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As portfolios adjust to protect against a drag in performance from rising rates and inflationary concerns, investors increasingly find themselves in the hunt for income. We believe they would do well to consider an exposure to high yield bonds – an asset class with low duration risk, low projected levels of defaults, comfortable levels of liquidity, and rising yields driven by dramatically improving valuations.

Inflation – the widowmaker of bond markets?

Not necessarily. When investors see inflation on the horizon the kneejerk reaction is often to rapidly steer the ship away from fixed income assets. However, for high yield bonds, continued inflation – as long as it can be passed on – should, ironically, act as a tailwind. For example, more recently, we have seen inflation benefitting sub-investment grade rated issuers income statements, particularly in energy.

That said, when inflation can no longer be passed on, it is a potential problem. However, our base case scenario right now is that the current inflationary environment should be a constructive one for high yield assets.

In addition, if we see a slowing in inflation, and rates adjust tighter that backdrop would be constructive for credit markets. Looking at European markets, such a scenario could well play out. The bond market is currently anticipating a steady rise in European Central Bank (ECB) interest rates, and we expect them to front-load rate hikes into year end to a peak of 1.5%. However, after that the ECB will struggle to raise rates further with the economy in recession and medium-term inflation forecasts likely to be revised lower.

Interest rates – headwind or performance driver?

Interest rates affect all markets and high yield is no exception, but because this asset class is so much shorter in duration versus, for example, investment grade, rising rates are far less impactful, meaning that investors should see a yield pick-up from a high yield exposure over core fixed income.

Looking ahead at the potential impact of US monetary policy - if the Federal Reserve (Fed) limited interest rates the resulting impact on the performance of high yield would depend on why they limited it.

In the scenario where the Fed slows because inflation comes down while GDP and employment remain high, then high yield should thrive. However, if it slows because it hiked rates too dramatically and shocked markets causing a recession, then the reverse could happen and high yield would suffer. However, even if this scenario were to play out, I would argue that high yield balance sheets are in much better shape today than they have been during any other recession in my lifetime.

Lower issuance levels = less liquidity?

Similar to how inflation is not necessarily the death knell for all fixed income assets, nor do lower issuance levels always result in reduced levels of market liquidity.

It should go without saying that investors should always consider liquidity in any market, but – case and point – the lack of supply in high yield markets is actually a positive technical for the asset class, resulting from the lack of need to refinance. We would go so far as arguing that despite comparatively reduced levels of issuance, high yield is actually more liquid today than it was 2-3 years ago.

But what about rising default rates?

The level of unprecedented events and volatility that we have witnessed this year have been unquestionably high. Within credit, you don't have to scratch the surface too hard to find a drumbeat of assertion that with this backdrop of volatility and market shocks, there will be bankruptcies to come; that companies will fail to sufficiently support the debt burdens that they have taken on.

This is perhaps true, and we anticipate that default levels will likely triple from where they currently sit. However, they are coming from an incredibly low base. When your leverage loan default rate is 1.1%, high yield defaults could triple to 3.3%, but this would equate to half of where they were during the Covid crisis.

Whisper it quietly – medium-term valuations are relatively attractive

With the yield-to-worst on global HY markets above 8.5% and spreads hovering around 550bps, we are historically at compelling valuations that usually generate positive returns on a three- and five-year horizon, even if spreads widen further.

Given the current backdrop of low defaults, low duration, high income and greater liquidity in comparison to other higher risk fixed income assets such as direct lending, securitized credit and broadly syndicated loans, we are expecting the positive flows trend towards high yield to continue for the remainder of 2022 and well into 2023.

Now is the time for high yield.

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