Manulife Investment Management

Investment Note

14 Sept 2022

Yields have moved quickly in many areas of the bond market this year, but particularly among high-yield bonds. Does that make high yield an attractive area for investment, or should we read it as a sign flashing “recession risk ahead”? Caryn E. Rothman, Senior Portfolio Manager, Head of Global Credit, makes a brief case for the fundamental stability—and usefulness—of the asset class, even in the face of recession.

The high-yield market isn’t signaling a recession

Investors today are facing a series of potentially long-term shifts, including structurally higher inflation, rapidly rising interest rates, and amplified volatility. These are concerning issues for both equity investors and investors in fixed income.

For example, through the first half of 2022, high-yield bonds underwent a high-velocity adjustment that was painful for investors in the asset class. Spreads—or the difference in yield between high-yield bonds and U.S. Treasuries of similar maturity— widened from 343 basis points (bps) at the start of April to 587bps by the end of June, leapfrogging the 10-year average spread of 451bps.

Market levels continued to change dramatically, as spreads then tightened back toward the long-term average in July’s market rally. Because bond yields move inversely to prices, the first half’s rapid spread widening reflected an equally rapid deflation of bond prices, leading to declines in many investors’ portfolios and causing companies that issue high-yield debt to put a hold on further issuance.

How should we read today's rapid moves in bond yields?

Effective yield (%) of the high-yield market

Source: Bloomberg and Manulife Investment Management. Data from July 31, 2012, to July 31, 2022. Data is based on the ICE (Intercontinental Exchange) BofA (Bank of America) U.S. High Yield Index, which tracks the performance of below-investment-grade U.S. dollar-denominated corporate bonds publicly issued in the U.S. domestic market and includes issues with a credit rating of BBB or below. It is not possible to invest directly in an index.

The lack of fresh issuance today may actually reflect another long-standing shift in corporate debt refinancing, as companies may collectively be gaining an ability to fund operations without tapping the high-yield market. That in itself could be a sign of corporate strength rather than weakness.

But the question on many investors’ minds—particularly those who didn’t wait around for July’s high-yield market rally—is whether the first half’s high-yield performance pullback means there’s something rotten in the high-yield market.

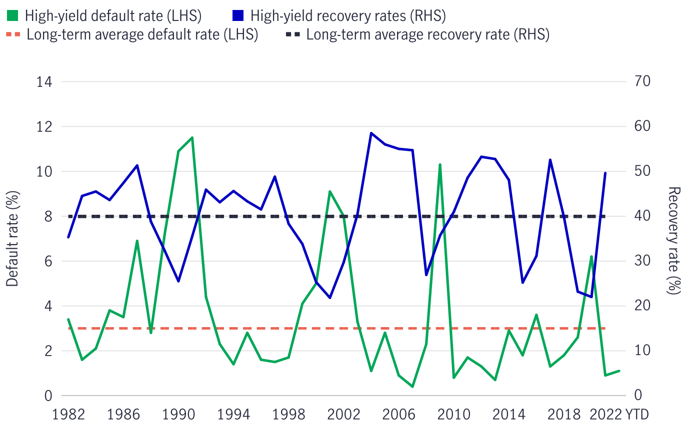
Credit risks isn’t the problem

On the contrary, we think investors should be looking past today's volatility to find enduring investment opportunity in high yield bonds.

From a credit risk perspective, two key data series suggest strength rather than weakness is readily found among high-yield issuers. We think this is particularly true for higher-quality tranches of debt. The high-yield default rate, which measures the momentum of corporate failure to repay debt, is currently at multidecade lows, while the recovery rate, which measures the ability of investors to recoup capital from defaulting issuers, is above its long-term average.

While market observers may've read spread widening as an indicator of economic trouble ahead, we didn’t see a meltdown being priced into higher-quality segments of the below-investment-grade market in the recent pullback.

High-yield defaults are low while recovery rates are high by historical standards



Source: JPMorgan, June 30, 2022. Default rate year-to-date (YTD) data through June 30, 2022. LHS refers to left-hand side. RHS refers to right-hand side.

If a recession were to materialize down the road, we’d certainly expect this gap to close; that defaults would tick up while recovery rates would come down. But we also think that this would be felt most acutely in the lowest-rated segments of the high- yield market—and possibly not at all in the higher-quality segments. In our view, many of the better-quality examples among traditional issuers of high-yield debt, particularly in information technology to name one relevant sector, have the strength and the pricing power to weather today’s inflation-driven market disruption.

High-yield bonds are less affected by interest-rate changes versus popular bond indexes

This backdrop of historically low defaults and high recovery rates is remarkable given the recent period of pandemic-induced economic disruption, but it’s also remarkable considering the interest-rate environment in 2022. Interest rates have surged this year, largely as a result of the U.S. Federal Reserve’s attempts to put a ceiling on inflation. Against this backdrop, fixed-income investors face two problems: Fixed- coupon bonds will produce subpar yields as long as rates continue to rise, and the buying power of debt-generated income will fall so long as inflation can’t be reined in.

For this reason, bond duration matters a great deal. And because high-yield bonds aren’t long duration assets, their sensitivity to changes in interest rates is lower than that of other fixed-income asset types, such as investment-grade corporate bonds or a broad benchmark like the Bloomberg U.S. Aggregate Bond Index (the U.S. Agg). Furthermore, today’s effective yield of roughly 7.5% exceeds long-term stock market returns, but high-yield bonds have historically delivered lower volatility than equities across market cycles.

Higher-yield bonds have shorter duration than many other fixed income assets

Fixed-income segment	Effective duration (years)
U.S. high-yield bonds	4.24
Corporate bonds	7.41
Broad U.S. fixed-income market	6.38
International bonds	7.02

Source: Bloomberg, as of July 31, 2022. High-yield bonds are represented by the ICE BofA U.S. High Yield Index, which tracks the performance of below-investment-grade U.S. dollar-denominated corporate bonds publicly issued in the U.S. domestic market and includes issues with a credit rating of BBB or below. Corporate bonds are represented by the Bloomberg U.S. Corporate Index, which tracks the performance of the investment-grade, U.S. dollar-denominated, fixed-rate, taxable corporate bond market. The broad U.S. fixed-income market is represented by the Bloomberg U.S. Aggregate Bond Index, which tracks the performance of U.S. investment-grade bonds in government, asset-backed, and corporate debt markets. International corporate bonds are represented by the Bloomberg Global Aggregate Bond Index, which tracks the performance of global investment-grade debt in fixed-rate treasury, government-related, corporate, and securitized bond markets. It is not possible to invest directly in an index.

The diversifying power of high-yield bonds

While no one can be 100% correct in their forecast of the performance of any asset class, we can investigate the data and draw reasonable conclusions about how investors may inadvertently be exposing their portfolios to outsize levels of risk. Broad- based indexes such as the U.S. Agg account for a huge proportion of investors' fixed- income portfolios, which implies generally high exposure to interest-rate risk and a history of negative performance under conditions in which rates have risen.

The overwhelming investment risk today isn't an issue stemming from credit fundamentals, in our view. There's no financial alchemy in the system that's particularly concerning to us; no over-levered bank exposures to frothy real estate markets that we can see. While yields will continue to fluctuate around sentiment related to the risk of recession, we continue to think high yield is very much worth consideration given the backdrop of higher effective yields and the long-term risk-adjusted return potential for income-seeking investors.

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