Insights
Fixed Income

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The Case for High Yield Bonds

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Adding high yield bonds to a fixed income portfolio can potentially both boost the stability of returns and reduce volatility, as the asset class is largely uncorrelated to government bonds.

The traditional appeal of bonds is that they can provide income when economic conditions are strong and a safe haven when the backdrop turns sour (benefitting from price appreciation). However, the combination of negative ECB rates coupled with asset purchases and low inflation has left many European government bonds with negative yields. With yield curves back close to their flattest levels since 2008, additional returns from extending out along the curve and taking extra duration risk are low.

The alternative route to enhancing yield has been to add credit risk. There were substantial flows into credit funds during 2019. According to State Street Global Markets data, in Q4 2019 there were heavy inflows into the EUR corporate universe (see the Q1 2020 SPDR Bond Compass for full analysis and commentary).

However, investors now look heavily overweight, according to this flow data. With investment grade (IG) credit spreads having compressed to government bonds, the option-adjusted spread on the Bloomberg Barclays Euro Corporate Bond Index has narrowed from over 160bp in early 2019 to below 100bp. Those seeking yields will need to continue the journey out along the credit spectrum.

Yield Appeal

High yield (or non-investment grade) bonds offer a material pick-up in yield. Investors can access this pick-up through the SPDR Bloomberg Barclays Euro High Yield Bond UCITS ETF, which has a yield-to-maturity of around 3.25% against just 0.5% for the Bloomberg Barclays Euro Corporate Bond Index.

Higher levels of yield are important for two reasons:

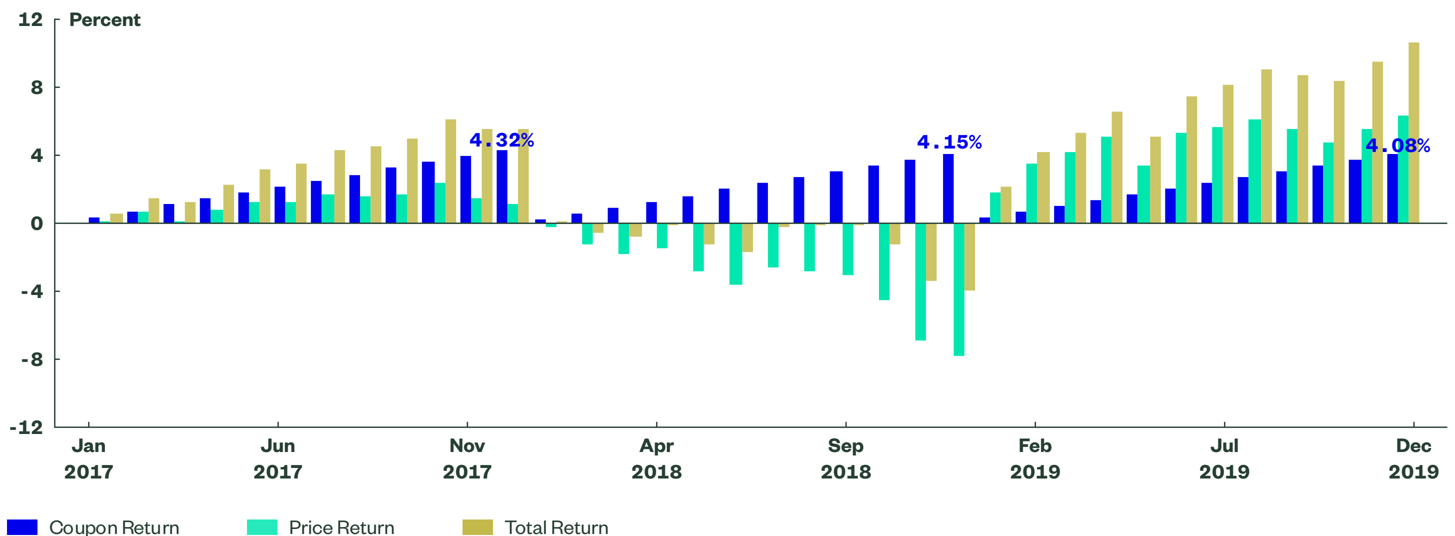
1. As bond yields head towards or even below zero, investors become increasingly reliant on price appreciation for portfolio returns. While further price gains are possible, they depend on a deterioration in expectations for global growth. In contrast, greater coupon flows mean that high yield bonds are not dependent on moves in the underlying price of the bond in order to generate a return.

   Figure 1 illustrates the degree to which coupons combined with price appreciation in both 2017 and 2019 to produce total returns in excess of 5% and 10%, respectively. Even with no rise in value of the underlying asset, returns would have been more than 4%.

2 The higher average coupon also buys investors a degree of protection. In the case of 2018, coupon flows helped to mitigate the effects of falling bond values. It wasn't until a more aggressive phase of spread widening in Q4 2018 that total returns pushed more meaningfully into negative territory.

In such a scenario, the value of the underlying ETF would need to fall by more than 3.25% in order for the price depreciation to fully offset the yield and for the investor to lose money on the position. Given the SPDR Bloomberg Barclays Euro High Yield Bond UCITS ETF has an effective duration of 3.3 years, yields would have to rise close to 100bp before that would occur.

Figure 1
Bloomberg Barclays Liquidity Screened Euro High Yield Index

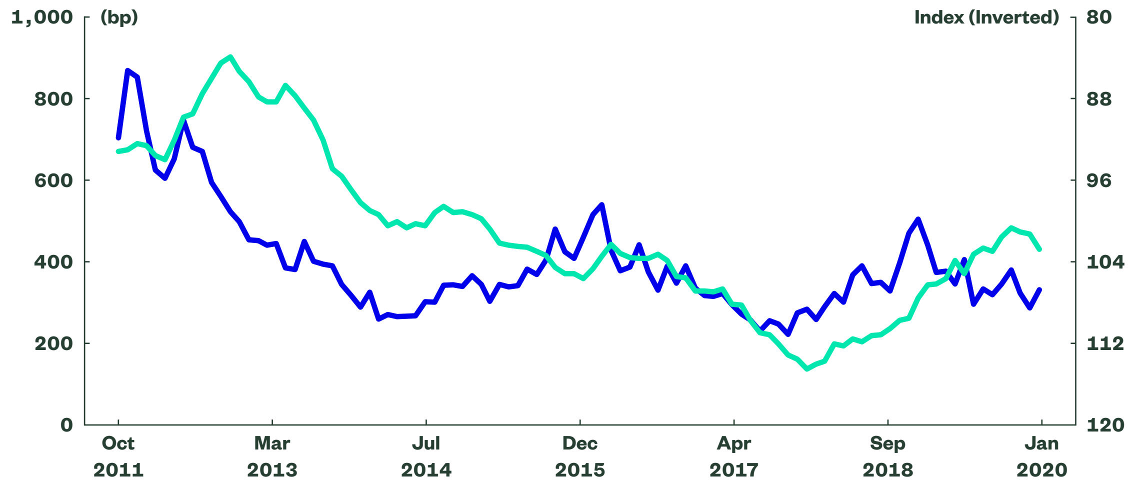


Source: State Street Global Advisors, Bloomberg Finance L.P., as of 31 December 2019. **Past performance is not a guarantee of future results.** Index returns reflect capital gains and losses, income, and the reinvestment of dividends. The percentage return highlighted above is the cumulative coupon return.

High Yield and the Investment Cycle

The cyclical nature of the high yield market is well understood. Higher economic growth supports corporate profit generation and therefore interest coverage, which may ultimately result in ratings upgrades. This cyclicality can be seen in Figure 2, which shows the option-adjusted spread of the Bloomberg Barclays Liquidity Screened Euro HY Index plotted against the European Commission's Economic Sentiment index (which has been inverted).

Figure 2
Euro High Yield and the Economic Cycle

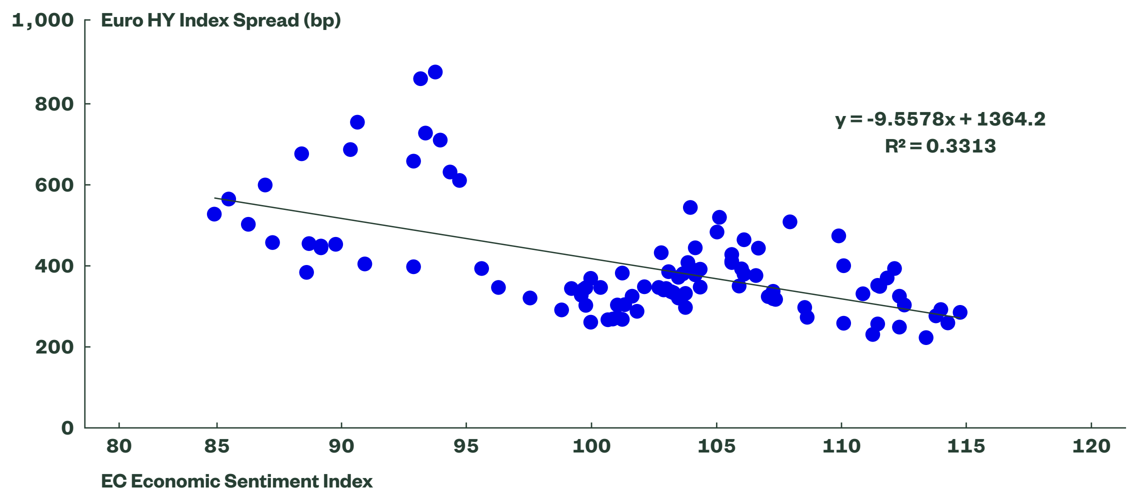


Source: State Street Global Advisors, Bloomberg Finance L.P, European Commission, as of 31 January 2019.

The relationship is largely as anticipated, with improvements in economic sentiment resulting in a tightening (relative outperformance) of high yield spreads to government bonds and vice versa. There have been some periods of divergence, such as in 2012, but this was driven by the fact that spreads were falling as the ECB cut rates while the economic backdrop continued to deteriorate.

Since 2018, spreads have been in the 250–500bp range despite the swing in economic momentum. Spreads remain well supported by the fact that the ECB eased policy rates and restarted asset purchases in 2019. This move helped to limit the fall in economic sentiment as the index declined to 100, which has historically indicated eurozone GDP growth of just above 1%.[1] Indeed, only when the index has slipped below around 95 (equivalent to growth of approximately 0.3% YoY) have spreads widened beyond 550bp (see Figure 3).

Figure 3
Relatively Stable Spreads in a Positive Growth Environment



Source: State Street Global Advisors, Bloomberg Finance L.P, European Commission, as of 31 January 2019.

The cushion afforded by the coupon creates a surprisingly robust investment profile for high yield bonds. Our colleagues Daniel Ung and Shankar Abburu looked at asset performance over the business cycle[2] and concluded that high yield has historically been the best performing fixed income asset during both the 'expansion' and 'slowdown' phases of the business cycle. High yield lags only investment grade bonds during the 'recovery' stage and only underperforms in the 'contractionary' phase of the business cycle. The fact that there are strong high yield bond returns during three of the four stages of the cycle suggests there are advantages to holding them as part of a balanced portfolio.

This ability of high yield to perform in the expansion and slowdown scenarios is in a large part due to its fixed income qualities. Aside from the protective benefits of the strong income stream (as noted above), the higher coupons of the underlying bonds usually result in a shorter duration than for government bonds or IG credit funds. Lower duration funds are typically less volatile and thus more defensive in nature.

For instance, the SPDR Bloomberg Barclays Euro High Yield Bond UCITS ETF has an average maturity of close to 5 years and an effective duration of 3.2 years. By comparison, the Bloomberg Barclays Euro Corporate Bond Index has a maturity that is just 0.7 years longer but an effective duration that is more than 2 years longer. What this means in practice is that for a 50bp rise in yields, the longer duration fund will lose 1% more in value than the shorter one. Note that the lower duration takes into account the optionality of high yield corporate bonds, which tend to be issued with more callable features compared with investment grade peers.

The Potential Benefits of a Risk Asset

As a non-investment grade product, it should come as no surprise that high yield aligns more closely with risk assets than government bonds. Figure 4 shows correlations on monthly data over the past 10 years. The relationship of high yield is strong with both credit and equities. Correlations to government bonds are low.

Figure 4
Correlation Matrix Based on Monthly Changes Over the Past 10 Years

Correlation Matrix	Bbg Barc Liquidity Screened Euro HY TR Index EUR	Bbg Barc Euro Agg Govt TR Index Value EUR	Bbg Barc Euro Agg Treas 3–5 Year TR Index Value	Bbg Barc EuroAgg Govt 7–10 Year TR Index TR	Bbg Barc EuroAgg Corp TR Index Value EU	Bbg Barc EM Local Curncy Liquid Govt TR Index USD	MSCI EMU Net TR EUR Index
Bbg Barc Liquidity Screened Euro HY TR Index EUR	1.00						
Bbg Barc EuroAgg Govt TR Index Value EUR	0.14	1.00					
Bbg Barc EuroAgg Treas 3–5 Year TR Index Value	0.17	0.87	1.00				
Bbg Barc EuroAgg Govt 7–10 Year TR Index TR	0.13	0.98	0.90	1.00			
Bbg Barc EuroAgg Corp TR Index Value EU	0.73	0.66	0.59	0.65	1.00		
Bbg Barc EM Local Curncy Liquid Govt TR Index USD	0.56	0.10	0.15	0.12	0.41	1.00	
MSCI EMU Net TR EUR Index	0.73	0.00	0.01	-0.01	0.39	0.42	1.00

Source: State Street Global Advisors, Bloomberg Finance L.P, as of 31 January 2019.

Including an uncorrelated risk asset in a fixed income portfolio can offer diversification benefits, reducing volatility and, in the case of high yield, potentially increasing the stability of returns.

For some investors, high yield bonds may look a little too much like an equity product. Not only are correlations to equities high but the distribution yield on the SPDR Bloomberg Barclays Euro High Yield Bond UCITS ETF is 3.25%, similar to the dividend yield on the SPDR MSCI EMU eurozone equity ETF (3.2%). However, it is important to note that bonds included in the Bloomberg Barclays Euro High Yield Bond Index are all senior. This means that coupon payments cannot be missed without triggering a default. This makes the coupon a far less variable income stream than the dividend from an equity.

Potential Risks on the Horizon

Default risk looks contained for now. Moody's expects a modest rise in default rates in 2020 on the back of slowing growth, with speculative grade defaults rising to 3.3% from 3.0% under its central scenario. The flipside of weaker growth is that the ECB looks highly unlikely to push rates higher in 2020, which may keep a cap on corporate funding costs.

Issuance risks also appear limited. There was a substantial €12.4 billion of high yield issuance in January 2020, according to Bloomberg, but supply is expected to prove more muted in February as issuers sit out the corporate results season. In the bigger picture, high levels of issuance in H2 2019, as companies took advantage of low EUR rates, should mean that near-term funding needs are limited.

That said, low rates mean that EUR-denominated issuance remains a relatively attractive option for US corporates. Any supply pressures could be partially offset by the ECB, which continues to add to its holdings of corporate bonds. Although its Corporate Sector Purchase Programme ("CSPP") targets investment grade paper, it is likely that some of the liquidity injected into the market finds its way into high yield issues.

Conclusion

In summary, there is a case for including high yield in fixed income portfolios. Doing so can both boost the stability of returns and reduce volatility as an asset largely uncorrelated to government bonds. As a risk asset, a rebound in the economic data should be supportive but, as long as growth remains positive, we would expect high yield to remain relatively stable versus government bonds. Issuance and default risks look contained with the main risk being a recession in the eurozone.

Endnotes

1 Based on a regression of the European Commission Economic Sentiment Index against the quarterly YoY rate of GDP growth since 2005.

2 See Asset Performance and the Business Cycle: A European Case Study by Daniel Ung and Shankar Abburu, January 2020.

Figure 5
Performance
(Annualised, %, in Base Currency)

	1 Month (%)	3 Months (%)	YTD (%)	1 Year (%)	3 Years (%)	5 Years (%)	Since Inception (%)
Inception Date: 3 February 2012							
SPDR Bloomberg Barclays Euro High Yield Bond UCITS ETF (Dist)	-0.01	2.06	-0.01	7.80	3.26	3.55	5.87
Bloomberg Barclays Liquidity Screened Euro High Yield Bond Index	0.00	2.13	0.00	8.35	3.75	4.02	6.27
Difference	**-0.01**	**-0.06**	**-0.01**	**-0.55**	**-0.49**	**-0.48**	**-0.40**

Source: State Street Global Advisors, as at 31 January 2020. **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 ssga 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. **Some of the products are not available to investors in certain jurisdictions. Please contact your relationship manager in regards to availability.**

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