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Asset Management

Healthy high yield market offers attractive entry point

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High yield bonds have fared well amidst broad, risk-on market appetite. Yet even with lending standards set to remain significantly tighter for longer, the outlook for the asset class still looks favourable, says Justin Jewell.

Markets were in a tricky place last year, but an economy that has essentially found its feet amidst falling inflationary pressures has given investors more confidence to say they've seen the worst of the policy challenges.

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Meanwhile, headwinds such as a deterioration in credit quality or weakness in the economy, along with potential tailwinds like multiple Federal Reserve interest rate cuts, would broadly balance out and are unlikely to move the dial meaningfully one way or the other.

Investors are back in a world that is about accumulating income from high yielding assets. As a result of last year's much higher starting yields for high yield bonds, the asset class now offers attractive compensation for the risk of spread or rate shocks over the medium term. Investors can realistically expect yields of 7-9% compared to two or three years ago.

Defaults could pose challenges

The largest external challenge is what's happening in the real economy and the policy mix it brings, because rates have been such a powerful driver over the last couple of years. Within the asset class, however, there are challenges at the tail of the market.

Back in 2021 and 2022 defaults were near zero. The challenge that slightly detracts from returns over the next couple of years is that defaults are expected to be back in the 2.5-4% range. Businesses are operating in a world with higher costs of capital and could have balance sheets that may be too stretched. Some may struggle through this period.

This is the time for active managers to pick through those thornier issuers and make the right calls on credit. To some extent, delivering more returns into portfolios comes from identifying either the businesses that the market is unsure about but that ultimately make it through, or those businesses that are trading at a big discount because investors do not see a clear path to refinancing.

There is no doubt that investors must pick their way through the winners and the losers in the lower-rated part of the market. Balance sheets are the key markers of challenge and that inevitably comes with lower ratings; so, the lower Bs and CCCs are where there is a healthy amount of discount to historic average spreads today.

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We also see some discount in some of the higher quality businesses in Europe. On a historic basis, some hybrid securities in Europe look slightly cheap but if one was to look at them relative to where high-quality BBBs and BBs trade for fixed maturities on a global basis, there is currently a significant discount. That has a lot to do with the proliferation of vehicles, such as fixed maturity funds that cannot buy those hybrid securities, so a differential has opened in that space.

M&A and new issues could be on the horizon

M&A supply is a big swing factor for the high yield market and while that supply has not yet materialised, over the course of the next two or three quarters it has strong potential to sway the market.

The centre of potential supply is private equity. Last year, if sponsors were looking to finance a leveraged buyout, they would have had to assume a cost of capital of 11% or 12%[1]. Today, investors can expect around 8%[2] for a decent business. There is potential for M&A activity to recover, simply because financing costs have become more straightforward, and that can bring some volume back.

Elsewhere, the primary market recovery in high yield has been off to a slow start but is expected to come back during this year. Over time, new issues add returns without meaningfully adding extra risk to portfolios, and there is a premium paid for a new company that needs to access the market.

As new issues are the bread and butter of the day-to-day, we are engaging in that area and ensuring that we are positioned to source those that we want and at the optimum levels.

[1,2] RBC BlueBay Asset Management.

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