HIGH YIELD BONDS: INVESTING IN THE GRASS ROOTS OF THE US ECONOMY

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The US is the original high yield fixed income market, with a history stretching back to the 1980s and total outstanding issuance of around US$1.3 trillion, largely thanks to the size of the US private equity industry, a major issuer of high yield bonds to finance leveraged buy-outs.

Although other regions have developed significant high yield bond markets more recently, the US market remains the world's largest and it continues to offer international investors attractive opportunities to diversify exposure and find additional income.

For non US investors, US high yield offers fixed income exposure to a cross section of domestically focused, small and mid-cap companies that represent the grass roots of the US economy across sectors including energy, telecoms, industrials and consumer businesses.

The past few years have seen high yield companies take advantage of low borrowing rates and the strong global appetite for yield to refinance their debts on attractive terms — coupons that previously hovered around 8%-9% have been replaced with bonds paying 5%-6%*. At the same time, companies have taken the opportunity to borrow for longer periods, reducing the refinancing pressure they previously faced from shorter maturities. Helped by an improving domestic economy, typical US companies that issue high yield bonds are benefiting from stronger cash flows and better business fundamentals. As a result, default rates in the US high yield market are low by historical standards, at around 2% compared to a historical average of around 4%*.

The US market offers several attractive benefits for international investors in high yield, notably the opportunity to broaden sources of return by investing in a different set of companies operating in the world's largest economy. The US high yield universe is large and average issue sizes tend to be somewhat bigger than in other regions, which helps create a more liquid market.

The mix of sectors also differs from that in Europe, especially because the amount of high yield debt issued by US banks has shrunk dramatically since the financial crisis, while in Europe smaller banks still account for a significant proportion of the market. Adding US high yield therefore offers European investors a way to diversify their exposure in terms of sectors and to counterbalance the weighting of financials in the European high yield universe.

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Going forward, managers are going to need to adapt their approach to a rising interest rate environment as the more than 30-year decline in rates bottoms out and starts to turn. Default rates are unlikely to fall from today's low levels, so active security selection will be as important as ever to avoid the weak issuers. Even so, the US high yield market offers exposure to issuers that balance decent financial fundamentals with relatively attractive income — a potentially useful complement to high yield markets in other parts of the world.

*Source: JP Morgan as of March 31, 2018. Information has been obtained from sources believed to be reliable but J.P. Morgan does not warrant its completeness or accuracy. Copyright © 2018, J.P. Morgan Chase & Co. All rights reserved.

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