Insights
Fixed Income

June 2020

An Update on High Yield Bonds

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High yield bonds have benefitted as risk appetite has returned to markets. We believe there could still be upside as investors search for yield.

Macro Backdrop

High yield (HY) has been an increasing focus for investors as risk appetite returns to the market. There are three main interconnected macro drivers of inflows into HY investments:

- As European lockdowns are starting to ease and the economic numbers start to improve, market participants have become more comfortable moving into higher-risk products such as emerging markets and high yield. While many uncertainties remain, the pandemic is looking more manageable, meaning market sentiment is erring towards the view that some of the worst performing assets have priced in too much bad news. While equities have recouped a large portion of their losses, yields on the Bloomberg Barclays Liquidity Screened Euro HY Index are around 4.40%, against an average of 2.90% in the 12 months before the crisis. So they have lagged the wider recovery in risk assets.

- In a world where cash and many European government bonds have negative yields, there is pressure on investors to re-allocate into assets that earn a return. HY is obviously at the top of the pile. The yield at least protects investors against some declines in capital value before total returns turn negative, which is not the case for a lot of government bonds.

- Central banks provide some protection. The ECB may not be a buyer of HY like the Fed, but its purchases of government bonds and investment grade (IG) paper, which depress the yield, do encourage investors to move to higher yielding assets. At present, the ECB almost certainly holds HY paper, originally IG paper that has been bought and subsequently downgraded. There is speculation over whether the ECB will ultimately end up purchasing HY paper. The ECB's Rehn's comments on 9 June 2020, to the effect that they should be buying HY debt, is likely to keep that optimism alive.

What Has Been Driving Performance?

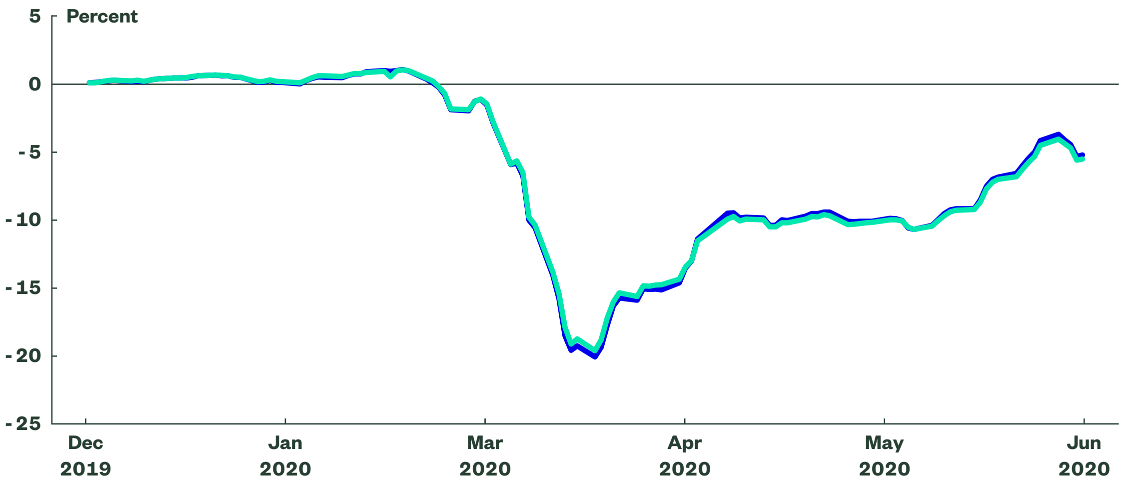
In terms of performance, the Bloomberg Barclays Liquidity Screened Euro HY Index has done well versus the competition. YTD total returns are -5.31% (to 12 June 2020), which is ahead of the Markit iBoxx EUR Liquid High Yield Index, favoured by iShares, which is -5.62%. Given the longer duration on the Bloomberg Barclays Liquidity Screened Euro High Yield Bond index versus the Markit iBoxx EUR Liquid High Yield Index (3.67 versus 3.29), a continued recovery in HY should mean price returns remain higher on the Bloomberg Barclays index. For details on the differences between the indices, please see our index comparison.

Figure 1

Performance Comparison

Bloomberg Barclays Liquidity Screened Euro HY Index

Markit iBoxx EUR Liquid High Yield Index



Source: Bloomberg Finance L.P., as of 12 June 2020. Past performance is not a reliable indicator of future performance. Sector returns shown are as of the date indicated and are subject to change. This information should not be considered a recommendation to invest in a particular sector or to buy or sell any security shown. It is not known whether the sectors or securities shown will be profitable in the future.

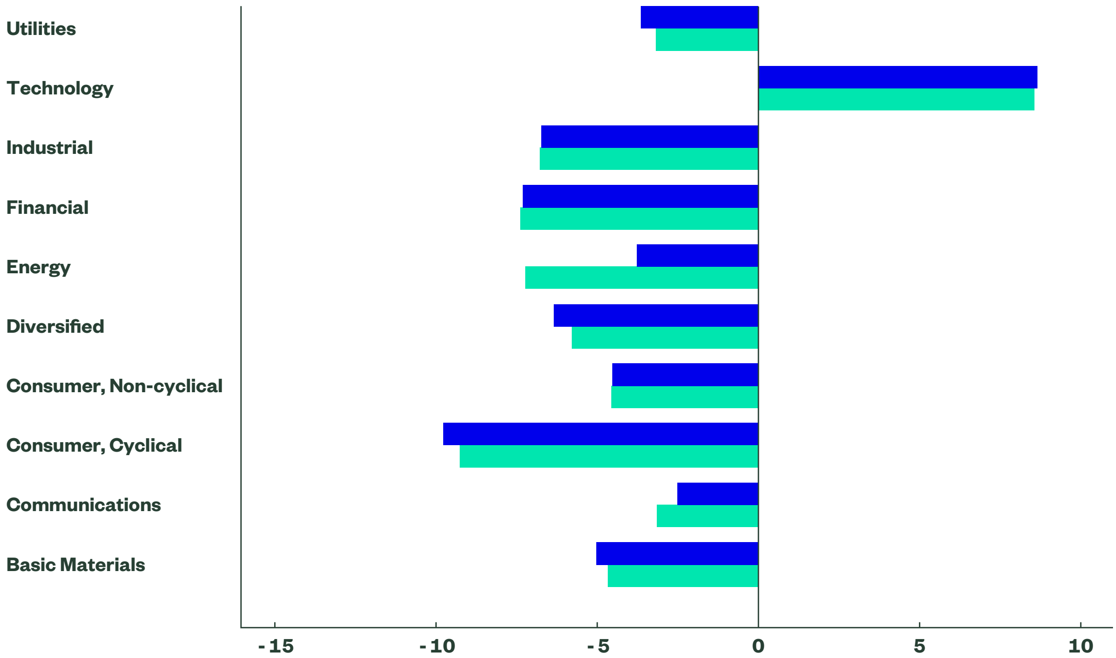
Figure 2 below shows the key performance drivers for SPDR Bloomberg Barclays Euro High Yield Bond ETF (JNKE) versus the index. Strong gains from Technology have been more than offset by all other categories. The only place where there is a meaningful divergence of the SPDR ETF versus the Bloomberg Barclays Liquidity Screened Euro High Yield Bond index is in Energy.

Figure 2

Sector Returns YTD (%)

Bloomberg Barclays Liquidity Screened Euro HY Index

SPDR Bloomberg Barclays Euro High Yield Bond UCITS ETF



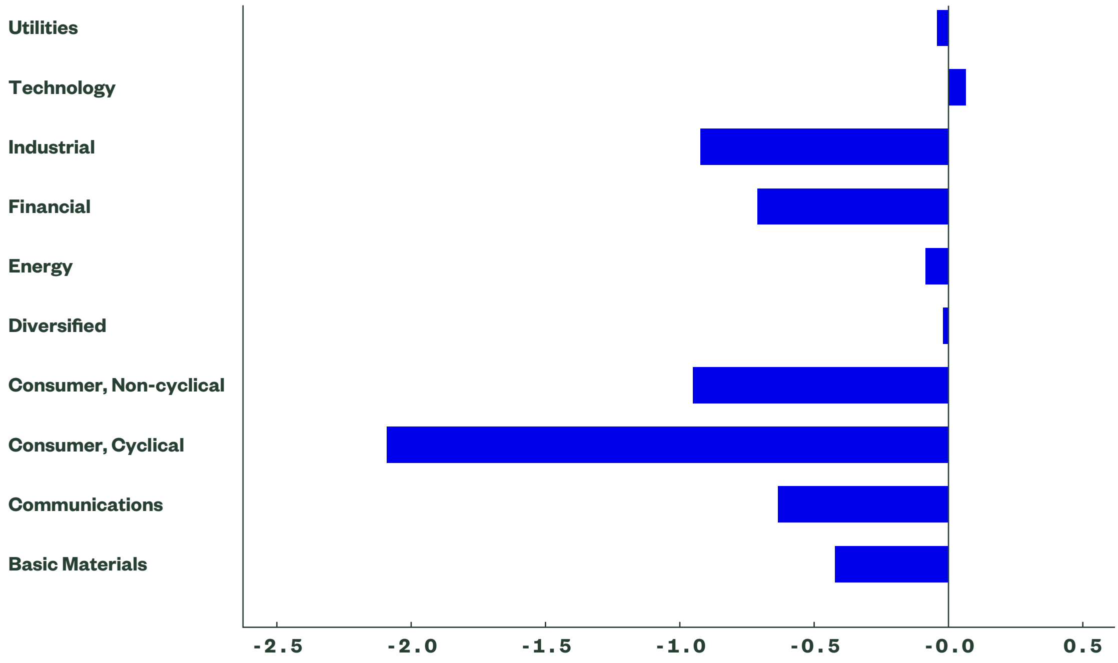
Source: State Street Global Advisors, Bloomberg Finance L.P., as of 12 June 2020. Past performance is not a reliable indicator of future performance. Sector returns shown are as of the date indicated and are subject to change. This information should not be considered a recommendation to invest in a particular sector or to buy or sell any security shown. It is not known whether the sectors or securities shown will be profitable in the future.

Looking at contributions to performance (returns*weight of bonds in the fund), it becomes clear that exposure to consumer cyclicals was the key drag on outright performance accounting for over 2% of the fund's 5.44% decline. Despite this showing, other funds fared even worse, with returns for consumer cyclicals in the Markit iBoxx index down more than 10%.

Note that energy becomes almost irrelevant because it accounts for less than 1.2% of the portfolio.

The positive contribution from technology ultimately becomes small as it is less than 1% of the index, but again this was a key sector in which the Bloomberg Barclays index outperformed iBoxx.

Figure 3
Weighted Sector Returns YTD (%)



Source: State Street Global Advisors, Bloomberg Finance L.P., as of 12 June 2020. Past performance is not a reliable indicator of future performance. Sector returns shown are as of the date indicated and are subject to change. This information should not be considered a recommendation to invest in a particular sector or to buy or sell any security shown. It is not known whether the sectors or securities shown will be profitable in the future.

The Outlook — Still Searching for Yield

The low level of yields on government bonds and the fact that IG corporates have already seen a sharp spread narrowing should encourage many investors to continue to seek out higher-yielding assets or areas of the market where perceived returns are greater. The message from State Street Global Markets is that investors still have cash to deploy, which suggests that flows into HY could continue.

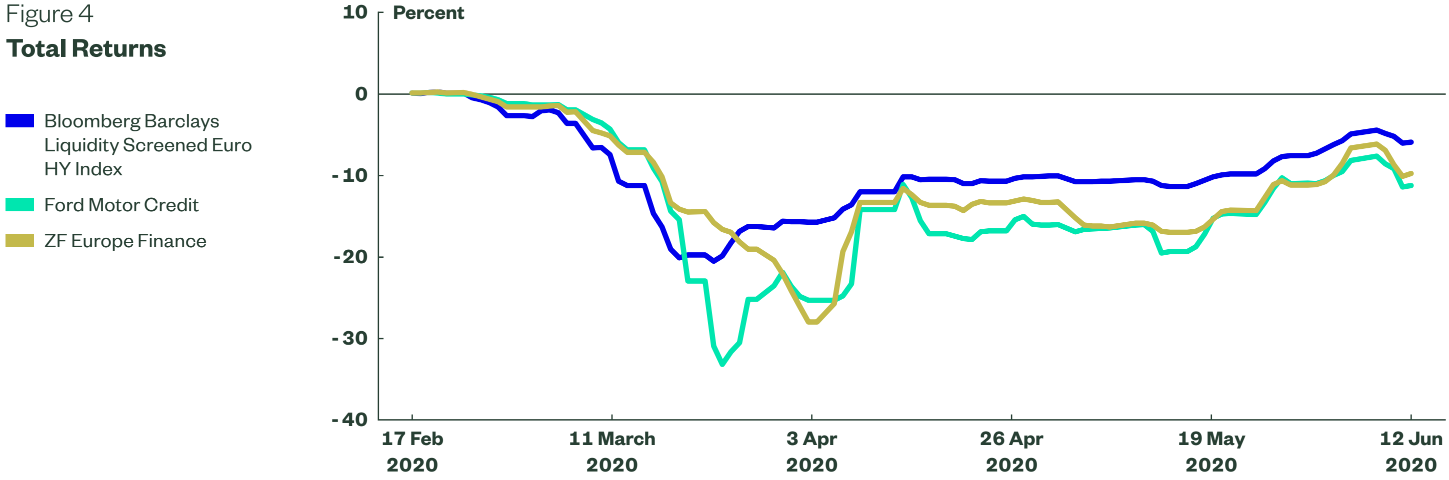
Aside from the yield and any general market price gains, current conditions are favourable for fund managers to enhance returns via two methods.

First, with significant amounts of HY issuance there is scope for enhancing returns by picking up 'cheap' paper in the primary market that is trading at a discount at the time of issue.

Second, through adept management of Fallen Angels could prove helpful. In 2020 so far, there have been 14 Fallen Angels in the Western Europe region, or companies that have lost their Moody's IG status. These are generally perceived as a risk to HY indices given the smaller size of the market means paper is often aggressively sold as it leaves the IG indices and there is far less demand as it enters HY space. However, this transition also creates opportunities. For instance, at March month-end 15 bonds from 5 issuers came into the Bloomberg Barclays Euro High Yield Bond index. By far the majority (80% by market value) of this was accounted for by 2 issuers: Ford and ZF.

The chart below shows the total return of the middle maturity bond from each issuer against returns from Bloomberg Barclays Liquidity Screened Euro HY Index. Prices dropped quite sharply in March and April as IG funds sold these bonds. However, from 5 April 2020 onwards there was a sharp improvement in performance.

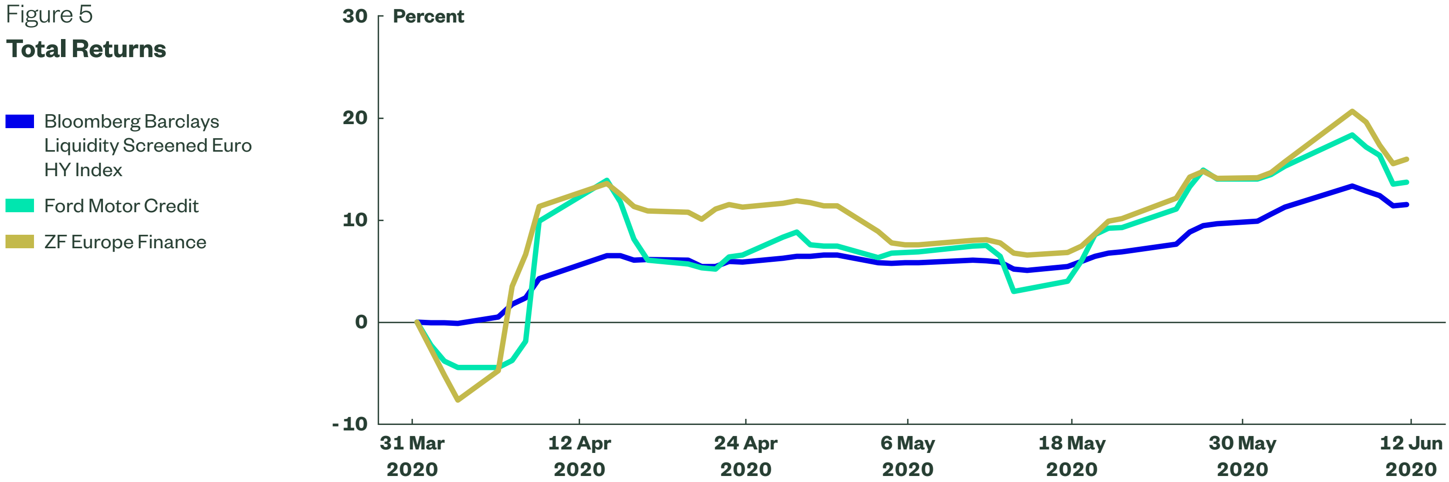
Figure 4
Total Returns



Source: Bloomberg Finance L.P., as of 12 June 2020. Past performance is not a reliable indicator of future performance. Index returns reflect capital gains and losses, income, and the reinvestment of dividends.

Resetting the chart so that it dates from 31 March 2020, when these bonds would have entered the index, shows both have delivered a significant outperformance versus the index. In short, returns can be enhanced by acquiring Fallen Angels shortly after they fall out of IG indices.

Figure 5
Total Returns



Source: Bloomberg Finance L.P., as of 12 June 2020. Past performance is not a reliable indicator of future performance. Index returns reflect capital gains and losses, income, and the reinvestment of dividends.

The Risks

The big risk relates to issuer defaults. Moody's has made 428 downgrades to sub-investment grade issuers in 2020 so far, which is higher than the annual total since 2012. Assuming downgrades are genuinely forward looking, rather than reactive, the worst could be behind us. However, a second wave of the pandemic and subsequent shut-downs could cause a spike in defaults, thus damaging fund returns.

How to Play This Theme

To learn more about investing in high yield bonds with SPDR ETFs, please visit the fund page linked below, where full fund performance history is also available.

SPDR Bloomberg Barclays Euro High Yield Bond UCITS ETF.

Figure 6
Performance

	1 Month (%)	3 Month (%)	YTD (%)	1 Year (%)	3 Years (%)	5 Years (%)	Since Inception (%)
SPDR Bloomberg Barclays Euro High Yield Bond UCITS ETF	2.72	-5.16	-7.11	-2.47	-0.15	8.78	46.61
Bloomberg Barclays Liquidity Screened Euro High Yield Bond Index	2.85	-5.08	-6.97	-2.06	1.27	11.22	51.32
Difference	**-0.13**	**-0.09**	**-0.14**	**-0.41**	**-1.42**	**-2.44**	**-4.71**

Source: State Street Global Advisors, as at 31 May 2020. The fund inception date is 3 February 2012. **Performance quoted represents past performance, which is no guarantee of future results. Investment return and principal value will fluctuate, so you may have a gain or loss when shares are sold. Current performance may be higher or lower than that quoted. The contained performance data do not take account of the commissions and costs incurred on the issue and redemption, or purchases and sale, of units. Visit spdrs.com for most recent month-end performance. The performance figures contained herein are provided on a net of fees basis.** Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Performance returns for periods of less than one year are not annualised.

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- Invest as stewards
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Exp. Date: 31/07/2020