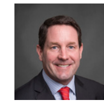
U.S. High Yield Bonds Should Benefit From Improving Fundamentals

The asset class offers current high income, lower rate sensitivity.

March 2021



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KEY INSIGHTS

- The U.S. high yield bond market offers an attractive combination of higher income and lower interest rate sensitivity relative to investment-grade bonds.
- We expect defaults in the asset class to decrease to below longer-term averages in 2021 amid the expected economic reopening and improving fundamentals.
- We are broadly focusing on issuers with improving credit quality and are still finding value in select names related to travel and in the energy industry.

With interest rates still historically low but increasing amid worries about inflation, the U.S. high yield bond market offers an attractive combination of higher income and lower duration[1] relative to investment-grade bonds. We expect defaults in the asset class to decrease to below longer-term averages in 2021 amid the expected economic reopening and broadly improving fundamentals, but rigorous credit analysis is still vital.

Going into the 2020 economic downturn, the U.S. below investment-grade bond market had benefited from 10 years of economic expansion and improved credit fundamentals. From 2007 through the end of 2020, the amount of outstanding higher-quality bonds (BB rating) increased by more than 50%, while the combined amount of lower-rated bonds (B and CCC) decreased by 30%.[2] The 2020 crisis brought higher-quality fallen angels—bonds downgraded from investment grade into the high yield category—into the market, further contributing to a higher overall credit quality in the asset class today than in the past.

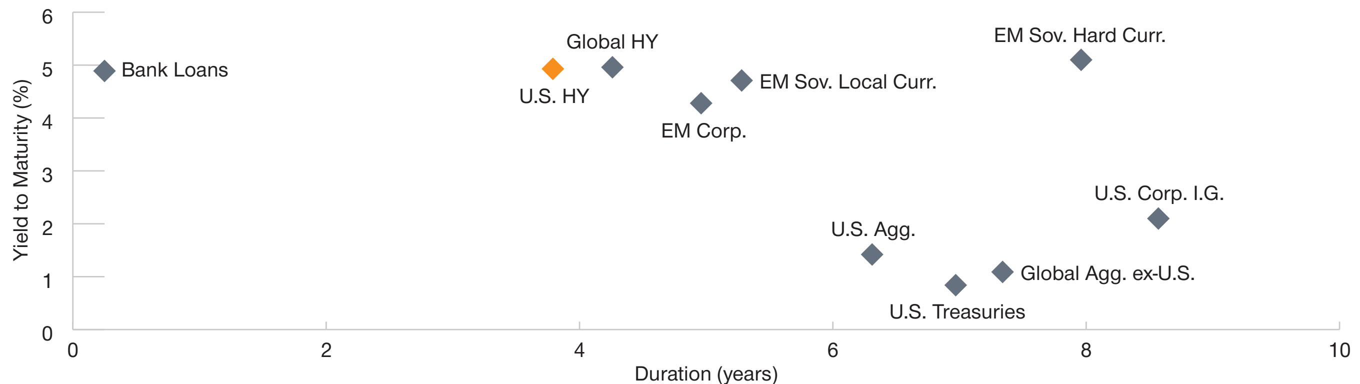
Healthy Income and Lower Duration

Even after the shift toward higher quality, the U.S. high yield bond market currently provides healthy income relative to investment-grade sectors. As of the end of February, the Bloomberg Barclays U.S. High Yield Index yielded 4.9%. In contrast, the broad investment-grade Bloomberg Barclays U.S. Aggregate Index yielded only 1.4%, and the Bloomberg Barclays U.S. Corporate Investment Grade Index's yield was 2.1%.

[1] Duration measures a bond's sensitivity to changes in interest rates.
[2] Data source: Credit Suisse.

Higher Income With Lower Duration

Duration and yield across fixed income sectors



As of February 28, 2021.

Past performance is not a reliable indicator of future performance.

Sources: Bloomberg Finance L.P., T. Rowe Price, and J.P. Morgan Chase (see Additional Disclosures).

Indexes used: U.S. Treasuries: Bloomberg Barclays U.S. Treasury Index; U.S. Aggregate: Bloomberg Barclays U.S. Aggregate Index; U.S. Corp. I.G.: Bloomberg Barclays U.S. Corp. I.G. Index; U.S. High Yield: Bloomberg Barclays U.S. High Yield Index; EM Sovereign Hard Currency: J.P. Morgan EMBI Global Diversified; EM Corporates: J.P. Morgan CEMBI Broad Diversified; EM Sovereign Local Currency: J.P. Morgan GBI EM GD Index; Global Aggregate ex-U.S.: Bloomberg Barclays Global Aggregate ex-U.S. Index; Global High Yield: Bloomberg Barclays Global High Yield; Bank Loans: JPM Levered Loan Index.

Yield and duration are subject to change.

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Rates could continue to increase meaningfully as global economies more fully reopen later in 2021 after vaccines are more widely distributed. The U.S. below investment-grade market is much less exposed to interest rate risk than investment-grade sectors. The duration of the Bloomberg Barclays U.S. Corporate Investment Grade Index was 8.6 years at the end of February, meaning that its price would decline approximately 8.6% if interest rates increased by one percentage point. The duration of the Bloomberg Barclays U.S. High Yield Index was only 3.8 years on February 28.

As investors seek instruments with lower duration profiles to combat rising interest rates, the bank loan market should offer compelling assistance. Because bank loans pay a floating coupon rate that generally resets quarterly, they have minimal interest rate risk. Loans are also higher in an issuer's capital structure than bonds, so they receive repayment priority in the event of default. Recent credit spreads[3] for the same issuer's loans and bonds have been close to equal, so we believe the market is not fully reflecting the more attractive characteristics of loans. We have maintained a meaningful allocation to bank loans[4] partly because of their unique low-duration characteristics.

Ongoing Improvement in Fundamentals

We expect the fundamentals of most U.S. high yield issuers to improve as the economy continues to reopen and expand. Further fiscal stimulus, which appears likely, should strengthen this process. At the end of 2020, the default rate in the asset class was running near 6%.[5] We think that this may decline to

[3] Credit spreads measure the additional yield that investors demand for holding a bond with credit risk over a similar-maturity, high-quality government security.

[4] The weight of bank loans in the U.S. High Yield Representative Portfolio as of 12/31/2020 was 8.8%. The representative portfolio is an account we believe most closely reflects current portfolio management style for the strategy. Performance is not a consideration in the selection of the representative portfolio. The characteristics of the representative portfolio shown may differ from those of other accounts in the strategy. Information regarding the representative portfolio and the other accounts in the strategy is available upon request.

[5] Data source: J.P. Morgan (see Additional Disclosures).

below the long-run average in 2021. After the flood of fallen angels in 2020, we anticipate that there will be opportunities to buy future rising stars—bonds upgraded from high yield to investment grade—this year. We believe that our relatively concentrated portfolio and focus on credit research should allow us to benefit from opportunities in improving credits.

Selectivity Is Key to Source Value

Our process for selecting individual names to include in the strategy relies on the insights of our dedicated team of U.S. high yield credit analysts. Environmental, social, and governance (ESG) analysis is a key component of the credit research process. ESG insight can help us identify issuers that are more optimally positioned for the long term while also helping us assess risks associated with ESG factors.

In terms of credit quality positioning, we broadly favor the single B rating segment, which is where we are finding the most relative value after the compression in credit spreads as the market recovered from the March 2020 sell-off. We also have positions in issuers that may have lower ratings from external rating agencies—we select these holdings when our forward-looking proprietary research reveals that they are, in our view, higher quality than their credit ratings convey and may be primed for an upgrade. Within the BB rating segment, which is more exposed to rising rates, we seek to balance the interest rate risk against select improving credit stories that may return to investment grade.

We have been finding select credits in industries related to travel and leisure that still trade at spreads that represent attractive value. In addition, we favor some issuers in the energy sector because we think that oil prices can remain resilient as economic growth accelerates. We believe that our flexible approach to managing a U.S. high yield strategy and experience over many past credit cycles gives us the ability to navigate the volatile environment as the economy emerges from the pandemic.

WHAT WE'RE WATCHING NEXT

Our outlook for improving fundamentals and a declining default rate in 2021 should mark the beginning of another credit cycle. Since the global financial crisis of 2008–2009, credit cycles have become more compressed, so we will be monitoring issuer fundamentals going into 2022 for signs of broad deterioration.

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Debt securities could suffer an adverse change in financial condition due to ratings downgrade or default, which may affect the value of an investment. Fixed income securities are subject to credit risk, liquidity risk, call risk, and interest rate risk. As interest rates rise, bond prices generally fall. Investments in high yield bonds involve greater risk of price volatility, illiquidity, and default than higher-rated debt securities. Investments in bank loans may at times become difficult to value and highly illiquid; they are subject to credit risk such as nonpayment of principal or interest, and risks of bankruptcy and insolvency.

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