

Principal Fixed Income

Yield beyond spread

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“ Investors eat yield not spread ”

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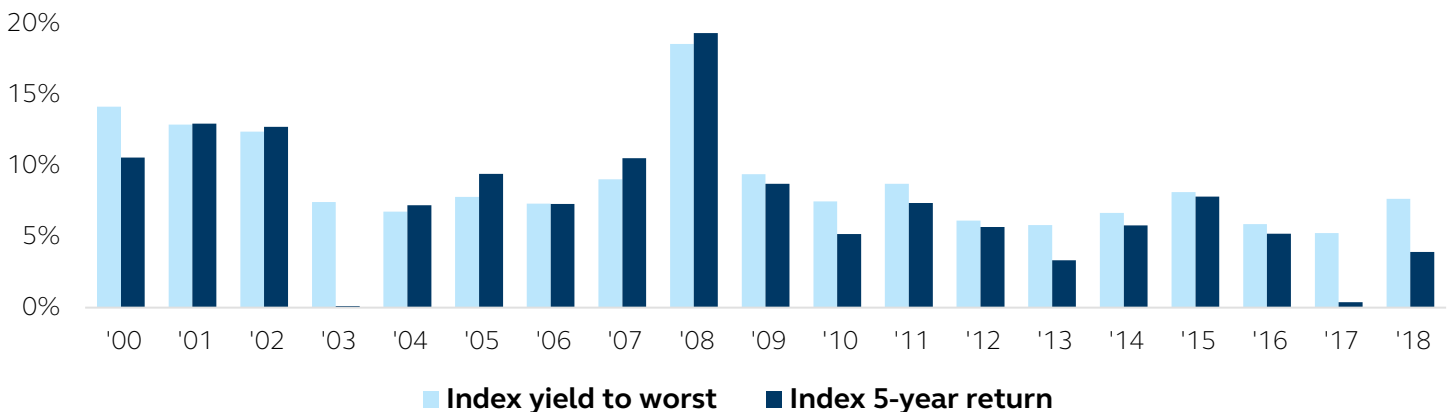
Never mind spread...it's yield that matters

Many investors look at credit spread levels – or the difference in yield between a security relative to a risk-free security with the same maturity – as the hallmark indicator for when to enter or exit credit markets. However, history tells us that tactically timing spread movements can be incredibly challenging, especially in high yield credit markets.

Though spread levels are important, we argue that yield can be a more powerful gauge of the attractiveness of credit markets. The reason is simple: High yield allocations should be a strategic (long-term) allocation and not a tactical (short-term) allocation within portfolios. In other words, it pays to be patient in high yield.

When charting the asset class's starting yield to worst against its corresponding 5-year forward annualized returns, we see a correlation of 0.87 – which is higher than the correlation between starting option-adjusted spread and corresponding 5-year forward annualized returns.

Yield to worst & 5-year return



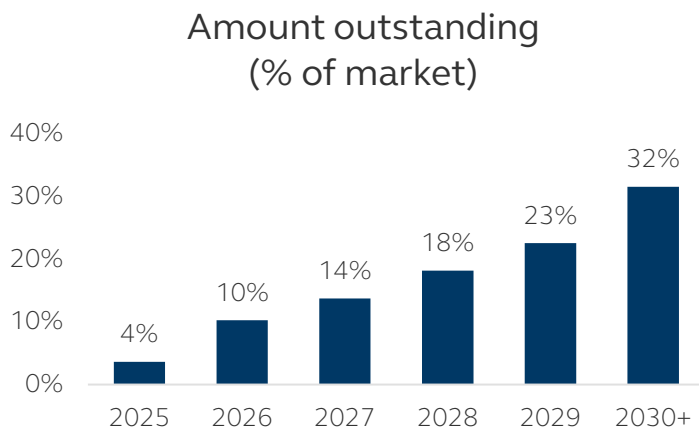
Average Yield 8.82% **Average 5YR Return 7.56%** **Correlation 0.87**

Source: Bloomberg, Bloomberg U.S. Corporate High Yield Bond Index.

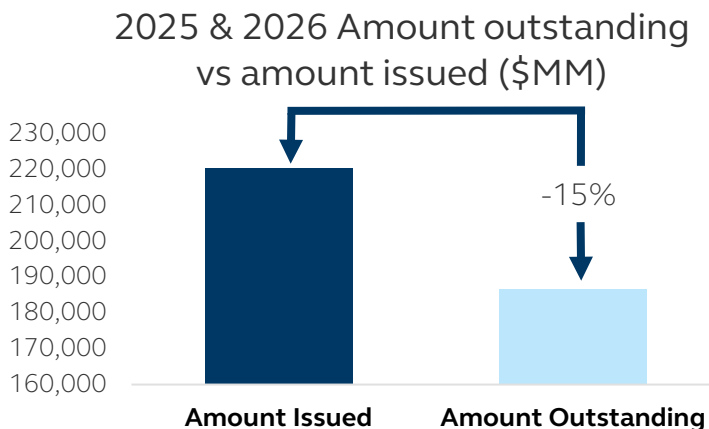
Spring cleaning is over, there isn't much left to default...

Despite concerns about rising inflation and slowing economic growth, we don't anticipate a widespread rise in defaults, for two key reasons:

- 1. Businesses have balance sheet runway** – Not only is the maturity wall – or the amount of debt outstanding coming due over the next few calendar years – very manageable, but it has also been proactively addressed as shown by the amount outstanding versus the amount issued.

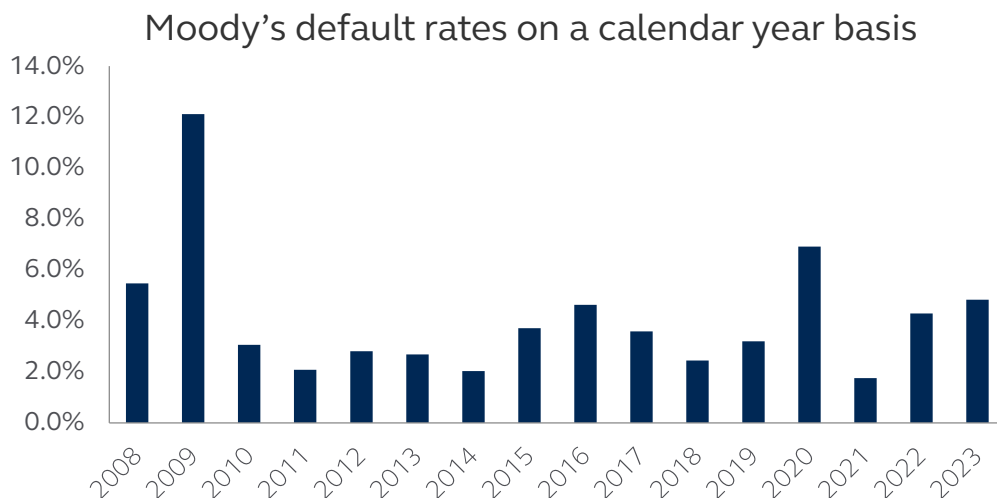


Source: Bloomberg, Bloomberg U.S. Corporate High Yield Bond Index.



Source: Bloomberg, Bloomberg U.S. Corporate High Yield Bond Index.

- 2. Survival of the fittest has been determined** – The pandemic already brought a short, but painful, cycle of corporate defaults. The surviving businesses are now generally better capitalized and have stronger support from their shareholders.



Average default rates
(2008 – 2023)

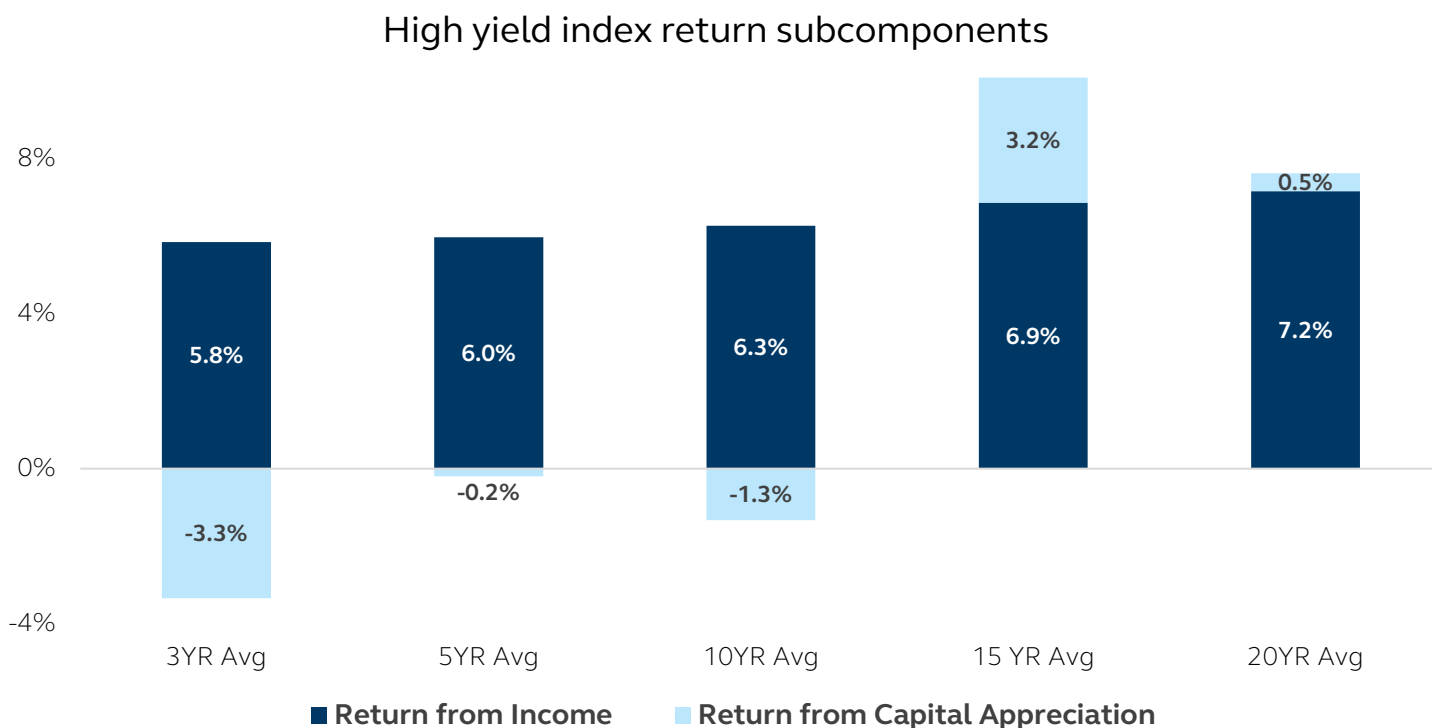
Moody's: **4.10%**

As of 31 December 2023. Source: Moody's. Information about Moody's default rate methodology is available upon request.

Coupons aren't discretionary, but they're growing

Let yield – or income – be your guide when investing in the high yield asset class. It's important to remember that coupons aren't dividends nor discretionary, but they are contractual. The income component of the asset class makes up the majority of the total return; therefore, being able to maximize income is crucial to long-term performance.

Attributing return to either income or capital appreciation shows us that, quite often, the income component accounts for more than 100% of total return as shown in the chart below.



As of 31 December 2023. Source: Bloomberg, Bloomberg U.S. Corporate High Yield Bond Index.

In short, focus on the long-term

In an environment of higher-for-longer policy rates, the argument for taking a strategic (long-term) approach to investing in the high yield asset class is amplified. Historically attractive starting yields help to more than offset unappealing credit spread entry points; particularly, considering the strong fundamental picture and muted default expectations underlying the sector today. Though high yield is often viewed as a tactical (short-term) allocation within portfolios, we argue that a more patient approach to investing in the asset class is warranted and can lead to strong results.

Principal Fixed Income: A leading global fixed income platform

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