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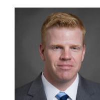
Outlook May Favor High Yield Bonds Over Equities

October 2022



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KEY INSIGHTS

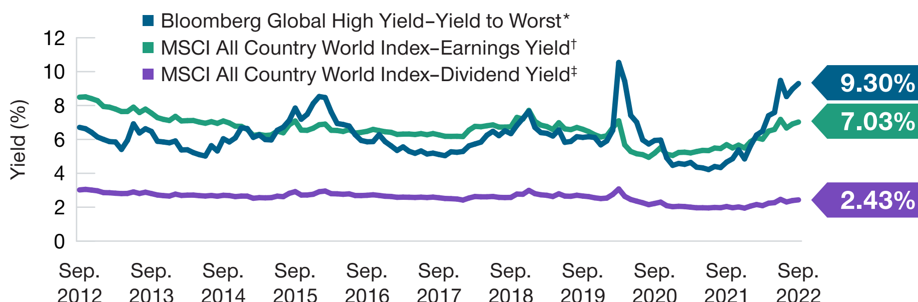
- An unfavorable macroeconomic backdrop is weighing on the near-term global economic outlook and is a headwind for equity markets.
- In our view, high yield bond fundamentals are strong, and they could offer investors a compelling yield advantage relative to equities.

The confluence of several factors—including tightening monetary and fiscal policies, geopolitical turmoil, and stubbornly high inflation—has created an environment in which the potential risks for equities outweigh the potential rewards in the near to medium term.

For investors seeking alternatives, we believe that high yield bonds currently may offer a compelling yield advantage relative to equities. In particular, a comparison against the forward equity earnings yield, which accounts for a company's entire earnings and not just

High Yield Advantage Over Equities

(Fig. 1) High yield bonds could offer a more attractive risk/reward trade-off in the near term



10 years ended September 20, 2022.

Past performance is not a reliable indicator of future performance. Actual outcomes may differ materially from expectations.

Sources: Bloomberg Index Services Limited and MSCI. T. Rowe Price analysis using data from FactSet Research Systems Inc. All rights reserved. See Additional Disclosures.

* Yield to worst is a measure of the lowest possible yield that can be received on a bond with an early retirement provision.

† Forward earnings yield is calculated by dividing the expected earnings per share (EPS) in the next twelve months by the current share price.

‡ Forward dividend yield is the percentage of a company's share price that is expected to be paid out in dividends over the next year.

the portion paid out in dividends, shows a significant yield advantage for global high yield (Figure 1). Further, while equity earnings may be revised downward if economic growth weakens, a potential added advantage for high yield bond investors is that cash flows are unlikely to be affected unless a company defaults.

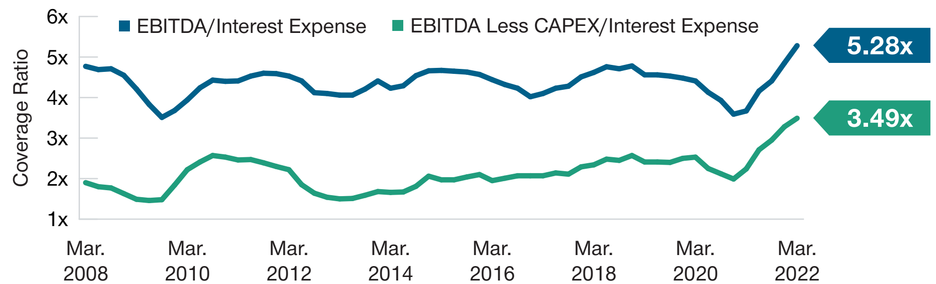
Although we recognize that credit risk is a valid concern, credit quality in the high yield universe has steadily improved, on average, since the end of the 2008–2009 global financial crisis. Over the past 15 years, the share of high yield bond issuers in the Credit Suisse High Yield Index rated[1] higher than single B—levels typically deemed less susceptible to default risk—has increased from 37% to 59%.

High yield sector fundamentals are also generally stronger since 2008, with corporate balance sheets holding more cash and less leverage, as illustrated by interest coverage ratios (Figure 2). While earnings could decline in a recessionary scenario, we believe healthy balance sheets could help limit widespread default risk.

In our view, financial markets face a challenging economic environment, with an increasing likelihood of a global recession within the next year. While our Asset Allocation Committee remains cautious and is maintaining a notable underweight allocation to equities, we believe that high yield bonds are supported by strong sector fundamentals and could offer relatively attractive yields.

Stronger Fundamentals Lower Potential Default Risk

(Fig. 2) Interest coverage ratios show that company earnings for high yield issuers far exceed their ongoing interest expense



March 31, 2008, to March 31, 2022.
Past performance is not a reliable indicator of future performance.
Sources: Based on J.P Morgan North America Credit Research. Not from an Index.
EBITDA = Earnings Before Interest, Taxes, Depreciation, and Amortization.
CAPEX = Capital Expenditures.

[1] The credit ratings are based on methodology of Credit Suisse using Moody's, Standard & Poor's and Fitch ratings. A bond is considered non-investment grade (or high yield) if it has a rating of BB+ or below from Standard & Poor's and Fitch, or Ba1 or below from Moody's. A rating of "B" represents the second-highest rung of non-investment-grade credit ratings from S&P and Fitch. Investors cannot invest directly in an index.

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