High yield: the full spectrum

High yield bonds are more than just a subset of fixed income, they are a microcosm of investing. It is this characteristic that is increasingly putting them on investors' radar.

By *Tom Ross*

Occupying the centre ground between investment grade bonds and equities from a risk-return perspective, sub-investment grade bonds – or high yield bonds as they are more commonly known – have become increasingly sought after by investors.

Driving the demand has been the search for yield. Central banks remain committed to keeping interest rates low and this has driven investors further along the credit spectrum. In Europe, with yields in negative territory on many sovereign bonds and meagre yields on higher quality investment grade corporate debt, high yield is one of the few areas in fixed income markets that currently offers yields above inflation.

Ultimately, those high yields act as a form of compensation for the higher default risk that accompanies bonds with lower credit ratings. Yet it is this aspect of risk that makes them attractive. High yield bonds simultaneously share the key characteristics an investor expects of bonds, namely a regular income and the prospect of par value returned at maturity, with a degree of equity sensitivity to corporate conditions that reflects the higher risk of default.

This risk premium feeds through into credit spreads that lead to high yield bonds on average, historically offering upwards of 300 basis points more in yield than government bonds of similar maturity.[1] The higher yields on bonds, together with relatively short maturities, means that high yield typically has a lower duration (sensitivity to interest rate changes) than investment grade credit and government bond markets – a potentially valuable characteristic at a time when inflation fears are heightened.

Tom Ross

Corporate Credit Portfolio Manager at Janus Henderson Investors

A welcome expansion

It might be thought that low yields would encourage companies to borrow heavily, yet the high yield market has grown at a relatively restrained rate. In fact, prior to the COVID-19 crisis, the size of the high yield market had been static for several years. Financial commentators used to fret about the growing size of the BBB market (the lowest section of investment grade) prophesying a tidal wave of Fallen Angels (investment grade bonds downgraded into high yield). For high yield managers, this was less of a threat and more of an opportunity.

The tidal wave never transpired. There were a

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few sizeable downgrades in 2020, such as Ford the automobile company, but nothing of a size that the high yield market could not absorb. In fact, new issues from companies during the crisis actively helped high yield portfolio managers find a home for inflows of client money.

The high yield market is always in flux. At one end, there are bonds journeying back and forth between investment grade and high yield. At the other end, there are bonds that are on the brink of default. All the while, there are hundreds of different issuers jostling for position along the credit spectrum. The essence of good asset management is identifying those with improving credit fundamentals and avoiding those that are deteriorating and could suffer a credit downgrade or default.

Are defaults a major concern?

A phenomenon of this credit cycle is that defaults have remained relatively contained. During the 2008/09 Global Financial Crisis the global high yield default rate peaked at 13.4% according to Moody's, the credit ratings agency. Their baseline estimate is that defaults are likely to peak in Q1 2021 somewhere between 6-7% for the COVID-19 crisis. This relatively low default rate speaks to the extraordinary levels of monetary and fiscal support offered by central banks and governments. By creating favourable liquidity conditions, it allowed companies to raise equity and debt capital to offset the revenue droughts caused by lockdown.

Structural change

The emergence from lockdown should allow a meaningful bounce-back in earnings as economies recover. We need to be cognisant, however, that COVID-19 will leave permanent scarring. Borrowers among consumer-facing sectors such as travel and retail have become more indebted and social distancing rules have accelerated digitalisation. While we expect companies to seek to deleverage over the coming year, assumptions about cash flows need to take into account the fact that economic disruption may have permanently altered the prospects for some borrowers.

Creditor influence at the ESG level

Another legacy of the pandemic has been the heightened interest in environmental, social and governance (ESG) factors. Creditors may lack the shareholder votes to direct corporate boards, but as a key player in providing finance to companies we can make our voice heard. By working in tandem with equity colleagues we can double the impact of our engagement.

Both the European Union and the Biden administration in the US are promoting a green agenda to recovery. Carbon-intensive sectors such as basic industry, capital goods, energy and transport collectively represented 31% of the ICE BofA Global High Yield Index (at 17 March 2021), so there are plenty of opportunities for high yield managers to influence change.

Taken together, we see high yield bonds as playing a valuable role, not just in terms of portfolio construction, but also in contributing to the shape of the economic recovery. ■

SUMMARY

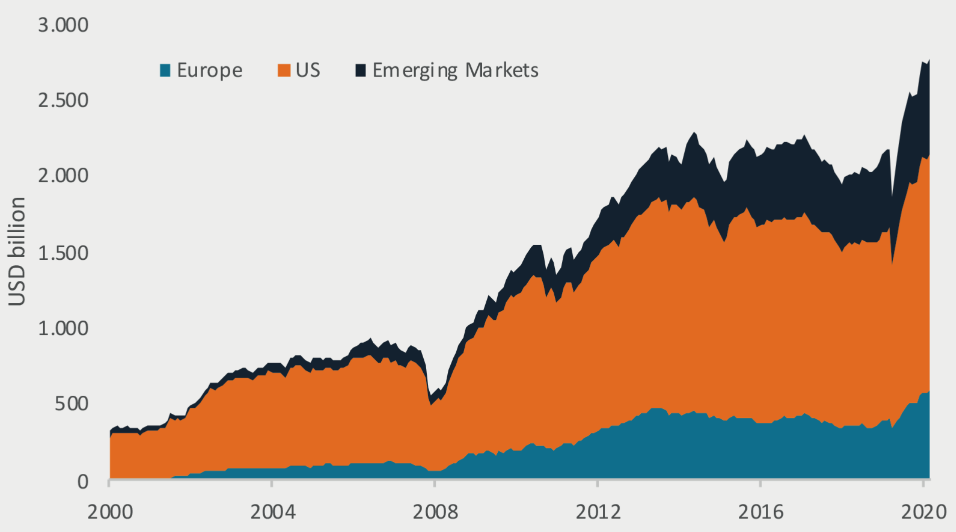
Central banks are likely to keep rates low, driving investors down the credit spectrum.

The high yield market is always in flux, but this offers investors the potential to select corporate borrowers with improving credit prospects and to seek to avoid those on a deteriorating path.

Defaults are expected to remain relatively low and an economic recovery should help to support de-leveraging.

Bondholders are increasingly recognising the role they can play in influencing good corporate behaviour.

FIGURE 1 MARKET SIZE OF HIGH YIELD BOND SECTOR



Source: Bloomberg, Full market value in USD billion of ICE BofA European Currency High Yield Index, ICE BofA US High Yield Index, ICE BofA High Yield Emerging Markets Corporate Plus Index, 31 December 2000 to 28 February 2021.

1 Source: Bloomberg, ICE BofA Global High Yield Bond Index, credit spread. Lowest credit spread on index has been above 300 basis points in 10 years to 17 March 2021. Yields may vary and are not guaranteed.