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AEGON Asset Management

HIGH YIELD: WARNING SIGNS OR OPPORTUNITIES?

Relentless inflation and rising recession fears rattled markets during the first half of 2022, leading to weakness across credit and equity markets. Amid the bearish sentiment, high yield has experienced a significant repricing year to date. While rate moves drove part of the weakness, spreads also widened and yields jumped from around 4% to over 8% in July 2022.[1]

As macro uncertainties and recession fears cloud the economic outlook, many investors are grappling with the same question: Does recent spread widening present warning signs or attractive buying opportunities?

Compelling entry points

With yields around 8%, we believe high yield bonds currently present a buying opportunity. Although the current economic environment is challenging, opportunities to add exposure to yields above 8% have been relatively rare. Prior to 2022, there were only eight months over the past 10 years that offered starting yields above 8% (Exhibit 1).

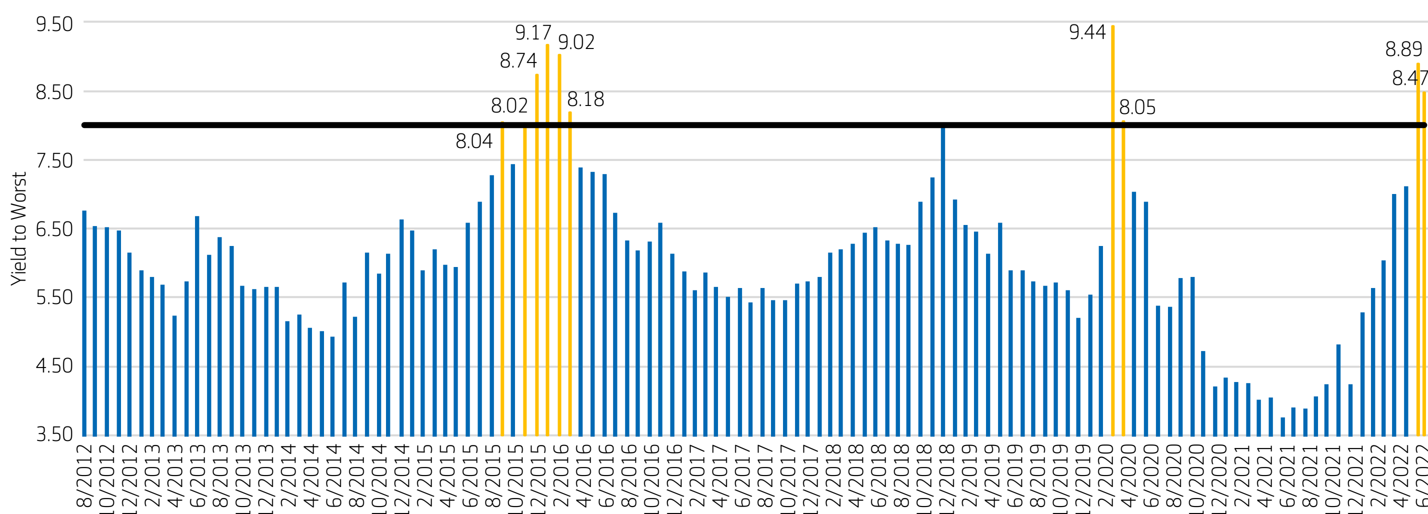
Those periods included March to April 2020 during the depths of the global pandemic, as well as late 2015 and early 2016 amid the energy sector weakness. While these environments were fraught with risk and economic weakness, they were followed by strong rallies that provided opportunities for investors to generate above-average forward returns. Based on the Bloomberg US Corporate High Yield Index, for those who invested when yields were above 8% over the past 10 years, these entry points produced above-average annualized returns:

- One-year average annualized return: 18.04%[2]
- Three-year average annualized return: 8.38%[3]
- Five-year average annualized return: 8.18% [3]

While this highlights how infrequently 8%-plus starting yields present themselves, each economic cycle is different. Notably, there are stark fundamental differences between the 2015 to 2016 period, as well as 2020 relative to now. Prior periods with 8%-plus yields were characterized by deteriorating or weak fundamentals and a very challenging economic landscape.

In 2022, many companies are facing macro headwinds and economic growth is slowing. However, high yield company fundamentals are in a stable and relatively healthy state. Many issuers have historically low leverage, high interest coverage

Exhibit 1: High yield index yield to worst has rarely breached 8% over the last 10 years



Past performance is not indicative of future results. Source: Aegon AM and Bloomberg. Based on monthly Bloomberg US Corporate High Yield Index data from August 31, 2012 – July 18, 2022. Highlights months with a yield to worst above 8%.

[1]Source: Bloomberg US Corporate High Yield Index. The yield to worst increased from 4.21% as of December 31, 2021 to 8.47% as of July 18, 2022. [2]One-year returns based on eight months in 2015, 2016 and 2020 that had starting yields of more than 8%. [3]Three- and five-year returns based on six months in 2015 and 2016 that had starting yields of more than 8%.

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and few near-term maturity concerns. As a result, we think that most high yield companies are well-positioned to navigate an economic slowdown. At these yield levels, we believe high yield investors are being compensated for taking risk in certain credits with solid fundamentals.

Assessing downside risk and long-term returns

While current yields are attractive, we must also consider the downside risks. Given the negative sentiment and number of macro risks, the market could be biased toward spread widening in the short term, especially if the macro backdrop deteriorates further. Since timing the market is nearly impossible, the investment time horizon must be a key consideration. For long-term investors, we think current yields and prices provide attractive entry points (Exhibit 2).

Over the last three decades, when the starting yield to worst was 8%+, we observed that:

- 9.21% was the average annualized forward **five-year return.**
- 81% of periods had an annualized index **total return of 6% or more** over the next five years.
- 99% of periods had **positive index returns** over the next five years.

Exhibit 2: US high yield index yields of 8% or more and subsequent three- and five- year returns

	Three-Year Returns	Five-Year Returns
Average annualized return	9.12%	9.21%
% of periods with positive returns	92%	99%
% of periods with negative returns	8%	1%
% of periods with 6%+ annualized returns	72%	81%
% of periods with 8%+ annualized returns	67%	69%

Past performance is not indicative of future results. Source: Aegon AM and Bloomberg. Based on monthly Bloomberg US Corporate High Yield Index data from January 1, 1987–July 19, 2022. Compares the month-end periods when the index yield to worst was 8% or more relative to the forward or subsequent 3- and 5-year annualized index returns. This analysis included 267 months with a starting yield to worst of 8% or more and long enough time periods to calculate 3- and 5-year returns.

High income and discounted prices

High yield also provides compelling opportunities to harvest income. After all, income tends to drive long-term total returns more so than price movements over time. In addition to high income, discounted prices provide appreciation potential. At these levels, valuations provide room for high yield to rebound and generate coupon-like or coupon-plus returns in the remainder of the year if rates stabilize and volatility subsides.

We are currently seeing many situations where bond prices look cheap relative to the fundamental strength of the company. For those issuers, it is plausible to envision positive catalysts that could prompt a rally and help realize capital appreciation more quickly than expected. That said, the murky economic outlook warrants rigorous credit underwriting. In this environment, selection is key as idiosyncratic factors will continue to create bifurcation across the high yield market.

Recession risk and rebound potential

Although there are many wildcards, our high yield team is modestly more optimistic than the perceived broad market consensus. Yes, the macro backdrop is challenged, however we believe the economy and US consumer could be more resilient than most market participants think. If this view is correct, high yield could stage a rebound as early as the second half of this year. Conversely, if a recession does materialize, our base prediction would be markets begin to recover within a few months of entering the recession, as high yield market recoveries have historically led actual economic activity. In other words, high yield bond spreads could begin to recover before economic activity hits the lows.

Attractive relative value, constructive outlook

Despite a cloudy economic backdrop, we maintain a cautiously constructive outlook on high yield for the remainder of 2022 as outlined in our Global Fixed Income Mid-Year 2022 Outlook. Stable credit fundamentals, subdued default forecasts and a high-quality high yield market are the key factors underpinning our view. High yield also remains attractive on a relative basis, providing opportunities to generate enhanced yield and lower duration risk amid rising rates. While spread widening may be alarming, we believe current valuations present rare opportunities to add exposure to solid companies at attractive yields.

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