CONCISE
CAPITAL

January 2023 High Yield Market Insights

- Purchase yield is a predictor of future fixed income return.
- Regardless of short-term volatility, longer horizon bond returns converge towards purchase yield.
- The recent selloff seems to offer the right conditions for investment in high yield debt.

In life, where you start can have an outsize effect on where you finish. That holds in investing too. Returns often depend upon the relative value of the assets you bought at the time you bought them. This is truest when the determining variables are few, as purchase yields are in determining the ultimate returns of bonds.

US treasuries are considered risk-free, meaning free of credit risk. The US treasury aways pays its debts. Treasury bonds can be volatile between issuance and maturity, but in the end a treasury's yield at purchase largely dictates its return in the long run.

Corporate bond returns are also tied to their yields at purchase, but in a looser fashion. Credit risk creeps in, along with interest rate risk. If a company's prospects dim, its yield premium, or spread, to treasuries will increase. If its prospects improve, its spread to treasuries will shrink.

The figures below show the long versus short run effects of the purchase yield on IG bond returns. Returns one year after purchase are spread widely. They are affected by changes in rates, changes in individual credit perception and in the perception of IG corporate bonds overall. Over five years, returns are determined far more by the purchase yield than not. Evidence for this lies in the R^2, the statistic that in this case measures what percent of the one year or five-year return is explained by the starting yield. For one year the R^2 is 0.23 or 23%, while for five year returns it is 0.64 or 64%.

Figure 1: IG Corporate returns, start yield v 1 year return

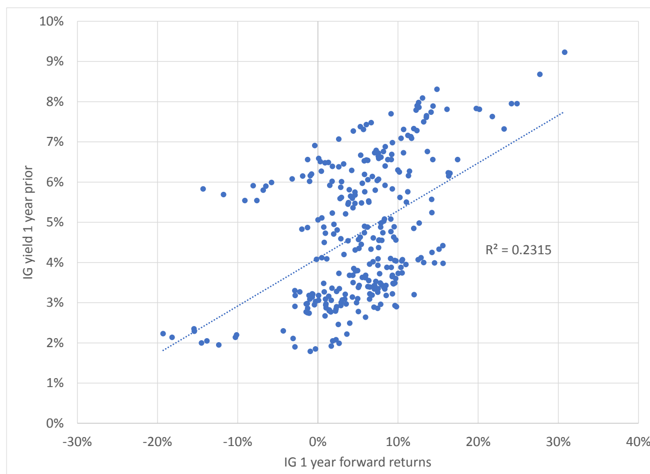
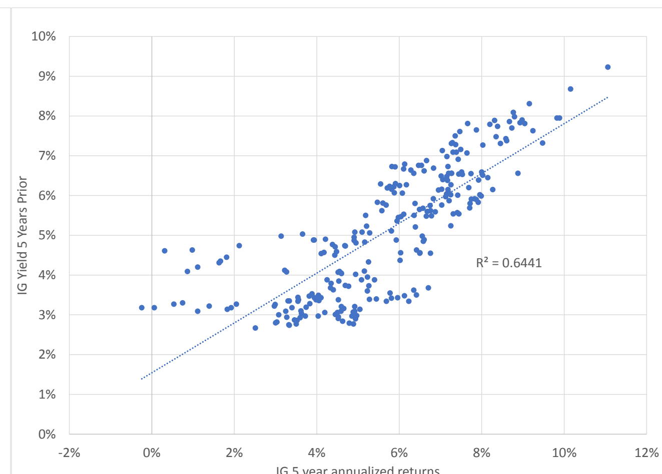


Figure 2: IG Corporate returns, start yield v 5 rear return

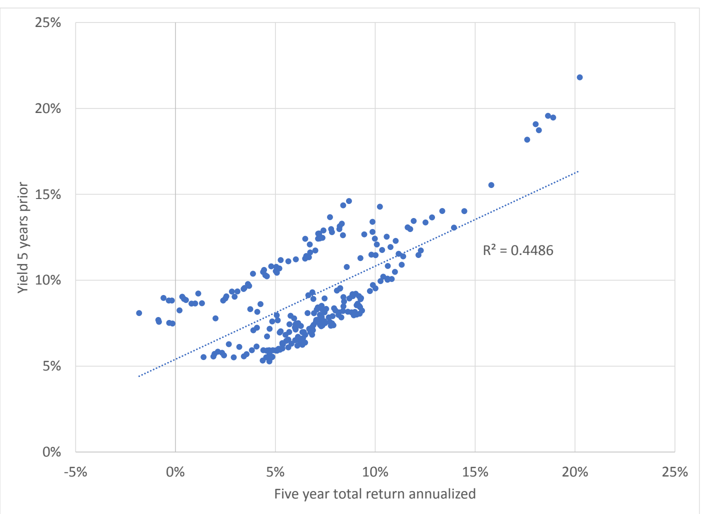


High yield bonds (HY) are further away from treasuries than IG in terms of risk. What distinguishes them is higher yields to compensate for their higher volatility and higher potential for individual corporate distress. This would lead us to expect less of a relationship between starting yields and returns down the road. This

is true, but not by much for one year returns and while noticeably lower for five year returns, starting yield remains significant. 20% of one year HY returns are explained by their initial yield while 45% of five year returns are attributable to beginning yields.

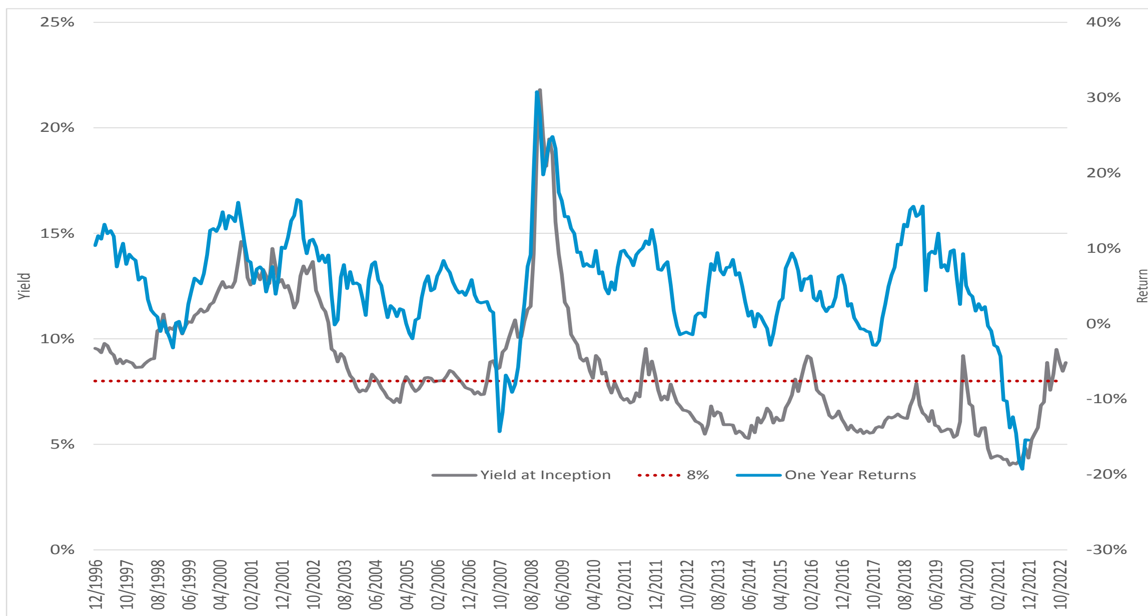
Figure 3: HY Corporate returns, start yields v 1 year returns

Figure 4: HY Corporate returns, start yield v 5 rear return



Yields currently sit around 8%. It appears from the above charts that 8% is typically, but not always, a good starting point to invest. Since the yield level does not tell us everything we need to know to decide about investing in HY, what else would help?

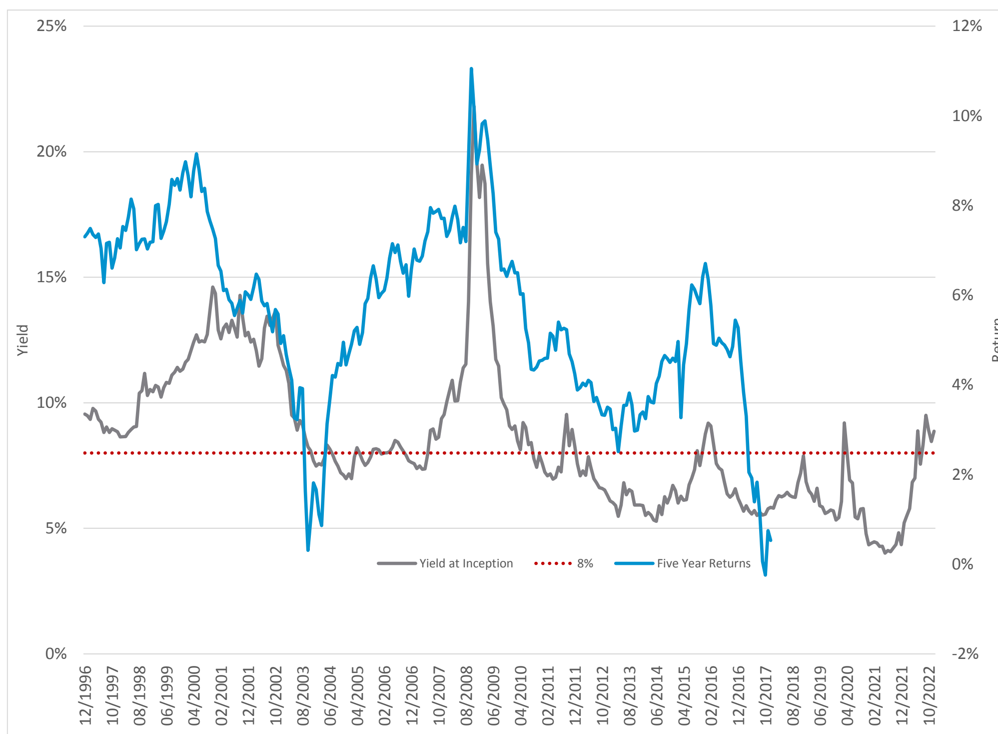
Figure 5: HY Corporate returns, start yields v 1-year returns



We would want to know the kind of circumstances that might dictate good or bad outcomes, given a starting yield. In Figure 5, where the gray line shows the history of yields and the blue line shows the return outcomes one year later, 8%, the red dotted line, appears to be a good yield at which to invest in HY securities. It appears particularly good if the timing comes after a selloff.

In Figure 6, which shows yields versus five-year returns, the only instance where you would have experienced a negative return with an 8% starting yield would have been five years before the financial crisis. And that starting point, unlike today, came just after a decline in HY yields as bonds recovered from a selloff early this century.

Figure 6: HY Corporate returns, start yields v 5 year returns



So the punchline is, you want to know both typical historical outcomes from yield levels at the time you are considering investing and the history of yields in the years prior. Good historical outcomes for a particular yield level, combined with a recent selloff seem to offer the right conditions for investment in high yield debt. That is where we are today.

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