High Yield – a fulcrum between greed and fear?

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February 2023

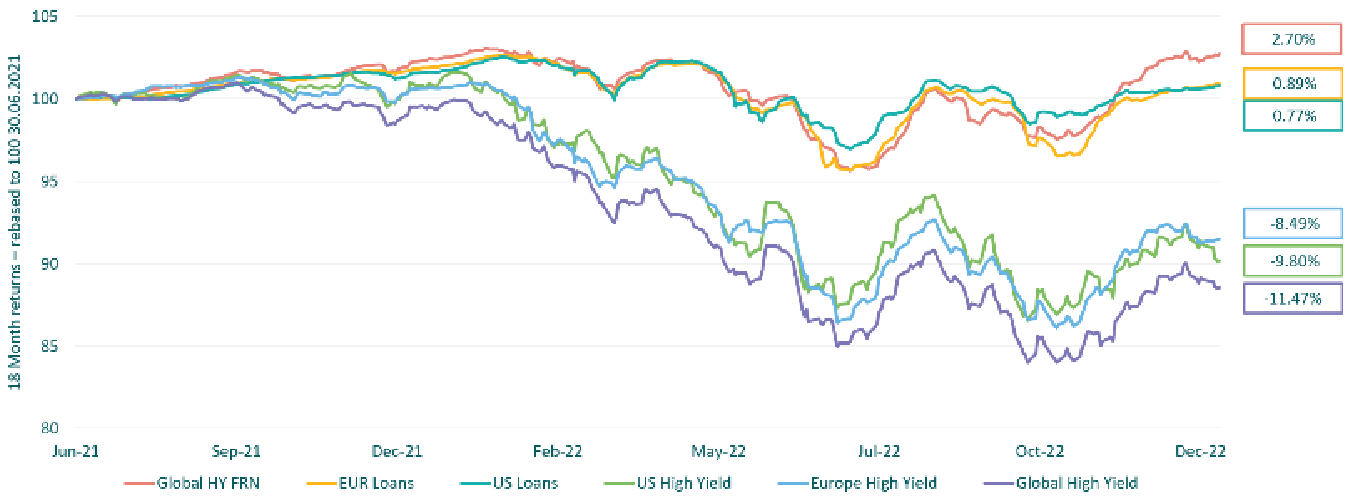
Last year was a brutal one for fixed income markets, although floating rate high yield credit was a notable bright spot and proved remarkably resilient. While conventional fixed rate high yield bonds sold off sharply, HY floating rate notes (FRNs) and European and US loans held up well and were able to generate a small positive return over the year.

Floating rate high yield – a source of resilience in 2022

A key factor driving the relative outperformance of FRNs and leveraged loans over their fixed counterparts in 2022 (see Figure 1) was their lack of interest rate duration – as floating rate instruments, their coupons are automatically adjusted in line with short-term interest rates. They were therefore well insulated from the turbulence in government markets as the Federal Reserve pushed ahead with its rate hiking agenda.

Figure 1. Performance review – floating rate vs fixed rate high yield

Past performance is not a guide to future performance



Source: ICE Bank of America Indices, 31 December 2022. Index performance shown 100% hedged to USD. Global HY: ICE BoA Global High Yield Index. Global HY FRN: ICE BofA Global Floating Rate High Yield 3% Constrained (USD Hedged) Index. US HY: ICE BoA US High Yield Index. Europe HY: ICE BoA European High Yield Index. European loans: Credit Suisse Western European Leveraged Loan Index 3 year DM. US loans: Credit Suisse Leveraged Loan Index 3 year DM

Floating rate HY bonds also benefited from their senior-secured characteristics, which provides them with a strong claim on a company's assets in a default scenario. As a result, recovery rates tend to be materially higher compared to unsecured bonds. To reflect this lower credit risk, senior secured bonds are generally more resilient in a rising default environment, and this proved the case in 2022.

Yield without duration – a useful asset for these times

Looking across the menu of fixed income assets, we think floating rate HY currently offers one of the most attractive yield-to-duration ratios, providing an elevated income stream but with minimal levels of interest rate risk. Floating rate HY may therefore appeal to investors who think the interest rate cycle has a bit further to run. Indeed, we would argue that we are still in the early phases of the rate hiking cycle in Europe and the UK, where inflation remains near 40-year highs.

Even for those expecting an early Fed pivot, we believe this has already been partly priced in given the recent rally in longer-term rates. While switching to longer duration bonds may prove fruitful when rate cuts are finally back on the agenda, it is notoriously difficult to get the timing right – we would argue that floating rate assets remove the guesswork and allow investors to capture an attractive credit premium without being exposed to further volatility in interest rates.

Figure 2. Floating rate credit – yield without duration

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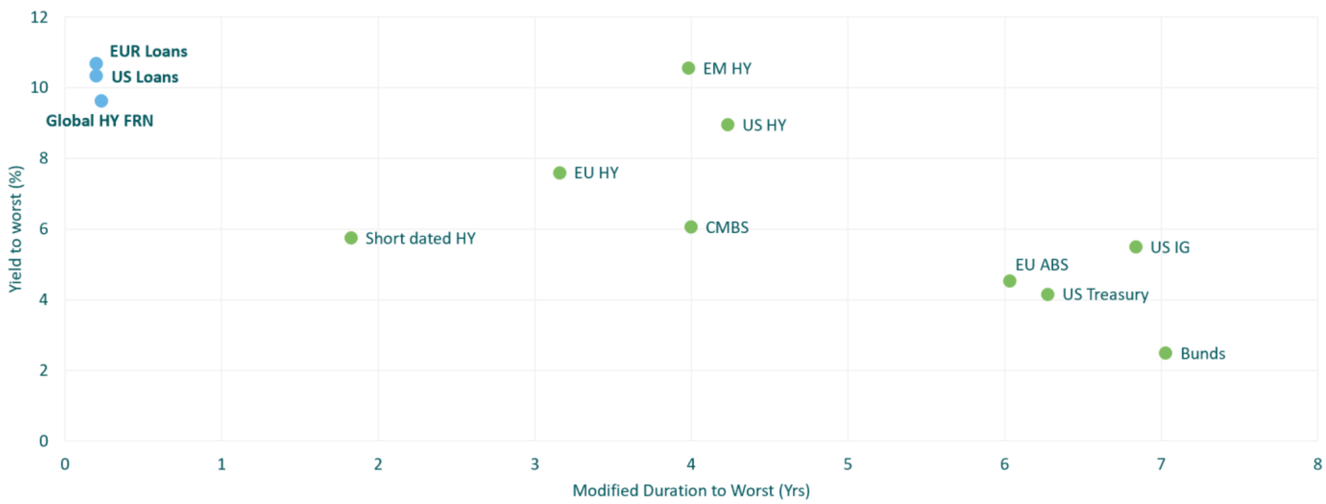

Source: M&G, Bloomberg, 31 December 2022. Global HY FRN: ICE BoA Global Floating Rate High Yield (3% Constrained) Index. US HY: ICE BoA US High Yield Index. Europe HY: ICE BoA European High Yield Index. Short Duration HY: ICE 1-3 Year US Corporate & HY Index. EM HY: ICE BoA HY US Emerging Markets Corporate Plus Index. CMBS: ICE BoA US Fixed Rate CMBS Index. EU ABS: ICE BoA Euro Asset Backed & MBS Index. UST: ICE BoA US Treasury Index. US IG: ICE BoA US Corporate Index. Bunds: ICE BoA German Govt Index.

Capturing an attractive income stream

We currently see good value in floating rate HY where spreads remain significantly wider than their long-term average. This is in contrast to conventional HY, where spreads have rallied strongly in recent months and no longer look especially cheap, in our opinion. We think this disparity reflects some dislocation in the high yield market, but we see potential for floating rate HY spreads to compress from current levels as fundamentals come back into play.

We also believe investors are being well-compensated to take credit risk. While defaults are expected to rise, we do not think they will do so to anything like the extent that is currently priced in. Moreover, we would expect defaults to be concentrated in certain sectors where we remain wary, such as consumer cyclicals and real estate. We therefore continue to focus on more defensive sectors where cashflows should be more resilient in a downturn, such as healthcare, education and telecom companies. In times like these, being an active, selective investor and not buying the market is even more important, in our view.

Figure 3. HY floating rate spreads significantly wider than long-term average

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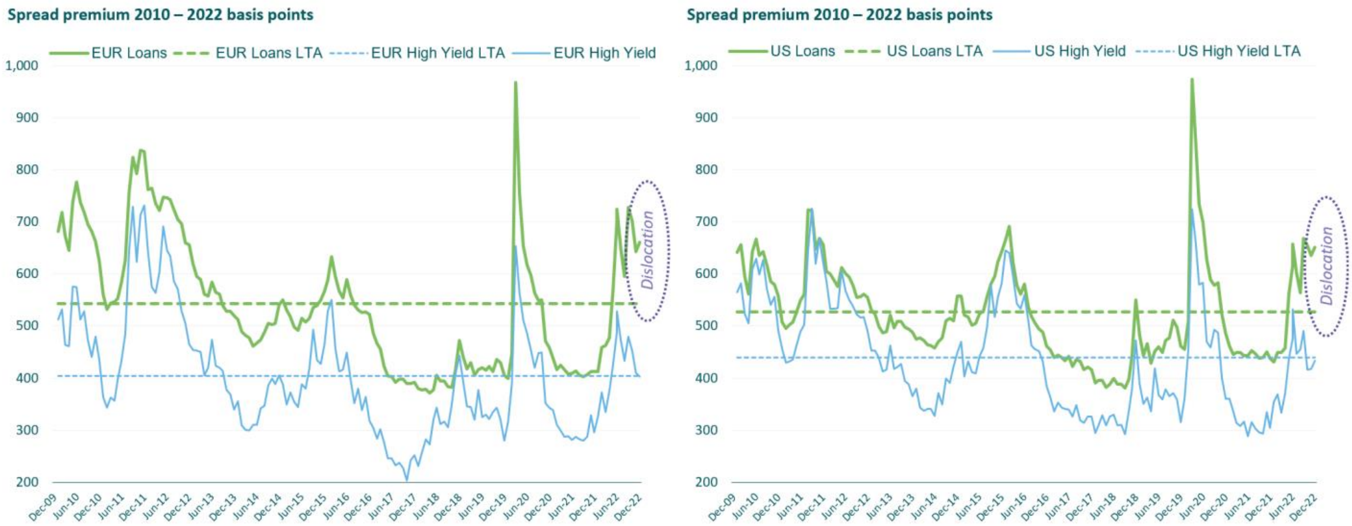

Sources: European loans: Credit Suisse Western European Leveraged Loan Index 3 year DM; European HY: ICE BofA European Currency Non-Financial High Yield 2% Constrained Index Asset Spread, as at 31 December 2022. LTA =Long-term average. US loans: Credit Suisse Leveraged Loan Index 3 year DM; US HY: ICE BofA US High Yield Index Asset Spread, as at 31 December 2022

Elevated yields provide a cushion against market turbulence

After years of ultra-low interest rates, we believe floating rate HY offers an attractive source of income and a strong cushion against any further period of market turbulence. Thanks to its lack of interest rate duration and senior-secured properties, floating rate HY as an asset class demonstrated its resilience in 2022. By providing yield with effectively no interest rate risk, floating rate HY will, we believe, continue to serve a useful role within a fixed income portfolio. Moreover, while conventional fixed rate HY markets have rallied strongly in the past few months, the floating rate HY market has lagged and we believe this currently represents a value opportunity for fixed income allocators.

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

The value and income from a fund's assets will go down as well as up. This will cause the value of your investment to fall as well as rise and you may get back less than you originally invested. Where any performance is mentioned, please note that past performance is not a guide to future performance.

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