M&G Public Fixed Income

What next for global high yield bonds?

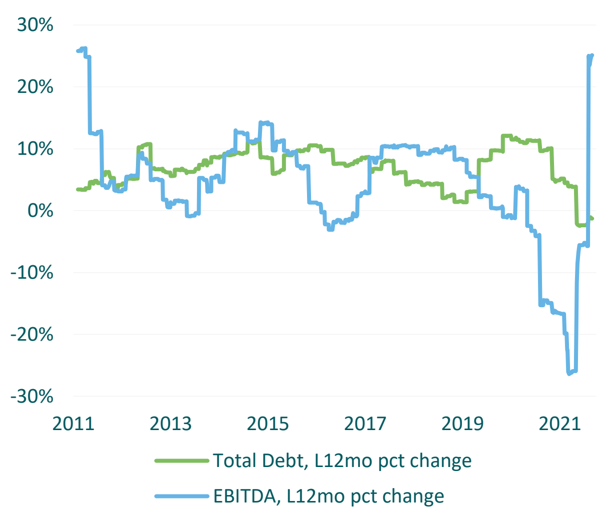
December 2021

- Despite the doomsayers, we think the global economic recovery remains on track; in our view, underlying corporate fundamentals remain solid for many high yield (HY) bond issuers, backed up by record low levels of defaults.
- Could this be encouraging news for investors looking for an element of inflation-proofing and the positive real yields the HY asset class can offer, or are current bond valuations a significant stumbling block?
- Global HY bonds have been more effective than investment grade (IG) bonds at absorbing the threat of higher inflation and interest rates year-to-date, but credit spreads have continued tightening for much of 2021, posing a valuation conundrum for fixed income investors.

Strong corporate fundamentals

The recent quarterly earnings season has again highlighted just how strong the underlying recovery remains for many companies around the world, including for many high yield bond issuers. Third-quarter earnings were generally quite strong across the board, following on from a blockbuster second quarter, despite many firms having to digest rising input costs and navigate supply chain blockages. Rising inflation so far has been compensated for by strong revenue growth, and the margin compression that many had feared has not materialised yet. Clearly there are risks investors need to be aware of from here, some of which we will address later in this piece. But provided there is no sting in the recovery tail, we are able to outline several reasons why we think the current environment could bode well for investors favouring HY exposure.

Figure 1. US HY issuers' total debt vs EBITDA (last 12m % change)



Past performance is not a guide to future performance.

Source: ICE Bank of America HY Global Credit chartbook, September 2021. Universe represented by ICE BofA US High Yield Index.

Examining current total debt levels among US HY issuers and their 12-month earnings (EBITDA) growth (Figure 1) highlights just how resilient the earnings recovery continues to be, while at the same time, total outstanding liabilities have fallen significantly.

The drop in net leverage among HY issuers demonstrates the extent of the balance sheet repairs that have been carried out, following several consecutive quarters of improvement. Furthermore, in the US, refinancing activity and earnings momentum have pushed the interest coverage ratio to 4.7x – well above the 2020 lows.

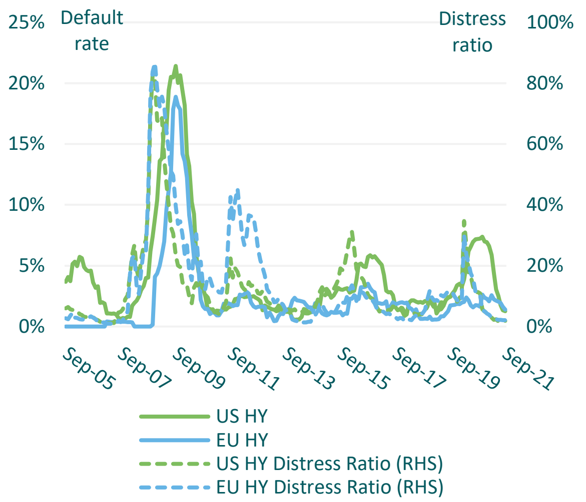
Record low default rates

According to data from Credit Suisse (October 2021) the US HY default rate has plummeted to 1.8%, from last year's peak of 6.6% thanks to good funding conditions and the strength of the economic recovery. In fact, there had been no defaults in the US market between the early summer of this year and November, taking the annual default rate to its lowest level since 2007, if energy names are excluded. It's a similar story in Europe, where the default rate has dropped to 0.8%. Clearly the picture isn't so rosy in Asia, where several defaults occurred in October as the fallout from the troubled Chinese property sector began to spread. However, providing contagion risk remains limited outside of the property market, as appears to be the case so far, then we think the benign environment for corporate defaults should continue be a supportive for global HY credit spreads.

Many high yield issuers have used the current environment to carry out liability management, extending maturity walls out over several years. A good demonstration of the underlying health of many corporates in the HY space is perhaps best reflected in the HY distress ratio[1]. The distress ratio among issuers in the US and Europe HY markets (Figure 2) remains low and has been on a gently declining trend since last year. An increase in the number of distressed issuers tends to be a leading indicator of defaults (typically with a six to 12-month lag). We saw this play out recently during the COVID-19 crisis, when a rise in the distress ratio was followed by an increase in the default rate a few months later. Increased balance sheet prudence among issuers and the low-default environment are both factors that should continue to support the underlying health of the global HY market, in our opinion.

The elephant in the room: valuations

Figure 2. US and European high yield default cycles



Source: ICE Bank of America HY Global Credit chartbook, September 2021. Universe represented by ICE BofA US High Yield Index.

Clearly, we must acknowledge that a fair amount of the positive noises in the HY space has been baked into bond valuations already. However, given the ongoing strength of the post-pandemic recovery, and the degree of protection offered by the asset class in a high inflation environment, current valuations seem broadly justified, in our opinion. There are risks circling the asset class, not least the threat of a potential stagflation (low growth, high inflation) environment which could threaten HY issuers whose business models restrict their ability to pass on higher energy price rises (and other input cost increases) as easily as companies in the IG space. However, the financial health of most households remains exceptionally strong, and we expect consumer spending to help keep global economic growth buoyant well into 2022, supporting bond issuer fundamentals.

[1] Percentage of bond issuers in the index trading with credit spreads over 1000 basis points.

Are there opportunities in this market?

We believe there are several ways in which active credit investors can adapt to this environment and use strategies to seek to add value:

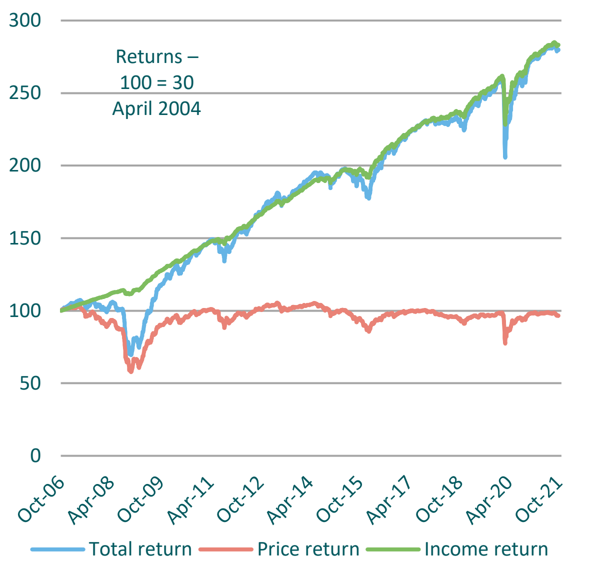
- **Rising Stars** – while 2020 was all about the wave of 'fallen angels' – investment-grade issuers dropping into the high yield rating cohort as much of the world went into lockdown – 2021 has been about upgrades, or so-called 'rising stars'. The US HY market, for example, has seen US$50bn worth of upgrades year-to-date, only 27% of last year's fallen angel volume of US$184bn. This leaves a significant slice of the market with the potential to be upgraded over the next 18 months. Correctly identifying these issuers early could give active managers the chance of picking up some valuable relative performance points. We expect more volume to leave the HY index via the upgrade path, including some significant index constituents.

- **Individual credit selection** – Inflation fears, supply bottlenecks and recovery-correlated sectors are presenting some interesting opportunities and challenges for active bond investors as we move through the final phase of the recovery. The ability to identify companies and sub-sectors that are better shielded from inflation cost pressures has the potential to reward active managers from here. Similarly, a focus on companies that can intensify their deleveraging strategies could help active managers identify bonds issuers that offer lower credit risk, and therefore potentially more resilient future bond prices.

- The **income-generating qualities** of high yield bonds are a frequently overlooked part of the asset class, in our opinion. While movements in credit spreads can have a significant impact on short-term valuations, income has historically been the main driver of high yield returns over the long term (Figure 3). While yields have continued to fall this year, the ICE BofA Global High Yield Index currently offers an effective yield of 5.1%. We believe these income streams can help to smooth overall investment returns and reduce volatility in the asset class.

- **Market technicals** – are still present and generally favourable, although less favourable than last year. The global "hunt for yield" continues, but has been diminished by rising rates recently. Bond supply and

Figure 3. Components of HY total return over time



Past performance is not a guide to future performance.

Source: M&G, Bloomberg, BofA Merrill Lynch Indices. 31 October 2021. Chart data represented by the ICE BoA Global High Yield Index.

demand dynamics remain generally stable – this year's record HY new issuance (US$427bn year-to-date to November) has been absorbed mainly by still-positive inflows into the asset class.

Summary

The benign default outlook across many sectors, combined with improving HY company fundamentals on a backdrop of growing expectations that most developed market central banks will soon tighten monetary policy, indicate to us that HY bonds could continue to offer a potentially attractive way for investors to help mitigate the risks to their portfolios from rising interest rate and inflation.

We expect default rates to remain low, as the benign funding conditions of the last 12 months have allowed many issuers to reduce funding costs and carry out balance sheet repairs. The sustained improvement in the global economic environment and favourable funding conditions, if they are to go on, should continue to be supportive for high yield, in our view, if corporate earnings continue to recover and balance sheet metrics improve.

However, we must acknowledge that credit spreads have continued to rally and are now sitting at historically tight levels, potentially pricing in too much good news in some areas of the market. We maintain our view of not taking on excessive credit risk, particularly following the start of the withdrawal of monetary stimulus from the US Fed, as announced in October.

With investors increasingly nervous about a market correction, high yield markets have continued to rally on the back of improving fundamentals, relatively attractive income level and lower interest rate sensitivity. In this environment, an active and risk-controlled investment approach to the asset class remains crucial, in our opinion.

Investments in bonds are affected by interest rates, inflation and credit ratings. It is possible that bond issuers will not pay interest or return the capital. All of these events can reduce the value of bonds held by the fund.

High yield bonds usually carry greater risk that the bond issuers may not be able to pay interest or return the capital.

The views expressed in this document should not be taken as a recommendation, advice or forecast.

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