# High yield enters unchartered waters

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- **Higher inflation and interest rates are unknowns for the high yield bond market, but with inflation far above US and European 2% targets central banks are having to raise rates**
- **Rising rates will put pressure on weaker companies, and could be particularly challenging for the private equity portfolio companies that make up a proportion of the HY universe**
- **This is an environment in which we believe credit selection based on research intensity will become increasingly important**

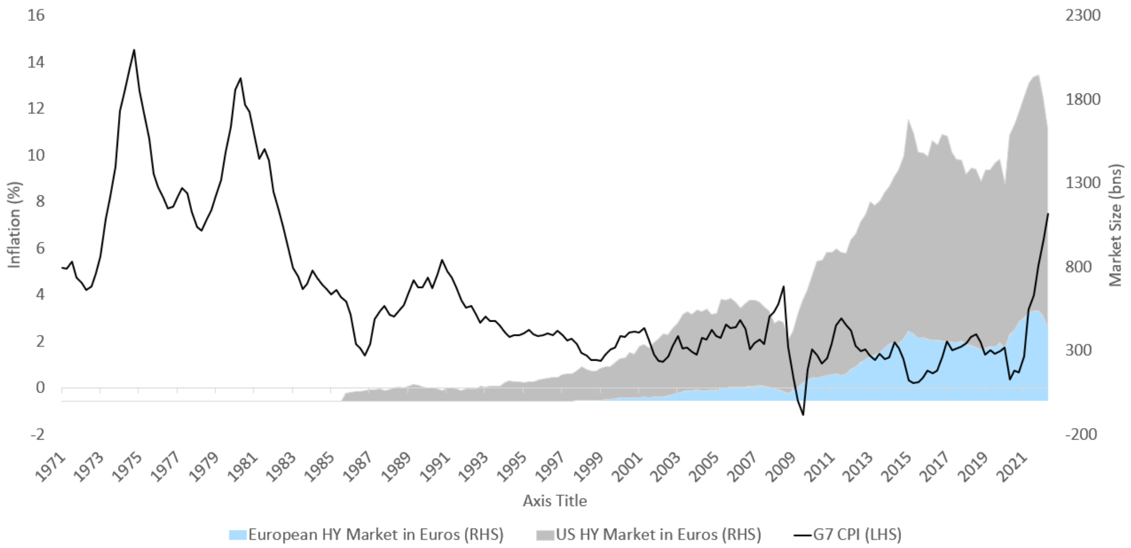
When the high yield bond markets were born 35 years ago, a period of sustained low inflation was just beginning. For the past two decades, inflation has remained subdued and interest rates far below the levels that prevailed for much of the second half of the 20th Century. This was a time of plain sailing for high yield.

Indeed, high yield's birth followed the period of exceptionally high inflation from the 1970s and early 1980s. In the US, the high yield market began in the mid-1980s, partly helping to fund the leveraged buyouts designed to take advantage of companies' under-used assets. Europe followed around a decade later.

So, with higher inflation and interest rates returning, it is fair to say that high yield bond markets are entering uncharted waters (Figure 1); an environment in which we believe credit selection based on research intensity will become increasingly important.

The 15 or so years so since the global financial crisis (GFC) have been characterised by quantitative easing and exceptional monetary conditions specifically designed to support companies. Interest rates have been at historically low levels – especially in contrast to the inflationary era of the 1970s and 80s. While the US Federal Reserve attempted to end the era of easy money in 2013 and then 2019, adverse reactions in financial market deterred it.

**Figure 1: an inflationary environment … for the first time**




Source: ICE BoA Indices/OECD, as at 30 September 2022

But in 2022 central banks have had no choice but to raise interest rates as inflation has breached 10% in the eurozone[1] and 8% in the US[2] – far above their 2% targets. As government bond interest rates also rise across the yield curve, and corporate spreads widen, the inevitable result is that companies' funding costs are increasing to higher levels than we have seen for many years.

## Rising rates put pressure on weaker companies

For leveraged high-yield issuers, the greater cost of servicing debt inevitably eats into cashflow and earnings. Some will simply earn lower profits and shrink their dividend payments; others may struggle to survive. We expect to see more pressure on the weakest credits – rated CCC – and there is a sense of a higher risk of default than in the past 15 years of cheap funding conditions.

To add to the pressure on corporate borrowers, today's high inflation may last for some time. This is because many of the drivers of inflation are outside central banks' control. Raising rates does little to solve issues such as logistics bottlenecks, commodity shortages and the scarcity of labour in some countries.

From a fund management perspective, understanding which companies can thrive in this harsher world is critical. Some companies are in a strong position: they make exceptional products and can control their prices. However, such robust firms tend to be more common among investment grade bond issuers.

The current environment could, however, be particularly challenging for the private equity portfolio companies that make up a proportion of the high yield universe. Rises in so-called risk-

[1] https://tradingeconomics.com/euro-area/inflation-cpi 30 September 2022

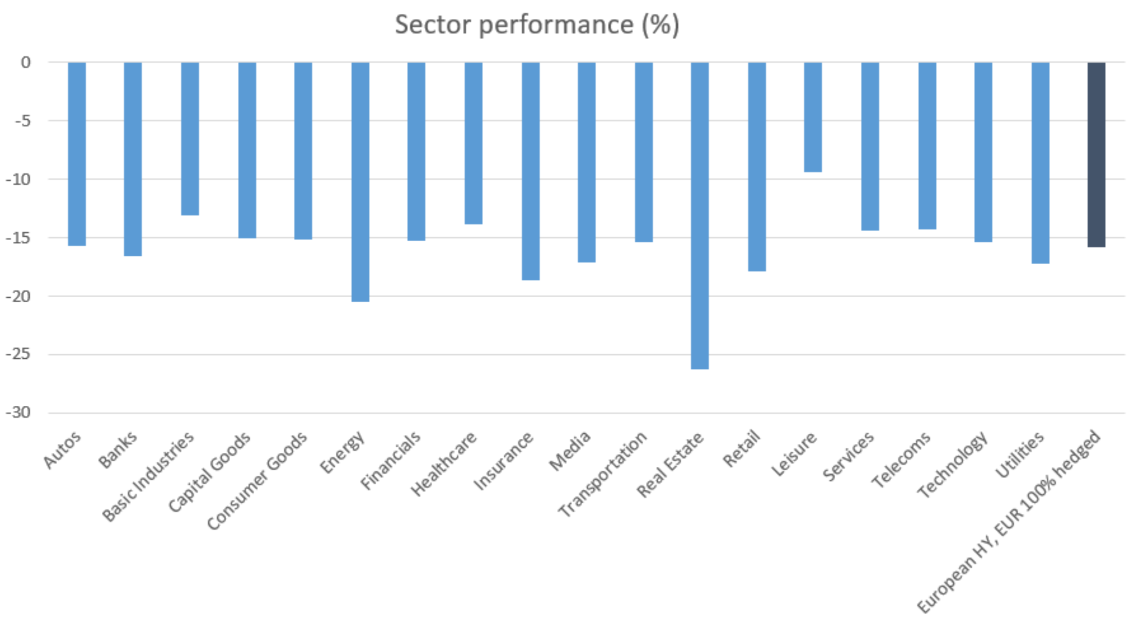
[2] https://tradingeconomics.com/united-states/inflation-cpi 30 September 2022

free rates – effectively, the interest rate on government bonds – increase the discount rate used to value equities in public markets. Hence, equity valuations such as price/earnings (P/E) ratios are falling. For example, the P/E on the US S&P 500 index is now 20 times (based on reported 2021 earnings), down from 25 a year ago, while that on the tech-heavy US Nasdaq index has fallen from 31 a year ago to 25, bottoming out at 20 in May[3].

Surprisingly, there has been little distinction between the performance of bonds with different credit ratings in 2022. We do not believe this will last, however, because the weaker companies will struggle as interest rates rise and should subsequently trade at a higher risk premium.

Another challenge for high yield companies is the ongoing energy crisis and the energy transition. Together, they are making energy more expensive, putting further pressure on companies in all sectors (Figure 2). In such an environment we continue to favour traditionally stable sectors, such as telecoms, or companies with robust order books and stronger credit ratings in sectors such as automotives.

**Figure 2: no sector left untouched**




Source: ICE BoA Indices, as at 30 September 2022

## Research intensity will count

So far in 2022, the cautious positioning in our portfolios has not been rewarded, which is frustrating. In such unprecedented times for high yield, though, intensive credit analysis is critical. We have a team and an investment process that has weathered a number of challenging credit cycles. They continue to seek out the higher quality companies that can survive this tough environment, with managements that have the flexibility to adapt their mindsets accordingly.

[3] Bloomberg, September 2022

While today's high and rising interest rates are unprecedented for high yield bonds, all crises are unique in their own way: for instance, the turmoil in financial markets triggered by the recent Covid-19 pandemic was unique, as was the 2008-2009 GFC.

It's a question of deploying intensive research to find the companies that will ride out the storm. At some point inflation and interest rates fall; then waters will calm – for those who reach the other side.