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The case for short duration, high yield bonds

With interest rates peaking, shorter maturity high yield bonds could offer a combination of healthy income and lower volatility.

Looking at asset performance across 2023 it was little surprise to see US high yield bonds topping the fixed income charts, far outstripping the returns on perceived lower risk assets such as US investment grade corporate bonds and US Treasuries.[1]

High yield bonds (bonds issued by companies with credit ratings below BBB-) pay investors a credit spread over "risk-free" assets (such as US Treasuries) to compensate for expected losses stemming from defaults, plus an extra amount to reflect the greater volatility of the asset class. Investor appetite for high yield bonds thus tends to increase as their assessment of economic conditions improves, since a stable or growing economy reduces the risk of corporate defaults. This can occur both in the primary market, where investors demand lower yields for newly issued bonds, and in the secondary market, where increased demand for high yield bonds sees prices rise and yields fall.

1 Bloomberg, ICE BofA and JP Morgan indices, AllianzGI, 29 December 2023

KEY TAKEAWAYS

- US high yield bonds were one of fixed income's top performers in 2023 but yields remain high by historical standards.
- Current yields in the US high yield bond market have historically been associated with strong returns in the ensuing 12-24 months.
- Short maturity (1-2yr) high yield bonds could offer access to elevated yields but typically with lower volatility.
- Healthy fundamentals such as low net leverage and healthy interest coverage can help defend returns against a more severe slowdown than is currently anticipated.

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Navigating Rates

In this context, high yield's recent outperformance has partly reflected fading expectations of a US recession. At the beginning of 2023, markets were still unsure where and when US interest rates might peak, and whether the lagged effect of substantial rate hikes from the US Federal Reserve would lead to an economic downturn as companies faced mounting funding costs. But with inflation coming down steadily and economic data seemingly holding firm, markets have become increasingly confident that US interest rates have peaked and the economy will avoid the sort of "hard landing" that would trigger a sharp rise in high yield default rates.

In our view, US high yield bonds offer competitive yields and healthy fundamentals. In addition, shorter maturities could provide better risk-adjusted returns in an environment of uncertainty around the strength of the US economy.

Today's yields suggest potentially strong near-term returns

For the broader US high yield market, yields remain just under 8% after the recent sharp rise in interest rates.[2] According to a 2022 study by JP Morgan analysing 35 years of performance data, this bodes well for future total returns (see Exhibit 1). When high yield bonds have been in the 8-9% range, returns over the ensuing 12-24 months have historically been in the mid to high single digits, on average.

Exhibit 1: Today's yield levels have historically been associated with strong returns

High yield forward return (%) over X months (Jan 1987 – Oct 2022)

Starting yield	12M	18M	24M
<6%	2.0	1.4	2.0
6-7%	4.2	5.3	5.4
7-8%	7.2	6.5	5.9
8-9%	9.1	7.3	6.4
9-10%	8.4	8.0	7.9
10-11%	6.6	9.0	8.9
11-12%	12.4	12.2	10.9
>12%	13.6	13.0	12.9

Source: JP Morgan, data as at October 2022. Based on JP Morgan Domestic High Yield Index. Performance for periods greater than one year have been annualised. Past performance, or any prediction, projection or forecast, is not indicative of future performance.

Fundamentals look supportive despite macro uncertainty

Under classic "late cycle" conditions, when interest rates are peaking and markets would typically begin to price in a coming recession, investors tend to become wary of high yield bonds as lower quality credits are more vulnerable to the higher cost of debt.

In response, the credit spread high yield bonds pay over "risk-free" assets such as US Treasuries tends to widen (with bond prices falling) as investors demand more compensation for the rising risk of high yield issuers defaulting.

However, credit fundamentals can help investors gauge the financial strength of high yield issuers, and today several of these metrics suggest the sector can cope with tighter conditions:

- **Low net leverage** – Debt as a proportion of equity or earnings is a key measure of financial strength for high yield issuers. As of end-Q3 2023, net leverage (a measure of debt divided by cash profit) across US high yield issuers was 3.44x, above the lows of late 2022 but also well below previous peaks of around 5x in 2021 and 4.7x in 2016-17.[3]

2 Bloomberg, 29 December 2023. High yield bonds are represented by the ICE BofA US High Yield Index
3 JP Morgan, October 2023

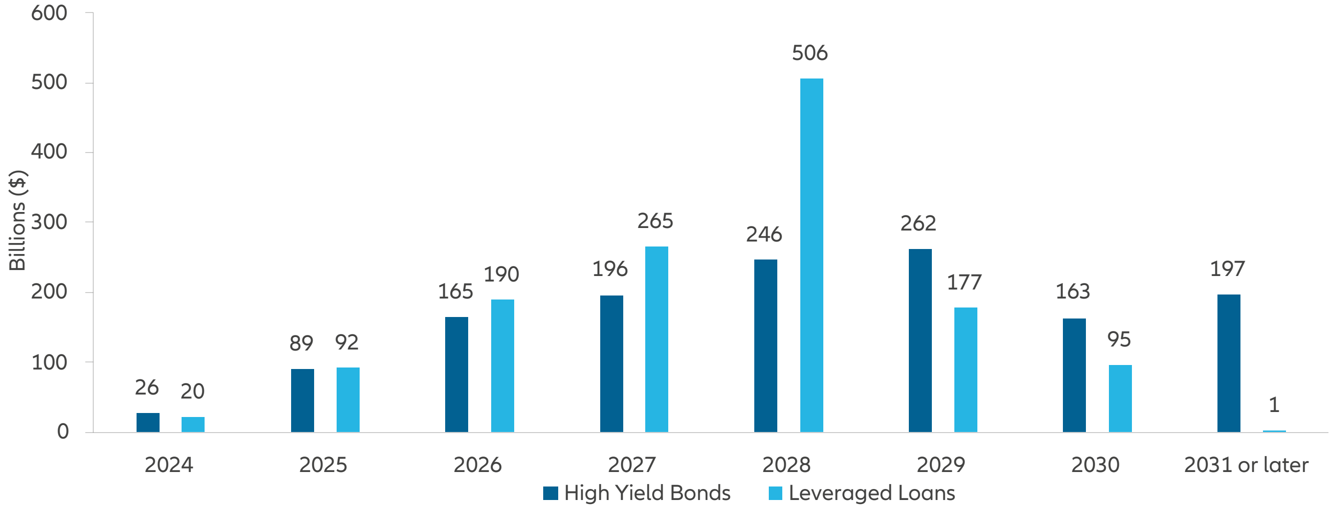
- **Healthy interest coverage** – The amount of cash firms have on hand to pay the interest on their debt can be expected to deteriorate given higher refinancing costs, but it is starting from a healthy level as issuers did an impressive job of extending maturities on attractive terms in 2020 and 2021. As of end-Q3 2023, interest coverage across US high yield was around 5x – still well above dips below 3.5x in 2011, 2013 and 2016.[4]

- **Low maturity wall** – High yield investors keep a close eye on when maturing bonds will require issuers to refinance at current market levels (widely known as the "maturity wall"). Currently US high yield issuers' near-term refinancing obligations are low by historical standards (see Exhibit 2), with only USD 115.3 billion of bonds maturing in 2024-2025.[5]

- **Lower CCC exposure** – Today's US high yield market includes a lower-than-normal exposure to CCC rated bonds, which have historically had higher default rates than higher-quality bonds.[6]

Exhibit 2: Near-term refinancing needs remain manageable

US high yield bond and leveraged loan maturities



Source: Bank of America HY Chartbook, data as at 29 December 2023. Past performance, or any prediction, projection or forecast, is not indicative of future performance.

Focus on the short end of high yield

Within high yield bonds, shorter maturities benefit from two favourable characteristics.

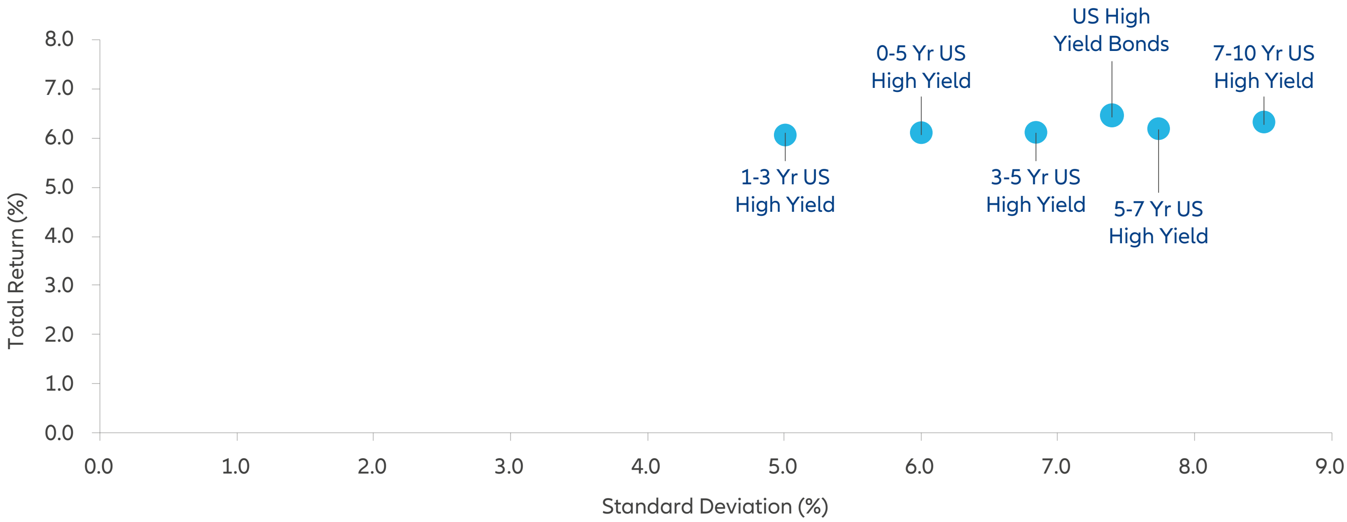
1) A historically better risk-return ratio than longer dated bonds

The short end of the US high yield market (as measured by the 1-3 year US High Yield Index) has provided comparable returns to the broader US high yield market, but with significantly lower volatility (see Exhibit 3).

One reason for this is a phenomenon known as "pull-to-par". As a bond approaches its maturity date, its price will "pull" towards its par value as default risk becomes increasingly negligible (this occurs whether the bond has risen or fallen in price since it was issued). This effect is more powerful in shorter maturity bonds since they are closer to the maturity date when bondholders are repaid at par. In other words, shorter maturity high yield bonds are less exposed to a deterioration in economic conditions that would increase default expectations.

4 JP Morgan, October 2023
5 Bank of America HY Chartbook, data as at 29 December 2023
6 BofA Global Research, ICE Data Indices, July 2023

Exhibit 3: Short maturity HY has provided comparable returns with lower volatility



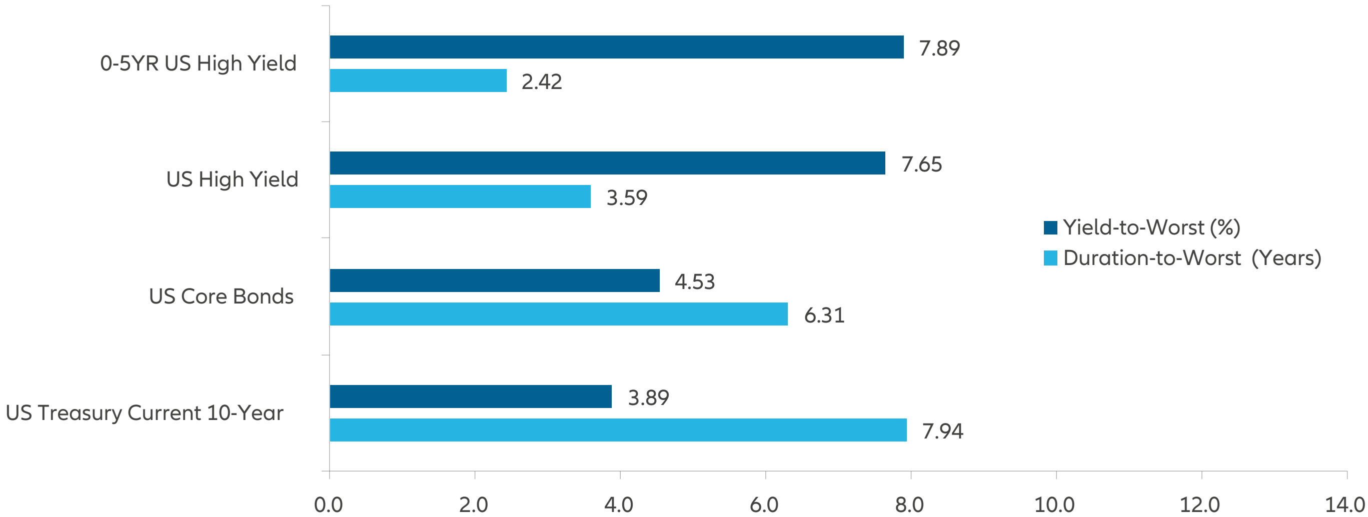
Data: November 2009 to December 2023. Source: Voya Investment Management, FactSet, ICE Data Services. Past performance, or any prediction, projection or forecast, is not indicative of future performance. This statement reflects performance and characteristics for the time period shown, results over a different time period may have been more or less favourable. The performance shown above is gross and does not reflect the deduction of investment advisory fees. 1-3 Yr: ICE BofA 1-3 Year US Cash Pay High Yield Index, 3-5Yr: ICE BofA 3-5 Year US Cash Pay High Yield Index, 5-7Yr: ICE BofA 5-7 Year US Cash Pay High Yield Index, 7-10Yr: ICE BofA 7-10 Year US Cash Pay High Yield Index, US High Yield Bonds: ICE BofA US High Yield Index; 0-5Yr: ICE BofA 0-5 Year US High Yield Constrained Index. Investors cannot invest directly in an index. Index returns are presented as net returns, which reflect both price performance and income from dividend payments, if any, but do not reflect fees, brokerage commissions or other expenses of investing. Individual costs such as fees, commissions and other charges have not been taken into consideration and would have a negative impact on the performance if they were included.

2) A more appealing yield-duration trade-off

Put simply, yield-duration measures how far a bond's price would have to fall before wiping out its yield, resulting in a capital loss (this is often called the "breakeven point"). Today's elevated yields thus provide a cushion against potential price falls in US high yield if recession fears re-emerge.

This is particularly true for the short end of US high yield, where record-high new issuance and refinancing activity in 2020 and 2021 pushed coupons and interest expense down and maturities out (see Exhibit 4).

Exhibit 4: Short maturity HY has greatest yield relative to duration



Data: November 2009 to December 2023. Source: Voya Investment Management, FactSet, ICE Data Services. Past performance, or any prediction, projection or forecast, is not indicative of future performance. statement reflects performance and characteristics for the time period shown, results over a different time period may have been more or less favourable. The performance shown above is gross and does not reflect the deduction of investment advisory fees. US High Yield Bonds: ICE BofA US High Yield Index, 0-5 Yr US High Yield Bonds: ICE BofA 0-5 Year US High Yield Constrained Index, US Core Bonds: Bloomberg US Aggregate Bond Index, US Treasury Current 10-Year: ICE BofA US Treasury Current 10 Year Index. Investors cannot invest directly in an index. Index returns are presented as net returns, which reflect both price performance and income from dividend payments, if any, but do not reflect fees, brokerage commissions or other expenses of investing. Individual costs such as fees, commissions and other charges have not been taken into consideration and would have a negative impact on the performance if they were included.

Credit selection remains important

Of course, active management and credit selection remains an important factor. The risks in high yield can vary significantly by credit rating, with a significant step-up in risk having been observed in past cycles where bonds are rated B- or lower.

After their strong recent performance high yield spreads may struggle to tighten much further in the medium term. But we think today's elevated yields – especially at shorter maturities – still offer value.

An investor cannot invest directly in an index, and index performance does not reflect the deduction of any fees, expenses or taxes. Index comparisons have limitations, as volatility and other characteristics may differ from a particular investment.

Index definitions: The Bloomberg U.S. Aggregate Index is a broad-based flagship benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, fixed-rate agency MBS, ABS and CMBS (agency and non-agency). The ICE BofA U.S. Treasury Index series is an unmanaged index that tracks the performance of the direct sovereign debt of the U.S. government with maturities in the ranges indicated. The Bloomberg U.S. Government/Credit 1-3 Year Index covers Treasuries, agencies, publicly issued U.S. corporate and foreign debentures and secured notes that meet specified maturity, liquidity and quality requirements. The ICE BofA U.S. High Yield Index is a market value–weighted index consisting of USD-denominated, non–investment grade bonds not currently in default.

Allianz Global Investors and Voya Investment Management (Voya IM) have entered into a long-term strategic partnership, and as such, as of 25 July 2022, the investment team transferred to Voya IM and Voya IM became the delegated manager for certain strategies. AllianzGI continues to provide information and services to Voya IM for this purpose through a transitional service agreement.

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