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Insight INVESTMENT

JUNE 2023

HIGH YIELD
MYTHS VERSUS REALITY

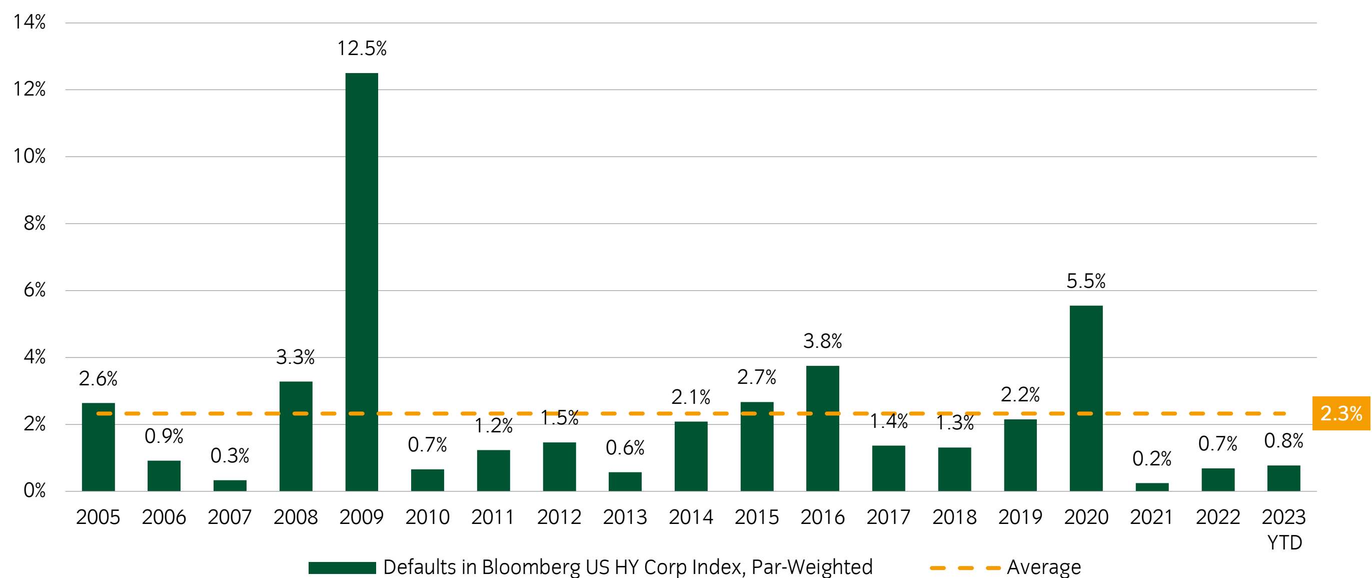
US HIGH YIELD CORPORATE CREDIT IS DIFFICULT TO IGNORE WITH YIELDS AT ~8.5%. ALTHOUGH INVESTORS NEED TO BE CAUTIOUS IN THIS UNCERTAIN ENVIRONMENT, KEY MYTHS AROUND THIS ASSET CLASS COULD HOLD INVESTORS BACK.

MYTH 1: DEFAULT RATES ARE BETWEEN 3% AND 5%

Reality: Default rates have averaged 2.3% pa

Many will be surprised to learn that the Bloomberg US High Yield Corporate Index[1] has only seen an average 2.3% pa default rate over the last 15 years (Figure 1).

Figure 1: US high yield default rates have been a lot lower than you may think[2]

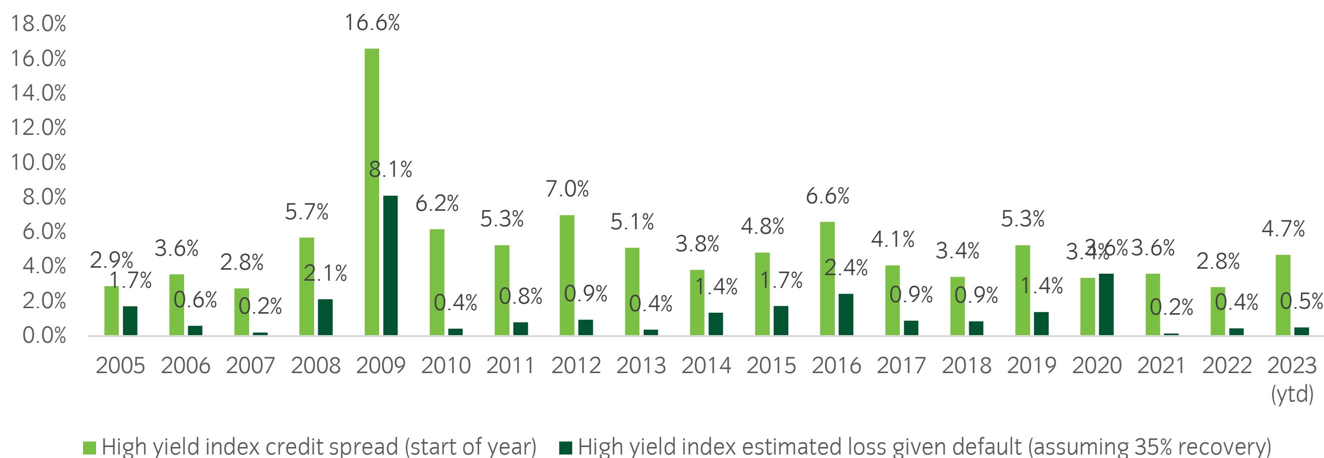


Historically, it has required a financial crisis (such as the start of the pandemic in March 2020 or the 2008 crisis) for US default rates to approach 4% or above. In 2021, defaults were the lowest in 15 years and rose only to 0.7% in 2022 even as recession risks began to build. We expect default rates to remain within historical norms, but even in the event of crisis-level defaults, history indicates the pain will be far less substantial than most have been led to believe.

Assuming recovery rates of ~35%, (which is historically conservative[3]), high yield credit spreads have been priced to overcompensate for default risks (see Figure 2).

[1] See index descriptions at the back of the document.
[2] Bloomberg, Insight calculations, March 2023.
[3] Moody's, December 2021.

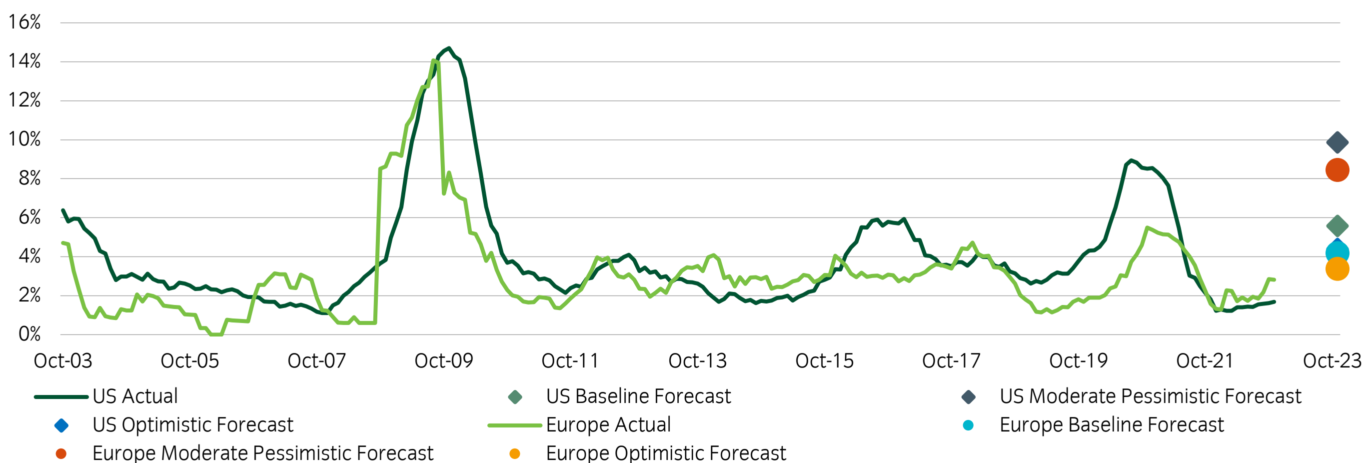
Figure 2: US high yield spreads have offered compensation for default risks[4]



Rating agencies report higher default rates

The high yield default rates investors are used to hearing from ratings agencies are typically 3% to 5% on average, and much higher during periods of stress (Figure 3).

Figure 3: Average default rates of US high yield bonds since 2005[5]



Ratings agency default analytics are not based on the high yield indices that investors are most likely to be exposed to, but the entire population of corporates for whom they have assigned a credit rating.

We believe these broader default samples are useful for top-down macro-level analysis or modelling. However, for high yield investors concerned about compensation for risk, index defaults have more direct relevance.

This is equivalent to how a climate scientist would never solely focus on global average temperatures to understand climate dynamics in the arctic – where temperatures are rising twice as fast.

MYTH 2: HIGH YIELD IS VULNERABLE TO RISING RATES

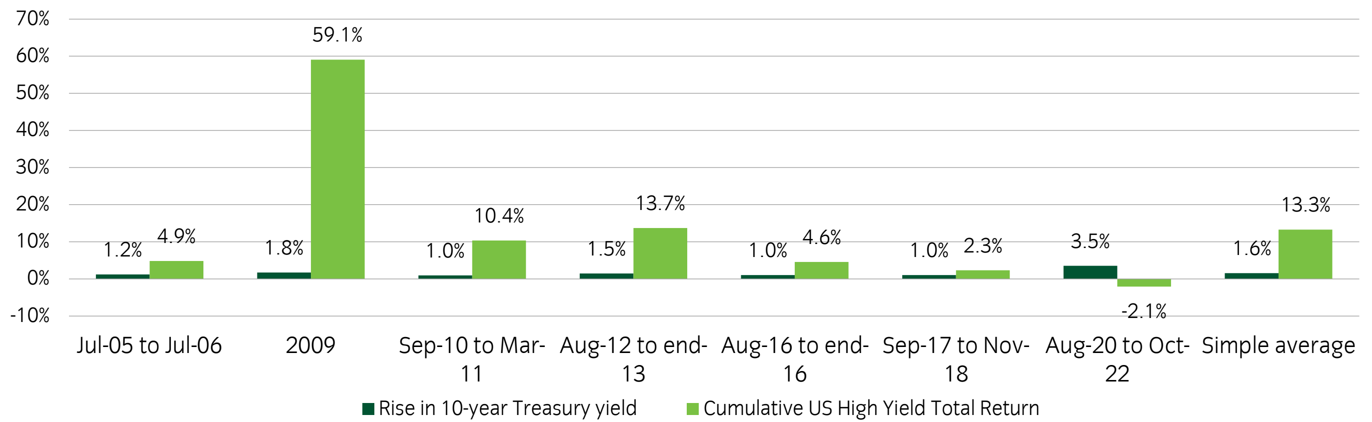
Reality: High yield returns have been positive in rising rate environments

Since 2005, there have been seven periods in which 10-year Treasury yields have risen by ~1% or more.

US high yield markets have consistently delivered positive total returns during most of these periods (Figure 4). The main exception has been the current period, which has not ended. We believe this could indicate a potential point for investors to consider high yield.

[4] Bloomberg, Insight calculation, May 2023.
[5] S&P Global, November 2022.

Figure 4: US high yield corporates have delivered positive returns during rising yield environments[6]



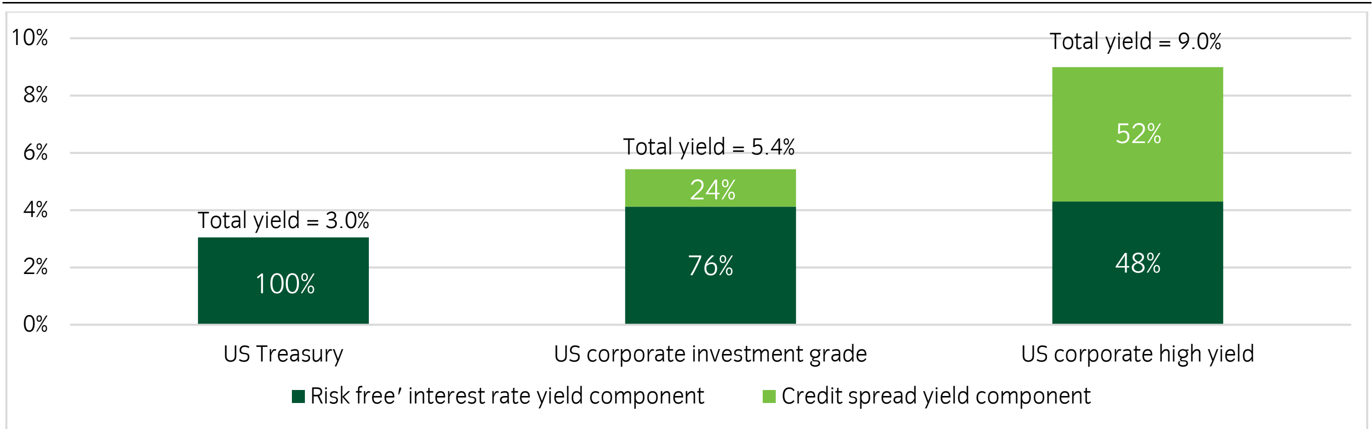
On average high yield returned close to 13% during these periods.

High yield is more naturally resilient to rising rates

High yield has less interest rate (or 'duration') risk than government or investment grade bonds, as high yield tends to be shorter dated on average.

Further, bond yields on high yield credit are mostly comprised of credit spread (Figure 5).

Figure 5: High yield bonds have historically been driven more by credit spreads than interest rates[7]



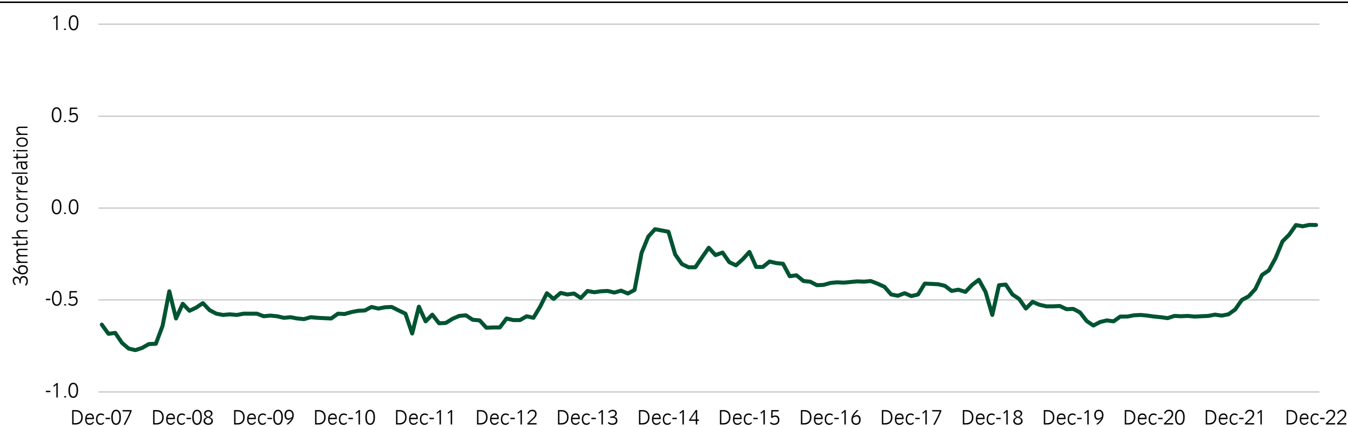
As such, changes in credit spreads have had more of an impact on high yield returns than changes in interest rates.

This is particularly important because interest rates and credit spreads tend to be negatively correlated (Figure 6). This is because central banks typically raise interest rates when the economy is growing, which is good for corporate balance sheets, and therefore credit spreads.

[6] Bloomberg, Insight calculations, December 2022.

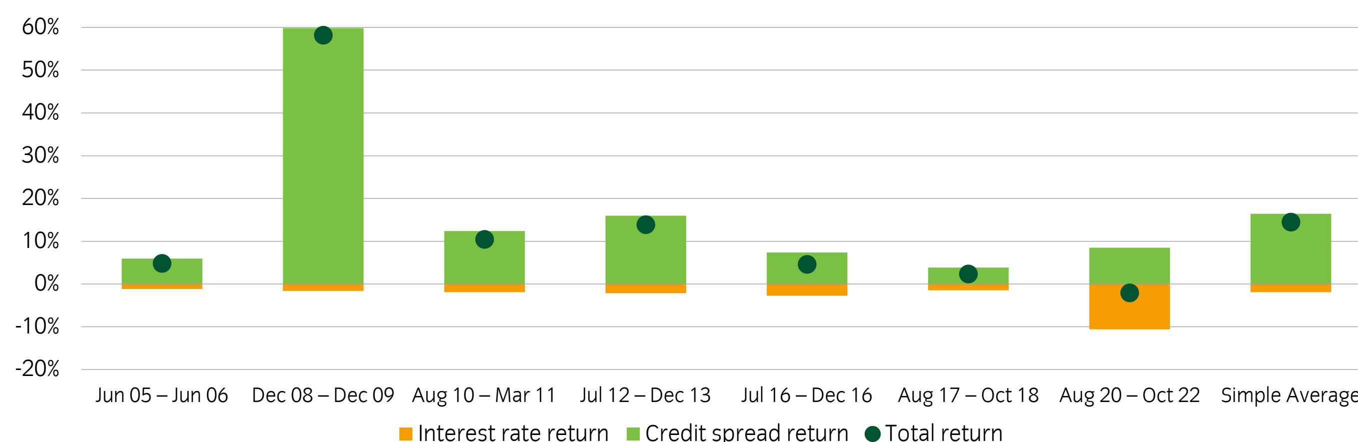
[7] Bloomberg, December 2022. Indices are The Bloomberg US Treasury Bond Index, The Bloomberg US Corporate Bond Index and The Bloomberg US Corporate High Yield Bond Index. Please see index descriptions at the back of the document.

Figure 6: High yield credit spreads have been negatively correlated with their benchmark Treasury bond yields[8]



As such, when rates have risen, gains from credit spreads narrowing have heavily outweighed losses from interest rate risk in most cases (Figure 7).

Figure 7: Positive credit spread returns have far outweighed negative interest rate returns[9]



MYTH 3: LIQUIDITY IS IMPOSSIBLE TO SOURCE

Reality: Specialists can tap 'hidden liquidity' from the ETF ecosystem

For most market participants, two-way liquidity in the high yield market did indeed deteriorate rapidly following the 2008 financial crisis, as new banking sector regulations took hold, making it less attractive for market makers to hold large inventories of bonds on their books.

As bonds are almost universally traded over-the-counter, one bond at a time, two-way liquidity became harder to source, particularly during times of market stress when the number of sellers overwhelmed buyers, exacerbating price swings.

Other investors have found new sources of liquidity

However, after the 2008 crisis the fixed income ETF market developed rapidly, providing a new source of bond market liquidity.

Skilled investors experienced within the fixed income ETF ecosystem were therefore able to unlock 'hidden liquidity' within the 'create and redeem' feature, similar to the programmatic trading that has been a staple of the equity market for decades.

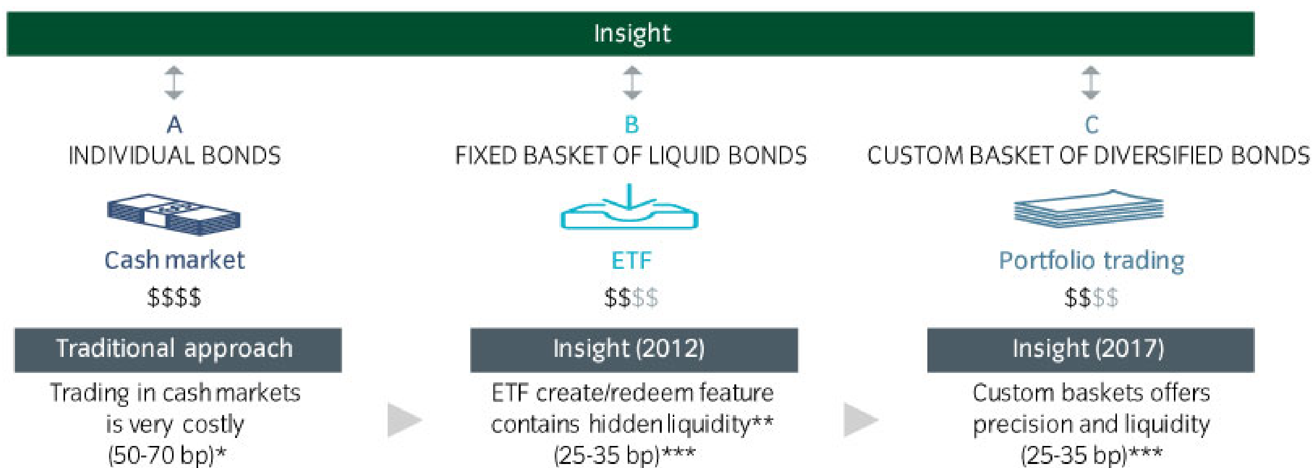
It has opened the door to trading large, customised baskets of bonds within hours for relatively low trading costs. In our experience, market makers even prefer trading diversified bond baskets because they can hedge them more efficiently and cost effectively.

In our view, this type of trading can help investors target alpha within smaller and traditionally less liquid issuers. Investors can also aim to eliminate much of the drag on returns imposed by high transaction costs.

[8] Bloomberg, December 2022. Past performance is not indicative of future results. Investment in any strategy involves a risk of loss which may partly be due to exchange rate fluctuations. The performance results shown are net of investment management fees and reflect the reinvestment of dividends and/or income and other earnings. Please refer to the important disclosures at the back of this presentation.

[9] Bloomberg, December 2022.

Figure 8: The ETF ecosystem offers the potential to execute highly liquid basket trades[10]

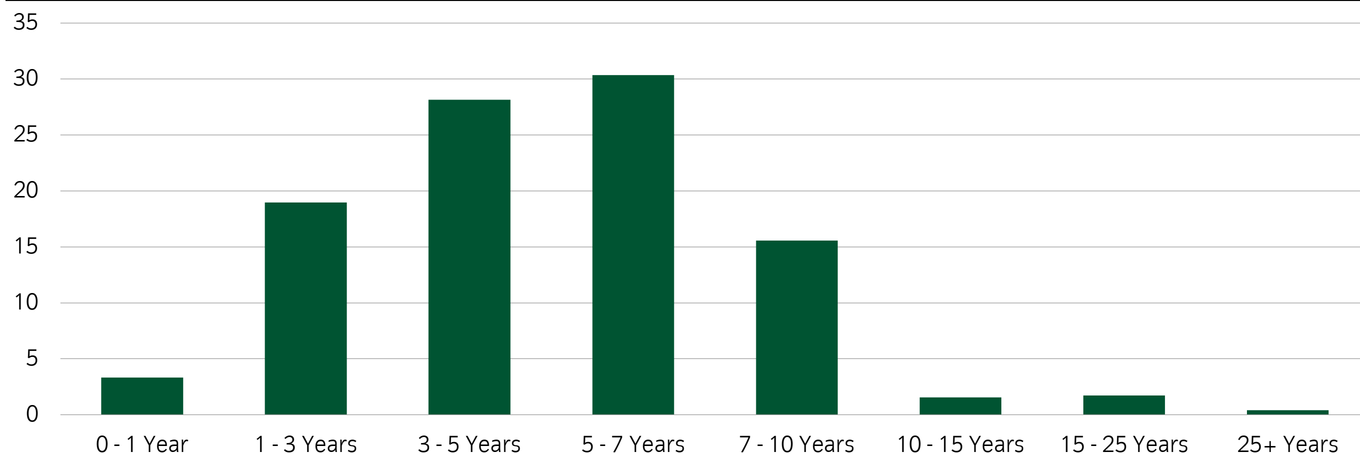


HIGH YIELD – THE ASSET CLASS TO WATCH FOR THE NEXT 12 MONTHS?

In our view – high yield corporate credit is emerging as an asset class to watch over the next 12 months. Last year's repricing of the asset class means it now offers investors a more attractive yield. Although the global economy is contending with a slow down or even a mild recession, corporate balance sheets look resilient: leverage is below the historical average and cash on books is above the historical average, which suggests to us that defaults are likely to be contained. Against this backdrop, the yield investors can collect from high yield is appealing. Moreover, high yield has held up well through conditions such as these, in contrast to equity markets which have tended to perform best during the highest growth periods.

Furthermore, corporates are starting from a strong fundamental position. Most high yield issuers took advantage of low rates over the past several years to shore up their balance sheets and refinance existing debt at lower rates. This has pushed out the maturity wall (see Figure 9) beyond one year and much of high yield market will not need to access the debt market in the near future.

Figure 9: Maturity wall: most high yield issuers will not need to access debt markets in the near term[11]



We believe investors can benefit from a greater understanding of the compensation for risk on offer in the high yield market. It could be a compelling time for investors to partner with managers able to overcome the high yield market's liquidity challenges, with the ability to fully understand and price market risks.

[10] For illustrative purposes only. Process presented represents that of predecessor firm Mellon Investments Corporation. Hypothetical trade example: actual trading may reflect prices from banks, bids and offers that are materially different than what is shown herein. Each account is individually managed and could differ from what is presented herein. *Extreme liquidity is in reference to the ability for investors to contribute and withdraw funds even in environments where liquidity is "extremely" scarce. **Hidden liquidity refers to potential liquidity sourced through basket trading of liquid and or diversified bonds. ***Represents typical range and subject to change. Insight makes no assurances that the bps represented on this slide will be within the range. Actual bps could be higher or lower than what is shown.
[11] Bloomberg, December 2022.

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