aegon asset management

Asset class perspective

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AEGON **INSIGHTS**

The High Yield Valuations Conundrum: Waiting for Godot?

In Samuel Beckett's 1953 tragicomic masterpiece Waiting for Godot, the two protagonists of the play are waiting for a mysterious figure to arrive, who never does. The more they wait, the harder it becomes to leave (despite the immense frustration), just in case the titular Godot actually does appear and provide the salvation they seek. What does this mean for high yield credit?

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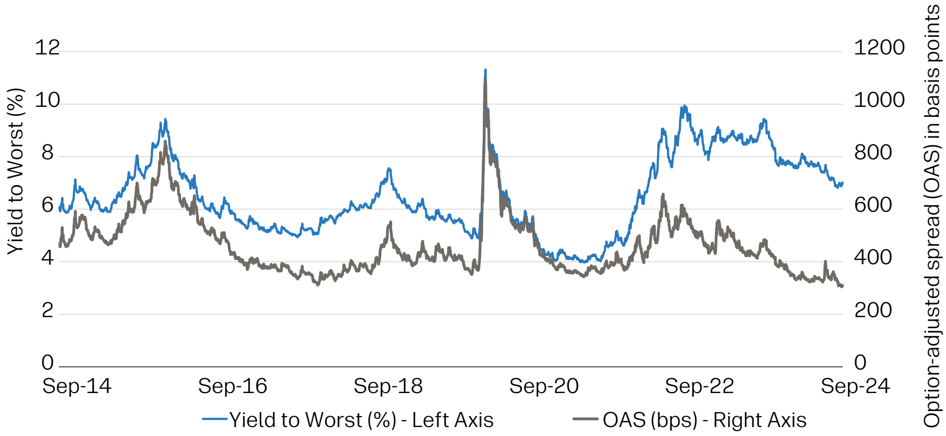
Well, there are some parallels between Beckett's Theatre of the Absurd tour de force and the current investor mindset when it comes to considering global high yield bonds. Waiting has been the one consistent theme amongst investors over the past year. As shown below, the asset class has attractive yield potential, but spreads are still tight, so most investors are waiting for a better entry point.

Exhibit 1: Elevated yields, tight spreads



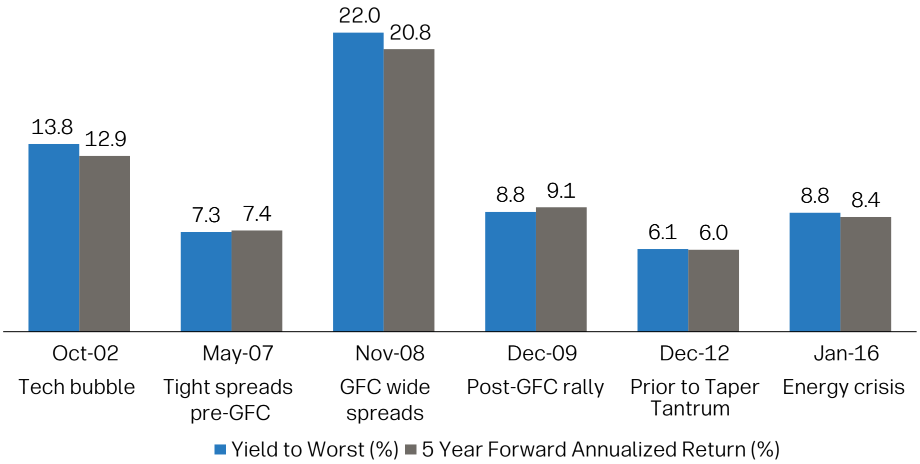
Source: Bloomberg, ICE BofA. Reflects the daily yield to worst and option-adjusted spread for the ICE BofA Global High Yield (HW0C) index from 30 September 2014 - 24 October 2024.

Spreads should reflect credit risk, and if they do not provide an adequate premium given the waning economic outlook then it is prudent to be cautious. The problem is that tight spreads could hang around, particularly when there is a heavily positive technical underpinning the market with demand for high yield bonds outpacing supply (as is the case currently). And in the absence of a clear catalyst for spread widening, there are no guarantees that a better entry point is just around the corner.

So we are where we are, but what is the best way to approach this conundrum?

We think high yield offers investors plenty of opportunities currently. Firstly, the starting yield in global high yield has historically been a reliable indicator of the 5-year forward annualised return[1]. As shown below, this has held true in both wide and tight spread environments. With a yield to worst (YTW) around 7% available on the broad market (ICE BofA Global High Yield Constrained Index), there is still plenty of future return generation potential.

Exhibit 2: High yield index starting yields and five-year returns
ICE BofA Global High Yield Index monthly YTW and forward five-year index returns



As of 31 December 2023. Source: Aegon AM, Bloomberg, ICE BofA. The chart is based on monthly ICE BofA Global High Yield (HW00) index data and includes the index YTW and forward five-year annualized return in local currency. Past performance is not indicative of future results. For illustrative purposes only. Indices do not reflect the performance of an actual investment. It is not possible to invest directly in an index, which also does not take into account trading commissions and costs. Statements concerning financial market trends are based on current market conditions which will fluctuate. All investments contain risk and may lose value.

Secondly, investors are well supported by a defensive breakeven (yield divided by duration) on the asset class that can help protect total returns in the event of spread widening. In addition, investors today can potentially access higher coupon rates and receive high income, while others sit on the sidelines waiting for wider spreads. Lastly, an active, high-conviction approach to this asset class can help uncover enhanced returns over the index, in all types of market environment.

To conclude on the topic of timing, we can only take the aforementioned literary allegory so far. In the world of high yield, a period of weakness will inevitably show up sooner or later (unlike the eponymous Godot) and we would welcome this as a healthy development for the market, all things considered. After all, market volatility creates compelling opportunities for active managers. Whilst passing the time however, we contend it is better to be paid to get in the game, rather than sit on the sidelines. That elusive, sustained market sell-off with wider spread entry points will eventually come soon – won't it?

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[1]There is no guarantee any investment will work under all market conditions or is suitable for all investors. Each investor should evaluate their ability to invest over the long-term, especially during periods of increased market volatility.

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