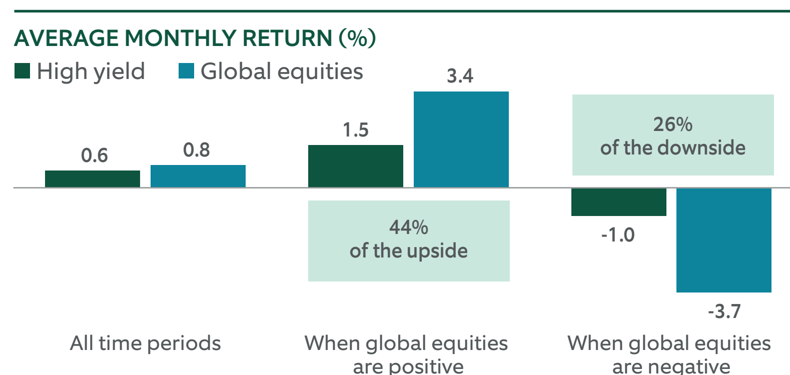
High-Yield Bonds: Gaining Traction for Good Reason

High-yield bonds have become an increasingly popular investment choice. At Northern Trust Asset Management, we strongly believe this asset class is positioned to continue delivering the strong performance seen in the first half of 2024.

This favourable trend is rooted in a notable confluence of solid fundamentals, low default risk, and strong performance relative to equities in volatile markets. In addition to their capacity as a yield-producing mainstay, high-yield bonds can help investors optimize portfolio diversification given their resilience during periods of equity decline. The asymmetrical return profile of high yield, when compared to equities (see chart), demonstrates the capture of a considerable portion of positive market gains but only a limited portion of equities' downside volatility, historically providing equity like returns without the equity like volatility over the full market cycle.



Source: Northern Trust Asset Management, Bloomberg. Data from 29/01/1993 to 30/06/2024. Global equities: MSCI ACWI Index; high yield: Bloomberg High Yield 2% Issuer Cap Index. Returns reflect the reinvestment of dividends and other earnings and are shown before the deduction of investment management fees, unless indicated otherwise. Returns of the indexes also do not typically reflect the deduction of investment management fees, trading costs or other expenses. It is not possible to invest directly in an index. Indexes are the property of their respective owners, all rights reserved. Past performance is not indicative or a guarantee of future results.

Strong Fundamentals Fuel Investor Appetite

Today's high-yield market offers higher credit quality than a decade ago, a consequence of the improved fundamentals which further support the case for a lower expectation of defaults vs historical averages. As of June 30, 2024, more than half of the high-yield market (51%) consisted of BB-rated bonds (up from 41% 10 years ago), with 37% B-rated, and 11% CCC-rated bonds (compared to 41% and 17% respectively 10 years ago)[1]. Furthermore, the size of the market, regarding the number of bonds in the high-yield universe, is at an all-time high.

The Portion of the Market in Distress is Low

While current rates on high-yield bonds are high, we expect default rates to be low. As a consequence of strong fundamentals and strong corporate balance sheets, the high-yield market's default outlook is notably benign. Treasurers continue to make tremendous progress in pushing out their maturity profile, thereby reducing near-term risks. In general, markets are open for most companies, and as a result, corporate distress levels remains low.

Further to this supportive environment of low default rates and opportunity for volatility in equity markets, we believe high yield presents a compelling case for strong risk-adjusted total returns. High yield spreads have exhibited a very low level of volatility on a year to date basis and reside at the tighter end of the spread range over the last couple of years. At the aggregate level, many investors may be curious as to the opportunity set available to them with all-in spreads hovering around 300 basis points. Given the outperformance of the asset class relative to other assets, it is clear that the consistent income generation that it affords is a major influence on investors.

Higher Interest Coverage & Lower Leverage in the High-Yield Market

Interest coverage ratios remain strong thanks to stronger earnings that look set to continue (5-5.75% in 2023), with leverage remaining well below historic peaks since 2011. Only 12% of the high-yield universe has debt maturing in the next two years. Approximately 40% of debt maturing between 2024 and 2026 has been refinanced over the last year. This has been the most rapid debt extension in history, providing attractive opportunities for investors to capture potential returns.

Conclusion

The era of ultra- low interest rates which, coupled with improved fiscal responsibility, allowed corporate bond issuers to shore up their balance sheets. As a result, their ability to cover interest with earnings is strong, and debt accumulation by companies is restrained, potentially helping to avoid defaults or mitigate losses if default does occur. The markets are welcoming for issuers looking to term out their debt, and there is little near-term need for refinancing by the more vulnerable issuers. Meanwhile, strong U.S. nominal growth supports a stable economic backdrop, allowing investors to explore opportunities with strategic security selection and practical portfolio construction.

The conditions described above make a compelling case for including a high-yield allocation in investor portfolios. The attraction of high yields and potential for strong total returns, coupled with lower volatility compared to other risk assets, remains significant.

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[1]Bloomberg U.S. Corporate High Yield Bond Index (2% Issuer Capped), as of 30/06/2024

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