High Yield Bonds: Compelling Risk/Reward Trade-Off

Strong fundamentals and limited supply support high yield bonds.

June 2019

KEY INSIGHTS

- Relative to other asset classes, such as equities, high yield bonds offer attractive risk-adjusted returns given their consistency of income with a lower volatility profile.
- The attractive yield levels and generally healthy fundamentals of sub-investment-grade issuers have led us to add to the high yield bond asset class.
- Limited new supply and recent flows into the asset class provide technical support for high yield bonds.

The attractive yield levels and generally healthy fundamentals of high yield bonds have led us to add to the asset class allocation in T. Rowe Price's multi-asset portfolios, although the strong 2019 rally in sub-investment-grade bonds has eroded some of the relative value in the segment. Relative to other asset classes, such as equities, high yield bonds offer attractive risk-adjusted returns given their consistency of income with a lower volatility profile than equities.

Sub-investment-grade bonds rallied in the first four months of 2019, along with risk assets globally and declined only modestly in May, when equity markets were off more notably. For the year through May 31, U.S. high yield bonds returned 7.42% while global below investment-grade bonds gained 7.51%, one of the strongest starts to a year since the end of the global financial crisis. Credit spreads[1] on U.S. high yield bonds were 502 basis points[2] on May 31, narrower than their 567 basis points level at the end of 2018 but wider than their 2018 low.

We expect corporate defaults to remain near their current low levels over our 12-month investment horizon in the context of slowing economic growth but not a recession. In addition, limited new supply and recent flows into the asset class provide technical support for high yield bonds.

Income as a Consistent Contributor to Return

High yield bonds currently offer a yield of approximately 7%, making the asset

7%

Approximate current yield of below investment-grade bonds.

[1] Credit spreads measure the additional yield over a Treasury security with a similar maturity that investors demand to hold a bond with credit risk.
[2] A basis point is 0.01 percentage points.

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>
> — **Charles Shriver**
> *Asset Allocation Committee Co-chair and Multi-Asset Portfolio Manager*

class a compelling source of income. The income from high yield bonds can provide a consistent contribution to total return, which can be beneficial in a more turbulent market environment.

While return patterns of high yield bonds and equities can be correlated, high yield returns are generally about half as volatile as equity returns, although this figure can increase in adverse markets. "With equity market valuations currently at or above long-term averages, equity returns will likely be driven more by earnings growth than valuation multiple expansion," says Charles Shriver, multi-asset portfolio manager and co-chair of the Asset Allocation Committee. "Consensus estimates are for U.S. earnings growth in the low- to mid-single-digit range in 2019, which is consistent with a low-growth economy but not a recession. As a consequence, return expectations for equities are fairly comparable to current yields on high yield bonds.

"While we may not see additional spread tightening since high yield valuations are in line with to slightly expensive relative to historical averages, we believe that steady income from the sector supports a reasonable risk/reward trade-off," explains Shriver. "In addition to valuations, our asset allocation process takes into consideration where we are in the economic cycle and the credit or earnings cycle, which suggest a measured addition to high yield bonds."

Solid Cash Flows Lead to Low Default Rates

Currently, high yield issuers generally have good fundamentals that position them well to generate the cash flow needed to meet their debt obligations as the lower U.S. tax rates enacted in early 2018 continue to have a beneficial impact on many issuers' financial health. In contrast, equities, which are more sensitive to future earnings growth, face a headwind as year-over-year earnings growth comparisons are more challenging given the boost to 2018 earnings levels from tax cuts. High yield bond investors tend to prioritize cash flows over earnings growth when analyzing debt, and this remains a supportive factor.

In sectors related to commodities, high yield issuers have become more aware of their balance sheet strength compared with 2015 and 2016 after the price of oil dropped precipitously. Their capital allocation is now more disciplined. Although commodities prices have rebounded, issuers in the energy and metals and mining sectors are now largely able to withstand another downturn in oil prices. The energy-related sectors account for a larger portion of high yield benchmark indexes than investment-grade corporate bond benchmarks, so this trend has had a much more pronounced effect on the sub-investment-grade market.

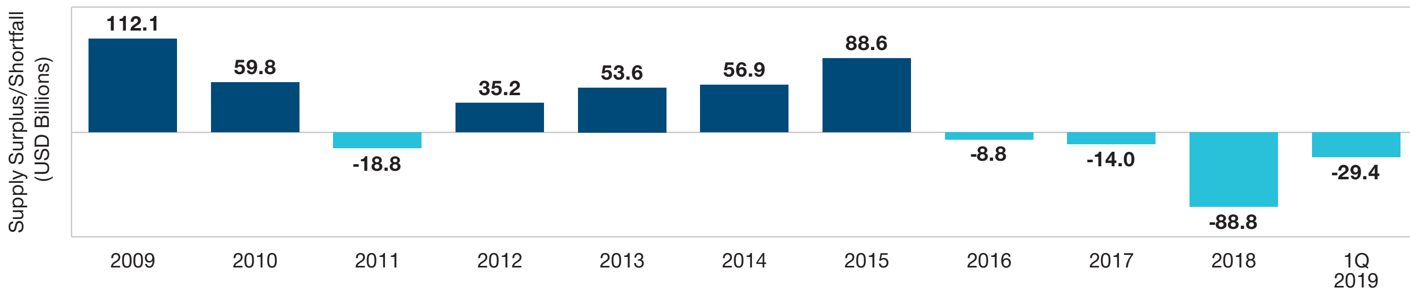
As a result of these fundamental improvements, the high yield bond default rate in 2018 was 1.8%, meaningfully lower than the 20-year average of 3.2%. "A default rate of about 1.0% is probably the structural minimum because there is always a low level of idiosyncratic defaults," explains Rodney Rayburn, high yield bond portfolio manager. "Absent a recession, upticks in the default rate can be confined to a particular industry, as evidenced by the 10.9% retail sector default rate last year."

While high yield does have several sector concentrations, the asset class provides a more diversified exposure to individual credit risk than other higher-risk fixed income sectors, such as emerging markets debt, which is susceptible to investor concerns about large sovereign issuers like Argentina and Turkey. "Fundamental credit research is instrumental to investing in high yield bonds as a source of adding value through evaluating mispriced credits or identifying underappreciated risks," adds Shriver. "It also contributes to increased confidence in our ability to hold our positions through the cycle."

(Fig. 1) High Yield Supply Shortage Is a Tailwind

High yield bond supply surplus or shortfall[1]

As of March 31, 2019



Source: J.P. Morgan (see Additional Disclosures).

[1] The high yield supply surplus or shortfall accounts for gross new issuance, calls, tenders, and maturities; credit rating changes that move bonds into or out of the high yield category; and coupon reinvestments (at 75%) and mutual fund flows.

> …about 60% of new issuance is now for refinancing, which extends maturities and removes the risk of a looming maturity wall.
>
> — **Rodney Rayburn**
> *High Yield Bond Portfolio Manager*

Limited Issuance Supports Market

From a technical point of view, a notable decrease in the volume of new high yield bond issuance is supporting the market. Gross new issuance in 2018 was USD 187.4 billion, a steep drop from USD 328.1 billion in 2017. Calls and maturities also remove debt from the opportunity set. Although, industry wide, high yield bond mutual funds experienced USD 46.9 billion in outflows last year, the 2019 rally in the asset class attracted USD 12.6 billion of inflows in the first quarter. Less supply coupled with increased demand has created a high yield supply shortfall[3] of USD -88.8 billion in 2018 and USD -29.4 billion in the first quarter of this year.

In addition to the technical shortfall, the overall credit quality of the asset class has improved over the last 10 years, with more issuers migrating up to BB and split BB[4] than down into the CCC category. Further, the use of proceeds from new issuance continues to support the health of the market. "New issuance in the high yield market today is much less likely to be used for new leveraged buyout funding," says Mr. Rayburn. "In fact, about 60% of new issuance is now for refinancing, which extends maturities and removes the risk of a looming maturity wall."

Attractive Risk/Reward Trade-Off Offsets Risks

While these fundamental and technical factors are supporting the high yield bond market, we are also aware that there are significant risks that could undermine our favorable view of the asset class. The most meaningful is probably a recession that occurs within the next 12 months, whether induced by a Fed policy error—overtightening rates in a slowing economy—or other issues. The ongoing trade tensions between the U.S. and China, which currently do not appear likely to dissipate soon, could also hurt investor sentiment toward risk assets, including below investment-grade bonds. However, even taking these risks into consideration, we believe that high yield bonds are well-positioned to generate attractive yield with less volatility than equities.

[3] The high yield supply shortfall accounts for gross new issuance, calls, tenders, and maturities; credit rating changes that move bonds into or out of the high yield category; and coupon reinvestments (at 75%) and mutual fund flows.

[4] BB rating from one credit rating agency and B rating from another.

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