A timely fixed income solution

The case for European high yield short duration bonds[1]

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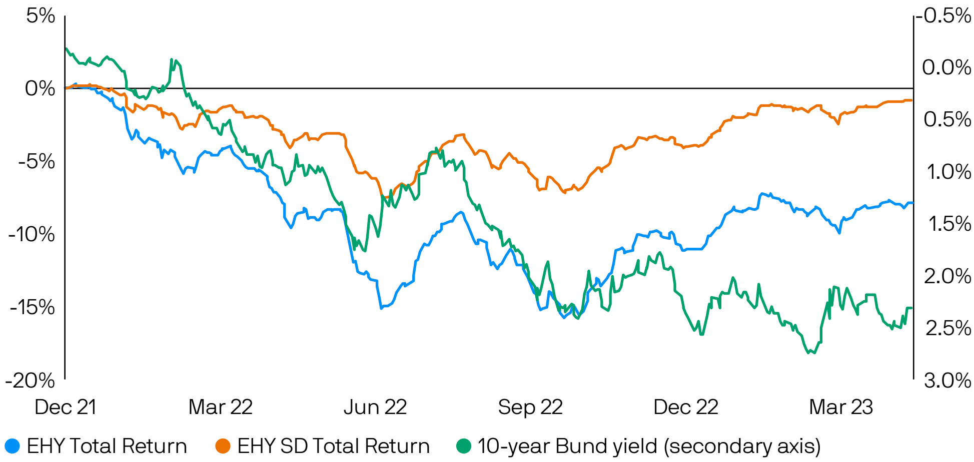
Why short duration?

Aggressive central bank rate hikes have contributed to an inverted yield curve whereby yields on shorter-dated bond investments exceed those on longer-dated fixed income securities.

Short duration bonds have less price sensitivity than longer dated bonds to a given move in yields. All other things being equal, this makes their returns less volatile (**Exhibit 1**).

Flows into short duration fixed income assets have been strong, given the combination of higher carry (i.e. higher yield levels) and lower mark-to-market volatility versus longer dated bonds.

Exhibit 1: EHY and EHY SD – Total Return



Past performance is not a reliable indicator of current and future results. Indices do not include fees or operating expenses.

Source: Bloomberg. EHY Benchmark is the ICE BofA BB-B Euro Developed Markets Non-Financials High Yield Constrained Index (HE5M). EHY SD: ICE BofA Euro Developed Markets High Yield ex-Financials BB-B 1-3 year 3% Constrained Index (Q936). Data as of 01 May 2023.

Why European high yield short duration?

European high yield short duration (EHY SD) compares well to the full duration EHY market – The EHY SD[2] yield to worst (YTW)[3] is 7.02% (436 basis points Option Adjusted Spread) with 1.3 years of duration versus regular duration EHY[4] 6.72% YTW (409 basis points Option Adjusted Spread) with 3.1 years of duration.

[1] All market data as of 01 May 2023, unless otherwise stated.
[2] The fund's benchmark is a 1-3 year customised index which excludes CCC-rated credits and includes floating-rate notes. ICE BofA Euro Developed Markets High Yield ex-Financials BB-B 1-3 year 3% Constrained Index (Q936).
[3] The yield-to-worst is a measure of the lowest possible yield that can be received from owning a bond.
[4] For EHY's benchmark we use ICE BofA BB-B Euro Developed Markets Non-Financials High Yield Constrained Index (HE5M), which excludes CCC-rated credit.

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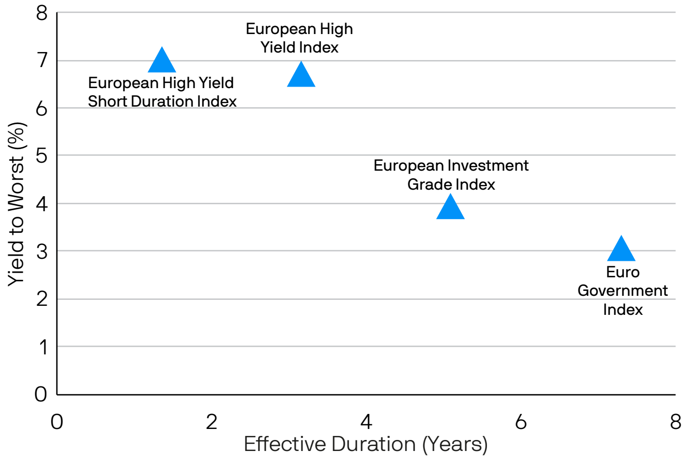
In other words, European HY investors can halve their sensitivity to changes in yields while only giving up 27 basis points (bps) of carry by moving into the short duration part of the market. (**Exhibit 2** and **3**).

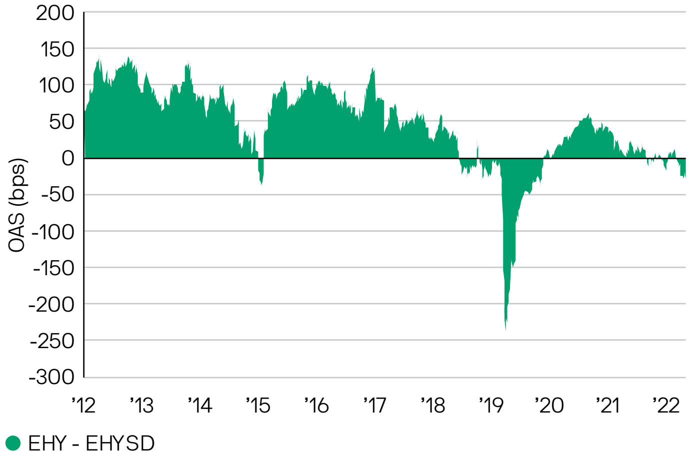
Exhibit 2: Yield to Worst & Effective Duration for Euro fixed income asset classes



Indices do not include fees or operating expenses.

Source: Bloomberg, ICE BofA Indices (EZAS, EN00, Q936, HE5M). All corporate indices are non-financial. European High Yield is ICE BofA BB-B Euro Developed Markets Non-Financials High Yield Constrained Index (HE5M). Data as at 1 May 2023.

Exhibit 3: EHY and EHY SD: OAS* difference (bps) – since December 2012



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*OAS is the Option Adjusted Spread, a yield spread which is added to the benchmark treasury curve in order to take into account an embedded option.

Source: Bloomberg, ICE BofA. Data as 01 May 2023. EHY: ICE BofA BB-B Euro Developed Markets Non-Financials High Yield Constrained Index (HE5M); EHY SD is provided by the ICE Q936 Index.

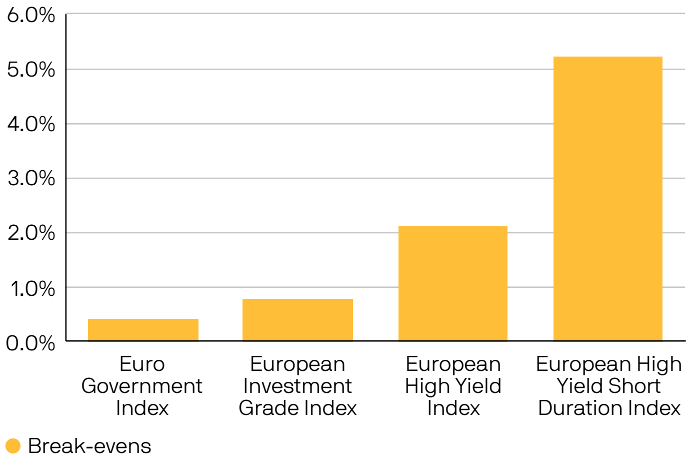
EHY SD is historically cheap – All-in-yields are attractive with the current EHY SD Yield to Worst, currently in the 97th percentile of its historical daily yields over the past 10 years.

Break-evens are attractive – The combination of high yields and short duration translates into attractive break-evens.[5] This means that investors could tolerate a 524bps move higher in short duration yields before their annualised carry is negated. (**Exhibit 4**).

Low cash prices provide buffer against downside exposure – The average cash price for European high yield short duration bonds is 93.35 versus a 10-yr average of 102.35. This discount to par provides an enhanced buffer against downside exposure to potential credit losses.

The opportunity set is growing – The investment universe, which is currently at ~EUR 125bn, can potentially grow to ~EUR 155bn by the end of 2024,[6] as higher yields reduce the incentive of issuers to call their debt early.

Exhibit 4: Increase in yields required to negate current annualized yields



Source: Bloomberg, ICE BofA Indices (EZAS, EN00, Q936, HE5M). All corporate indices are non-financial. European High Yield is ICE BofA BB-B Euro Developed Markets Non-Financials High Yield Constrained Index (HE5M). Data as at 01 May 2023.

[5] Breakeven means how much yields need to widen from current levels before the asset class starts to generate negative total returns.
[6] Assuming no refinancing from the HECM index (which is filtered from HE00, developed markets and non-financials). Only single-B and above have been considered.

Key risks to bear in mind

- The shorter duration subset of the overall EHY market is smaller and less diversified than the broader universe.
- There is generally more refinancing risk associated with shorter dated maturities.
- During periods of severe financial market stress, such as that seen in March 2020, short duration spreads can widen more than the broader market.

Why J.P. Morgan Asset Management?

- Our JPMorgan Funds - Europe High Yield Short Duration Bond Fund is ranked 5-stars by Morningstar[7] and is ranked No. 1 out of all Morningstar-rated (and categorised) "EUR High Yield" funds, for the past 12 months.[8]
- The fund has been in existence since 2017 and is managed by a highly experienced team led by Peter Aspbury, the head of our European High Yield strategies, along with co-portfolio manager Russell Taylor and five dedicated European high yield research analysts.
- The portfolio managers have been with J.P. Morgan Asset Management since 2010 and have an average experience of 24 years in the EHY market.
- The investment style is a fundamental-based active approach, with an up-in-quality bias.

Summary

With the continued prospect of underlying rates curves remaining inverted and broad European high yield spread curves flat, we believe EHY SD provides an appealing alternative to higher duration credit markets.

In our view, short duration sub-investment grade bonds still manage to provide a relatively high yield compared to other fixed income asset classes, but with lower interest rate risk and therefore a lower correlation to moves in government bond yields.

Overlaying active management to avoid potential defaults can add significant excess returns above the benchmark.

EHY SD really does look like a timely fixed income solution for bond investors for the remainder of the year.

[7] Sourced from © 2023 Morningstar, Inc. All rights reserved.
[8] Sourced from Morningstar's EUR High Yield Bond Category (filtered), for the JPMorgan Funds –Europe High Yield Short Duration Bond Fund C (acc) share class, as of 28 February 2023.

Next steps

For more information, contact your
J.P. Morgan Asset Management representative.

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