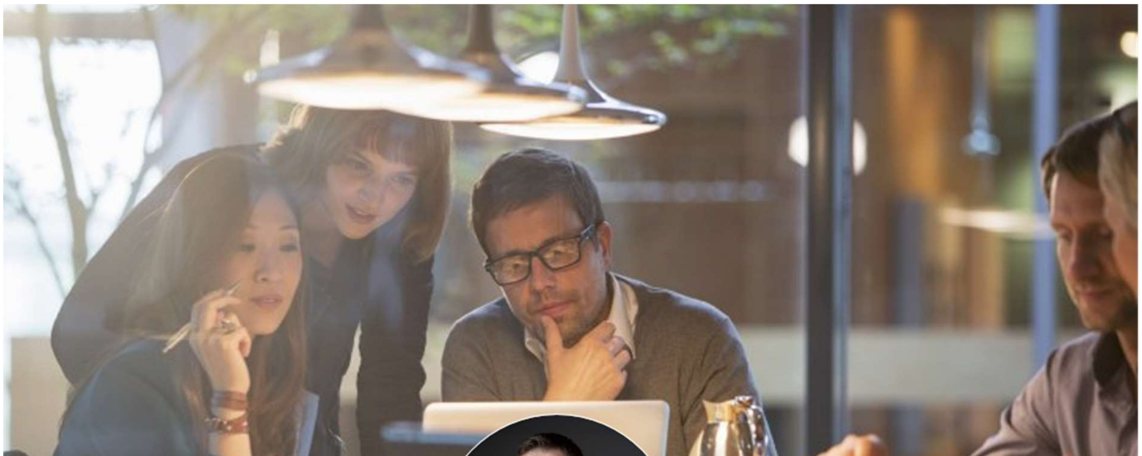
The incredible health of High Yield bonds

20 August 2020



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IN A WORD:

Valuations have become high. Even though central banks remain supportive, a little caution is needed in view of future risks.

A powerful rebound

High Yield bonds performed remarkably in July despite newsflow dominated by Covid-19 and lingering concerns about the strength of the economic recovery: +4.7% in the United States, almost the best monthly performance over the past ten years, and +1.7% in the eurozone. Year-to-date, the performance of High Yield bonds remains negative in the eurozone (-2.6%) and has turned positive in the US (+0.8%).

A particularly active US primary market

By mid-August, issuance volumes had already surpassed all other August records. The bond issue by Ball Corporation, an American company specialising in metal packaging (e.g. cans, aerosols) and rated BB+ by S&P, i.e. the best rating in the High Yield category, spilt a lot of ink. This is indeed the first time in history that a High Yield company has issued a 10-year bond with a yield below 3% (2.875% in this case).

Support from governments and central banks

Investors have rushed to buy High Yield in their search for decent returns, reassured by announcements of government support and the safety net offered by central banks. Indeed, the US Federal Reserve announced on 23 March that it was planning to buy High Yield debt in order to boost liquidity: ETFs initially, and then at a later stage, single lines, known as "fallen angels", i.e. bonds initially issued as Investment Grade but downgraded to High Yield in the wake of the health crisis. In the end, the signal sent to the market was enough and the Federal Reserve did not have to buy any significant amounts. This support programme has been extended to the end of the year. As for the European Central Bank, it has always refused to intervene directly in the High Yield market segment, but nevertheless has supported fallen angel bonds by accepting them as collateral. The risk of Italian debt being downgraded to High Yield has also played a role.

Valuations are now high

The market value of High Yield bonds is at its highest, both in the eurozone and in the US. Risk premiums have declined significantly in the eurozone and even more so in the United States. Yield spreads over government bonds have retraced roughly 75% since their peak in the eurozone and 85% in the United States and are now at 4.36% and 4.86% respectively. In fact, the average yield is 4.5% in the eurozone and 5.5% in the United States. Some valuation models suggest spreads could tighten further as equity volatility (VIX) has plummeted significantly more. However, current spread levels suggest future default rates of around 6-8%, well below what rating agencies expect. Moody's, for example, expects a default rate of 13% within the next 12 months.

Our view

Even if opportunities exist with some issuers, we prefer to keep a neutral view on the High Yield asset class. Average yields are attractive compared with other asset classes and central banks remain supportive by guaranteeing low rates over the long term that will allow companies to continue to refinance themselves at a low cost. However, corporate credit fundamentals have deteriorated and central banks cannot solve solvency problems. In addition, geopolitical risks (Sino-US trade tensions, US elections) and the health crisis are likely to intensify at the end of the summer. This could lead to an increase in volatility and doubts about the strength of the economic recovery, which in turn could weigh on High Yield bond prices, at a time when valuations are already high. Moreover, the liquidity of this asset class tends to dry up rapidly during periods of stress, thereby amplifying downward movements.

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