

# High Yield Bonds – In The “Sweet Spot”

FIXED INCOME INSIGHTS – FEBRUARY 2023



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## KEY TAKEAWAYS

- > In our opinion, high yield bonds offer investors an attractive risk/reward profile compared to other asset classes – higher income potential than investment grade corporate bonds and historically less volatility than equities
- > With the run-up in yields over the past year, the prospects for income generation in high yield bonds have improved
- > At current dollar prices, high yield bonds also have the potential for capital appreciation

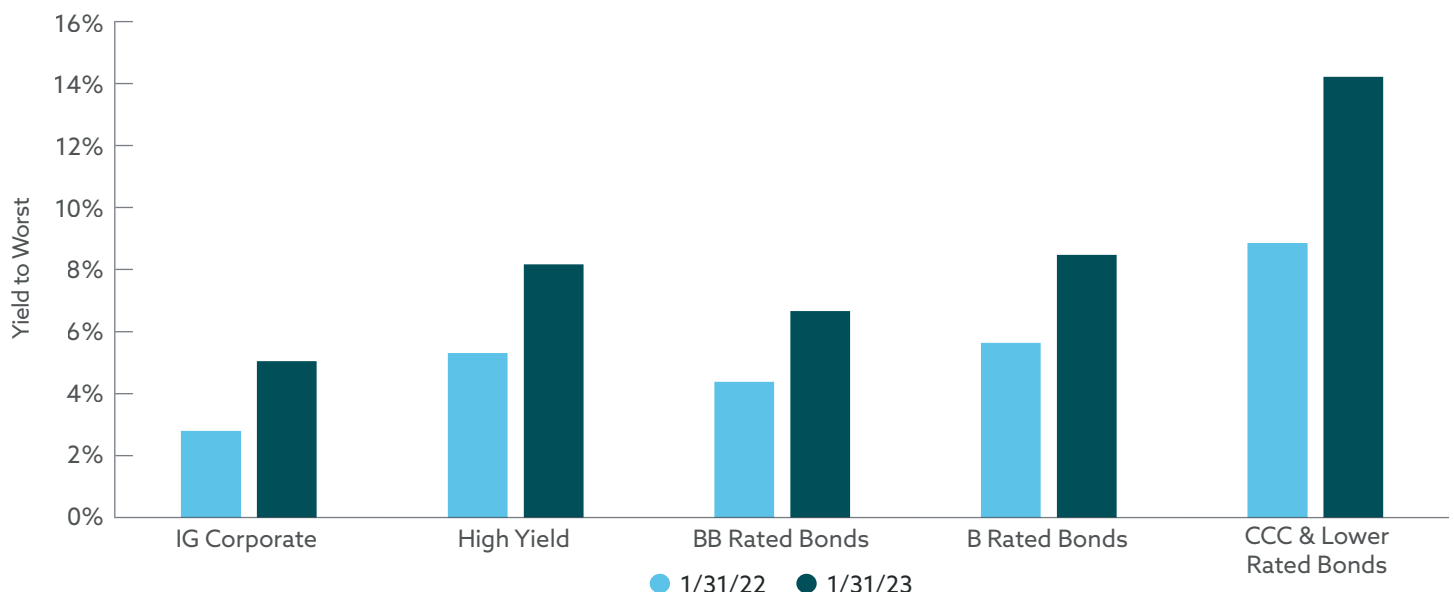
After a tumultuous 2022 which saw double-digit losses in both fixed income and equity markets, many investors likely entered the new year understandably cautious.<sup>1</sup> The push-and-pull between the Federal Reserve's (Fed) policy actions to combat inflation and the market's

expectations continues, while growth concerns and a possible recession remain macro headwinds. Given current market conditions, investors may need to look for opportunities that strike the right risk/reward balance. High yield bonds can offer an attractive blend with potential for higher income than investment grade corporate bonds and historically lower standard deviations when compared to equities.

## HIGHER YIELDS LEADING TO HIGHER INCOME POTENTIAL

One outcome of the Fed Funds rate increase has been the rise in yields across fixed income asset classes, especially high yield bonds. Even after recent compression, the yield to worst of the ICE BofA US High Yield Index (HY Index) has risen from 5.31% a year ago to 8.17% as of January 31, an increase of 2.86%.<sup>2</sup> Lower-rated bonds have led the way with CCC & Lower yielding 14.22% as of January 31, up 5.36% YoY; B at 8.47%, up 2.84% YoY; and BB at 6.66%, up 2.28% YoY. As a comparison, yields for investment grade corporate bonds are at 5.05%, up 2.25% from a year earlier.

## YIELDS NEAR DECADE HIGHS IN HIGH YIELD BONDS<sup>2</sup>

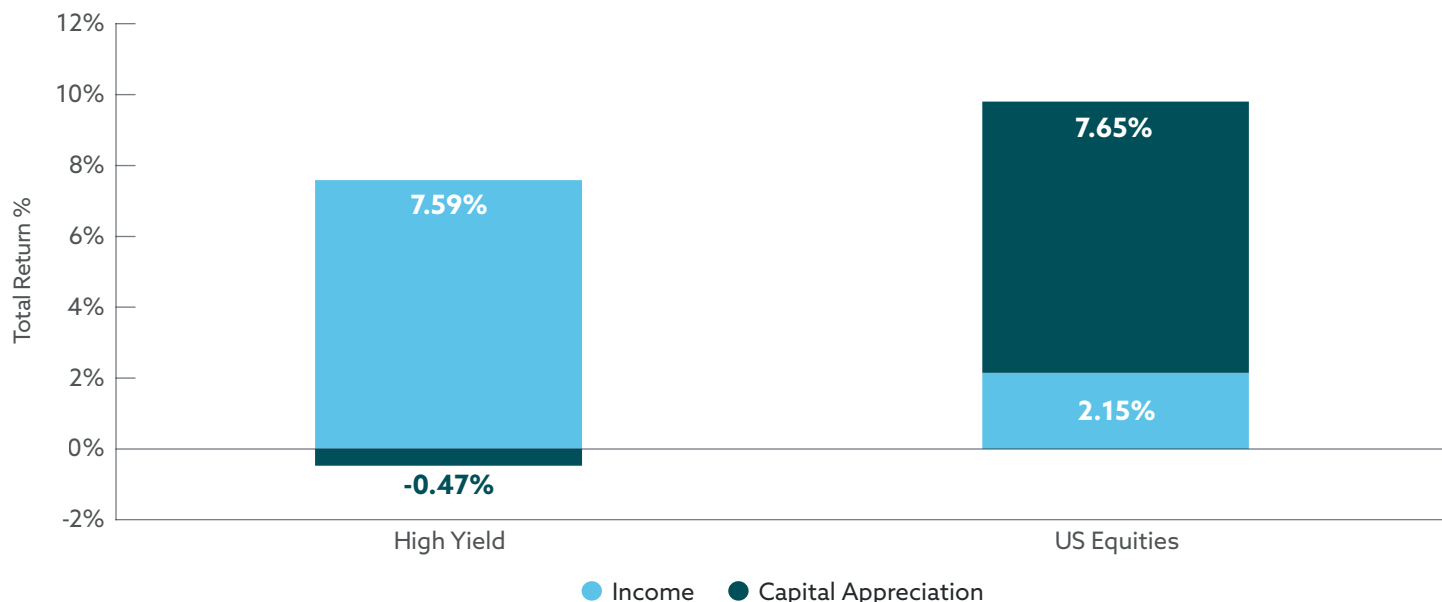


(1) As of 13 February 2023. Unless otherwise stated, the information presented has been prepared from market observations and other sources believed in good faith to be reliable. Information and opinions expressed by PPM are current as of the date indicated and are subject to change without notice. Past performance is no guarantee of future results. Forward-looking statements are subject to uncertainties that could cause actual developments and results to differ materially from the expectations expressed. (2) ICE Data Services. Yields for the ICE BofA US Corporate Bond Index, ICE BofA US High Yield Index and its rating categories. 1 February 2023.

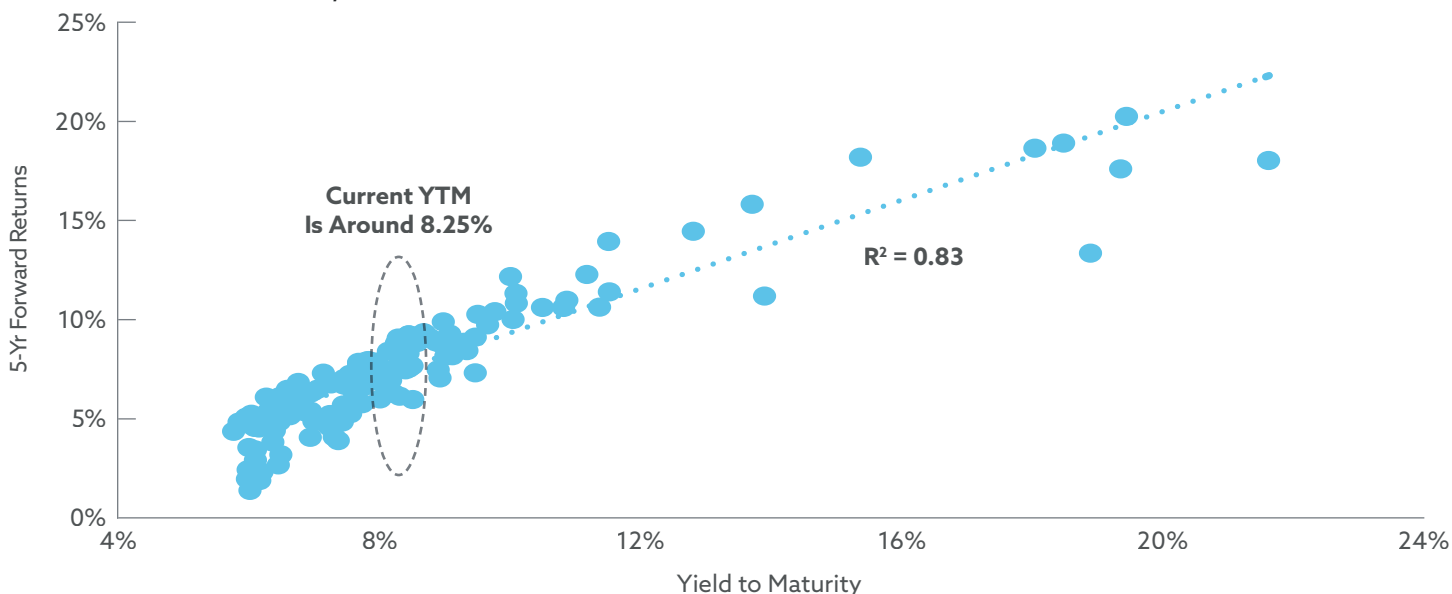
Why may this be important to investors? Coupon income and yields at the time of investment are typically much larger long-term drivers of total return than capital appreciation in the high yield bond market than for equities. Looking at the contribution to annualized returns of the HY Index and the S&P 500 over the past 20 years, this difference becomes more clear (see chart below). Now, with the run-up in yields over the past year, the prospects for income generation have improved significantly in high yield.

Another way to illustrate the above point is by comparing the 5-year forward returns of the HY Index to yields at the time of investment. From 2005 onward, the forward returns have been closely tied to starting yields, as evident by an R-squared value of 0.83 (statistically speaking, a value above 0.7 indicates a strong correlation with 1.0 representing a direct correlation).<sup>4</sup> As such, investors may do well to take advantage of the current elevated yields in the high yield market (8.17% for the HY Index), which rival historical returns in the stock market (9.80%).<sup>2,3</sup>

### INCOME ACTS AS THE PRIMARY SOURCE OF FIXED INCOME RETURNS<sup>3</sup>



### SINCE 2005, STARTING YIELDS AND FORWARD RETURNS ARE CLOSELY CORRELATED<sup>4</sup>



(3) Morningstar Direct. High Yield as represented by the ICE BofA US High Yield Index and US Equities as represented by the S&P 500 Index. Annualized returns from January 1, 2003, to December 31, 2022. Income return was estimated by subtracting price return (capital appreciation) of the index from total return of the index. This measurement is approximate in order to demonstrate the difference in components of return for high yield bonds. Past performance is no guarantee of future results. (4) ICE Data Services, Morningstar. Monthly yields and 5-year forward returns for the ICE BofA US High Yield Index from January 2005 through December 2018. Past performance is no guarantee of future results.

## INCOME-DRIVEN RETURNS TYPICALLY COME WITH LOWER VOLATILITY

With financial markets facing continued macroeconomic pressures, considering the performance per unit of risk can be important when determining a proper allocation of assets. High yield bonds achieve the bulk of their returns through their coupon payments and are historically less volatile than stocks. In fact, the standard deviation of high yield bonds over the past 20 years (9.1%) is closer to investment grade corporate bonds (6.1%) than equities (14.8%).<sup>5</sup>

## THE POTENTIAL UPSIDE OF LOWER BOND PRICES

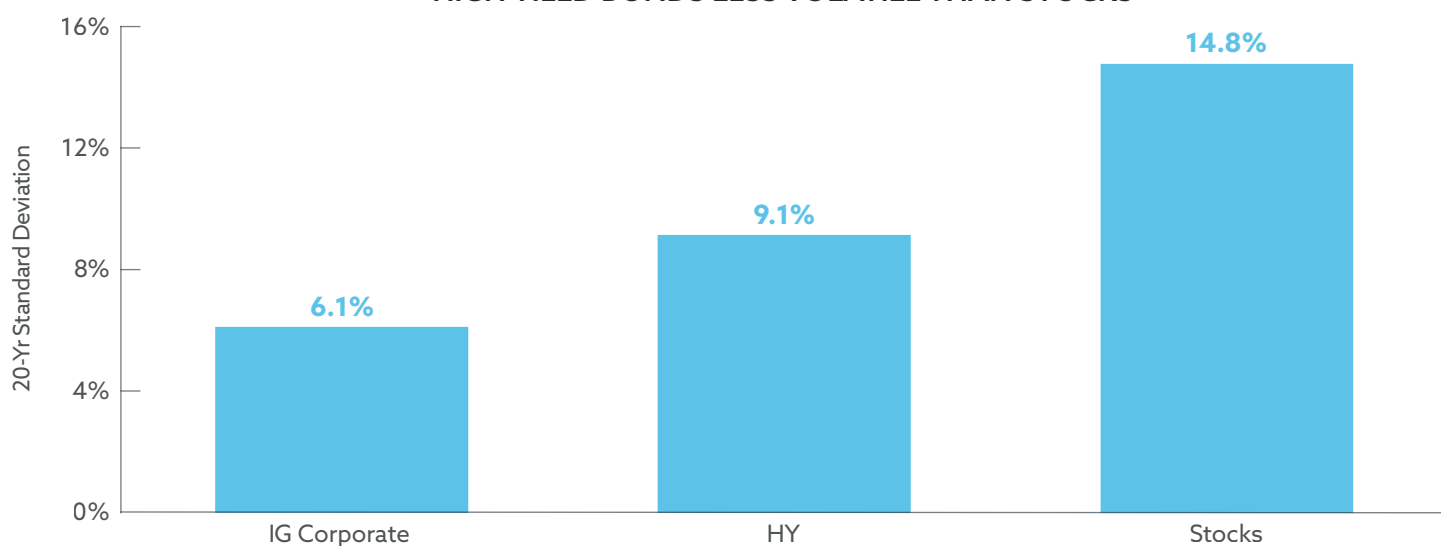
Still, we believe investors should not overlook dollar prices in today's high yield market and how that may provide better upside returns and more downside protection. The

price of the HY Index sits at 88.93 as of January 31, with a total return 7.31% since July 2022, the month after it initially traded below 90. Since the Global Financial Crisis in 2008, the HY Index has previously traded below 90 twice, averaging a 1-year total return of 20.40% following the month the HY Index crossed that threshold.<sup>6</sup>

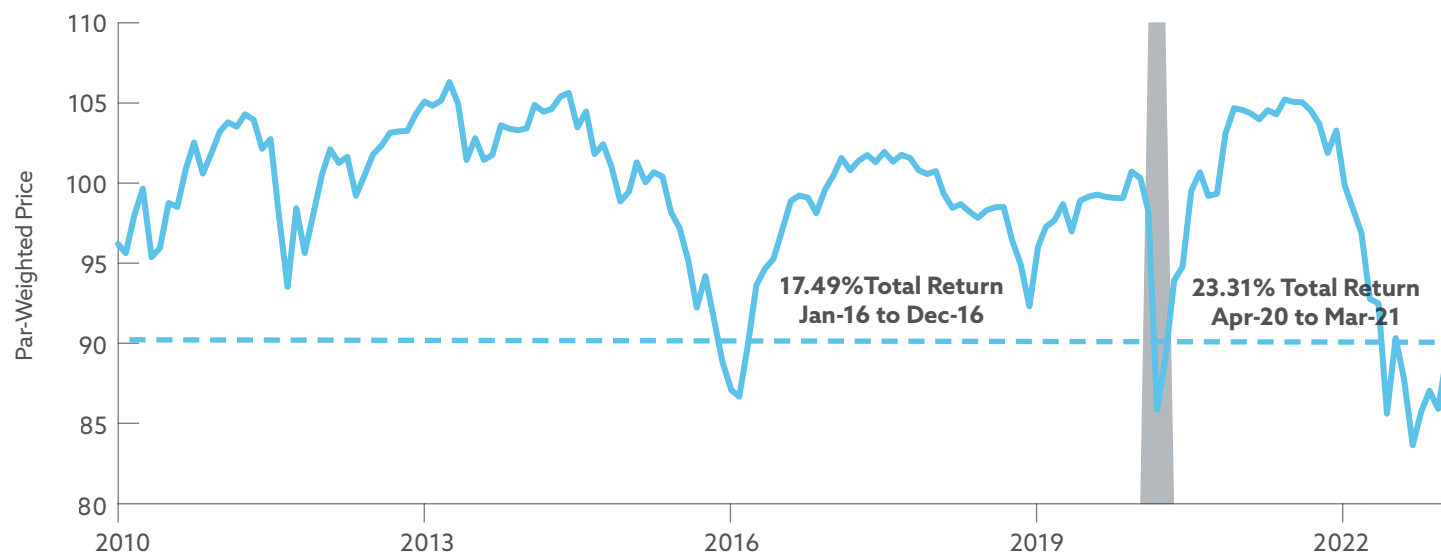
## CONCLUSION

In our view, high yield bonds currently sit in a "sweet spot" between higher-rated corporate bonds and equities. They offer more income potential than the former but with historically less risk than the latter. For this reason, investors may want to consider this asset class as an alternative to the more volatile stock market while still achieving their income goals.

### HIGH YIELD BONDS LESS VOLATILE THAN STOCKS<sup>5</sup>



### CURRENT HIGH YIELD PRICES COULD PROVIDE UPSIDE<sup>6,7</sup>



(5) Morningstar. 20-year standard deviations through December 31, 2022, for the ICE BofA US Corporate Bond Index, the ICE BofA US High Yield Index and the S&P 500 Index. (6) ICE Data Services. Total returns of the ICE BofA US High Yield Bond Index. Past performance is no guarantee of future results. (7) ICE Data Services. Monthly price of the ICE BofA US High Yield Index through 31 January 2023. Gray band represents the 2020 US recession. Past performance is no guarantee of future results.

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The **ICE BofA US Corporate Bond Index** provides a broad measure of the USD-denominated investment grade corporate debt securities publicly issued in the US domestic market.

The **ICE BofA US High Yield Index** provides a broad measure of below investment grade, USD-denominated fixed rate corporate debt. It includes corporate bonds with risk exposures to countries that are members of the FX-G10, Western Europe or territories of the US and Western Europe.

The **S&P 500 Index** provides a broad, market capitalization-weighted measure of US large cap stocks. It includes approximately 500 publicly-traded stocks of the largest US companies.

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