



Improving Credit Quality Boosts High Yield Bonds

Attractive valuations and fallen angels offer opportunities.

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KEY INSIGHTS

- The high yield bond sector represents value as a result of its improving credit quality and valuations that are still at attractive levels.
- We have been finding opportunities in fallen angels, including select energy-related issuers that have been sold off amid the oil price volatility.
- These factors, combined with the Fed providing abundant liquidity, have led us to increase the high yield bond allocation in the Total Return Strategy.

The high yield bond sector represents attractive value as a result of its improving credit quality and credit spreads¹ that are still relatively wide, even after the rally from the March sell-off. The highest-quality (BB rated) bonds in the high yield universe offer an interesting spread premium and are attractive versus the lowest-quality (BBB rated) segment of the investment-grade market. We have been finding opportunities in fallen angels—bonds that have been downgraded into the BB category, losing their investment-grade rating—including select energy-related issuers that have been sold off amid the oil price volatility. These factors have led

us to increase the high yield bond allocation in the Total Return Strategy.

Rising Demand Given Valuation Levels

As of mid-July, the credit spread on the J.P. Morgan Domestic High Yield Index was about 700 basis points² (bp), well below the March peak but still at a level that has historically resulted in a high probability of positive returns over the following 12 to 24 months.³ This has also attracted interest from non-dedicated high yield investors seeking attractive risk-adjusted returns.

The demand from crossover investors has provided technical support for the asset class, helping the market digest



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¹ Credit spreads measure the additional yield that investors demand for holding a bond with credit risk over a similar-maturity, high-quality government security.

² A basis point is 0.01 percentage points.

³ Based on data from January 1986–June 2020. High yield spreads were measured using historical monthly spread to worst values, and there were 89 instances where spreads reached 700 basis points or more. High yield is represented by the J.P. Morgan Domestic High Yield Index; prior to 1/31/95, the Credit Suisse High Yield Index was used. We then measured subsequent annualized returns of the index over 1- and 2-year periods. Indices cannot be invested into directly.

“The overall credit quality of the high yield bond sector has steadily improved...”

the recent downgrades as well as a heavy new-issuance calendar since the Federal Reserve stabilized credit markets in late March by announcing that it would buy investment-grade corporates and some fallen angels. Many companies have used this period to come to market and fortify their liquidity positions amid the business disruptions caused by the pandemic. There was more than USD 145 billion in high yield new issuance in the second quarter versus just over USD 285 billion in all of 2019, according to J.P. Morgan data.

Steadily Improving Credit Quality

The overall credit quality of the high yield bond sector has steadily improved in recent years, making the current spread levels even more attractive relative to history, particularly from a risk-adjusted perspective. At the end of 2013, only 41% of the Bloomberg Barclays U.S. High Yield 2% Issuer Cap Index was rated BB or BB+. By the end of 2019, the percentage had increased to 48%. As of June 30, 2020, it had climbed to 55%.⁴

We think that the additional spread offered by BB rated bonds versus BBB rated debt—approximately 230 bp as of mid-July, according to Bloomberg Barclays indexes—adequately compensates investors for the additional credit risk. Several of these bonds that are new to the BB segment are from large, relatively high-quality issuers, providing multibillion-dollar market capitalizations and earnings before interest, taxes, depreciation, and amortization (EBITDA) far superior to traditional high yield names. BB rated companies have been able to tap the new-issue market to build up their balance sheets, enhancing their ability to repay their debt obligations.

Preference for Higher-Quality Credits

In general, we favor the higher-quality segments of the noninvestment-grade universe—those rated BB and

B—including some fallen angels. We have also taken some measured risk on exposure to select lower-quality and CCC rated credits that we think will be able to continue to meet their debt obligations.

In terms of industries, we have been finding select opportunities in energy-related issues. Some higher-quality energy companies that are fundamentally strong enough to make it through the recession and low oil prices have sold off along with low-quality firms with elevated default risk, creating attractive pricing dislocations. The recent rebound in commodities prices, which our energy sector credit analysts expect to continue in the medium term amid production cuts and reviving global demand, is providing further support for the segment. However, defaults in this industry will likely persist, so being able to distinguish the performers from those expected to default is crucial.

We are seeking upside optionality in noncallable⁵ bonds and have been rotating out of higher-quality callable bonds trading at high dollar prices because we do not think they provide adequate compensation for the risk of being paid back at par if the issuer calls the debt. Although bonds from some of the industries most affected by the pandemic—such as cruise lines and airlines—trade at low prices, we have no exposure to the low-quality companies in those segments because we believe they are unlikely to survive the crisis.

Larger Allocation to High Yield Bonds Than Loans

In the past, the Total Return Strategy has typically maintained a larger allocation to bank loans than to high yield bonds due to the loan sector's historically stronger risk-adjusted return profile. However, in the current environment, we favor noninvestment-grade bonds over loans. Bank loans also have high yield credit ratings but are higher in the capital

⁴ Data source: Barclays Live.

⁵ A callable bond can be repurchased by the issuer before maturity.

structure than bonds. While we remain constructive on loans, we are cognizant that lower underwriting standards in the last few years may negatively impact their credit quality. Also, loans pay floating coupon rates linked to the London interbank offered rate (LIBOR), which is likely to stay very low for the foreseeable future.

The main risk in our relatively large exposure to high yield bonds is that the pandemic continues unabated, keeping

the economy in an extended recession and weighing on issuers' fundamental health and ability to repay their debt. However, we believe that current credit spreads more than offset this risk. The Fed and other global central banks are providing abundant liquidity, which facilitates a constructive environment for credit. Also, we are confident that our global team of credit analysts can help select high yield credits that have a better probability of surviving a longer-than-expected economic downturn.

WHAT WE'RE WATCHING NEXT

The second-quarter 2020 earnings season will provide some of the first solid data on how corporations are weathering the recession triggered by the coronavirus pandemic. Our credit analysts will be closely monitoring the result of high yield issuers in one of the most unpredictable earnings seasons in decades.

Key Risks—The following risks are materially relevant to the strategy highlighted in this material:

Debt securities could suffer an adverse change in financial condition due to ratings downgrades or defaults, 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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