Time to buy high yield debt: Where now?

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In mid-March 2020, panic gripped the globe. The dire reality of the COVID-19 pandemic became apparent as the public became aware of the harm it posed as a global health crisis. Fear of the economic consequences became widespread and was expressed in the financial markets by risk assets selling off at a severity not seen since the global financial crisis of 2008.

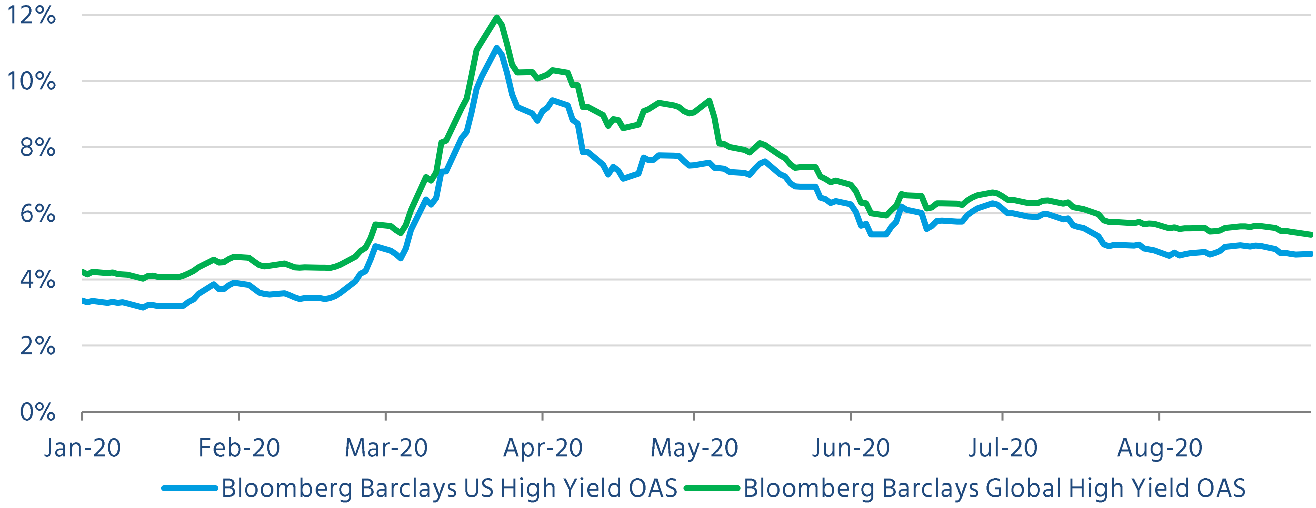
Against this economic backdrop and with year-to-date returns through March 30, 2020 for the Bloomberg Barclays Global High Yield index at -15.55%, Mercer published a research piece "Time to Buy" in which we made the case that despite the unprecedented price volatility and uncertain outlook, now was the time to buy high yield bonds. Our view rested on the observation that spread levels over a certain threshold could adequately compensate investors, based on loss projections for future default probabilities. While noting the risk that high yield spreads might increase further, we observed that the market would be supported by monetary policy, with central banks adding additional liquidity to the market, as well as fiscal policy, with sovereign governments implementing programs to help keep small-to-large businesses solvent.

As spreads have tightened back to more normal levels, we feel it would be useful to look back to see how investors would have fared if they had rotated into high yield bonds. This paper also aims to provide guidance on the best path forward for investors, given what we have learned over recent months, and to ask that key question once again: Is now still a "time to buy" high yield?

Looking back

High yield spreads, as measured by the Bloomberg Barclays Global High Yield Index, started 2020 at 416 bps and peaked at 1,192 bps on March 23, 2020.[1] Credit spreads have tightened substantially since, and were at 536 bps on August 31, 2020 (see Figure 1).

Figure 1. High yield spreads



Source: Bloomberg

Obviously, purchasing high yield when spreads have reached their zenith and benefiting from subsequent compression requires perfect market timing. However, history tells us that the returns in high yield are incredibly attractive as early as two years after hitting 700 bps of spread. (See our companion high yield piece "Braving the Unknown" which shows quantitatively this pattern.) Our view to allocate to high yield was supported by three primary observations:

- High yield spreads crossing a certain threshold and have — historically — more than compensated investors for realized defaults over a timeframe as short as two years.
- The wave of fiscal and monetary support that has come from central banks and sovereign governments.
- Active managers have been able to make timely portfolio allocation decisions when encountering significant market dislocations.

[1] Option-adjusted spread of the Bloomberg Barclays Global High Yield Index in USD. Source: Thomson Reuters Datastream

So how would an investor have fared if they had bought high yield recently? Taking the investment period of March 30, 2020 through August 31, 2020, an allocation to global high yield would have generated a return of 18.4%[2], almost 85% of which would have come from price appreciation. This represents an exceedingly attractive return for a holding period of just five months. For additional illustration of potential investment returns, other holding periods are listed in Figure 2.

Figure 2. Investment returns of the Bloomberg Barclays Global High Yield Index[2]

Beginning date	Ending date	Investment return (USD hedged)
March 23, 2020	August 31, 2020	26.0%
March 30, 2020	August 31, 2020	18.4%
April 30, 2020	August 31, 2020	12.6%
May 29, 2020	August 31, 2020	7.3%
June 30, 2020	August 31, 2020	5.1%

Source: Barclays Live

Investors with more discretionary governance policies may have been in a stronger position to benefit from the recent market dislocation through tactical risk rotation decisions. Regardless, there remains one pressing question for current and prospective investors: What is the current value of high yield, and how attractive is the outlook going forward?

[2] Bloomberg Barclays Global High Yield Index – total returns in USD – daily data series, reinvested
For informational and illustrative purposes only. Time periods have been selected with the benefit of hindsight based on actual historical data and not based on assumptions. Past performance is no guarantee of future results. It is not possible to invest directly in an index. Indexes are unmanaged and do not incur fees or expenses.

Dynamic asset allocation

Mercer's Global Dynamic Asset Allocation committee, an international team of leading researchers and consultants, meets quarterly to determine our relative value views on key asset classes, looking to the next one to three years. The committee decided to upgrade global high yield from "underweight" going into Q1 2020 to "overweight" for Q2 2020, believing the sharp elevation in credit spreads would likely reward investors for the level of risk.

At the most recent Q3 2020 meeting, the committee decided to keep the "overweight" view for global high yield. The committee recognized that while spreads have narrowed significantly, they still remain above long-term averages, and at current levels, have historically offered investors an opportunity to generate compelling returns on a forward-looking basis. Further, the asset class continues to benefit from the Fed's intervention in credit markets, which has acted as an implicit backstop for high yield. In addition, as investment grade yields continue to compress, there is the expectation of a "spill-over" effect as investors' desire for yield further increases demand for high yield credit. Lastly, macroeconomic research suggests a slowly improving global economy, which bodes well for leveraged asset classes such as high yield.

Risks

As of August 31, 2020, the year-to-date return for global high yield was 0.45%.[3] It is remarkable that this asset class has been able to provide a positive return so far this year considering the extreme volatility of and disruptions to the global economy. Looking back at historical data from the Bloomberg Barclays Global High Yield Index, never before has the asset class seen such a dramatic sell-off and subsequent reversal. Given the speed of the recovery in spreads, investors have to accept that most of the gains in high yield have likely been made already. However, current valuations remain compelling and support our views to maintain an overweight relative to the long-term strategic allocation to the asset class.

The biggest risk to high yield remains the fundamental strength of the underlying issuers as the number of defaults is expected to continue to increase. According to JP Morgan, the par-weighted US high yield default rate reached a 10-year high of 6.22% in July. For context, the rate was at 2.13% in July 2019, and the long-term average is 3.43%. There are expectations by market participants that the level of defaults will rise in the months ahead. However, in our view, the majority of this will take place in the energy and retail sectors, which have long faced secular headwinds that are only being exaggerated by COVID-19. There are also industries such as casinos, travel and airlines, which were in a relatively healthy position at the beginning of the year, but now find themselves struggling. It is important for investors to evaluate opportunities on a name-by-name basis, as security selection decisions are more important than ever.

[3] Source: Barclays Live

Active management to navigate the storm

We have always believed active management within high yield to be the best approach, and this is very much the case in the current volatile environment. The high yield market has witnessed extreme bifurcation across the quality spectrum − this can create pockets of opportunity as strong companies can sell off should they find themselves in an unfavorable ratings or sector category. Additionally, active managers can advantageously rotate into recently downgraded "fallen angels", which typically enter high yield with a price concession relative to their fundamentals, due to forced selling from investors who cannot hold non-investment grade rated credits.[4] We continue to favor active over passive management, given the former's ability to ride out through troubled sectors and issuers, but we recognize that passive investing in high yield could still prove beneficial to investors particularly constrained by fees.

What should investors do now?

While high yield credit spreads are much tighter than they were in March, and default risk remains elevated, we find the ability of high yield issuers to access the new issue market provides them with the flexibility they need to withstand the challenging economic environment.

As we wrote in our paper in March, investors should also develop a plan for implementation, one that involves lining up prospective managers, and a strategy for building exposure. Given the importance of timeliness when it comes to benefitting from opportunistic ideas, Mercer published a paper entitled "How to Be Ready for Investment Opportunities" to help investors balance the need for speed with the right governance approach.

While the global economy may take some time to rebound from the COVID-19-induced devastation, for investors seeking yield in their fixed income portfolio, we believe high yield bonds will continue to shine.

Daniel Natale, CFA
Asset Class Specialist, Fixed Income Boutique

[4] See also Mercer's paper "Investment Grade Credit Downgrades Present Both Risks and Opportunities"

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http://www.mercer.com/content/dam/mercer/attachments/private/nurture-cycle/gl-2020-investment-management-index-definitions-mercer.pdf

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