Investment Insights

US high yield: using underlying fundamentals to steer through uncertainty

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US high yield: using underlying fundamentals to steer through uncertainty

As markets have moved closer to a consensus that developed markets, including the US, have entered "late cycle", a prevailing question needs answering: What do we do with our investments in the high-yield bond market?

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The US Federal Reserve's (Fed) commitment at its March meeting – to keep interest rates on hold and end its balance sheet reduction in September – seems a long way away from the tightening stance it held just a few months earlier.

With the US already showing late-cycle characteristics – such as tight labour markets, rising wages and profit margin pressures – it's difficult to know whether the Fed's dovish stance will be enough to prolong the US economy's expansion. This uncertainty has led to some investor concern about their exposure to credit, especially high yield.

For a more detailed look at our global fixed income outlook, please read our Fixed Income Perspectives report.

All data in US dollar terms.

What risks are investors taking with an allocation to corporate credit?

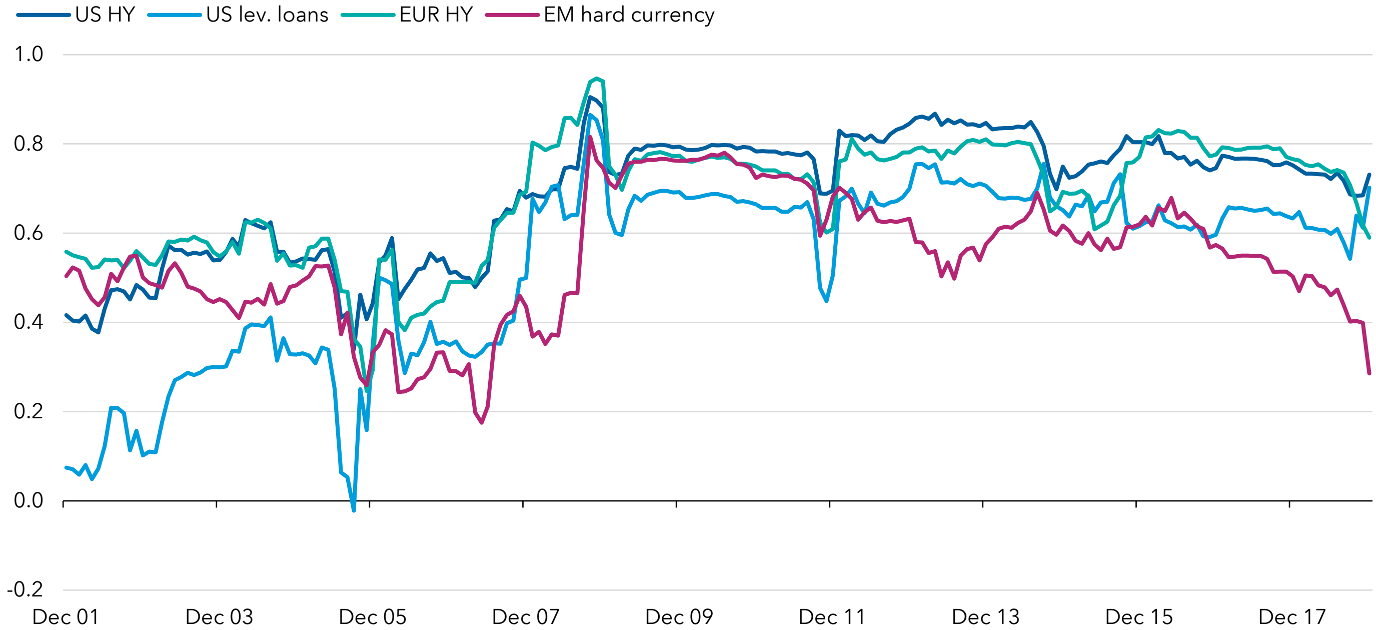
Correlations of high-yielding corporate credit to equities increased significantly when quantitative easing was initiated in 2008, and these correlations appear to have persisted into this late stage of the cycle.

As presented in the chart below, risk assets such as high-yield and emerging market bonds, as well as bank loans, have exhibited a higher correlation to equities compared with their historical norm. If volatility increases in equities, this will likely impact risk assets, including high-yield markets.

Should this be the case, it is important to remain calm and disciplined in your positioning. Uncertain times provide opportunities for managers to focus on the quality of the underlying assets in a portfolio – to identify issuers with strong fundamentals that will be able to sustain cash flows in order to service and potentially repay their existing debt. Uncertain times also necessitate building a portfolio that adequately compensates for the credit risk that comes with investing in high yield.

Correlation of risk assets with equities are above historical norms

Historical correlations compared with MSCI World (rolling 3 year)[1]



Past results are not a guarantee of future results.

1. As at 31 December 2018. Sources: Capital Group, Bloomberg Barclays, Credit Suisse, JPMorgan, MSCI
MSCI World = MSCI World Gross Total Return USD Index, US HY = Bloomberg Barclays US High Yield 2% Issuer Cap Index, US lev. loans = Credit Suisse Leveraged Loan Index, EUR HY = Bloomberg Barclays High Yield (Euro) Ex-Fin Index, EM hard currency = JPMorgan EMBI Global Index.

Recognising the implications of a growing US bank loan market

The US high-yield bond market does not operate in a vacuum, and risks remain across the broader fixed income market – particularly sub-investment-grade credit markets. One sector that may impact the high-yield market is the US bank loan market – or floating rate loan market – which has seen tremendous growth over the past few years.

Interest in this asset class has largely been driven by its floating rate nature in addition to the appeal of the security and seniority of the debt's position in the capital structure. That said, as a result of the Fed's "pivot" from a hawkish to a dovish stance, flows out of the asset class have largely led the loan market to miss out on much of the rally seen in the first quarter of this year.

Despite the recent outflows, prior to 2019, strong demand for loans caused a shift in the US bank loan market's underlying fundamentals, which may not be widely understood. It has resulted in more loan-only capital structures for bank loan issuers, which will most likely impact future recoveries during the next default cycle. This could then have a knock-on effect on returns – and, in particular, principal. At the same time, as issuers rated single B and below now make up the largest part of the US bank loan market, the credit risk profile of the market has shifted. The bank loan market now has a larger percentage of issuers rated B and below than the high-yield bond market.

Historically, US high-yield bonds have provided a higher total rate of return relative to US bank loans. Since 2003 – when the bank loan market could be considered developed – we have witnessed high default environments, periods of rising interest rates and the global financial crisis. During this time, high-yield bonds have outpaced bank loans in every calendar year but three, providing an average annualised excess return of 3.9%.[2]

Supportive fundamentals can provide opportunities in a highly levered market

A significant rally across equities, corporate bonds and leveraged loans since the start of the year has resulted in yields of less than 7% for the US high-yield market, down from close to 8% at the end of 2018.[3] Given where spreads have moved year-to-date, further spread tightening is not expected to have a material impact on returns going forward. That said, slower growth, a lack of interest rate hikes and positive corporate earnings growth, albeit at a reduced rate, may support fundamentals for the remainder of the year.

Over the next 12 months, there is the potential for spreads to widen, but this could still provide a positive return for a portfolio that is focused on companies that have strong fundamentals, attractive coupons and good market technicals.

There are many areas to focus on when analysing the outlook for the US high-yield market. Here are some questions to consider:

1. Are corporate debt levels still a problem for high-yield markets?

Leverage remains a key risk to credit valuations in high-yield markets but levels may have peaked for the cycle – at peak EBITDA[4] – as companies become less incentivised to issue debt to finance activities such as mergers, acquisitions, leveraged buyouts, share buybacks or issuing dividends.

Although we believe it to be unlikely, if a recession were to hit today, we could see record new highs for leverage ratios, should the absolute amount of debt outstanding not change and EBITDA decline. If spreads were to widen and

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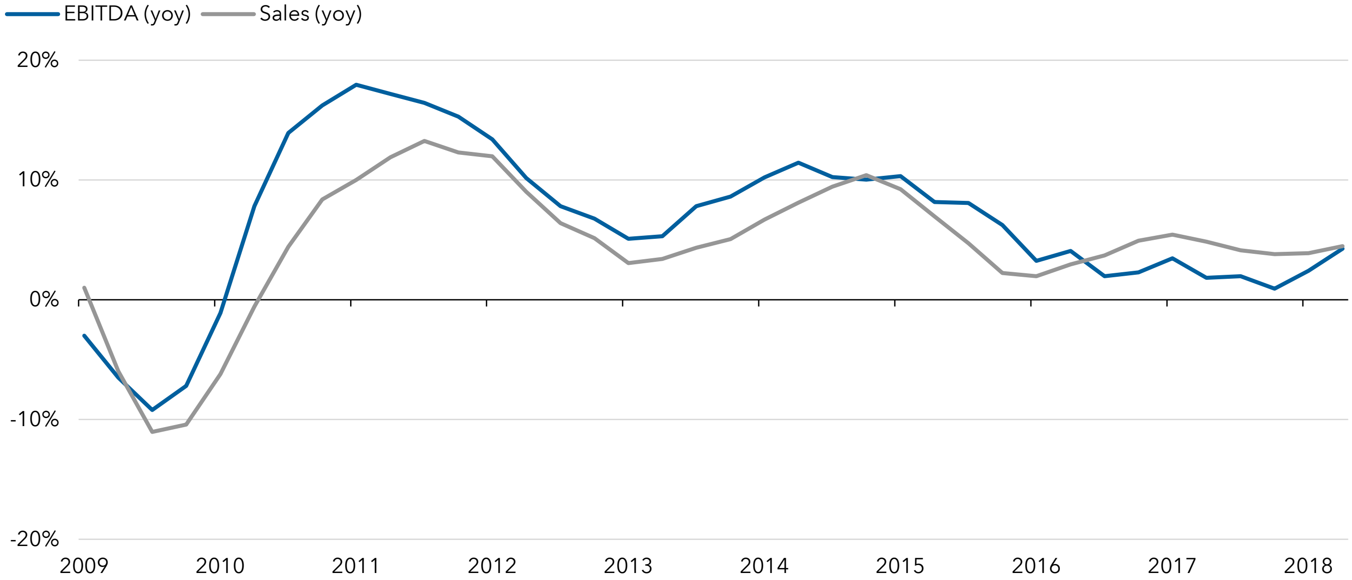
2. Data as at 31 August 2018. Total return for Bloomberg Barclays US High Yield Index and Credit Suisse Leveraged Loan Index. Sources: Bloomberg Barclays, Credit Suisse
3. Data as at 28 March 2019. Bloomberg Barclays US High Yield Index. Source: Bloomberg Barclays
4. EBITDA: earnings before interest, tax, depreciation and amortisation

EBITDA trough, companies with large outstanding debt loads would be forced to refinance at higher rates, thereby lowering interest coverage ratios.

Having said that, interest coverage ratios currently remain close to historical highs.

Sales and earnings have held up since the 2008 global financial crisis

US high-yield EBITDA and sales growth (excluding commodities)[5]



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2. Can fundamentals support returns in this environment?

Fundamentals remain positive. Fiscal stimulus – both from the deficit finance budget in 2018 and from tax reform for corporations and individuals – were tailwinds to corporate growth and consumption levels in the latter half of 2018.

Generally, we have seen a slight decrease in medium-term sales and earnings targets based on the outlook for economic growth. Combined with a lack of headwinds from interest rate hikes, this environment should be supportive of corporate credit.

3. Could default rates spike when the cycle ends?

Default rates in 2018 were 1.8% and 1.6% for US high-yield and leveraged loans, respectively; these rates represent near historical lows and fall below the averages of 2.7% and 2.4% (excluding 2009).[6]

When this current cycle ends, we expect to see the same trend as we did following the dot.com bubble in the late 1990s: a gradual rise and reversal of default rates. We expect default levels, in time, to resemble previous default cycles.

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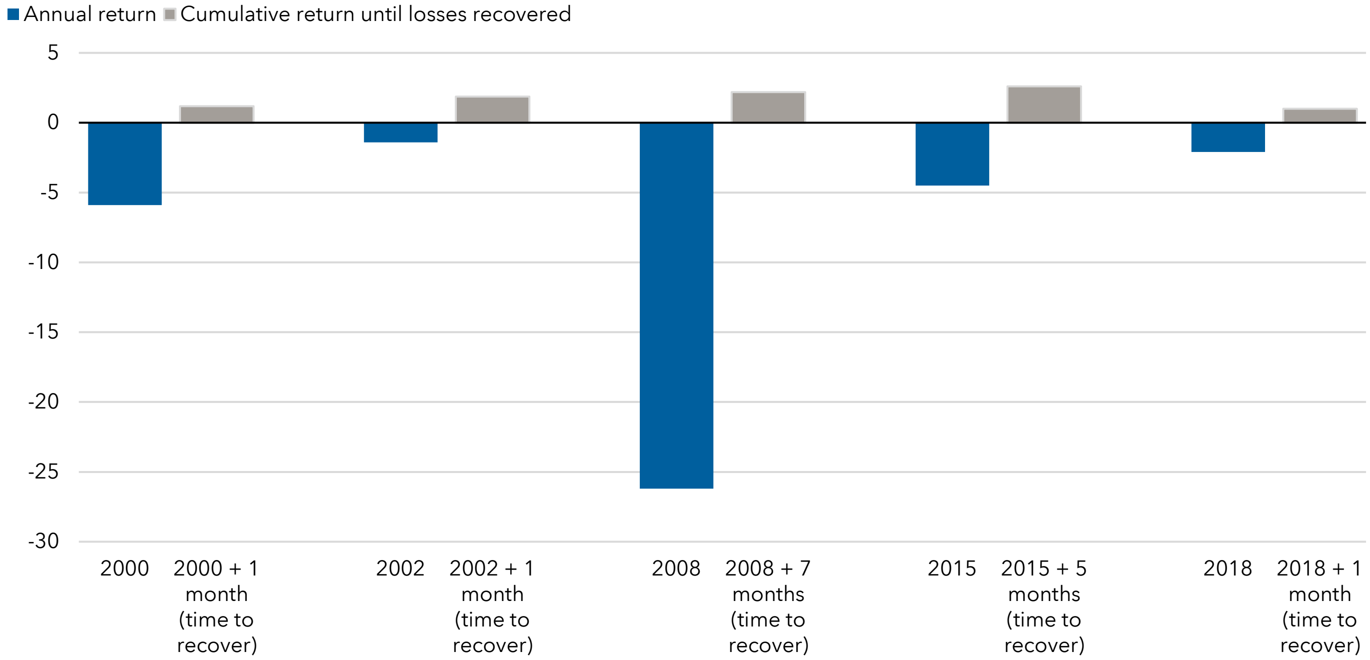
5. Data as at 31 December 2018. Sources: Morgan Stanley Research, Bloomberg, S&P
6. Data as at 31 December 2018. Source: JPMorgan Research

Myth vs. reality: is the pain severe when US high-yield bond markets are hit?

Negative – and subsequent positive – annual returns for US high-yield bonds (%)[7]



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US high yield: a durable asset class for long-term investors

There is a widely held belief that during times of market volatility, and when US high-yield bonds post negative returns, the pain is severe and can have a detrimental impact on a portfolio.

However, as shown in the chart above, in the 21 years since the inception of the Bloomberg Barclays US High Yield Index, there have only been five years of negative returns. These five years' annual average was -8%, yet if the global financial crisis in 2008 were excluded, the average would be -3.5%. In addition, investors who stayed in the market for that whole period would have received an average annual return of 7.4%.[7]

We believe that remaining calm during downturns and maintaining exposure to the market is more likely to benefit investors than trying to time it. The chart shows the specific five years of negative returns – as well as the short period it took to shift back to positive returns. It highlights the importance of not looking at returns on an annual basis – particularly as high-yield bonds can often be hit at the end of a particular year, but can snap back just as quickly.

In our view, investors are more likely to be rewarded by aligning their approach with the market they are invested in. Companies don't tend to take an annual approach to their objectives; instead, they take a longer term view and a more strategic outlook for their business. A long-term diversified allocation to US high-yield bonds could allow investors to capitalise on the ever-evolving market trends and generate positive returns over the years.

7. Data as at 31 December 2018. Bloomberg Barclays US High Yield Index. Source: Bloomberg Barclays

Risk factors you should consider before investing:

- **This material is not intended to provide investment advice or be considered a personal recommendation.**
- **The value of investments can go down as well as up and you may lose some or all of your initial investment.**
- **Past results are not a guide to future results.**
- **If the currency in which you invest strengthens against the currency in which the underlying investments of the fund are made, the value of your investment will decrease.**
- **Depending on the strategy, risks may be associated with investing in fixed income, emerging markets and/or high-yield securities; emerging markets are volatile and may suffer from liquidity problems.**