# State of the high yield market: Top-of-mind questions for investors

## 1) How has high yield[1] performed in 2022?

2022 was a challenging year, characterised by tightening monetary policy in response to high inflation caused by a post-Covid pickup in demand, and by a European war. The desire of central banks to conquer inflation has, in turn, prompted recession fears. Against this backdrop, US and European high yield bonds have delivered a year-to-date (YTD) total return[2] of -10.34% and -11.32%, respectively. Most of this performance has been driven by the rates markets, while credit was a much smaller detractor. European spreads peaked at 677 basis points (bps), having risen 360bps from their January lows. From a similar starting point, US spreads peaked at 601bps. Both markets have retraced ~25% from their peaks, with spreads settling in the mid 400s for US high yield and the low 500s for European high yield.

While it might have been surprising to see how much credit outperformed rates, the low level of dispersion has been just as unexpected in a negative year for credit returns. This muted dispersion has cut across credit ratings, sectors and individual names. Single-B performance is hardly worse than BB performance, and apart from the European real estate sector (-32.5% YTD) and US energy sector (-4.6% YTD), sector-level returns in both the European high yield and US high yield markets have performed mostly in line with one another. We have started to see a change to this trend, especially in the US market, both across and within sectors, and expect dispersion in 2023 to markedly increase to the benefit of careful credit selection.

### Expect dispersion across and within sectors to pick up in 2023

**Exhibit 1A: 2022 Sector Total and Excess Returns for European High Yield**

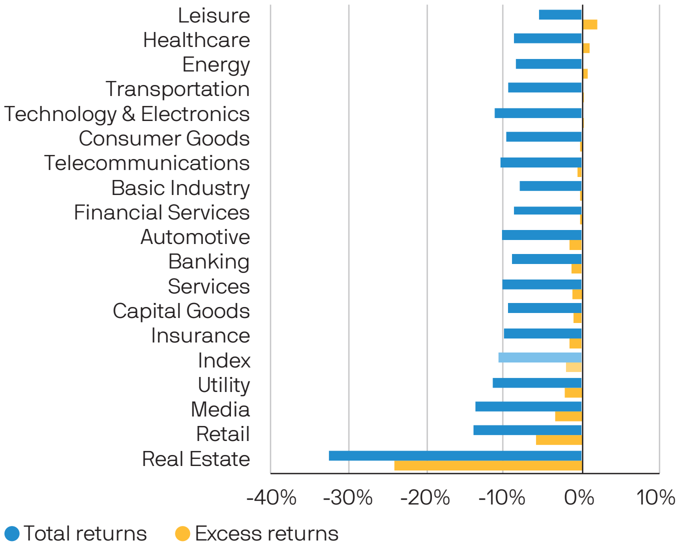
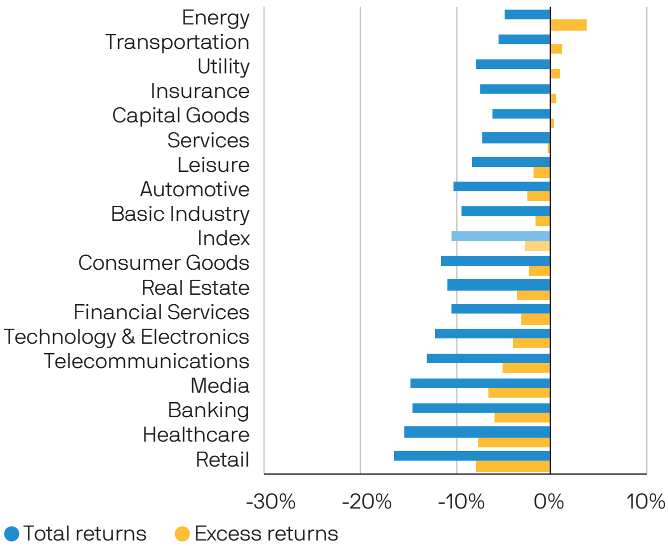



**Exhibit 1B: 2022 Sector Total and Excess Returns for US High Yield**




Source: Bloomberg, ICE BofA. USHY: ICE BofA US High Yield Constrained Index (HUC0); EHY: ICE BofA Euro Developed Markets High Yield Constrained Index (HECD). Data as of 23 December 2022.

**Past performance is not a reliable indicator of current and future results.**

### Authors

**Rohan Duggal**
Managing Director
Global High Yield
Investment Specialist
Fixed Income, Currency
and Commodities Group

**Lisa Tomasi**
Associate
Global High Yield
Investment Specialist
Fixed Income, Currency and
Commodities Group

[1] High yield refers to US and European high yield markets only.
[2] For US high yield, the benchmark used as reference is ICE BofA US High Yield Constrained Index (HUC0). For European High Yield, the benchmark used as reference is ICE BofA Euro Developed Markets non-Financial High Yield Constrained Index (HECM).

## 2) What is the current state of high yield fundamentals?

Companies globally were faced with a difficult economic environment for much of 2022. With the third-quarter earnings season behind us, the much-feared underperformance has not materialised. Indeed, liquidity positions are reverting to pre-pandemic levels and margins are plateauing, but balance sheets remain healthy with manageable leverage ratios. While we believe the macro overhang of volatile commodity prices, tightening lending standards, waning consumer demand, currency weakness and costlier capital will continue to impact earnings, the trough in the earnings cycle has probably been deferred by another quarter or two.

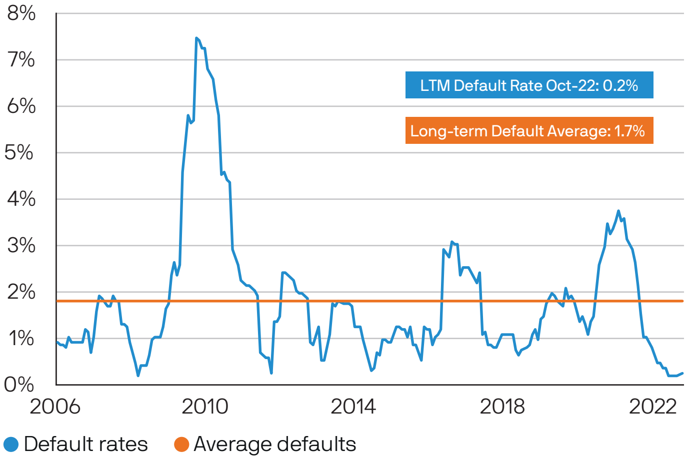
Despite the likelihood of more challenging corporate credit fundamentals in 2023, the high yield market has entered this period of economic uncertainty from a position of strength, which feeds into our default rate expectations. We expect default rates to increase from current record lows to 2%–4% in the US and 1.5%–3% in Europe for 2023. Our view is for a more moderate, albeit longer, default cycle that returns annual default rates closer to their longer-term historical averages (~3.2%[3] for US high yield and ~1.7%[3] for European high yield).

Our view on defaults is predicated on four main factors: 1) The Covid crisis prompted a brief spike in defaults, leaving the remaining universe fundamentally in better shape; 2) The BB portion of the market is near its all-time highs, both in Europe (68%) and the US (50%); 3) The maturity wall for the market is manageable, alleviating refinancing pressure; and 4) With the exception of the small European real estate sector, we do not foresee the kind of sector bubbles that drove default rates upwards in the past, as with telecoms in 2001, LBO 'bubble' in 2008, and energy in 2015/2016.

Roughly speaking, we think that the US and European high yield markets are currently pricing in a respective default rate of 3.5% and 4.2%, respectively.[4]

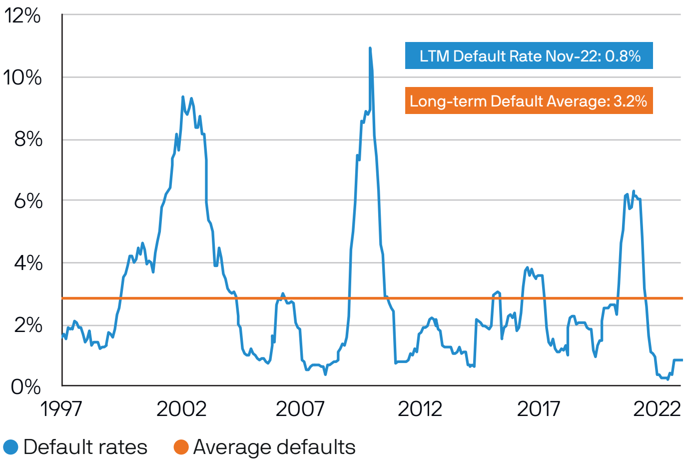
### Default rate will rise from cyclical lows but likely remain modest relative to prior recessions

**Exhibit 2A: European High Yield default rates**




Source: J.P. Morgan, Markit, BofA Research, Bloomberg, Moody's Investor Services. Data as at 31 October 2022. The default calculation universe is based on par value percentage of the EUR and GBP HY Non-Financials corporate bond universe. Defaults include missed coupon payments, restructuring and distressed exchanges.

**Exhibit 2B: US High Yield default rates**




Source: J.P. Morgan Asset Management and Moody's Investor Services. Default rates are par-weight. Recoveries are issuer-weighted and in 2009 were 22.4 based on prices 30-days post default and were 35.7 based on year-end prices. Data as of 30 November 2022. 12m rolling monthly data.

**Opinions, estimates, forecasts, projections and statements of financial market trends are based on market conditions at the date of the publication, constitute our judgment and are subject to change without notice. There can be no guarantee they will be met.**

[3] 30-year average for US high yield. Source: J.P. Morgan Default Monitor 1 December 2022. 17-year average for European high yield. Source: J.P. Morgan IB.
[4] For both calculations, the formula used is Loss Given Default (LGD) rate = (1-RR) *Default rate, using a recovery rate of 40% and liquidity premium of 250bps. Assumes that current spreads of 461bps for US high yield and 503bps for European high yield, less the aforementioned liquidity premium, equate to a one-year forward LGD.

## 3) What do return prospects look like?

Given recent tightening and our view that corporate credit metrics have yet to be tested by tougher economic conditions, we think that credit spreads have room to widen. However, at a yield of nearly 8.7% for US high yield and 7.6% for European high yield, valuations are attractive for long-term investors.

Even if the move to higher yields has been predominantly rates-driven, there have been two beneficial effects for high yield valuations that enhance downside protection. First, the move higher in discount rates has substantially lowered bond cash prices to levels not experienced since the depth of the Covid pandemic in 2020 (~85 cash price for both US and European markets). Second, the all-in yields provide a level of income that offers compensation for potential further spread moves. It is worth remembering that in risk-off markets, interest rate duration often acts as a natural hedge for spread risk. At the start of the year, when Bund yields were negative, there was little-to-no scope for income and rate duration to compensate for a more bearish market stance on spreads.[5] This situation is no longer the case.

**Yields are at near decade-highs, but credit spreads are not**

**Exhibit 3A: EHY: OAS (bps) and YTW (%) range – 10 years**

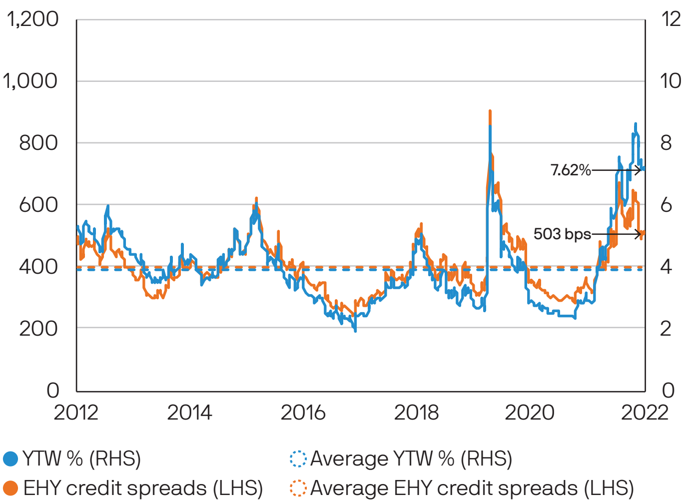
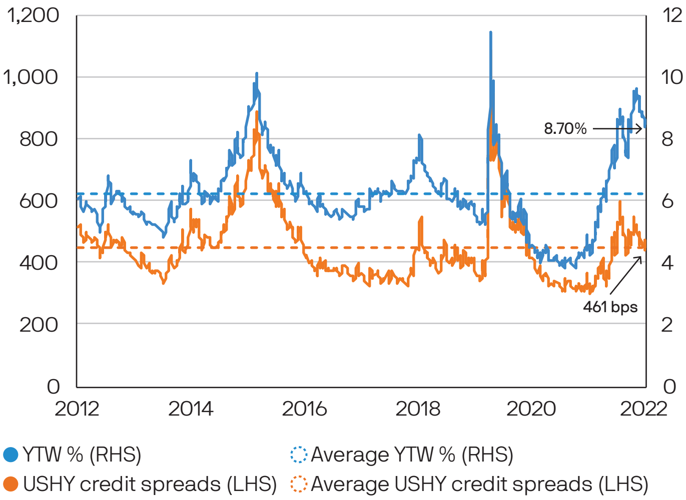



**Exhibit 3B: USHY: OAS (bps) and YTW (%) range – 10 years**




Source: Bloomberg, ICE BofA. Data as of 23 December 2022. USHY: ICE BofA US High Yield Constrained Index (HUC0); EHY: ICE BofA Euro Developed Markets Non-Financial High Yield Constrained Index (HECM).

[5] Breakeven is the point at which falling bond prices will overwhelm interest income, thereby resulting in a capital loss.

## 4) What is the current technical backdrop?

The asset class has experienced significant retail outflows in both the US (USD -41 billion[6]) and Europe (EUR -13 billion[6]) in 2022, as hawkish central bank policy and quantitative tightening induced a large drop in demand. However, 2022 also produced the lightest new-issue volume for bonds since 2008. The lack of primary supply, coupled with the year's rising stars, has shrunk the size of the high yield market and thus mitigated the impact of poor demand.

We expect supply in 2023 to be dominated by refinancing of existing debt, which would have a minimal impact on net supply. Furthermore, November retail fund flows in both the US and European markets indicate that investors are reengaging. This bodes well for technicals, but we have to expect that fallen angels (more so in Europe) will partly make up for the lack of net primary issuance.

## 5) What is the outlook for high yield?

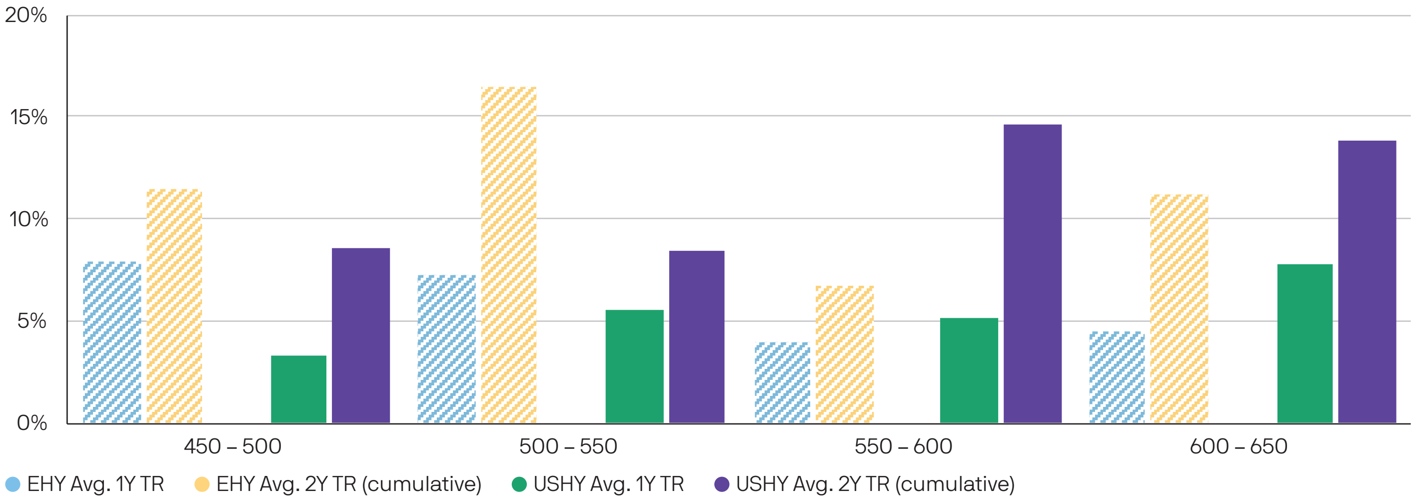
The long-term return prospects look attractive at current yields. Though the credit cycle has yet to hit the bottom, we expect that the widest spread levels will be achieved before that point. However, all-in yields now provide a level of income that offers compensation for spread widening. In the meantime, deliberate attempts by central banks to harness inflation, energy price uncertainty and a more cautious consumer will likely ensure that there is more volatility for risk assets. The good news is that we believe most of the discounting of these risks in high yield bonds has already occurred.

It is always difficult to time the bottom, but current entry points remain attractive, and the power of carry is hard to ignore in a market that offers considerable downside protection and has structurally evolved into a better rated market. Furthermore, active management can help to mitigate, if not avoid, any further market drawdowns.

We would all like to catch the best entry point whenever that might come, but given the prospects for longer-term returns, trying to play it too finely could be costly. We believe now is the time to consider high yield.

### If history is a guide, then return prospects at current spreads are appealing

**Exhibit 4: EHY and USHY Forward Total Returns for 1Y and 2Y at various spread levels – since 1997**

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[6] J.P. Morgan: Credit Strategy Weekly Update North America, 2 December 2022, European Credit Outlook and Strategy 2023, 16 November 2022.

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