5 factors shaping high yield returns

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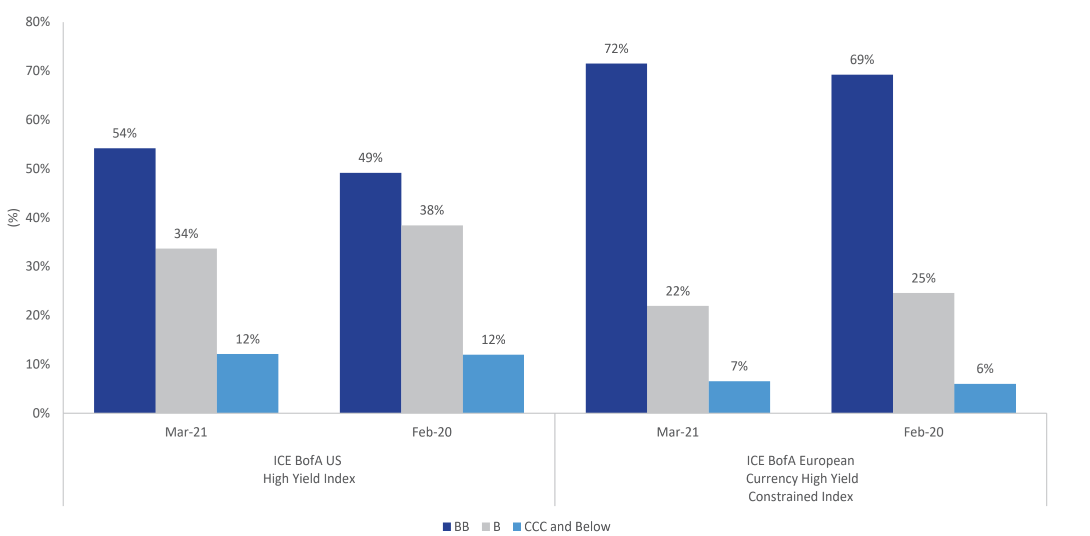
With credit quality improving despite the challenging macro environment, here's what we think could drive (or diverge) market performance as we move towards mid-year.

1. Fundamentals

The high yield (HY) universe is better rated today than it has been for a long time. Comparing the credit quality breakdown today versus pre-pandemic levels in both Europe and the US, we see an increase in BB-rated bonds, while CCC levels remain broadly unchanged. The result is an improvement in the underlying asset quality of the universe in the eyes of the rating agencies.

CREDIT QUALITY BREAKDOWN OF THE US & EUROPEAN HY INDICES



Source: BoA Global Markets, Bloomberg as at 31 March 2021. Note: US HY refers to ICE BofA US High Yield Index and European HY refers to ICE BofA European Currency High Yield Constrained Index. For illustrative purposes only. There is no assurance that any of the trends depicted or described herein will continue.

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2. Monetary policy

Markets are extrapolating a healthy recovery and starting to guess when policy support will be reduced.

With this, we expect to see a more normalised monetary policy framework and potential uncertainty regarding what happens to underlying rate curves. For HY investors, we view this as a mild concern, not a structural one.

When looking across the fixed income opportunity set, HY is relatively short duration and high yielding. Therefore, we believe it is more able to absorb the kind of normalisation of the rate curve that may occur in the US over the next 24 months than any other fixed income asset class.

From our perspective, monetary policy is not to be feared as a source of negative returns, more something to be aware of as a source of possible volatility which could influence portfolio positioning.

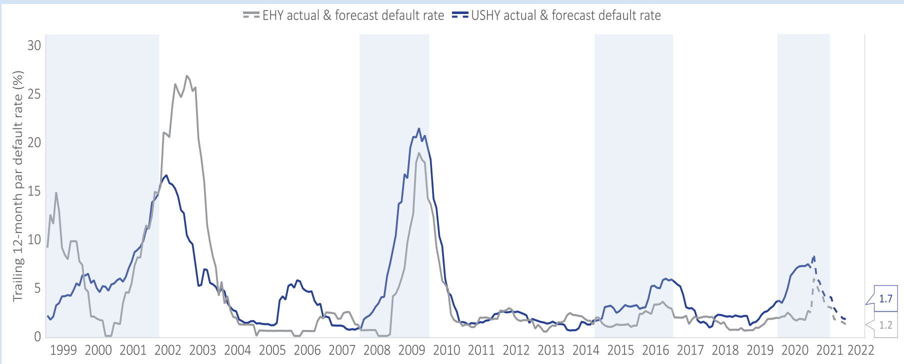
Why has credit quality improved given everything that's going on?

In 2020, markets suffered such a substantial shock that two things happened.

First, we saw a notable number of defaults in the US – around 7%. This liquidity shock washed the weakest issuers out of the HY universe. What's left are the better-rated credits, partly as we saw so many fallen angels.

Second, these fallen angels – former investment-grade rated issuers – are often large companies with diversified end-markets with ample scope to recover in line with the economic rebound and be re-upgraded to investment-grade. Known as 'rising stars', these credits can prove fruitful potential return generators for high yield investors.

US AND EUROPEAN HY ACTUAL & MARKET-IMPLIED FORWARD DEFAULT RATES



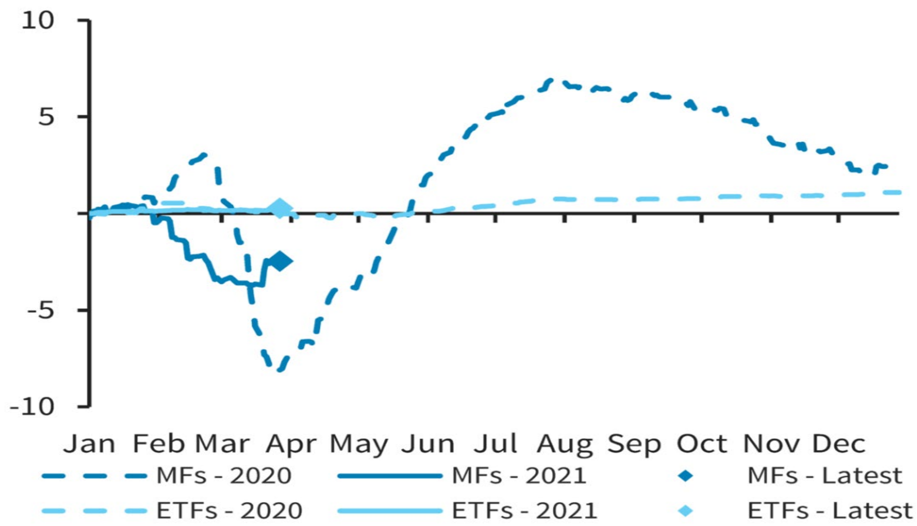
Source: BoA; BlueBay Asset Management; latest monthly data for March 2021. Note: shaded columns denote trough to peak annual default cycle according to Moody's. ICE BoA US High Yield index (H0A0) and ICE BoA Euro High Yield index (HP00) trailing 12-month part default rate; implied forward default rate derived from distress ratio (share of bonds trading 1000+bps) with a 9-month lag (R2=0.72 and 0.5 for USHY and EHY respectively).

3. Technicals

Today's environment is broadly supportive for HY flows over the medium-term, as investors need to find ways to deliver 'safe income' in a world where there are no real safe assets. With default rates expected to be low, HY has the potential to deliver positive real returns.

We expect the recovery in portfolio flows to continue, particularly given duration is in the 3.5–3.75 year range, meaning HY is not particularly sensitive to a rising interest rate environment.

GLOBAL HIGH YIELD FLOWS (USD BN)



Source: Barclays, Lipper as at 1 April 2021. For illustrative purposes only. There is no assurance that any of the trends depicted or described herein will continue.

4. Policy & politics

Policy outlook is a key area that separates the US and European HY markets.

In 2020, we looked to the US as leading with an early recovery and a robust vaccine programme, which has come to fruition with a spring 2021 re-opening and an accelerated economic recovery.

We're now tilting towards Europe on the basis there is less scope for policy shock and inflationary impulse and therefore spreads and yields (which have lagged a little) now offer more value than in the US.

Our general expectation for central bank normalisation is a slow-burn process and one which is unlikely to be disruptive to the HY market during the course of 2021.

5. Idiosyncratic risks

We're seeing pockets of value in the recovery section of the market. We're focusing our research on names that struggled through 2020 but have spread compression and higher return potential this year because of the promising recovery trajectory.

More broadly, HY doesn't have a lot of exposure to sectors that could be structurally challenged (like retail shopping malls), it is mostly end-markets that have experienced a temporary blip as a consequence of government policy. As such, we're seeing performance potential in pent-up demand and economic re-opening stories.

Our H2 2021 view

Our outlook is neutral – things are broadly fine in HY. We're not in an environment where valuations are highly compelling, but we're seeing potential for good yields, good spreads and gradual improvement over the course of the year.

In the context of a very challenging yield environment with limited real return opportunities, we believe HY stands out against other fixed income sectors.

Global Asset Management

BlueBay Asset Management