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Global high yield: the investment case for a growing asset class

The global high yield market has matured over recent decades from a niche segment of financial markets to a major component of the fixed income universe (see Exhibit 1).

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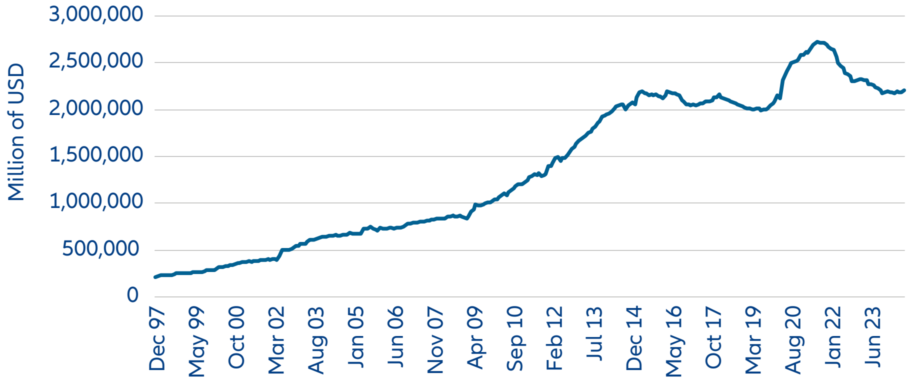
High yield is still at the riskier end of the fixed income universe – encompassing corporate bonds rated below BBB- or Baa3 by established credit rating agencies. Yet the asset class has proven extraordinarily resilient in recent years despite a shifting and sometimes challenging economic environment.

We think there's merit in considering a global approach to investing in the high yield market as part of a broader fixed income portfolio. Understanding the market – including its evolution, benefits and risks – can help inform investment decision-making.

Exhibit 1: Growth of the global high yield market, 1997-2024



Source: ICE Bank of America Merrill Lynch, ICE BofA Global High Yield Index, 31 August 2024.
Note: chart reflects notional value. Past performance does not predict future returns.

The early days: finding value in junk bonds

The origins of the high yield market can be traced to the 1970s when companies with lower credit ratings sought alternative financing to bank lending. Initially, the so-called junk bonds they issued were associated with high risk and scepticism about whether investors in them would get their money back. The 1980s marked a turning point for the asset class. Pioneers like US financier Michael Milken championed the market in the US and demonstrated that high yield bonds could offer lucrative return potential, above and beyond investment grade.

Gradually, more high yield companies began to issue bonds. Several factors contributed to the market's growth over this period, including:

- **Economic cycles**: economic booms and busts resulted in increased issuance of high yield bonds. During periods of economic prosperity, low-rated companies were more willing to take on debt to fuel growth, leading to increased issuance. In economic slumps, many investment-grade companies found themselves downgraded to high yield status and turned to the bond markets to secure the financing they needed.

- **Diversification and return potential**: investors began to see an allocation to high yield bonds as a useful way of diversifying and increasing the return potential of their portfolios. Their higher return potential than investment-grade bonds combined with the low correlation of their returns with those of government bonds attracted a broader range of institutional and retail investors.

- **Regulatory changes**: regulatory reforms, particularly in the US and Europe, provided a more favourable environment for high yield bond issuance. These changes included relaxed restrictions on pension funds and insurance companies investing in high yield securities.

Going global: a bumpy but fast ride

As high yield gained traction across the Atlantic, investment banks began setting up operations focused on the European market. But the bursting of the dot com bubble in 2000 ensured a bumpy start for European high yield. Yet it also led to an improvement in capital structures and documentation, helping boost the credibility of the asset class in the eyes of market participants.

After 2001, the globalisation of the high yield market accelerated, driven by:

- **Cross-border investment**: advances in technology and communication made international investing easier. As a result, investors began to explore high yield opportunities beyond their domestic markets, helping the asset class grow.

- **Standardisation**: the development of standardised financing structures, regulation and insolvency frameworks across regions increased investors' confidence in high yield bonds from countries other than the US.

- **Emerging markets**: rapid economic growth in emerging markets led to increased appetite for capital among companies in the region. High yield bonds became an attractive financing option for firms in Asia, Latin America and Eastern Europe.

Maturity phase: more bond issues and investors

The past decade has seen the high yield market mature further, with several key trends shaping its trajectory.

Increased issuance

High yield bond issuance has reached unprecedented levels. Favourable market conditions since the 2008 global financial crisis, including low interest rates up

Exhibit 2: Global high yield market composition by currency

	Global high yield	US high yield	EUR high yield	GBP high yield	USD emerging market high yield
% of global market	100	61	19	2	16
Notional value (USD bn)	2,200	1,330	410	50	360
Spread (OAS vs govt bp)	334	315	350	431	379
Yield (YTW* USD %)	7.1	7.3	7.6	8.2	7.7
Average rating	B+	B+	BB-	B+	BB-
% BB	60%	53%	71%	55%	71%
% B	30%	34%	22%	42%	22%
% CCC	10%	13%	7%	3%	7%

Data: as at 30 August 2024. Source: Allianz Global Investors, 2024. Bloomberg, ICE Bank of America Merrill Lynch, as of 30 August 2024. Past performance does not predict future returns. This is for guidance only and not indicative of future allocation.

*The Yield to worst represents the lowest potential yield that an investor could theoretically receive on the bond up to maturity if bought at the current price (excluding the default case of the issuer). The yield to worst is determined by making worst-case scenario assumptions, calculating the returns that would be received if worst-case scenario provisions, including prepayment, call or sinking fund, are used by the issuer (excluding the default case). It is assumed that the bonds are held until maturity and interest income is reinvested on the same conditions. The yield to worst is a portfolio characteristic; in particular, it does not reflect the actual fund income. The expenses charged to the fund are not taken into account. As a result, the yield to worst does not predict future returns of a bond fund.

to 2022, encouraged companies to tap into the high yield market for financing, especially in sectors such as technology, health care and energy.

As at 30 August 2024, the global high yield market had a notional value USD 2.2 trillion, of which bonds issued by US companies accounted for USD 1.3 trillion, European high yield nearly USD 0.5 trillion and US dollar denominated emerging-market high yield USD 0.4 trillion.

Diversification of the investor base

The investor base for high yield bonds has diversified significantly over time. Traditional institutional investors such as pension funds and mutual funds continue to play a dominant role. However, exchange-traded funds (ETFs) and retail investors are increasingly allocating to the asset class.

Premiums and low default levels

Investing in high yield bonds is riskier than allocating to higher-rated issues. But improvements in credit analysis and risk management have led to better pricing of the risk that they involve. High yield credit spreads are essentially a reflection of anticipated future default rates and likely recovery rates (how much of their money an investor will get back if a bond defaults). Investors in high yield demand an illiquidity premium to compensate for uncertainties stemming from issuers' lower credit quality. Since the global financial crisis, the illiquidity premium has typically been around 300 bp and has had a strong positive correlation to the VIX index, an indicator of the market's expectations of equity volatility. The asset class also offers a default premium, reflecting the larger risk of high yield companies defaulting on their debt in comparison to their higher-rated peers. Combined, we think these premiums provide a decent total return cushion against unexpected defaults, as well as movement in spread and rates.

In our view, default rates have remained generally manageable. Default rates exceeded the long-term average of 4.5% only once in the past decade in 2020 when Covid-19 struck. But the pandemic also highlighted the market's robustness as the default rate dropped back to below 2% the following year.

Looking forward: bigger companies and more refinancing

The growth of the global high yield market has several implications for investors, issuers and the broader financial system.

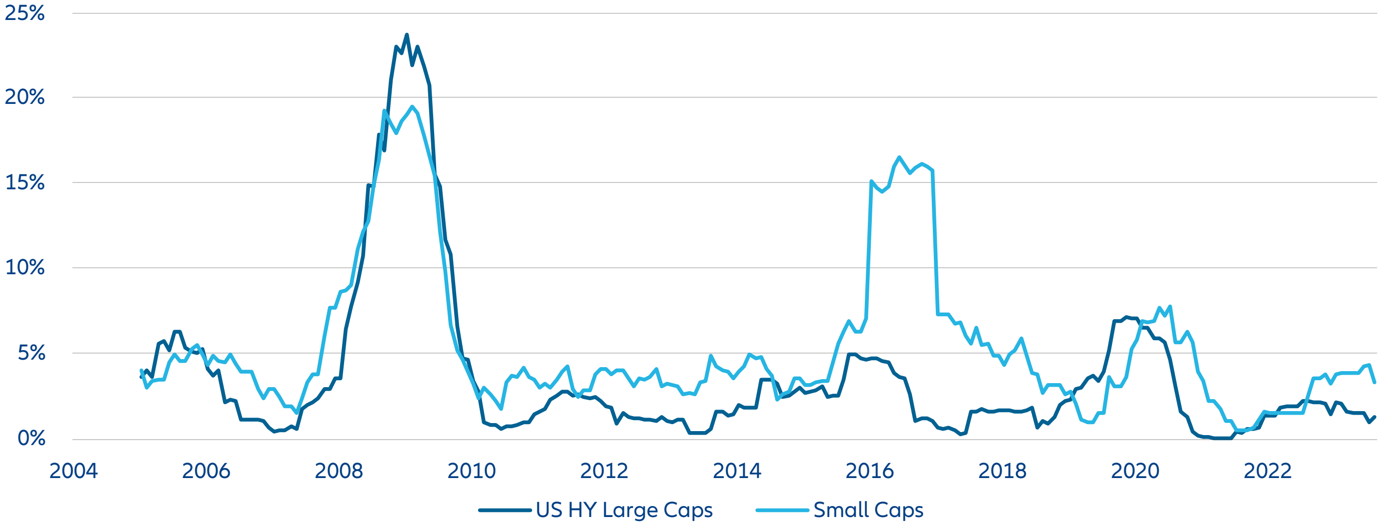
High yield universe increasingly made up of large companies

The expansion of the high yield market has provided companies with greater access to capital. This has been particularly beneficial for small- and medium-sized enterprises that do not qualify for investment-grade ratings.

However, the advent of private debt in recent years has eroded the competitiveness of high yield bonds as a source of financing for small-cap companies and firms in niche sectors like technology and biotech. As a result, high yield is now financing larger businesses that are often less niche than in the past. According to Bank of America, US high yield issuers have an average earnings before interest, taxes, depreciation, and amortisation (EBITDA) of around USD 1.2 billion – well above the average of around USD 500 million since the global financial crisis. By way of comparison, US investment grade companies' EBITDAs average around USD 2.2 billion, having ranged between USD 1.5–2.0 billion over the past 20 years. In other words, 20 years ago the EBITDA of an average US high yield company was around 25-30% that of an investment grade company, but today they are over half the size.

Typically, larger companies have more levers to pull if they enter financial distress. The growth in size of many high yield companies may be one reason why default rates have been lower in recent years and why the difference in default rates between large and small cap businesses has been quite pronounced (see Exhibit 3).

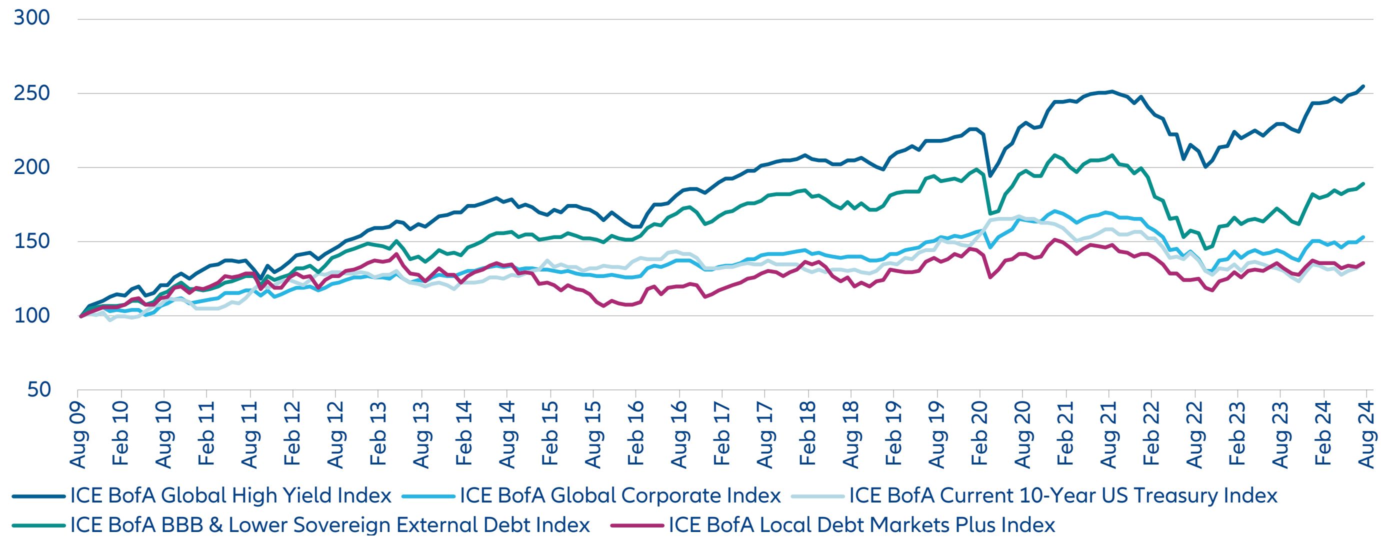
Exhibit 3: Differing default rates between high yield large- and small-cap issuers



Source: Bank of America, July 2024. Past performance does not predict future returns.

Increased portfolio diversification and return potential
We think high yield bonds represent a useful source of diversification and return in a balanced portfolio. Their higher yields and return potential than traditional fixed income instruments (see Exhibit 4) can enhance a broad portfolio's return both in absolute and risk-adjusted terms, the latter helped by global high yield being uncorrelated with US Treasuries: over the past 15 years, the correlation was 0.03 (based on daily returns of the indices shown in Exhibit 4).

Exhibit 4: Cumulative returns of various fixed income categories since August 2009

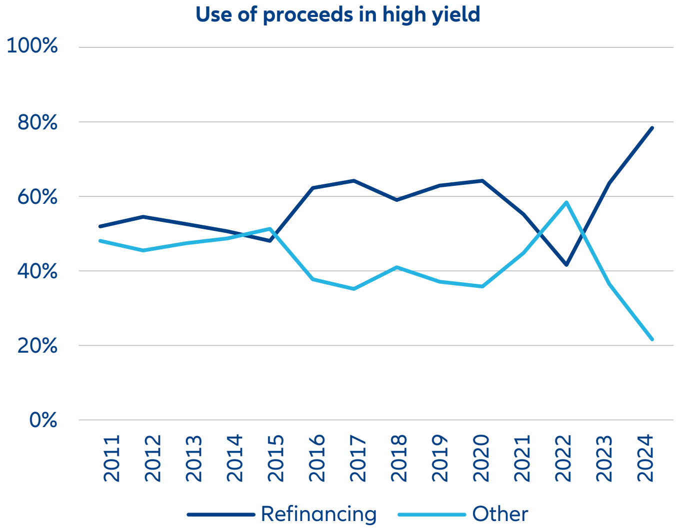


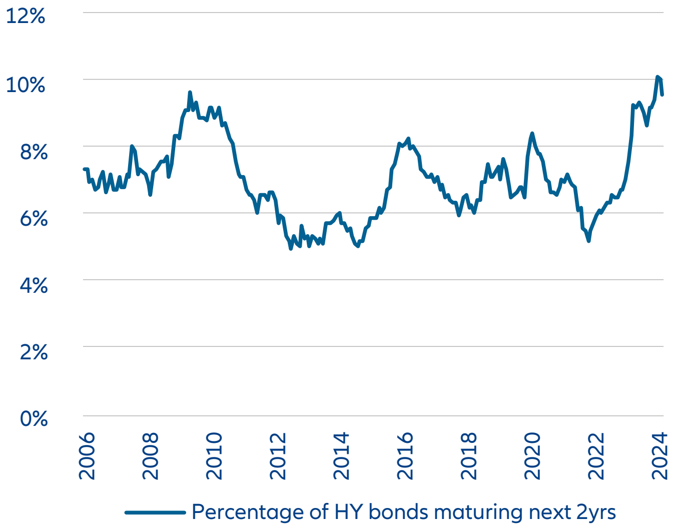
Source: ICE indices, Bloomberg, cumulative monthly total returns from 31/08/2009 to 31/08/2024. Past performance does not predict future returns.

Credit quality and refinancing risk

A measure we follow to help predict the creditworthiness of the high yield market is use of proceeds – in other words, what the money raised by issuing high yield bonds is to be used for (see Exhibit 5). The money can be used for two main purposes. The first is refinancing, which extends the timeframe for maturing debt and reduces the risk of a company defaulting. The second is general corporate purposes, M&A and paying dividends. Any dip in refinancing levels to below 50% of total new issuance (as it did in 2021 and 2022) is a sign that leverage is increasing in the market and that default rates could rise. But the proportion of proceeds being used for refinancing hit a record high in 2024, which should result in lower default rates. Still, it's important to bear in mind that the ability of high yield companies to refinance is now essential as the percentage of bonds that need to be refinanced in the coming two years has increased.

Exhibit 5: Refinancing has dominated use of proceeds in the new issue market recently

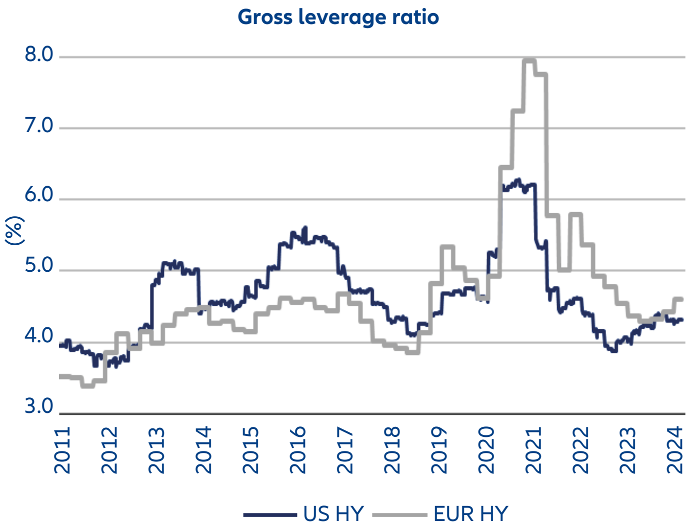


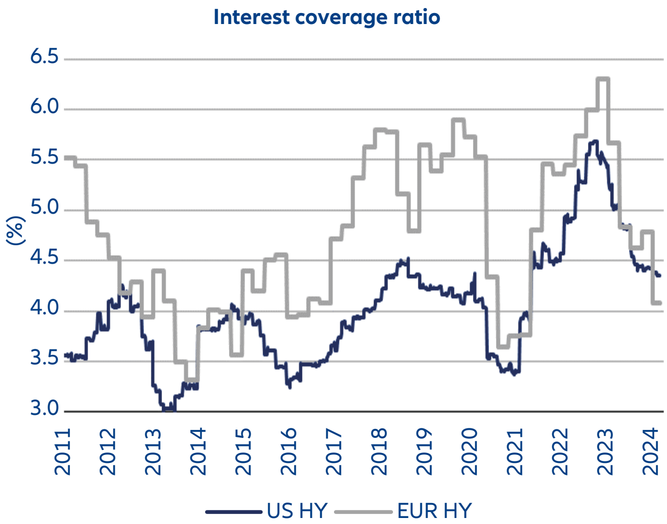


Source: Allianz Global Investors and LCD Pitchbook, July 2024. Past performance does not predict future returns.

With considerable refinancing required in the coming years, it is useful to note that corporate leverage is around average and interest coverage (a ratio showing how easily a company service its debt), is still well above the three times level below which analysts typically begin to become concerned about companies' ability to pay (see Exhibit 6).

Exhibit 6: High yield gross leverage and interest coverage generally remain stable





Source: BofA Global Research, July 2024. Past performance does not predict future returns.

Why invest in high yield on a global basis?

No individual high yield market has consistently posted better returns than others over time (see Exhibit 7). As a result, global high yield managers need to continuously adapt their portfolio's allocations between countries, regions, currencies and credit ratings based on changes in the prevailing backdrop to maximise its return potential. We think it's important that a global high yield team is part of a wider fixed income business with macro and emerging market specialists to help boost performance in comparison to the broader high yield market.

Exhibit 7: Performance of high yield market segments, 1999-2023

Total Return % USD hedged	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2000	2001	2002	2003
EUR	16.7	-13.4	-14.2	-6.6	27.6	13.9	7.2	13.8	-0.9	-33.1	74.9	15.4	-2.3	28.1	10.4	5.6	1.1	10.8	8.9	-0.8	14.7	4.4	4.2	-9.3	14.5
GBP	10.9	-1.0	-2.8	-14.2	36.7	17.7	3.8	12.5	-1.3	-25.2	104.2	21.9	-2.6	37.4	11.6	5.4	5.2	11.2	9.1	0.0	15.5	5.96	4.0	-9.9	16.6
USD	2.5	-5.1	4.5	-1.9	28.1	10.9	2.7	11.8	2.2	-26.4	57.5	15.2	4.4	15.6	7.4	2.5	-4.6	17.5	7.5	-2.2	14.4	6.2	5.4	-11.2	13.5
EM HY	15.5	7.1	0.9	1.7	26.0	12.5	9.3	9.4	3.5	-30.6	65.3	17.9	0.1	23.6	0.6	-2.0	2.9	18.4	8.9	-2.0	14.6	9.4	-5.0	-14.8	8.8
Spread (Highest - lowest)	14.2	20.5	18.7	15.9	10.7	6.8	6.6	4.4	4.8	7.9	46.7	6.7	7.0	21.8	11.0	7.6	9.8	7.6	1.6	2.2	1.1	5.0	10.4	5.5	7.9

Source: Allianz Global Investors, Bloomberg, ICE Bank of America Merrill Lynch, as of 31 March 2024. Figures in US dollar terms, so the return an investor receives will be impacted by hedging costs. Past performance does not predict future returns.

A regional strategy typically invests only in companies from one region issuing primarily in one currency. The manager will seek to outperform through sector and security selection and by adapting the portfolio's beta. By contrast, a global strategy can generate outperformance from additional sources.

And there are other advantages of a global strategy. Portfolio managers can aim to capitalise on the differences between economies. That could mean allocating to cyclical sectors in countries or regions where economies are buoyant and to defensive sectors in those parts of the world where growth is more sluggish. Portfolio managers can also seek to benefit from differences in monetary and fiscal policies between countries, as well as currency performance through hedging.

Our analysis of forward swap curves (see Exhibit 8) suggests that market-implied future interest rate differentials between USD and EUR – a no-arbitrage proxy for hedge costs – should go down, a marginal benefit to a euro-based investor. But we still think there may be opportunities for a US investor from a global approach as European spreads are wider than the US and the credit quality is higher (see Exhibit 2). A global manager should be able to take advantage of movements in hedge costs and relative spreads.

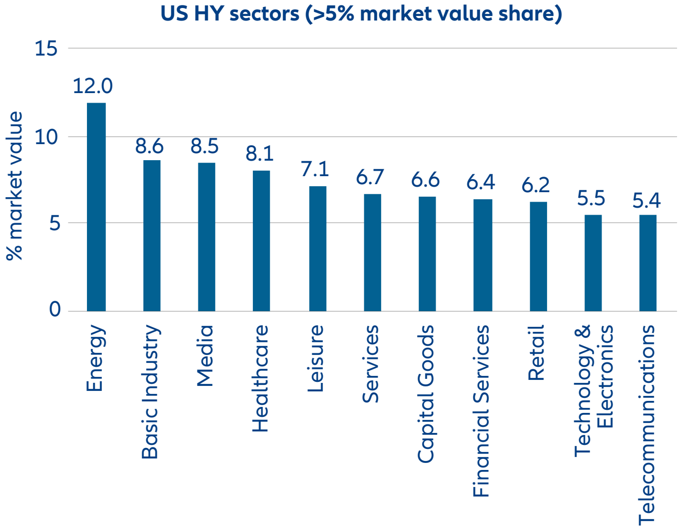
Exhibit 8: Market-implied EUR/USD hedge cost estimates (difference between 1-year USD and 1-year EUR swap rates starting at different times in the future)

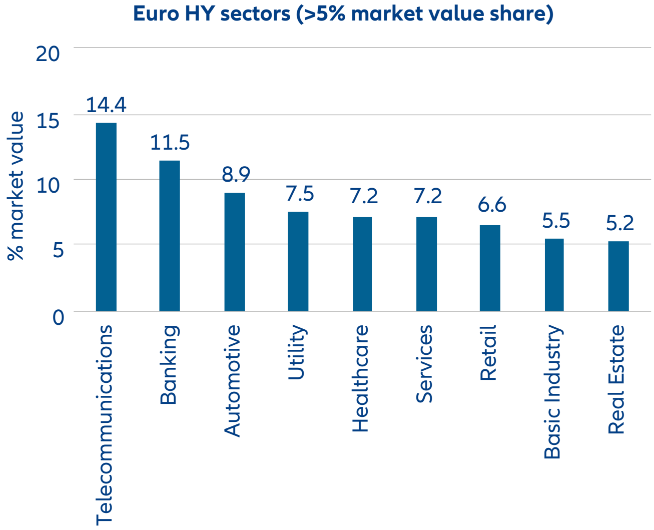
Forward 1-year rates, starting in:	Current	3 months	6 months	12 months	2 years	3 years
USD-EUR hedge estimate	1.6%	1.3%	1.3%	1.1%	1.0%	0.9%

Source: Bloomberg, difference between USD OIS forward swap rates and EUR OIS EStR forward swap rates, as of 31 August 2024. Past performance does not predict future returns.

In comparison to a regional approach, a global strategy will have a significantly broader range of bond issues to invest in across each sector, in addition to opportunities in different currencies. As some sectors are quite concentrated, especially in the euro universe (see Exhibit 9), a higher number of investment opportunities can help with diversification. This is especially important when applying ESG filters that exclude certain companies from the investment universe, potentially making it difficult to construct an adequately diversified regional portfolio. A manager of a global strategy can look across markets to allocate risk where the growth environment is most appropriate.

Exhibit 9: Sector concentrations vary across markets





Source: ICE indices and AllianzGI, as of 31 August 2024.

Finally, different markets are subject to different technical drivers, such as the impact of ETFs, pod traders and investor biases. Exploiting these drivers can also lead to outperformance of the global high yield market.

In summary, we think a global strategy can serve as a useful entry point for those considering investing in the high yield market.

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