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Outlook for High Yield

2020: where to go when yields are low?

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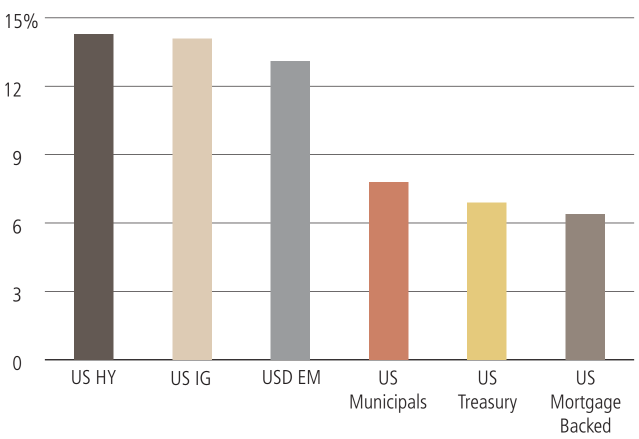
High yield market outlook

As we begin the year, we estimate approximately 90% of the market value of the global high yield universe is trading along a historical bottom in yields. In this outlook, we explain why yields are so low and how we think this will change in the coming year, helping us determine which areas of the high yield market look like good opportunities for fixed income investors.

The recent decline of global bond yields in 2019 resulted in strong total returns across every segment of the bond market.

Figure 1: 2019 Fixed Income total returns (%)



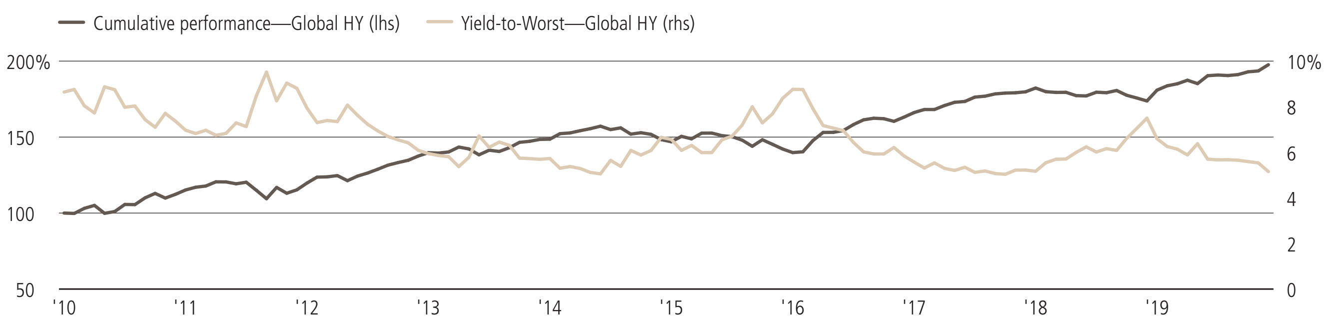
Source: ICE BofA Merrill Lynch and Bloomberg Barclays as at 31 December 2019. Note: Table shows annual total returns USD

As you can see from Figure 1, the high yield market was clearly no exception. While elementary to most seasoned bond investors, it is important to remember that yield is not total return. Yield is sometimes used as a simple valuation metric or as a proxy for the income generated by a bond portfolio. Total return, on the other hand, takes into account the income and the change in valuation of a bond portfolio. We call it 'total return' because it totals the income and the valuation change. To see how yield and total return are different, one only needs to reference figure 2. It is easy to see that as yields decrease, the total return on high yield bonds will increase; and as yields increase the total return on high yield bonds will decrease.

Ideally, the best time to invest in the high yield bond market is when yields are high and expected to decline. Based on total return, clearly 2019 was a good time to invest, but what can we expect for 2020?

Currently, yields are not so high in the high yield bond market when compared to historical levels. Simply looking at the today's yields across the US, Europe, and Asia high yield markets might be enough to help investors determine if they should continue to allocate risk to the sector (see figure 3). As we start 2020, the Euro high yield market currently offers only 2.6% and the US high yield market is near an all-time low of 5.3%. Only the Asia region offers a yield which is the usual realm of high yield credit at 7.2%. While higher is generally better when it comes to using yields as a basic entry point, we only cite these yields to establish a baseline from which

Figure 2: Performance and yield evolution (2010-2019)



Source: Bloomberg. Data as at 31 December 2019.

to jump off from. It is more important for us to explain how much we think these yields will change over time and detail what impact the change will have on total returns in 2020.

So why are high yield bond yields so low? High yield bond yields are low, in part, because government bond yields are low. Government bond yields are used as a starting point for determining the yield of a high yield corporate bond. At one point in the past year, over USD 17 trillion of the global bond market traded at a negative yield (see figure 4). Currently, about USD 11 trillion in global bonds trade actually at a negative yield. With global economic growth expected to be at or below trend and inflation expectations muted, we expect central banks will continue to use accommodative policies to keep short term borrowing rates low. Thus, our view is that government bond yields will remain low and possibly even decline slightly during 2020 (see figure 5).

Figure 3: High Yield yields evolution

Source: Bloomberg. As of end December 2019.

Figure 4: Global negative yielding debt (2017-2019)

Source: Bloomberg Barclays Global Aggregate Index, data as at 31 December 2019.

Figure 5: UBS-AM US and German rates forecasts for 2020

	Yields end 2019	Yields expected end 2020
US 2 year	1.61%	1.40%
US 10 year	1.82%	1.55%
Germany 2 year	-0.63%	-0.50%
Germany 10 year	-0.29%	-0.10%

Source: UBS Asset Management, data as at December 2019.

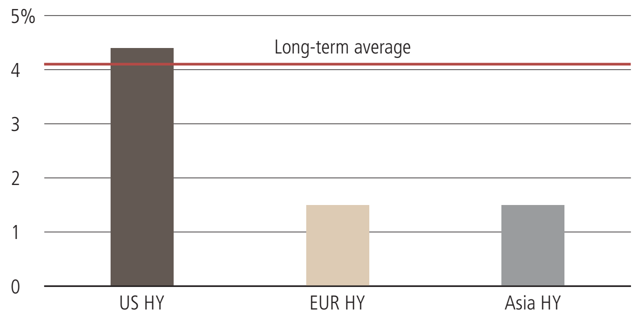
Since we do not see a material change in developed market government bond yields in the coming year, any change in high yield bond yields must come from a change in spread or the extra yield (above government bonds) that investors require to compensate for taking credit risk (and other risks) associated with high yield corporate bond investments. Like government bond yields, high yield bond spreads are low (see figure 7).

As long as the global economy continues to be supported by growth-oriented monetary policies at the world's major central banks, the market will likely continue to think that most high yield companies will be able to access the debt capital markets to finance balance sheets and ongoing operations. In other words, despite the potential for higher leverage, the market is suggesting that the risk of default is still not high enough to require an increase in spreads at this time. Our own internal default forecasts support this (see figure 6).

We have established that yields are low because spreads are low, in part, because default expectations are low (much lower in Asia and Europe than in the US). In addition to credit or default risk, additional risks need to be considered when forecasting spread changes and their effects on forward looking total returns. We choose to focus on volatility at the start of the year.

Despite the ongoing macro oriented friction associated with US/China trade war, political conflicts in the Middle East, and Brexit negotiations, investor uncertainty is also near an all-time low. When uncertainly is low, spreads are generally low too.

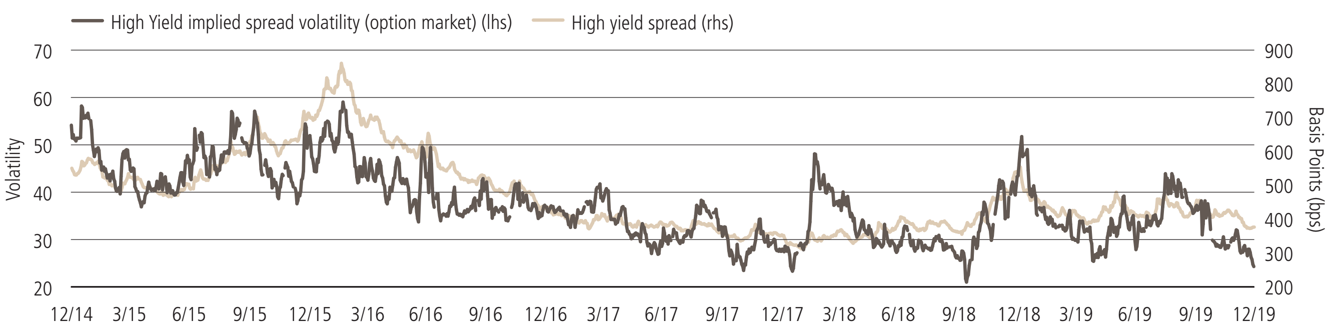
Figure 6: UBS-AM High Yield bond default expectations for 2020



Source: UBS Asset Management, data as at December 2019.
Note: This does not constitute a guarantee by UBS Asset Management. Long-term average is based on Global High Yield market since 2000, as reported by Moody's Investors Service.

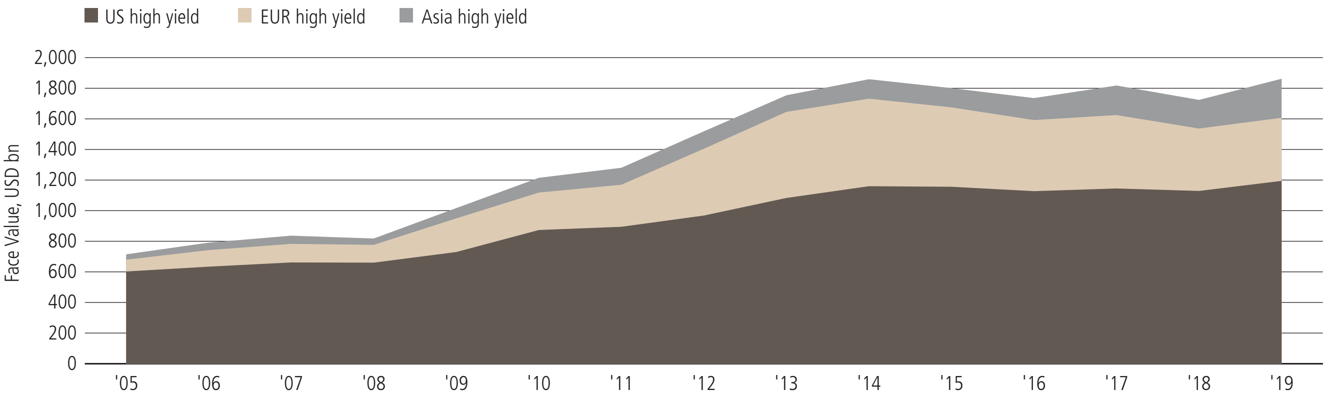
We gauge this uncertainty using the implied spread volatility in the high yield options market. The implied spread volatility indicates to what degree the market is certain that spreads will change (figure 7). Higher implied spread volatility denotes more uncertainty, while lower implied spread volatility denotes less uncertainty. At the start of 2020, the spread and the spread volatility were low, indicating to us that the market appears highly confident that high yield spreads will stay low. Is this confidence justified?

Figure 7: Evolution of spreads and volatility



Source: Spread volatility—Citi velocity, representing CDX.NA.HY 3M Volatility Rolling Maturity data as at December 2019 ; Spread—Bloomberg ICE BofA Merrill Lynch Global High Yield index data as December 2019.

Figure 8: Growth of High Yield market



Source: BofA Merrill Lynch Indices, data as at December 2019.

We believe the confidence is justified because of one extremely powerful development we need to consider when forecasting spreads and yields for the global high yield universe. High yield bond spreads and yields are low simply because growth in the high yield bond market is low. The global high yield bond market has not grown materially since 2014 (figure 8). Again, because we are operating in an environment where the world's largest central banks continue to remain accommodative by keeping government bond yields low, risk seeking investors continue to demand additional income from higher yielding corporate bonds. In the U.S. alone, JP Morgan estimates approximately USD 19 billion in new mutual fund inflows occurred in 2019. Since the supply of new high yield bonds will likely not be able to satiate the continued demand from fixed income investors, it is likely that spreads will not rise materially in 2020.

We do not expect a material increase in high yield bond yields in 2020.

With so many technical forces keeping government bond yields low, defaults low, volatility low, supply low, and spreads low, we do not expect a material increase in high yield bond yields (see figure 9). Remember, yield is only used as a proxy for the income generated by a bond portfolio and it does not equal total return. Since we are starting the year at historically low yield levels (in most cases), even the slightest upward change will negatively impact the total return on various segments of the global high yield market.

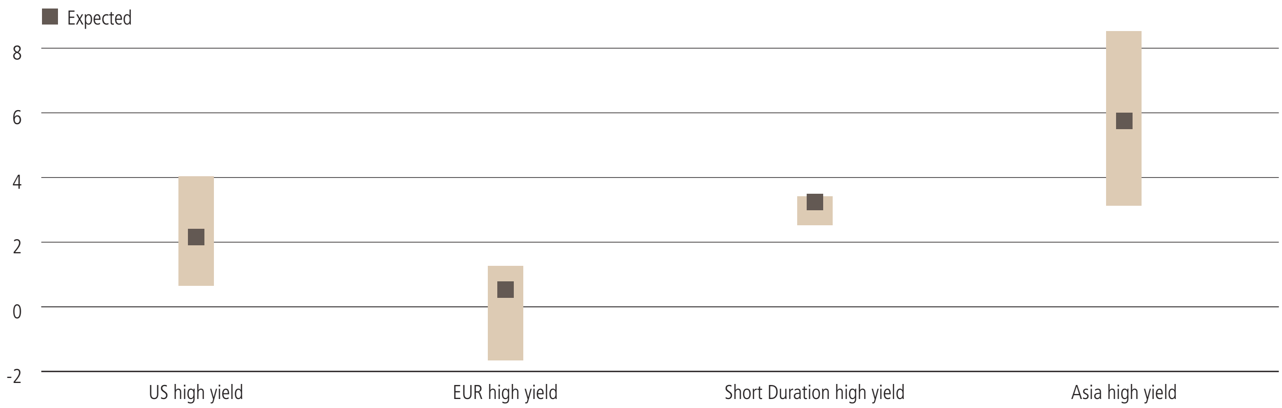
Figure 9: EUR, US and Asia high yield rates forecasts for 2020

	Yields end 2019	Yields expected end 2020
EUR HY	2.6%	3.0%
US HY	5.3%	5.8%
Asia HY	7.2%	7.5%

Source: UBS Asset Management, data as at December 2019.

Our recommendation is to continue to invest in high yield, but shift attention to the highest quality segments of the universe that are less sensitive to even minor changes in yield or toward high yield segments where yields are not nearly as close to a bottom. We expect all major segments of the global high yield universe to generate positive returns in 2020 (see figure 10), but we believe that the short duration high yield segment and the Asia high yield segment offer investors the two most favorable return profiles.

Figure 10: UBS-AM High Yield bond return forecasts for 2020



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