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Insight INVESTMENT

MARCH 2025

GLOBAL SHORT-DATED HIGH YIELD
WHY SPREADS MAY PROVE RESILIENT

Some investors may be wary about the high yield bond market given recent spread tightening, but high yield companies have demonstrated remarkable resilience and structural market changes may justify tighter spreads than historically observed. Barring a meaningful recession or crisis, we expect high absolute yields, improved credit quality and low defaults to sustain demand for the asset class.

HIGH YIELD IS NOT THE SAME AS IN THE PAST

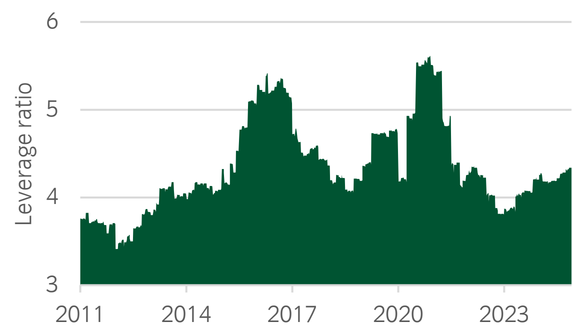
The credit quality of the global high yield (HY) market continues to show significant improvement. In Europe, 66% of the market was rated BB at the end of 2024, while in the US, over 50% of the market held this rating[1]. A decade ago, the average credit rating for both these markets was single B. This highlights a consistent trend towards higher credit quality that has been occurring over time (see Figure 1).

Figure 1: High yield credit quality has trended higher[1]

Analysis of leverage data further underscores this improvement; this measures the level of debt a company has relative to its to earnings before interest, taxes, depreciation and amortisation (EBITDA). Taking the US high yield market as an example, although leverage has crept up from the lows seen in 2023, at 3.98 times (meaning the level of debt is 3.98 times the level of equity) it stands well below the long-term average of 4.3 times.

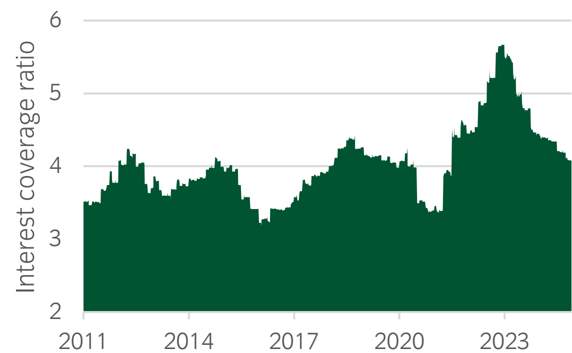
When we look back at recent history (see Figure 2), we can see that debt/EBITDA became elevated during crisis events such as the global financial crisis and pandemic. The pandemic was an especially notable stress test as companies borrowed extensively to sustain their operations; for example, to pay staff who were unable to work. As economies reopened and revenues recovered, company profits rebounded, allowing debt/EBITDA to decline.

Figure 2: Leverage ratios have climbed recently but remain reasonable vs history[1]



An alternative way to look at this is via interest coverage, which measures the number of times profits can cover interest on debt. Although leverage ratios rose during the pandemic, the sharp decline in rates saw interest coverage shoot upwards after an initial dip. Central banks have significantly tightened policy since, but interest coverage remains at healthy levels, supported by the reduction in leverage and the fact that many companies locked in low funding levels for many years into the future.

Figure 3: Interest coverage remains healthy despite higher rates[1]

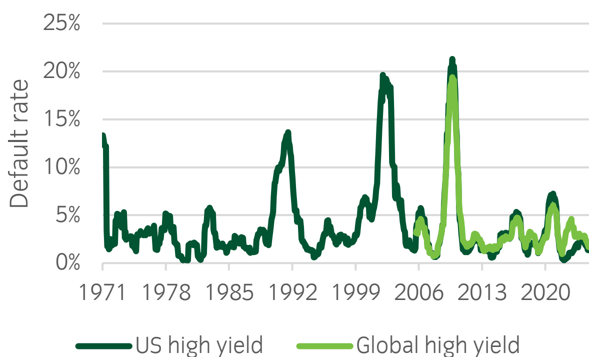


[1] Source: Bank of America, as at 31 December 2024.

DEFAULTS ARE RUNNING AT LOW LEVELS

Across all metrics—ratings, total debt/EBITDA (leverage), and EBITDA/Interest expense (coverage)—credit quality has markedly improved. This has translated into lower defaults and the expectation that defaults will remain low. The average rolling 12-month default rate for US high yield has been 3.4% over the past 25 years, and post-global financial crisis, it has been 2.5% (see Figure 4). At the end of 2024, the default rate stood at just 1.5% for the US and 1.8% globally, both well below the long-term average. This reinforces our view that global high markets are significantly more resilient than in the past.

Figure 4: 12-month rolling defaults are well below long-term average levels[2]



We believe the average annual credit loss from defaults over the 25 years to end 2024 has been 65bp. For illustration, this means that an investment in high yield at a spread of 270bp, with an expected loss of 65bp per annum from defaults, the investor would earn 205bp above government bonds per annum.

THE INVESTOR BASE HAS CHANGED

Over the past 20 years, high yield indices have generated negative returns in only six of those years. However, in each example, the subsequent rebound more than compensated for the prior year's negative returns (see Figure 5).

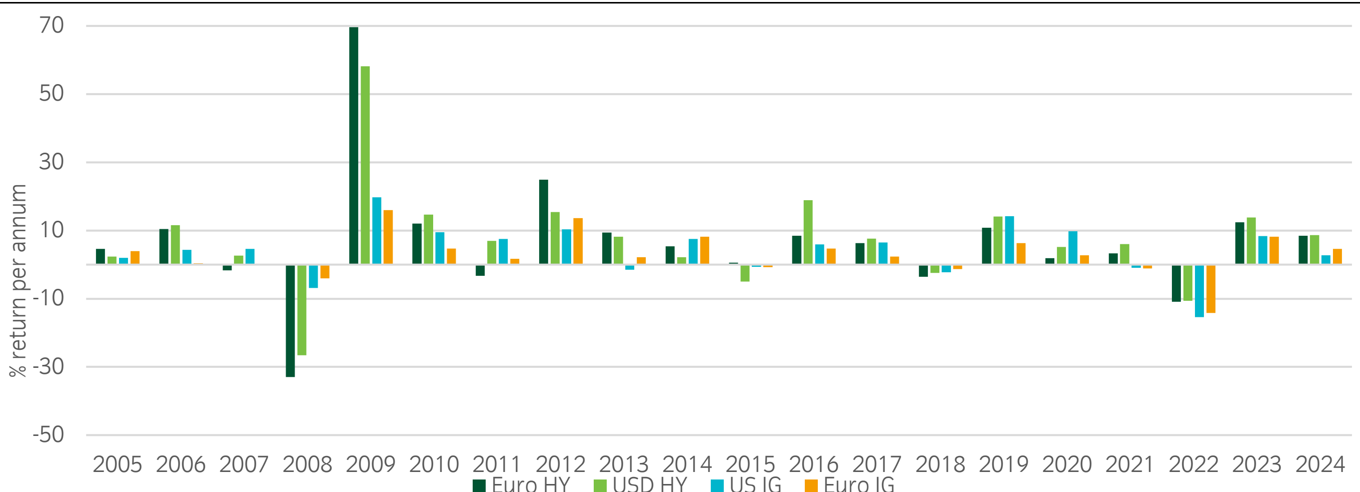
This return profile has significantly increased the appeal of the asset class to institutional investors. A decade ago, the high yield market was dominated by retail investors, which increased the volatility of the market. Today, 47% of the investor base is institutional (see Table 1), many of which have dedicated long-term allocations to high yield, contributing to a more stable investment environment.

Table 1: The composition of high yield investors[3]

AUM estimates in US$bn	
Dedicated funds	291
Core+/Flex funds	336
Pension funds	199
Insurance companies	324
Alternative managers	139
Banks/CLOs/Business development companies (BDCs)	10
Retail	42
Total	**1,339**

The high absolute level of yields, improved credit quality, low level of defaults, and a 20-year history of predominantly positive returns (see Figure 5), makes us confident that institutional investment flows will continue to flow towards the asset class. As a result, we believe that high yield spreads may remain well anchored barring a meaningful recession or market crisis.

Figure 5: Annual returns for major high yield indices[4]



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[2] Source: Bank of America, as at 31 December 2024.

[3] Source: Bank of America Global Research, select individual investors' regulatory filings, Fed's Flow of Funds Report. Data as at 31 December 2024.

[4] Source: JP Morgan and S&P Global as at December 2024. US high yield 'H0A0', European high yield 'HE00', European Investment Grade 'ER00', US Investment Grade 'C0A0', and Euro Stoxx 50 'SX5E'. Performance is for major indices so does not include fees.

IMPORTANT INFORMATION

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Past performance is not indicative of future results. Investment in any strategy involves a risk of loss which may partly be due to exchange rate fluctuations.

The performance results shown, whether net or gross of investment management fees, reflect the reinvestment of dividends and/or income and other earnings. Any gross of fees performance does not include fees, taxes and charges and these can have a material detrimental effect on the performance of an investment. Taxes and costs incurred when purchasing, holding, converting or selling any investment, will impact returns. Costs may increase or decrease as a result of certain currency conversions, such as currency hedging, investment exposure to international markets, and exchange rate fluctuations.

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Portfolio holdings are subject to change, for information only and are not investment recommendations.

ASSOCIATED INVESTMENT RISKS

Fixed income

Investments in bonds are affected by interest rates and inflation trends which may affect the value of the portfolio.

A credit default swap (CDS) provides a measure of protection against defaults of debt issuers but there is no assurance their use will be effective or will have the desired result.

The issuer of a debt security may not pay income or repay capital to the bondholder when due. The return risk to a portfolio is higher where a portfolio is highly concentrated in such an issuer.

Derivatives may be used to generate returns as well as to reduce costs and/or the overall risk of the portfolio. Using derivatives can involve a higher level of risk. A small movement in the price of an underlying investment may result in a disproportionately large movement in the price of the derivative investment.

Investments in emerging markets can be less liquid and riskier than more developed markets and difficulties in accounting, dealing, settlement and custody may arise.

Where high yield instruments are held, their low credit rating indicates a greater risk of default, which would affect the value of the portfolio.

The investment manager may invest in instruments which can be difficult to sell when markets are stressed.

Leveraged funds: as a result of market conditions, the value of the assets held by a Fund may fall and result in a higher degree of leverage than is deemed appropriate by the Investment Manager. In order to reduce the degree of leverage, the Investment Manager may seek to reduce a Funds' total asset exposure. Investors would need to subscribe for additional Shares in order to maintain the level of sensitivity to market movements. Where such an event is unanticipated, this may result in the investors having less sensitivity to market movements than they might consider appropriate to their individual requirements until they have subscribed for additional Shares

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