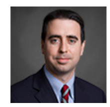
The Case for High Yield

Improved credit quality and attractive yields support the asset class.

October 2023

KEY INSIGHTS

- The global high yield market has performed well across different market cycles, thanks to high coupons and a return to par at maturity.
- Issuer fundamentals have remained resilient despite the challenging macro backdrop.
- Improved credit quality is paired with the most attractive yields available in over a decade.



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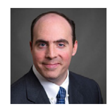

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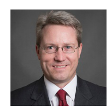

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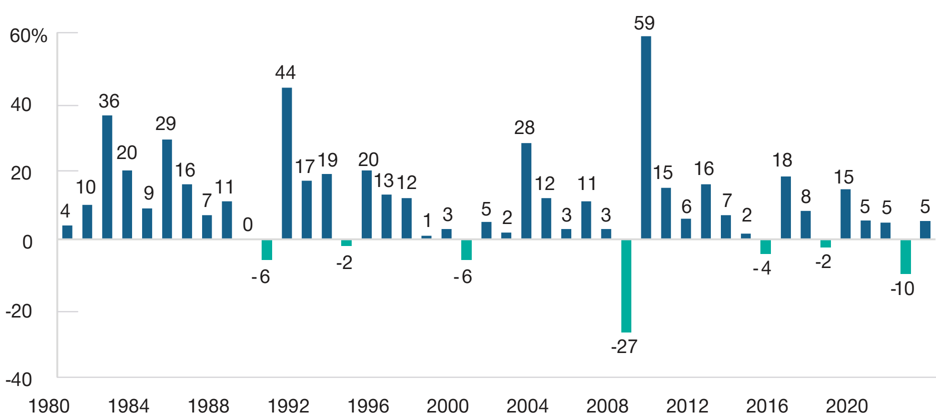
WHY HIGH YIELD BONDS?

Has Produced Durable Returns Over Time

Global high yield bonds have broadly performed favorably across different market cycles. Since 1980, the high yield market has only experienced seven calendar years of negative returns. Perhaps even more impressive is that there have never been two consecutive years of negative returns in the asset class covering 40 years (Fig. 1).

High Yield Bond Annual Returns

(Fig. 1) Only seven negative return years since 1980.



As of June 30, 2023.

Past performance is not a reliable indicator of future performance.

Source for annual returns data: J.P. Morgan Global High Yield Index. Please refer to Additional Disclosure for further source information.

Following years of negative returns, the asset class usually experienced years of either outsized gains or several years of modest returns. This resilient return pattern is simply due to "bond math." The high yield market may experience bouts of weakness, resulting in lower dollar prices; however, it still generates high coupons, and eventually bonds are pulled to par as they near maturity, fortifying the returns recovery.

Leveraged Credit Has Generated Compelling Risk-Adjusted Returns

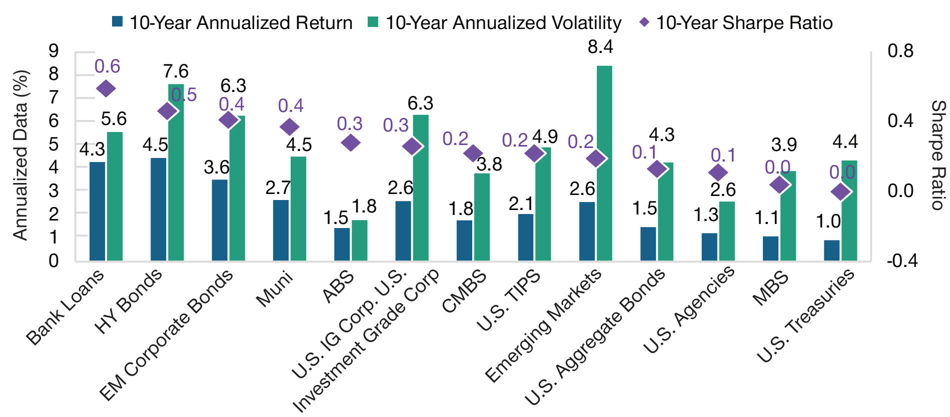
While return is certainly an important consideration when evaluating an asset class, volatility must also be evaluated. The Sharpe ratio, which measures return in excess of the risk-free rate[1], per unit of standard deviation[2], can be a useful metric to compare risk-adjusted returns across asset classes. Over the last 10 years, high yield bonds have had the second-highest risk-adjusted returns, trailing only below investment-grade bank loans (Fig. 2). Consequently, we believe that investors have been fairly compensated for the additional performance risk when moving to below investment-grade credits.

Low Default Rate Profile

Although the macro backdrop remains challenging for risk assets, high yield fundamentals continue to be resilient. Since the global financial crisis (GFC), high yield market new issuance has been dominated by refinancings as issuers capitalized on historically low interest rates. Additionally, record capital markets activity in 2020 and 2021 (post-COVID drawdown) at cheap financing rates strengthened balance sheet liquidity and increased interest coverage[3] metrics to peak levels. The high yield default rate marginally

Statistics Across the Markets

(Fig. 2) High yield compares favorably to other segments.



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Bloomberg Indices: U.S. Treasuries: US Treasury Index; Treasury Inflation-Protected Securities (TIPS): US TIPS Index; ABS: Asset-Backed Securities Index; MBS: U.S. Mortgage-Backed Securities Index; CMBS: CMBS ERISA Eligible Index; U.S. Aggregate: U.S. Aggregate Bond Index; Agencies: U.S. Agencies Index; U.S. Corp. Investment-Grade: U.S. Corporate Investment Grade Index; Muni: Municipal Index. Emerging Markets represented by J.P. Morgan Global Emerging Markets Bond Index; Emerging Corporate Bonds represented by J.P. Morgan CEMBI Broad Diversified Index; Bank Loans represented by the S&P Performing Loan Index; High Yield Bonds represented by the J.P. Morgan Global High Yield Index. Please refer to Additional Disclosure for further source information.

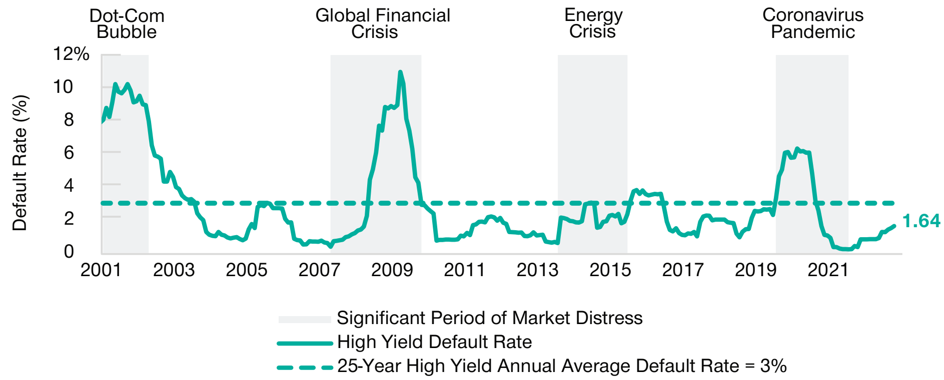
[1] Risk-free rate of return is a theoretical return of an investment with zero risk and the measure is used as a rate against which other returns are measured.

[2] Standard deviation measures historical volatility. Higher standard deviation implies greater volatility.

[3] Interest coverage measures an issuer's ability to meet its interest payment obligations.

Global High Yield Market Default Rates

(Fig. 3) Defaults are running below the historical average.



Past results are not a reliable indicator of future results. As of June 30, 2023.
Source: J.P. Morgan Chase & Co. Please refer to Additional Disclosure for further source information.

increased to 1.6% in June 2023 from 0.8% in December 2022 but remains well below its long-term average of 3% (Fig. 3).

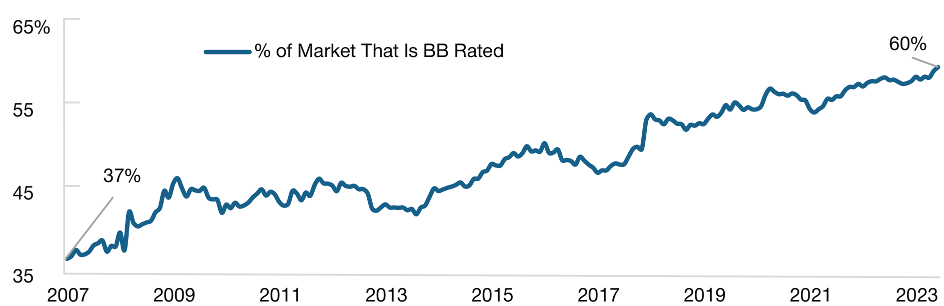
WHY HIGH YIELD BONDS NOW?

Evolution to a Higher Credit Quality Market

The current high yield market is drastically improved compared with the GFC in terms of credit quality. Using the Credit Suisse High Yield index as a proxy, the high yield market has migrated up considerably in credit quality since the GFC. In 2007, only 37% of the index had at least one BB rating; today, that figure is roughly 60% (Fig. 4). Partially the result of record fallen angel volume (USD 240 billion) entering high yield in 2020, the average company in the high yield market has a larger market cap and generates more free cash flow today than prior to the GFC. Therefore, we feel the asset class is in a position of strength should the economic outlook weaken.

BB Composition of the High Yield Market

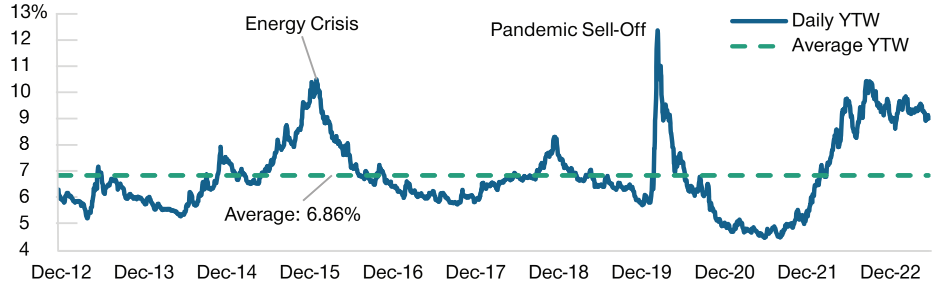
(Fig. 4) High yield credit quality has steadily improved.



As of June 30, 2023.
Source: Credit Suisse. High Yield Market is represented by the Credit Suisse High Yield Index. Please refer to Additional Disclosure for further source information
The credit ratings are based on S&P and Moody's ratings. A rating of "BB" represents the highest-rated high yield rating.

Yield to Worst of the High Yield Market

(Fig. 5) Attractive yields given higher credit quality.



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The Yield of the High Yield market is represented by the J.P Morgan Global High Yield Index.

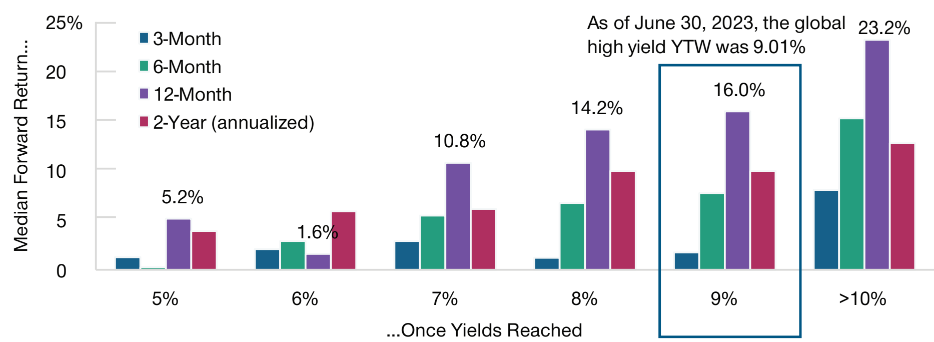
Source: J.P Morgan. Please refer to Additional Disclosure for further source information.

Today's Yields Have Rarely Been Observed Over the Last 10 Years

Rate and credit spread[4] volatility since the first quarter of 2022 have resulted in attractive yields and dollar discounts not seen since the GFC, attributed to unprecedented quantitative tightening and related recession fears. As of June 30, 2023, the yield to worst[5] on the J.P. Morgan Global High Yield Index was north of 9%. This is well above the average level of 6.86% observed over the last 10 years (Fig. 5). Considering the credit quality of the market is much higher today, the absolute yield on the asset class screens attractive, especially compared with similar dislocation levels during the energy crisis (2015–2016) and the pandemic sell-off, where both the quality and fundamentals of the market were lower than levels observed today.

Historical Global High Yield Returns Once Yields Reached Various Thresholds

(Fig. 6) History provides a baseline for similar yields.



As of June 30, 2023.

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Returns since January 1, 2012. Performance periods shown once index yields moved through the yield threshold and had not been at that level for the preceding 30 business days.

Global High Yield Market represented by the J.P. Morgan Global High Yield Index. Please refer to Additional Disclosure for further source information.

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

[5] Yield to worst is a measure of the lowest possible yield on a bond whose contract includes provisions that would allow the issuer to redeem the securities before they mature.

Yields Indicate Attractive Valuation

While we cannot predict future returns from current yields, we can use history as a baseline for when the high yield market had similar yield levels and what forward, or subsequent, returns looked like. Since 2012, the high yield market has crossed the 9% yield threshold five times. In each instance, the one-year forward return picture has been in the mid-double-digit range (Fig. 6). Since 2012, the median 12-month forward returns have been in double digits when yields in the market have exceeded 7%.

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