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High yield: Is it time to step back into the market?

With the sell-off in 2022, the high-yield bond market appears to be more attractive than it has been in years. The pandemic weeded out many of the weaker credits while credit quality still looks strong

Executive summary

- With the 2022 sell-off in the fixed-income market, high-yield bonds appear more attractive given the favorable fundamental and technical factors underpinning the asset class.
- Despite the economic environment, DWS believes defaults are unlikely to surge because:
 - The pandemic already eliminated many of the weakest credits,
 - Credit metrics are strong by historical standards,
 - Default-prone sectors — energy, metals & mining — are well-positioned given they are supported by high commodity prices, and
 - Issuers have refinanced much of the near-term debt, minimizing the maturity wall.
- Technical support: Issuance is down with fund flows showing early signs of a rebound.
- By historical standards, yields have improved, spreads are about average, yet prices can be perceived at value levels.
- When viewing the market, DWS is constructive on B and BB rated credits and underweight CCCs.
- Given the economic and geopolitical environment, risks remain, but we believe investors are now being adequately compensated for them.

Importantly, price, is in the 84th percentile — well below typical levels. This is especially critical, because it means there is less downside risk, as bond prices are much closer to their recovery values.

The High Yield market appears to have become more attractive in 2022



Source: St. Louis Federal Reserve, FRED Database, ICE BofA U.S. High Yield Index Effective Yield.

Higher yield, attractive prices

For the first time in many years, the high-yield market is now offering something it has long been lacking—yield. As of December 30, 2022, the yield on the broad BofA U.S. High Yield Constrained Index stood at 9.0%, up sharply from 4.3% at the end of 2021. While spreads are in the 52nd percentile, the market's yield is in the 70th percentile since inception of the index. So, while spread is largely in-line with historical average, yields are well above.

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The market toward the end of 2022 recently began to rebound, but not all segments have benefited. So, investors are now considering how best to navigate this situation. But given that high-yield bonds have historically been more correlated to stocks than to rates, the potential is there for equity-like returns, with both less volatility and higher income generation.

Fundamentals are sound

Despite the challenges of the economic environment of the past few years, high-yield borrowers have managed through these difficulties reasonably well. Although revenue and earnings outlooks have softened, issuers remain in relatively healthy condition. In fact, as they enter this period of likely below-trend growth, they are in much better shape than they have been in previous downturns. Leverage has generally decreased over the past several years, and interest coverage ratios have risen.

Default rates have also been very low. This is critical because it is often defaults that drive returns. Defaults in 2021 were approximately 0.5%, and through December 30, 2022, the default rate was 0.9%.

In our view, default rates will rise from the current lows as the economy continues to slow. But we expect defaults to remain measured and manageable, reaching only about 3.5%, roughly in-line with historical averages.

Why defaults are unlikely to spike

DWS points to four factors that are likely to keep defaults from spiking. First, because of the economic slowdown resulting from COVID-19, many of the weaker credits have already been “weeded out.” The pandemic produced a mini default cycle in 2020 in which the default rate reached approximately 6%.

Second, credit quality has broadly improved and is relatively strong by historical standards. BB-rated credits represent 52% of the market today, versus 44% historically. Meanwhile, riskier CCC-rated credits only represent 11% of the market, versus 14% historically.

In addition, secured bonds also comprise a larger portion of the high-yield market than in the past. At the end of 2022 secured bonds represented 27% of the market, versus the historical average of 15%. This is largely a result of the supply wave that hit in 2020-21 as companies issued secured debt to access the market. The larger portion of secured debt in the market could result in higher recoveries and less downside as a result of the senior priority of secured bonds in bankruptcy.

Investors should also note that toward the end of the fourth-quarter 2022, upgrades outnumbered downgrades, both in terms of issuers and dollar volumes. As expected at this point in the cycle, however, the pace of upgrades relative to downgrades is decelerating, and that is something DWS credit analysts are monitoring.

A third reason that defaults are unlikely to spike is that the sectors that typically lead in defaults—energy and metals & mining—appear to be well-positioned. Commodities prices are still elevated, and we believe that widespread downgrades are unlikely to materialize, especially in the energy sector. In fact, we are forecasting that a number of large issuers may even soon be upgraded to investment-grade credits.

Fourth, the refinancings that companies have undertaken over the past two years have reduced near-term default risks. Issuance surged in 2020 and 2021, and the majority of proceeds were used to refinance near-term maturities. So, there's less concern about a near-term maturity wall.

Technical Factors: Supply Is Down, Demand Is Rebounding

While markets have been quite volatile, technical factors are becoming more favorable. On the issuance front, 2022 issuance volume was 78% lower than the elevated levels of 2021. Lower issuance in 2022 is not necessarily due to a lack of market demand. Instead, this decline in issuance volume came as companies were selective in issuing at higher rate levels.

As for fund flows, 2022 witnessed some significant outflows from the asset class. Approximately \$47 billion in investor funds have left over the course of the year, which was a record amount. That pattern, however, started to reverse in the final months of the year, as inflows materialized in October and November and outflows were minimal in December.

Outlook and positioning for 2023

In DWS's view, the outlook for 2023 is pointing toward positive. We believe there are opportunities from a total return perspective and that it makes sense to average into high-yield allocations at this time.

Historically, high-yield returns have been attractive when the average yield is 8% or more, which is exactly where it was at the end of 2022. When yields breach the 8% mark, returns average 2.5% in the ensuing three months, 4.2% over the next six months, and about 13% over the next 12 months.

Security selection is important, especially in this portion of the cycle. Given DWS's bottom-up research and fundamental analysis approach to portfolio management, we are finding opportunities in a variety of segments.

As we enter 2023, the firm is most constructive on B-rated credits, especially within the upper-tier B1 bucket. We had been underweight in this segment, and while we remain cautious on B3-rated credits, DWS has become more constructive on B1s and B2s. Within B3s, we believe that tail risk remains elevated, but we could become more opportunistic if there is additional spread widening in this segment.

We are also constructive on BB rated credits and are focused on the Ba3 segment of the market. Prices for BBs are in the 95th percentile relative to historical levels. Prices are thus attractive considering expected recovery values and low probability of default.

Among CCC-rated credits, we are more cautious. Prices at year-end 2022 were only in the 76th percentile relative to historical levels, and this compares unfavorably to the 84th percentile for the index as a whole and the 95th percentile for BBs. We believe that with slowing economic growth on the horizon, this portion of the market is at risk.

As for our geographic positioning, on a macro level, the portfolio management team generally prefers companies with more exposure to the U.S. economy. Europe faces risk from energy volatility and from a potential decline in consumer demand. That said, we have been adding European risk in our global high-yield portfolios recently. We believe the risk of gas shortages in Europe has declined, and that the corporate sector is more resilient than many had feared earlier in the year.

We also prefer companies that have more fixed-rate than floating-rate debt. Companies with higher proportions of floating-rate debt face the potential for increased costs as interest rates rise. Lastly, DWS has a preference towards credits with pricing power. We want to be sure that companies in the portfolios have the ability to pass on at least some of the higher raw material input costs and labor costs they are facing.

Risks on the horizon

Of course, the higher yields available are not without risks, especially in the current environment. These include central banks keeping rates higher for longer, which could also lead to recession. Volatile and elevated energy prices also present a threat to cash flows and profit margins. In addition, supply chains continue to be at least partially disrupted, which also threatens revenues and costs. And geopolitical issues remain elevated as well.

But investors should remember that the high-yield market can be quite inefficient. DWS believes these volatile times can provide good opportunities to generate value via credit research and portfolio management. Insurance companies and institutional investors are particularly well-suited to take advantage of, and benefit from, these inefficiencies.

For some clients, these opportunities also extend to global markets. At DWS, we view the high-yield arena as one broad global market, not as separate regional silos. With this perspective, we have the ability to detect inefficiencies that may go unnoticed by others. For example, this would enable us to see that the euro bonds of a U.S.-based issuer carry a higher yield relative to the company's U.S. dollar bonds after the currency risk is hedged. This is the type of inefficiency that the market often misses, and it creates opportunities for us to generate value.

In summary

The high-yield bond market enters 2023 offering yields that are elevated compared to recent years. Fundamentals, however, are sound, and we believe the likelihood of a spike in defaults is low. While the list of risks is long, we believe investors are increasingly being compensated for them. This is especially true given our bottom-up fundamental approach, which we believe can help investors avoid deteriorating credits and capitalize on those that are best positioned in the current economic environment.

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