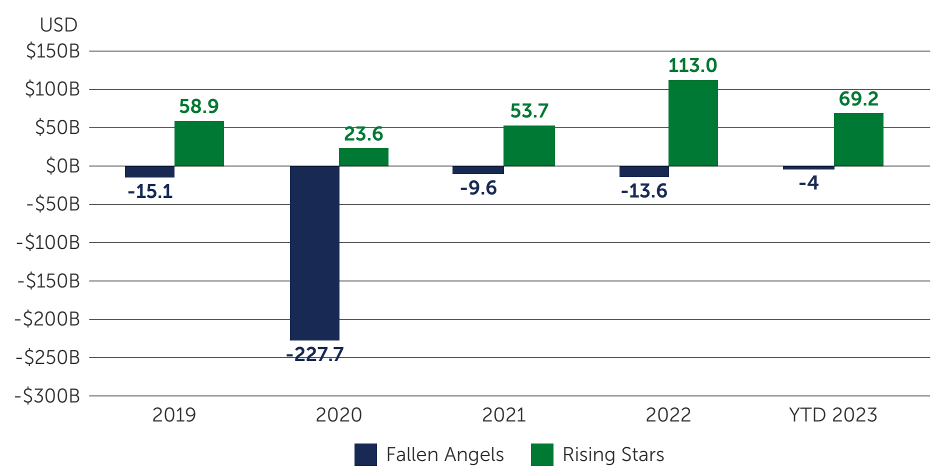


Source: Bloomberg; ICE BofA, please note the above data refers to U.S. market. As of September 30, 2023. The four previous U.S. rate-hiking cycles referenced here cover the periods 1994-1995 (last hike in February 1995), 1999–2001 (last hike in May 2000), 2004-2007 (last hike in June 2006), and 2015-2019 (last hike in December 2018). PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS.

4. The Supportive Technical Backdrop is likely to Persist

Technicals in the high yield market are quite robust, further supporting the resilience of the asset class. One factor behind this is the record level (US$113 billion) of rising stars—companies upgraded from high yield to investment grade—in 2022, which significantly outpaced fallen angels (-US$13.6 billion). The first three quarters of 2023, too, have seen rising stars activity outpace fallen angels by over US$70 billion **(Figure 4)**.

Figure 4: Rising Stars Have Materially Outpaced Fallen Angels, Driving a Supportive Technical Backdrop



Source: J.P. Morgan. As of September 30, 2023.

This migration of companies into the investment grade universe has led to a shrinking of the high yield market, which contracted in size by 11% in 2022, with further reduction anticipated in 2023.[10] From a technical perspective, this effectively means that the same amount of dollars is chasing fewer opportunities—which provides a strong technical tailwind for the asset class.

Exacerbating this supply/demand imbalance, new issuance this year has remained relatively muted, with the majority being used for refinancing activities. Coupled with the fact that merger and acquisition (M&A) is down roughly 40% year-over-year[11]—after what was arguably a lackluster 2022—there is virtually no new supply coming into the market.[12] This strong technical has been a positive for high yield and, given the shallow pipeline and large cash balances on the sidelines, should persist going forward.

The Bottom Line

There are a number of factors that could weigh on financial markets in the months ahead, from concern around economic growth and a potential recession, to heightened geopolitical tensions. As we consider high yield against this backdrop, there are four key reasons we believe the asset class will remain relatively resilient:

1. The **higher quality of the high yield market**, combined with a solid fundamental backdrop and limited near-term maturities, should keep defaults manageable.
2. The combination of **higher yields and discounted prices** currently on offer provide a potential cushion against credit losses and reflect capital appreciation potential.
3. Demand continues to outpace supply, providing **strong technical support** that is likely continue in the months ahead.
4. High yield does not need strong economic growth to perform well, and has historically delivered **positive returns following previous periods of peak rates**.[13]

9. Source: ICE BofA. As of December 31, 2022.
10. Source; J.P. Morgan. As of September 30, 2023.
11. Source: S&P/LCD. As of 2Q 2023.
12. Source: J.P. Morgan. As of September 30, 2023.
13. Source; Bloomberg; ICE BofA. As of September 30, 2023

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