Insights
Fixed Income

The Evergreen Case for a Strategic Allocation to High Yield

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- The High Yield (HY) market has grown and matured. It has changed from a niche exposure to a globally diversified, highly rewarding asset class worth investing in — albeit not without risks.
- Outsized contribution of income/yield to total returns has led HY to experience shorter recovery periods from market drawdowns. It serves a dual purpose in a balanced portfolio — as both a satellite allocation for core fixed income, and a less-volatile alternative to equities. Even a 5–10% reallocation into HY from equities could see investors benefit.
- Growth of electronic trading and ETFs have made indexing in HY viable — with investors ultimately benefiting from gaining access in a cost-efficient manner.
- With a soft landing for the global economy becoming increasingly viable and as both fundamentals and technicals remain strong, we stay constructive in the medium term — even in the face of tight spread valuations.

Introduction: Background

HY bonds have existed since the 1980s, either due to issuer downgrades, or when leveraged buyout deals were financed by raising debt in the capital markets. Later in the 1990s, the newly issued HY bond market quickly became popular — and grew from about $300 bn in 2000 to about $2.2Tn now. Very much US-dominated initially, the issuer base has broadened out regionally along the way, covering European and Emerging Markets corporates as well, and HY issuance has helped the blossoming of industries such as telecoms, shale oil, and healthcare. Now HY has become an essential part of corporate bonds globally, providing financing to many well-known names such as Telecom Italia, Virgin, Hilton, Vodafone, Renault, Uber, United Airlines, Petroleos Mexicanos etc. It also serves as a part of a typical 'income sleeve' to pension funds, insurance companies, SWFs and private investors — and is used and analyzed in conjunction with the adjacent asset classes of loans and private debt, which themselves are ~$1.5Tn each. Understanding the HY asset class's uniquely defining features along with the gradual shift in the way market participants now access it, its sources of return and risks, as well as similarities and differences with other assets is crucial to successfully deploy it in an investor's overall portfolio.

Factors Driving HY Returns

HY returns tend to follow the typical 'boom and bust' nature of the credit cycle stages — intertwined with the broader macroeconomic environment, credit availability and corporate sentiment (Figure 1). There are several high and low frequency indicators as well as signals that market participants track (some of which we touch upon in the outlook section), to understand which stage the cycle across regions are probably in, and try to anticipate the turns and adjust allocations. While credit cycles across time have different characteristics — and peaks in spreads, defaults, and problem sectors differ from one cycle to the next, this provides a good starting point to understand to what extent investors are compensated for taking risks appropriate to the stage of the cycle.

Figure 1
Credit Cycle Stages

	1. Expansion	2. Downturn	3. Repair	4. Recovery
Macro Backdrop	Growth returns	Weak/Deteriorating	Challenged/Uncertain	Moderate/Improving
Credit Environment	Renewed confidence	Credit growth stalls/ confidence shaken	Weak	Accelerating below trend
Corporate Behaviour	Optimism	Retrench	Survival Bondholders prioritized	Quiet
Median Spreads	250–300bps	700–800bps	350–400bps	300–350bps
Defaults	Low 2–3%	Starts here 6–8%	Peaks here 8–10%	Very Low 1.5–2%
HY Credit Returns	**Good/Low**	**Poor**	**Good**	**Stong**

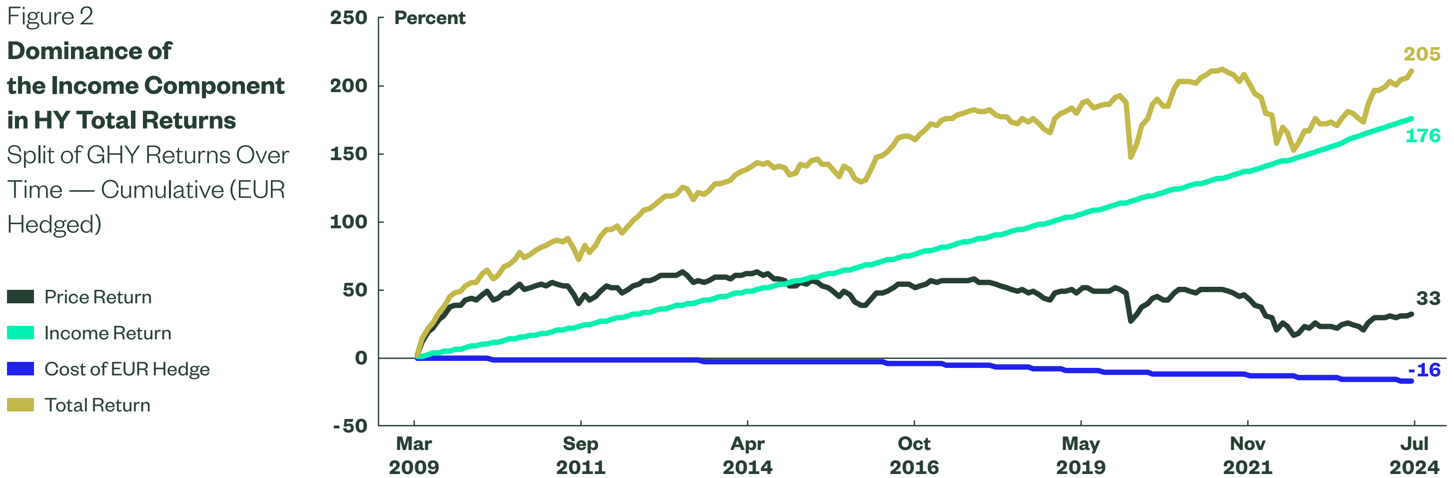
Given that borrowers are sub-investment grade, the most important risk for HY is credit risk, which materializes in the form of temporary or permanent loss of capital from downgrades and defaults. Liquidity risk comes next — as, in stressed periods, trading of bonds in the secondary market could become quite unidirectional, since the whole market becomes either very well bid or offered — with investors having to pay up significantly to be on the other side of the trade. Interest rate risk, as the bonds are fixed-rate, and reinvestment risk, as many bonds are issued with a call feature, are present as well — even though those are relatively minor compared to the first two.

Investors have been very well compensated for taking these risks historically, even in periods that include sharp drawdowns. There has never been two consecutive years of negative returns in Global High Yield (GHY) for the last 26 years (the same holds true for US HY as well, even with its longer history covering 40 years). Any negative year is usually followed by a year of outsized gains or several years of modest positive returns. This resilient return pattern is simply due to the outsized contribution of income/yield to total returns, particularly as the horizon of investment increases (Figure 2).

The days of bondholders physically clipping coupons are gone, but the benefits of receiving high regular coupon payments endure — with the income stream acting both as a cushion in downturns, and an additive return factor in recoveries. As with any fixed income instrument, entry yields give a very good indication of expected returns in the future, a point which is critical to be appreciated and remembered while timing entry and exit points (Figure 3).

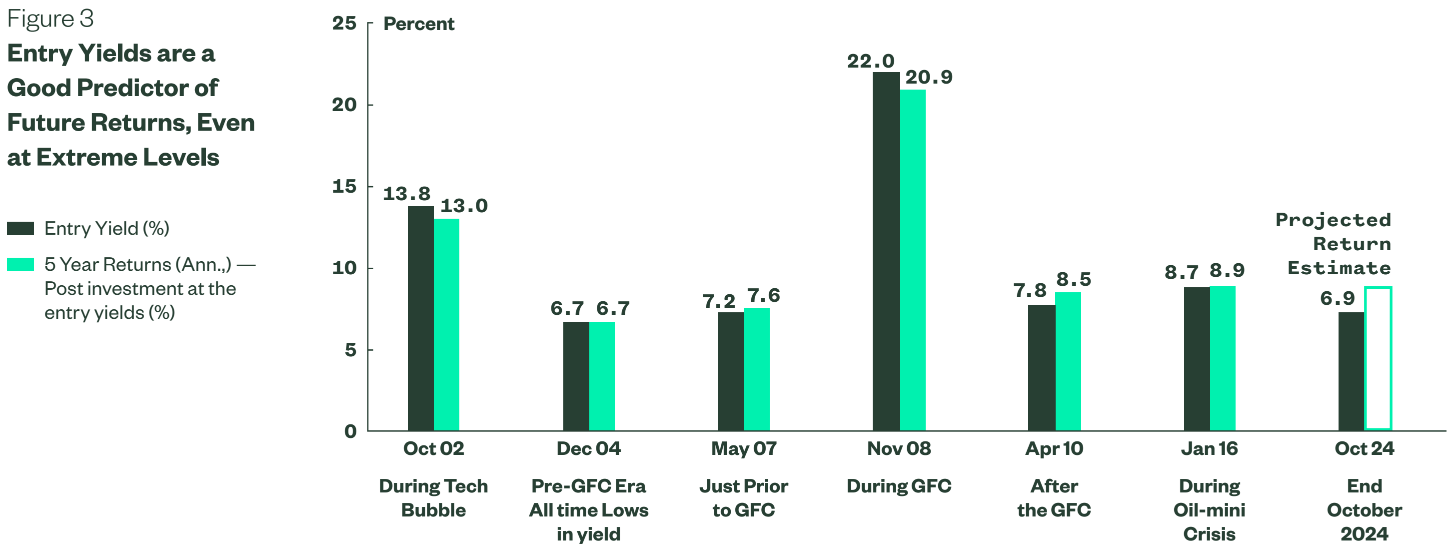
In HY, it is also worth giving additional consideration to levels of credit spreads, in conjunction with overall yield levels to get an indication of expected returns from a slightly shorter time frame of three years — particularly when yields are in the 7–9% range and when spreads are in the first three deciles, which carries a wider range of outcomes of future expected total returns (Figure 4). This applies to the current market environment, as credit spreads are at historical tights while yields are at comfortably high levels. We address this anomaly in the outlook section.

Figure 2
Dominance of the Income Component in HY Total Returns
Split of GHY Returns Over Time — Cumulative (EUR Hedged)



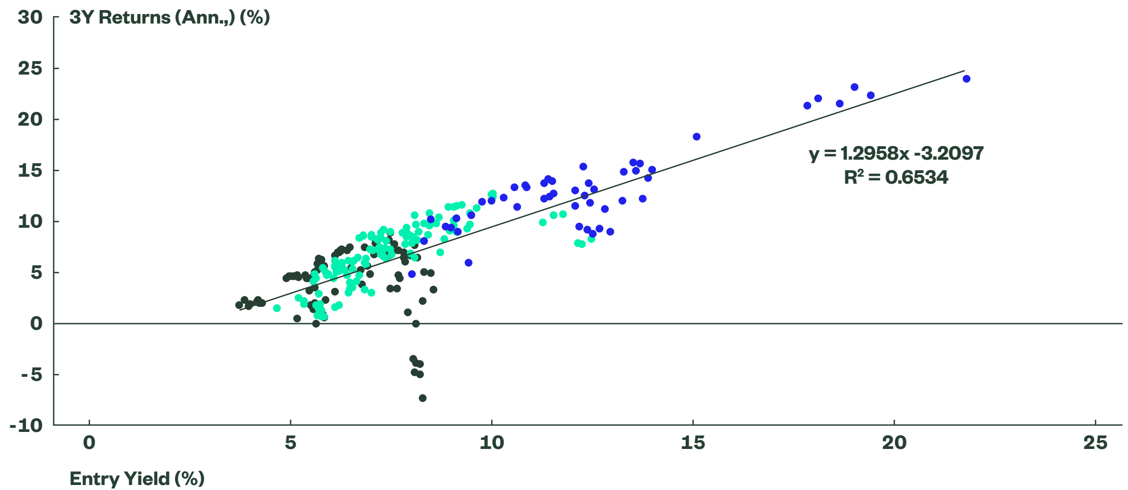
Source: Bloomberg, BofA. As of 31 July 2024. Analysis shown starting since GFC = Starting 1 March 2009. ICE BofA Global High Yield Index used as a representation of the GHY market.

Figure 3
Entry Yields are a Good Predictor of Future Returns, Even at Extreme Levels



Source: Bloomberg, BofA. As of 4 October 2024. BofA Global High Yield Index used as a representation of the GHY market. EUR Hedged Returns shown.

Figure 4
Entry Yields & Spreads (OAS) Together are Better Predictors of High Yield Returns for Shorter Time Horizons



Source: Bloomberg BofA, As of 31 July 2024. US HY market historical data since 31 Dec 2000 used. ICE BofA US High Yield Index used as a representation of the market.

How to Allocate To/Use HY in a Balanced Portfolio?

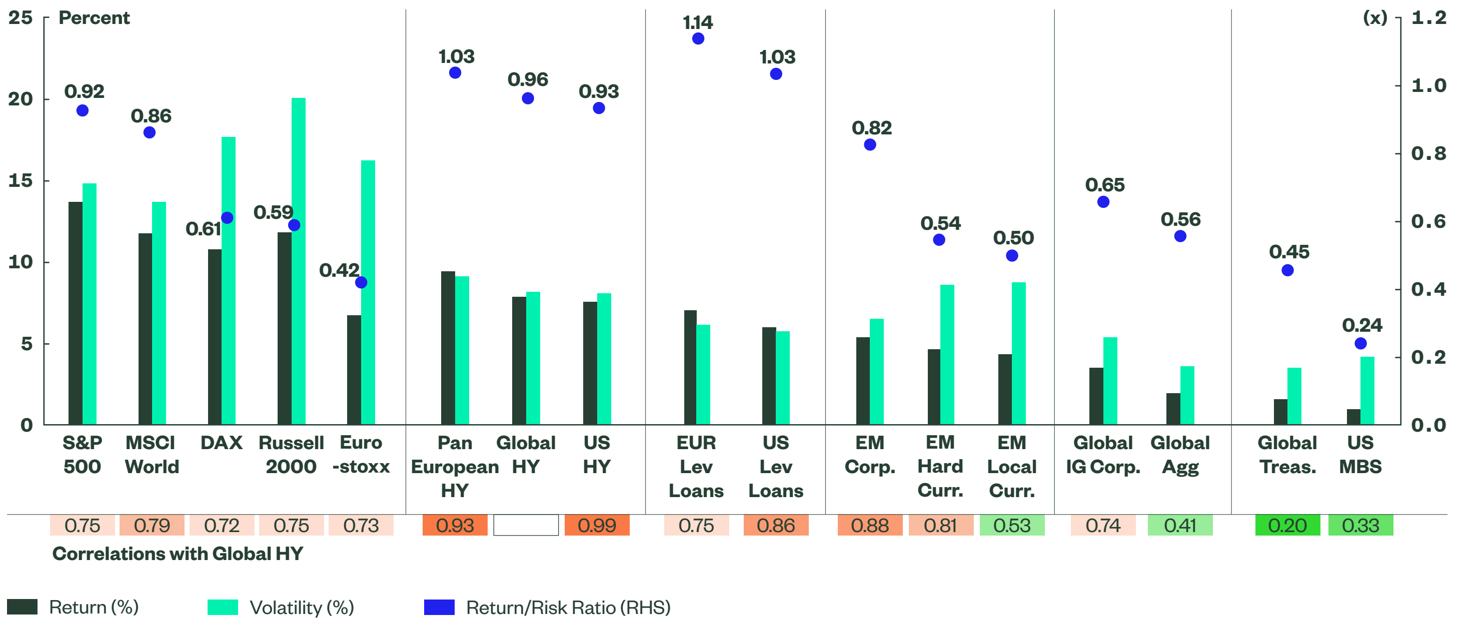
Historically, HY has compared very favorably to other fixed income and even equities in terms of risk-adjusted returns, and has seen low correlations to traditional fixed income such as Aggregate and Treasuries (Figure 5) — given its sensitivity to economic growth and the credit cycle, rather than interest rates. It has drawn down less than equities during downturns, and it has recovered its losses more quickly, preventing forced asset reallocations at unfavorable points (Figure 6).

Typical asset allocation models used by institutional investors have 45–50% allocated to equities, 30–35% to investment-grade fixed income, with the rest split across cash, alternatives, and commodities. While many do have a target allocation to HY, they are usually at modest levels of 2–3% — used as a satellite component to aid core FI allocations, or to be deployed on a tactical, temporary basis based on spread/yield targets etc. We recommend that an allocation to HY should be a permanent, strategic component of an investor's asset allocation model — and even as a substitute to replace a part of their equity allocation.

In fact, HY has stacked up so well against equities that a simple 3-asset-allocation model with Global Equities, Global Agg and GHY for the last 15 years (which covers multiple cycles and a substantial rally phase for equities surrounding investor enthusiasm in AI and big tech), suggests that the optimal allocation to get the best reward for the risk would have been a portfolio with 35% to Global Agg and almost half of Global Equities from their traditional allocation of 50%, replaced with GHY (Figure 5). While investors might not be open to such a drastic reallocation, the results simply point out that — rather than thinking about "how much of a % of core FI should be reduced to make way for HY", they should be thinking "how much % of equities can be reallocated to HY", where even a 5–10% reallocation could have a beneficial effect.

Figure 5

HY has Over-Compensated Investors for the Additional Default Risk Incurred vs. IG Assets, And Compelling Even Compared to Equities

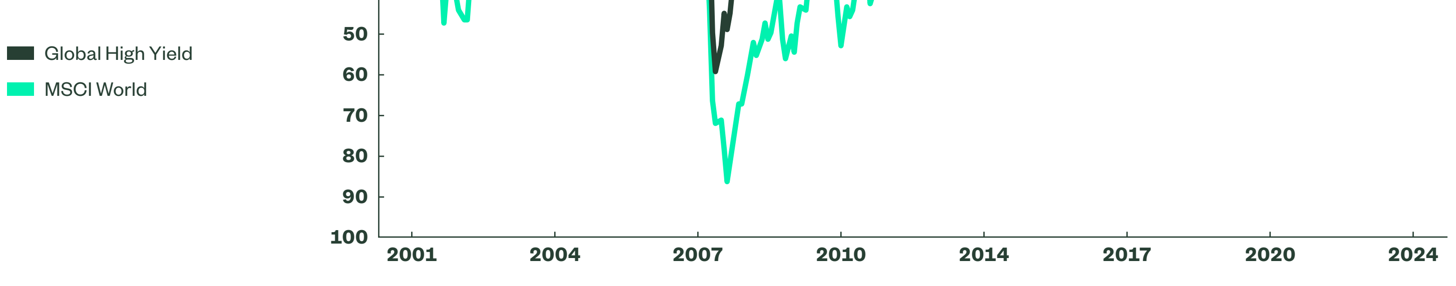


Source: Bloomberg, as of 31 July 2024. Bloomberg Pan-European High Yield, Bloomberg Global High Yield Corporates, Bloomberg US High Yield 2% Issuer Cap, Morningstar European Leveraged Loans, Morningstar LSTA US Leveraged Loans, JPM CEMBI Broad Diversified, JPM EMBI Global Diversified, JPM GBI-EM Global Diversified, Bloomberg Global Corporates, Bloomberg Global-Aggregate, Bloomberg Global Treasuries, Bloomberg US MBS Indices used as a representation of the Fixed Income markets in the order shown in the graph. EUR Hedged returns of all indices are used in the analysis. Analysis shown since GFC = Starting 1 March 2009.

Figure 6

HY Typically Draws Down Less and Recovers Quicker Compared to Equities

Drawdowns (%)

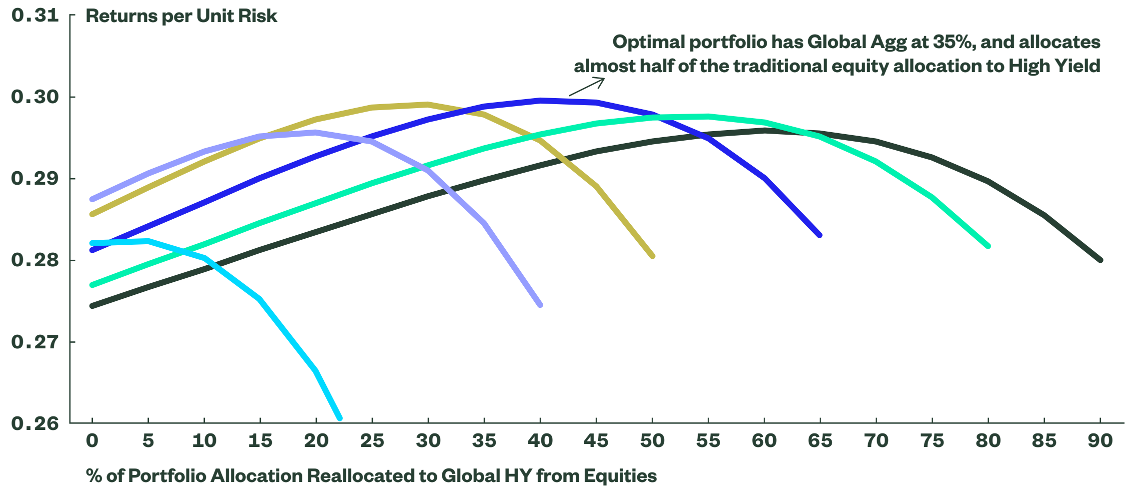


Source: State Street Global Advisors, BofA. As of 31 August 2024. ICE BofA Global High Yield Index used as a representation of the Global High Yield market. EUR-Hedged Returns shown for both indices.

Figure 7

Simple 3 Asset Portfolio: Equities, Global Agg (IG Bonds Universe), and High Yield

Moving a Part of Equity Exposure into HY can Lower Risk without Sacrificing Much Return



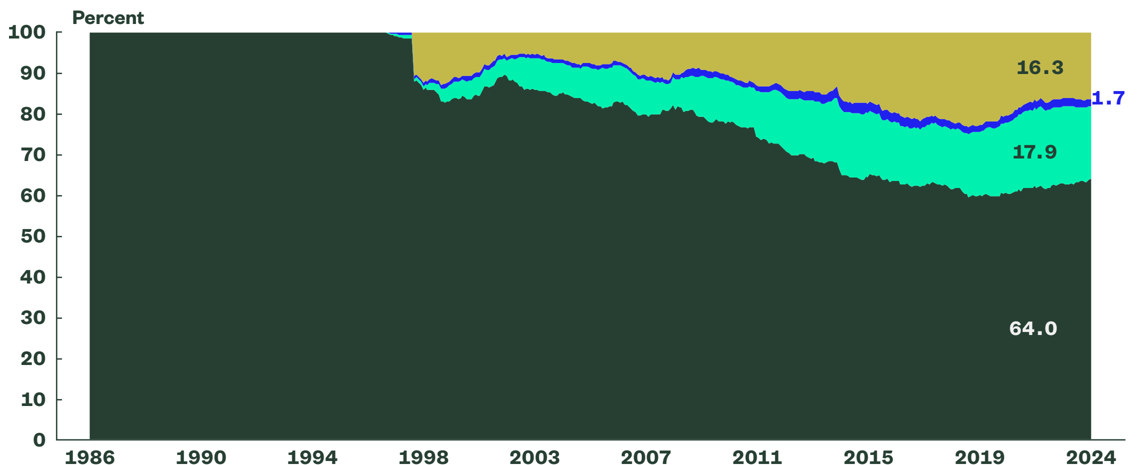
Source: State Street Global Advisors, BofA. As of 31 August 2024. ICE BofA Global High Yield Index and Bloomberg Global Aggregate Index used as a representation of the Global High Yield market and the Global Agg Bond market. EUR-Hedged Returns shown for all indices.

Investing with a Global Perspective

The HY market has expanded beyond its initial US-centric nature, with growth post 2000 coming from European and Emerging Market issuers. Non-US-based investors with a small domestic HY market, typically access GHY, hedging returns back to their local currency. While it may be tempting for US-based investors to just go with their domestic HY exposure which is still the largest, it is beneficial for them to seek opportunities from a global landscape due to several reasons. Going global gives an additional layer of sector diversification (Figure 9), avoiding drawdowns due to outsized impact from a single region's problem sector such as 2002's technology impact on European HY, 2016's energy crisis affecting US HY, 2022's China property crisis impact on EM HY etc. Also, historically no particular region has dominated returns versus the others over an extended period of time, and winners keep rotating, as default cycles across regions don't sync exactly (Figure 10). This makes a compelling argument against US investors ignoring EUR HY due to its structurally lower yields, without understanding the important defensive characteristics that EUR HY offers, such as its lower levels of defaults over time and higher average credit ratings.

Figure 8

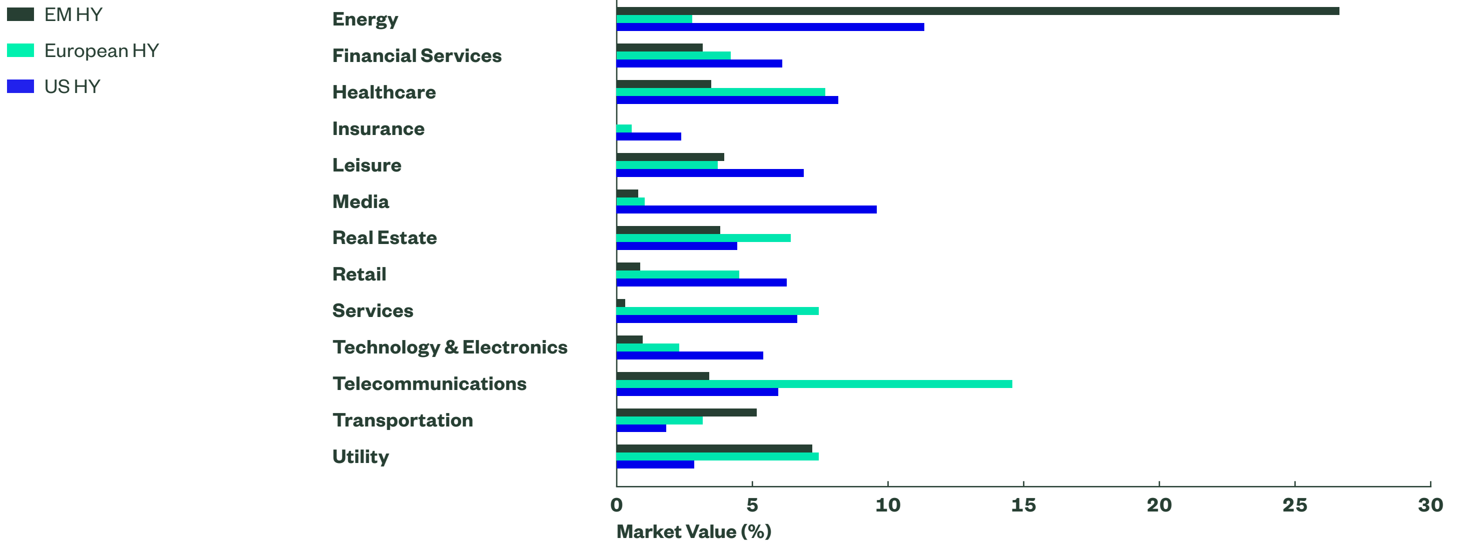
GHY Regional Split



Source: State Street Global Advisors, BofA. As of 30 September 2024. ICE BofA Global High Yield Index used as a representation of the Global High Yield market.

Figure 9

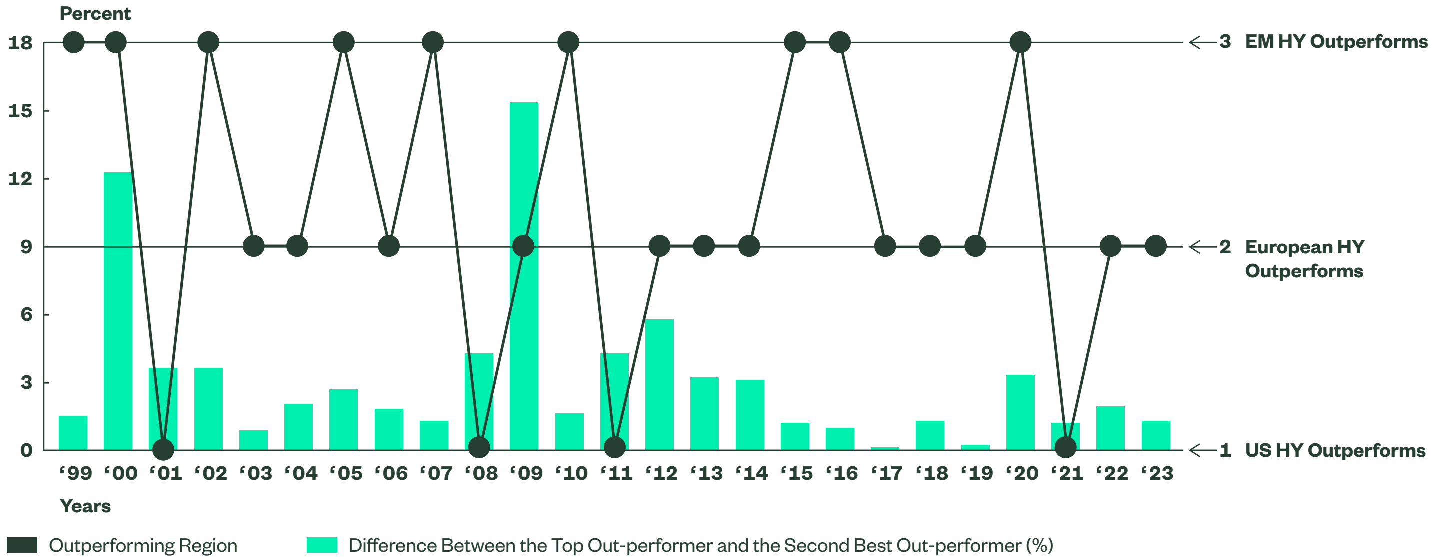
Sector Exposures Differ Markedly across Regional HY Markets



Source: State Street Global Advisors, BofA. As of 31 August 2024. ICE BofA Global High Yield Index used as a representation of the Global High Yield market.

Figure 10

Calendar Year Regional Performance (in Hedged Terms)



Source: State Street Global Advisors, BofA. As of 31 August 2024. ICE BofA Indices H0A0, HP00 and EMUH are used as representation of the US HY, European HY and EM HY markets respectively.

Paradigm Shift in The Way HY is being Traded and Accessed

The market structure dynamics for HY bonds has been evolving due to increased usage of electronic trading platforms, rapid adoption of HY ETFs by investors, as well as growth in low-/no-touch trading protocols and basket trading.

Almost a third of trading volume in HY now is executed electronically, up from less than 3% in 2014 (Figure 11a), and e-trading platforms have created an environment for all-to-all trading, which expands the universe of counterparties who can provide pricing in competition, thus improving execution results. While voice and high-touch protocols have their place, particularly in block trades sized $5 mm or more — smaller ticket sizes are increasingly being executed using pre-programmed low-touch trading instructions based on rules around time, price, and volume.

With investors using HY ETFs to gain exposure and transfer risk efficiently, ETF secondary trading volumes in HY have picked up to almost half of the underlying bond market volumes now, providing an additional layer of liquidity (Figure 11b). The entry of new market participants such as AP market makers, HFT market makers who can effectively price-discover an ETF's intrinsic value, and have the economic incentive to arbitrage — has resulted in consolidation of pricing information quickly and efficiently — and more importantly, when traded and used on their own, ETFs, and basket trading have resulted in certainty of execution, and a considerable reduction in bid-ask spreads — when compared to trading the underlying bonds individually.

Figure 11a
e-trading Platforms & ETF Usage have Bought in Unparalleled Access to Liquidity Providers
% Bond Trading Volume Electronically

US IG Corp
US HY Corp

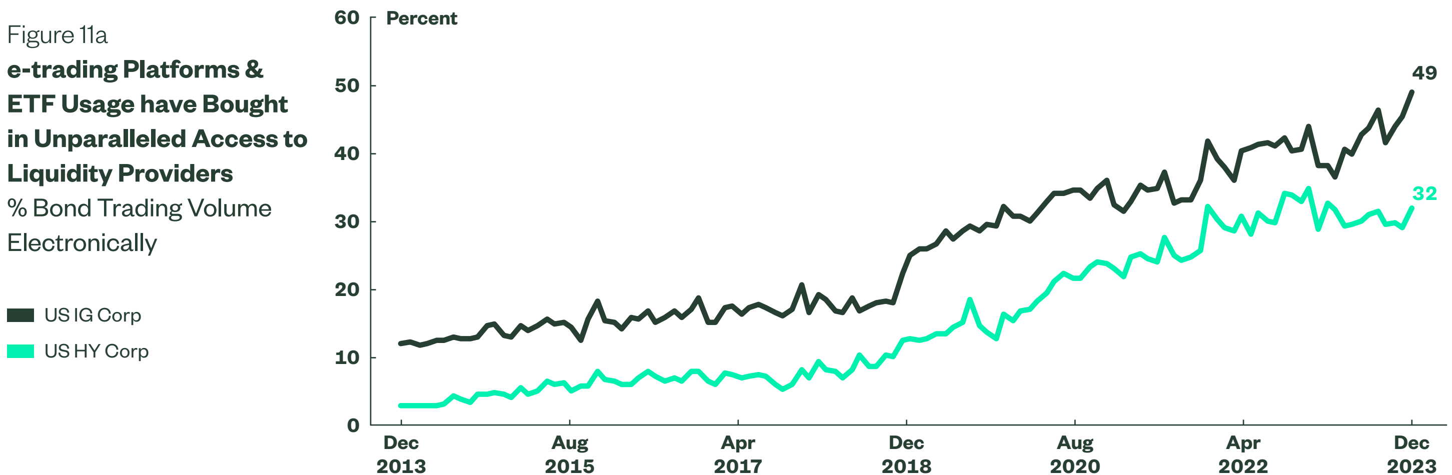
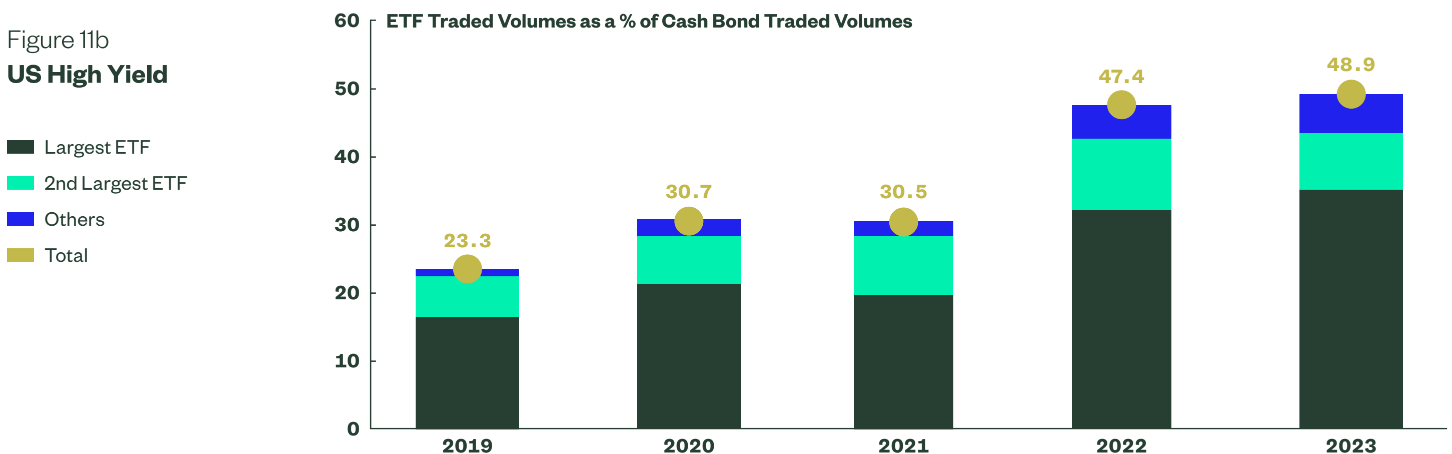


Figure 11b
US High Yield

Largest ETF
2nd Largest ETF
Others
Total



Source: Greenwich Associates. As of 31 August 2024.

Increased data availability has led to an upheaval in the mechanism of bond pricing as well. Market participants have traditionally used single-dealer quotes, or end-of-day pricing service runs to mark illiquid HY bonds. Entry of tech-native new entrants into the ecosystem has led to

development and usage of various machine learning pricing models with prediction engines. They take historical and real-time public and proprietary data such as earlier trades, streams, RFQ responses etc., adjusting those specific to the attributes of the bond that is being priced — to derive unbiased, two-sided pricing on infrequently traded bonds. This has led to a more efficient, liquid HY marketplace by providing a way to trade faster and at scale.

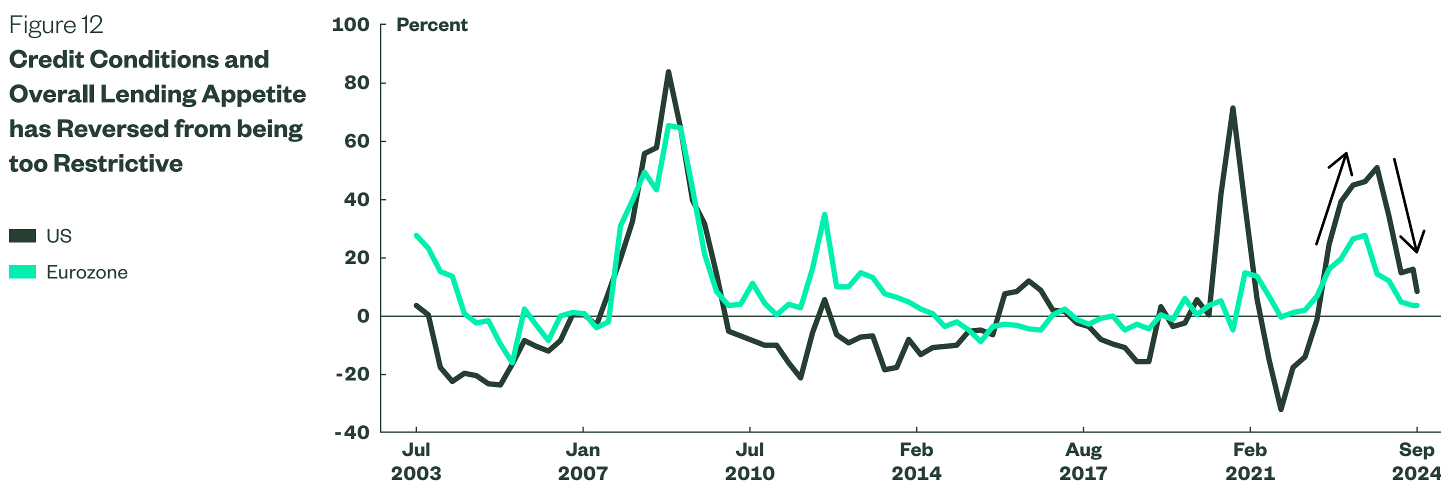
All these evolutions have made indexing in HY now suitable to be accomplished with precision for experienced index managers, who typically trade large volumes of consistent, diversified flows at small trade-sizes. Investors ultimately realize these benefits through lower realized transaction costs, and also by being able to access the broader (and not just a liquid subsection of the) HY market.

Why Invest into GHY Now?

The global macro backdrop remains quite supportive for HY — with a faster start to the easing cycle, alongside some good data (strong retail sales, low jobless claims), and moderating inflation across most major regions. US growth expectations have held up, with QoQ real GDP growth expected to gradually downshift from 2.0% in Q3 to 1.4% in Q4, with a slight uptick in unemployment to 4.3%, a core PCE moderating to 2.6% and the Fed going ahead with two more cuts by the end of the year. The outlook for the eurozone is solid as well, with a cyclical upswing in GDP growth supported by robust household savings, steady unemployment and rising dovish expectations for the ECB, with inflation in the eurozone slipping below the 2% policy target.

Without a severe downturn in macroeconomic data, broadening access to capital and easing credit conditions (Figure 12), and healthy balance sheets — we don't see cause for default rates to spike up into the mid-to-high single digits, but believe this cycle will carry a lower peak than previous recessions. The moderate but steady distress levels of around 7–8%, which have persisted even through the recent rally (Figure 13) corroborates our view, and a subjective observation of the default watchlist and the most distressed names indicates that the next 12M expected defaults in US HY would be in the 2.5% range. Even though EUR HY has been a very low default market in the past decade, the presence of a small number of larger distressed capital structures as well as a handful of real estate names which face headwinds from elevated energy and construction costs and expensive financing, tells us that the next 12M expected defaults in EUR HY could be in the 3.0% range. Stress in the post-Covid cycle has been in sectors such as telecom/health care, which added a lot of debt heading into the hiking cycle. This distressed universe might not be highly exposed to a slowing economy but could benefit significantly from debt costs going lower.

Figure 12
Credit Conditions and Overall Lending Appetite has Reversed from being too Restrictive



Source: Bloomberg. US depicts: Senior Loan Officer Opinion Survey on Bank Lending Practices for Commercial and Industrial Loans for large and medium firms. Eurozone depicts: ECB Bank Lending Survey for change in Credit Standards Lending to Businesses. As of October 2024.

Figure 13a
Prolonged Period of Medium Levels of Distress
US High Yield

- L12M Default Rate
- Distress Ratio (RHS, Shifted by 3 Quarters)
- Default at Current Level of Distress

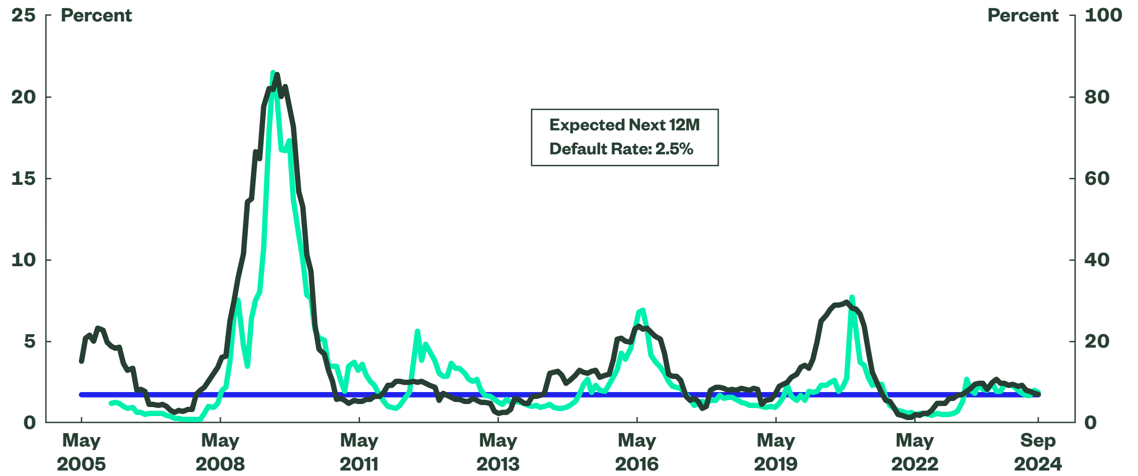
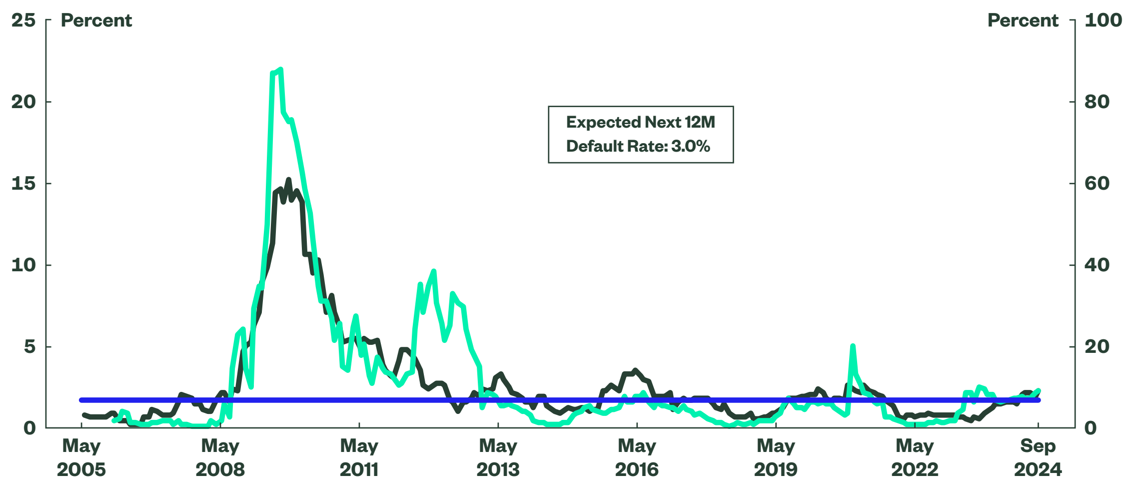


Figure 13b
EUR HY

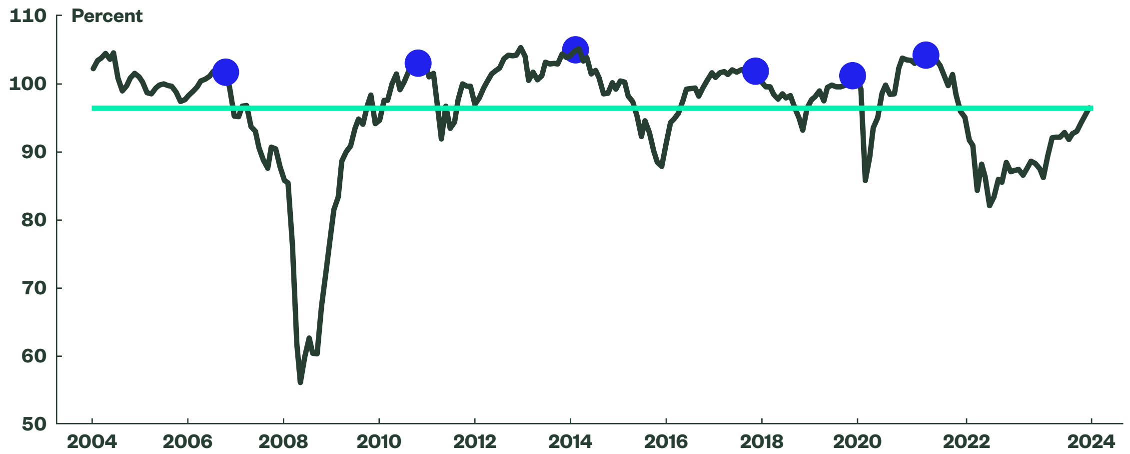


Source: State Street Global Advisors, BofA. As of October 2024.

Busy capital markets refinancing issuance has been met with strong demand, with YTD retail flows of +$14.9 bn for US HY and +€8.5 bn for EUR HY — the most on a calendar year basis since 2020. The maturity wall has been taken down for near-term maturities, with bonds maturing in the years 2025 and 2026 reduced by more than 50% since the end of 2022, with most of the refinancing activity having taken place in the higher-rated segments first, but recently B3 or lower-rated issuers have been active as well.

GHY spreads in the 300–320 bps range are close to their richest decile. However, the HY market today is significantly different from earlier cycle tights and hence spread comparisons across time need to be adjusted for this. The HY market now is higher quality, has a higher proportion of secured bonds, and has a significantly lower average price (Figure 14).

Figure 14
GHY Market is Significantly More BB-Weighted Than Before



Source: Bloomberg. US depicts: Senior Loan Officer Opinion Survey on Bank Lending Practices for Commercial and Industrial Loans for large and medium firms. Eurozone depicts: ECB Bank Lending Survey for change in Credit Standards Lending to Businesses. As of 31 July 2024.

The lower average price is important, due to convexity positively aiding the investor now compared to previous periods. Earlier or higher-priced takeouts can lead to a better yield-to-outcome than the yield-to-worst, which is the focus of many market participants.

The biggest near-term risk to GHY now is a material slowdown in growth or inflation, unwinding the goldilocks outcome for 2024 that markets had priced in, but the probability of that seems to be quite low, given the direction of recent data releases. Markets looking forward to positive economic impacts of the upcoming rate cuts, and growth which doesn't slow down too much to materially affect earnings estimate — is good for HY to continue to give out coupon-like returns in this environment.

A steeper rates curve will be positive for credit demand as well. Investors may consider moving/allocating to up-in-quality such as BB-B rated segments, or liquidity screened segments (versus broad market HY), depending upon their risk aversion, given that lower-quality assets face much bigger drawdown risks for a given level of potential gains — as we have seen markets rapidly extrapolating every data release, and repricing levels accordingly.

Conclusion

In a nutshell, HY as an asset class occupies a unique role in an asset allocation framework, generates high current income, and acts as a diversifier due to its low correlation to traditional fixed income. The trading environment for HY has seen a structural change driven by innovation, becoming more transparent and efficient. While spreads remain tight, the increased investor demand for HY — given improving probabilities of a soft landing and potential Fed cuts — may keep spreads at tight levels. In an environment where defaults are expected to be contained, spread direction might not matter as much for total returns. Headline yields on GHY offer a substantial cushion, providing more protection for investors.

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* Pensions & Investments Research Center, as of December 31, 2023.
† This figure is presented as of June 30, 2024 and includes ETF AUM of $1,393.92 billion USD of which approximately $69.35 billion USD is in gold assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated. Please note all AUM is unaudited.

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