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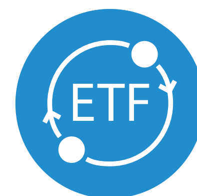
High yield: Is now the time to re-engage?

In this difficult economic environment, we believe high yield bonds still look attractive for long-term investors.



Balance sheets remain healthy, although challenges are yet to come

Companies globally have been faced with a difficult economic environment for much of this year but, surprisingly, they have managed to weather the turmoil relatively well. Indicators for economic growth have been worsening, with manufacturing and services new order purchasing managers' indexes in both the US and Europe now in contractionary territory, while we remain in a high inflationary environment.

Despite the challenging economic backdrop, third-quarter earnings have been notably resilient, rather than the disaster that many investors had feared. While most companies cited slower growth, balance sheets remain healthy. Nevertheless, we believe the wider economic difficulties will eventually feed into the next earnings cycles and we expect the more challenging corporate fundamental backdrop to translate into increased sectoral dispersion, spread widening and ratings decompression.

Spreads still have room to widen

When it comes to high yield valuations, we are facing a conundrum, as yields are attractive, but spreads have room to widen. Through the difficult economic backdrop, both US high yield (USHY) and European high yield (EHY) have only lost around 11% this year (YTD total return), at a time when US investment grade (IG) is down 16% and the S&P 500 is down 16% (YTD – data as of 22 November 2022). The flipside of these challenging returns is that valuations are attractive for long-term investors: USHY offers a yield close to 9% while EHY yields 7.5%, providing entry points that have rarely been seen over the past decade.

Meanwhile, the option-adjusted spread (OAS) for USHY and EHY peaked this year at the start of July at 601 and 677 basis points (bps) respectively, and has since tightened by over 20% to 459bps and 517bps. While current spreads reflect slower growth and a modest recession, they do not fully price in a recessionary outlook. Whereas it is common for stocks to bottom before entering a recession, high yield spreads typically reach their most extreme levels after we have entered a recessionary period, suggesting there could be more widening to come. (All data as of 22 November 2022).

Re-engagement in high yield investments

Technical factors have provided a short-term boost for high yield credit. The asset class has experienced significant outflows this year as investors have fled the wider fixed income asset class amid aggressive central bank hiking. However, there is now a tentative sign of outflows bottoming and investors starting to re-engage in high yield investments.

From a supply perspective, issuance in the primary market has remained extremely subdued throughout the year. Both European and US companies capitalized on the previous low rate environment by extending the maturity profile of their debt, allowing them to be patient in the near-term new issue market. The lack of primary supply in 2022, coupled with this year's rising stars, has shrunk the size of the high yield market and thus mitigated the poor demand technical.

High yield outlook looks attractive

With yields close to 9% and 7.5% for USHY and EHY respectively, we believe high yield currently looks attractive for long-term investors from a carry, convexity and break-even standpoint. Amid continued pressures from supply chains, freight, labor challenges, evolving consumer tendencies and increasingly bearish macro sentiment, we believe that the high yield market has entered this period of economic uncertainty from a position of strength, supported by resilient earnings, the market's strong overall credit quality and favorable technical.

Furthermore, default expectations for the next 18 months are well below those for historical recessionary periods (we expect USHY default rates to hover around their long-term averages and be between 2%-4% for next year, while we estimate EHY default rates at around 3%). Thanks to a cleanse of the poorest performing companies in 2020, and with no current pockets of cyclical weakness, high yield remains attractive, despite idiosyncratic risk in the market.

Lower cash prices also offer considerable downside protection and, together with all-in-yields, provide appealing break-evens. While we acknowledge that the asset class will likely trade on macroeconomic concerns, which could drive spreads wider over the coming months, we expect issuer dispersion to continue to rise and the increased volatility to offer an attractive environment for active credit selection.

Investment implications and ETF solutions

The JPMorgan High Yield Corporate Bond Multi-Factor UCITS ETF (JGHY*) follows a systematic and quantitative investment process that focuses exclusively on issuer selection. The portfolio seeks to deliver better risk-adjusted returns than a traditional passive (or debt-weighted) benchmark by owning issuers with strong value, quality and momentum characteristics. High yield issuers are evaluated relative to their sector peers and only the highest rated issuers (typically those that rank in the top 20% – 30%) are owned in the portfolio.

EXHIBIT 1: JGHY PERFORMANCE SINCE INCEPTION

Time Period	JGHY Index	Excess vs. HW00	Excess vs. HW40
QTD	2.54%	0.46%	0.33%
YTD	-12.99%	4.22%	4.19%
1Y	-12.90%	4.35%	4.24%
2Y	-2.31%	2.84%	3.39%
Since ETF Inception	-1.54%	2.01%	2.17%

Source: JGHY = J.P. Morgan Asset Management Global High Yield Multi-Factor Index, HW00 = ICE BofA Global High Yield Index, HW40 = ICE BofA BB-B Global High Yield Index. Source: JPMAM. As of Oct 2022. Since ETF inception represents index performance for closest month end: Jan 2020. Performance over 1 year is annualized. Past performance is not a reliable indicator of current and future returns.

The JPMorgan High Yield Corporate Bond Multi-Factor UCITS ETF (JGHY*) was launched in February 2020 has enjoyed a strong recent performance record, generating 422bps of alpha relative to a debt-weighted global high yield index over the past year. Since the ETF was launched, the investment process has generated over 200bps of annualized alpha (Exhibit 1). Simultaneously, the strong excess return has been achieved with lower volatility.

While JGHY has an inception date of February 2020, the benchmark it replicates – the J.P. Morgan Asset Management Global High Yield Multi-Factor Index – goes back to January 2007. This time period allows us to analyse historical performance over longer time periods, and most importantly contextualise the live performance relative to the historical index performance. Back tests show that the performance since 2020 is completely in line with our expectations and consistent with what we have seen since January 2007.

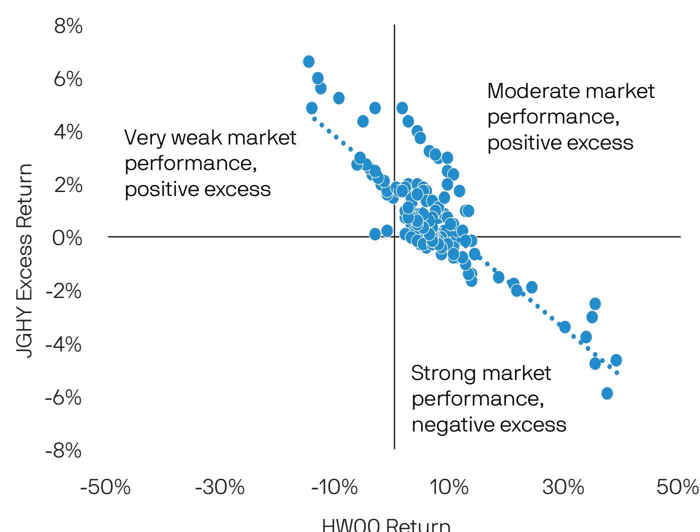
The systematic investment process has generated better returns with lower volatility, which has ultimately resulted in better risk-adjusted returns. We will look at two different market environments to illustrate the JGHY's performance.

1. Performance during periods of market stress

Using two-year rolling periods, we seek to understand the relationship between the factor strategy's excess return and the return of the overall global high yield market. In Exhibit 2, each dot represents a distinct two-year rolling time period. What we can see is that when the broad high yield market return is negative, the strategy is able to provide a meaningfully positive excess return (top left of the chart). When the broad market return is moderately positive (between 0% and 10%), the strategy still provides a positive excess return. When the broad high yield market return is strongly positive (15% or greater), the strategy lags on an excess return basis.

Year to date, the broad high yield market (as represented by HW00) has returned -17% and generated 422bps of excess return, which puts it almost exactly on the historical trendline.

Exhibit 1: JGHY Performance since inception



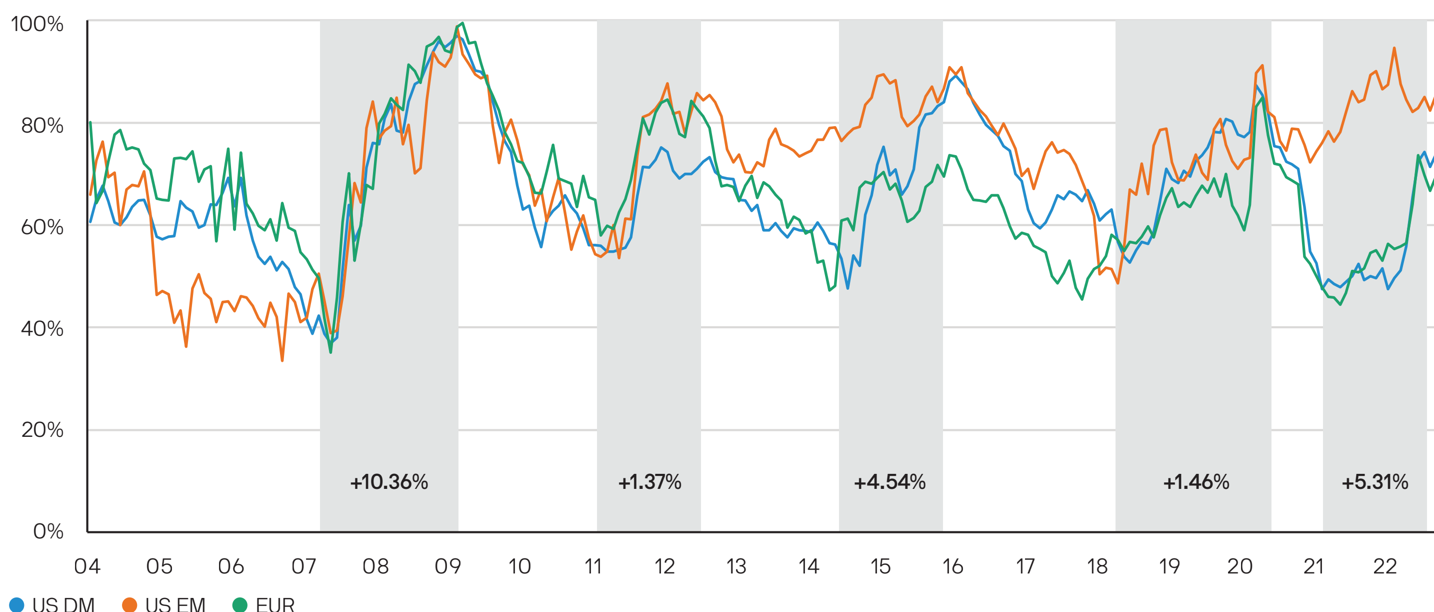
Source: JPMAM. Analysis period is from index inception: Dec 2006 to Oct 22. All performance is gross of fees and gross of transaction costs.
Past performance is not a reliable indicator of current and future returns.

2. Performance during periods of rising dispersion

As we mentioned above, JGHY employs a process that focuses exclusively on issuer selection. This approach means we expect the portfolio to outperform in periods where issuer selection is rewarded or in periods of rising dispersion within issuers. Specifically, when dispersion between issuers is wide, it's easier for our systematic process to differentiate issuers with strong fundamentals from issuers with weak fundamentals. One way we can proxy dispersion is by looking at the percentage of high yield issuers that have yields greater than +/-1% from the benchmark yield. If this value is close to 0%, then all issuers have a similar yield to the index, and dispersion is very low. The closer this value is to 100%, then issuers have yields that are meaningfully different from the overall index yield, and dispersion is high.

In **Exhibit 3**, we've looked at the historical yield dispersion within global high Yield markets. For each period of rising dispersion, we have also shown the relative excess return of the multi-factor strategy vs. a traditional debt-weighted benchmark (HW00). As you can see, almost every period of rising dispersion is associated with strong excess returns. This is precisely the behaviour we expect to see from a strategy that focuses exclusively on issuer selection. Perhaps most importantly, the strategy's strong performance since the beginning of 2021 is a continuation of the historical performance we have seen in previous episodes of rising dispersion.

Exhibit 3: Global High Yield Index Dispersion



Source: JPMAM. Analysis period from Jan 04 to Oct 22.

JPMorgan ETFs (Ireland) ICAV - Global High Yield Corporate Bond Multi-Factor UCITS ETF*

JGHY employs a systematic process that seeks to own high yield issuers with strong fundamental characteristics. While performance since the launch of the ETF in February 2020 has been strong vs. traditional debt-weighted benchmarks, it has been consistent with the performance we have seen through other periods of volatile markets and, specifically, in periods of rising issuer dispersion.

Despite strong performance from high yield markets in November 2022, dispersion levels remain elevated and downgrades continue to rise. We think a product approach that allows investors to capture the upside of current yields, but which also prioritizes issuers with strong fundamentals, makes sense in today's markets.

Investment objective	The Sub-Fund seeks to provide returns that correspond to those of its Index.
Available share classes	JGHY – USD (acc)
	JGHD - USD (dist)
	JHYU – USD hedged (acc)
	JYEH – EUR hedged (dist)
	JYHC – CHF hedged (acc)

Available share classes are country dependent. Please contact your client advisor for further details.

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