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High Yield Bonds Appear Well Positioned for a Downturn

The sector is in better health than prior to previous slowdowns.

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Key insights

- High yield issuers should be better placed to withstand this downturn as a key driver is the aggressive tightening from central banks, not credit bubbles.
- Corporate balance sheets are generally in solid shape, giving high yield issuers further protection against a slowdown.
- The credit default cycle in 2020 was challenging, but it has left the high yield sector in a better state of health.

Economic slowdown fears are mounting as the impact of monetary policy tightening is expected to start coming through more meaningfully in the second half of 2023. In the fight to bring down inflation, central banks from across the globe unleashed their most aggressive hiking cycles for more than two decades this past year. Although it is encouraging that inflation is finally showing signs of slowing, investors are concerned about the toll this monetary policy shock will have on the economy, which typically comes with a lag.

For companies, a slowing growth environment is challenging, but the good news is that we believe it is likely to inflict less damage on corporate earnings than prior downturns. We have three main reasons for thinking this, which we discuss here.

This Downturn Will Not Be Credit-Driven

Apart from the pandemic-induced recession in 2020, most other recent recessions have been credit-driven—in other words, they have been caused by concern over the creditworthiness of certain assets. The 2008 global financial crisis (GFC) and 2001 dot-com bust, for example, were caused primarily by the buildup of debt-related excesses in the U.S. housing sector and internet infrastructure, which resulted in bad loans.

If the current downturn becomes a recession, inflation and the sheer number and pace of interest rate hikes aimed at taming it will likely be the main causes, rather than asset bubbles. This is important because historically credit-driven recessions tend to inflict more damage to corporate earnings. For example, in the inflation-driven recession of 1982–1983, when the Federal Reserve hiked its policy rate to 20%, S&P 500 Index profits fell by 18%. In the 1973–1974 inflation-driven recession, when the interest rate reached 13%, profits also fell by 18%. This contrasts sharply with the GFC and dot-com crash, when profits fell by 49% and 25%, respectively.

Corporate Balance Sheets Are Broadly Solid

We recognize that an economic downturn is likely to weigh on profit margins and cash generation. While this may lead to a deterioration in balance sheets, most companies are entering this from a position of strength. High yield companies are underpinned by solid fundamentals at present. Interest coverage ratios (a measure to determine how able a company is to pay interest on its debt) are high, while leverage ratios (which show how much of a company's capital comes from debt) are relatively low.

In addition, the vast majority of high yield bond-issuing firms were able to benefit from attractive funding conditions in 2020 and 2021 to push out their maturity profiles. Just 6%[1] of global high yield debt will mature this year with the bulk of the "maturity walls" of issuers coming after 2025, indicating that balance sheets are broadly strong. It's also important to note that companies tend to have debt with varying maturities, so the impact of the rise in interest rates is not immediate—it's smoothed out over time.

We Went Through a Default Cycle In 2020

Many businesses, particularly in the U.S., defaulted on their debt because of pandemic lockdowns. In 2020, default rates among U.S. high yield energy firms reached almost 30% while debt restructurings rose among European retail firms. Default cycles are useful for separating stronger firms from weaker ones. Those with the potential to survive and thrive beyond a crisis tend to be well supported by their sponsor investors, who inject cash when necessary or provide lines of credit in order to realize their investment further down the line. Companies with little prospect of long-term success are typically allowed to go bust. The U.S. default cycle of 2020 was significant, but we believe it has left the high yield sector in a better state of health.

Overall, the period ahead is likely to be challenging for companies. But we believe that high yield debt is in a better place to navigate a downturn than it has been in the past as company balance sheets are broadly entering it from a position of strength. Furthermore, the main drivers of the slowdown are inflation and the aggressive monetary policy actions of the past year, not a credit bubble, which has historically weighed on corporate earnings more. The default cycle of 2020 also means the sector is in better health. However, we are cognizant that in an environment of slowing growth, defaults will inevitably rise, which underscores the importance of security selection.

[1] As of March 31, 2023. The index referred to is the ICE BofA Global High Yield Index (See Additional Disclosures).

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