

Will 2023 be the First Year with Repeat Negative High Yield Performance?



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Summary Points

- **In each year immediately following** a year with negative performance, the US high yield market has always generated a positive return.
- **We analyze the potential factors** contributing to this phenomenon, including default rate, inflation, the federal funds rate, and the unemployment rate.
- **While we cannot offer a definitive conclusion**, investors may wish to consider this historical performance pattern as they consider allocations to high-yield bonds in 2023.

Every fourth quarter, clients ask portfolio managers for their views on performance for the upcoming year. As with every year, we examine a multitude of factors to produce a reasonable forecast. 2022 is on track to be the high yield market's eighth negative year since tracking began, prompting us to consider whether this year's performance could influence that of 2023.

When the high yield market developed in the early 1980s, indices were created as early as 1983¹ to track performance. Since 1984, the first full year of the Bloomberg US Corporate High Yield Bond Index², the market has experienced seven years with negative returns. *In the year immediately following each negative return year, the US high yield market has always generated a positive return* (see Exhibit 1). With the high yield market likely to generate its second worst loss in 2022, we are seeking to:

- Identify any structural drivers for positive returns during recovery years.
- Identify any consistent relationships that could explain the magnitude of the recovery during the recovery years.

Exhibit 1: Key characteristics of years with negative performance and their subsequent recovery years

	Negative Performance Year	Recovery Year	Recession? ³	Negative Performance Driver ⁴
1990/1991	-4.40%	39.20%	Yes	Savings & Loan crisis
1994/1995	-1.00%	20.50%	No	Fed rate increases
2000/2001	-5.10%	4.50%	Yes	Telecom bubble
2002/2003	-1.90%	28.10%	No	High defaults
2008/2009	-26.40%	57.50%	Yes	Global Financial Crisis
2015/2016	-4.60%	17.50%	No	Energy downturn
2018/2019	-2.30%	14.40%	No	Fear of Fed overtightening
Average	-6.50%	26.00%		
Median	-4.40%	20.50%		

Source: ICE BofA US High Yield Index data. **Past performance is no guarantee of future results.** The Bloomberg US Corporate High Yield Bond also had seven negative performance years. All return, yield and spread data and remarks refer to the ICE BofA US High Yield index.

1. The Bloomberg US Corporate High Yield Bond Index was launched July 1, 1983 and the ICE BofA US High Yield Index was launched August 31, 1986.

2. Formerly known as the Barclays US Corporate High Yield Bond Index.

3. National Bureau of Economic Research (NBER). "Yes" indicates a recession as identified by the NBER occurred during either the negative year or recovery year.

4. Source: Amundi. These drivers are what we believe to be the commonly accepted cause of the weak high yield performance.

In Exhibit 1, we show the U.S. high yield market's seven years of negative returns paired with their respective recovery years. We also indicate whether a recession⁵ occurred in the US during either the negative year or the recovery year. Finally, we provide the commonly accepted driver of the negative performance year.

Structural Drivers of Positive Returns During Recovery Years

What could be driving the phenomena of never having two negative return years in a row? In Exhibit 2, we present various possibilities. We chose this data based on what we believe are commonly accepted drivers of market performance, including monetary, economic and valuation factors. We recognize a methodology focused on calendar year performance has limitations, but selected it for simplicity.

Exhibit 2: Possible contributing factors to negative performance / recovery pattern

Negative Performance /Recovery Year Pairs	Fed Funds Direction		Inflation Direction		Unemployment Direction		Default Direction		Above/Below Average Spread	
	Year of Negative Returns	Recovery Year	Year of Negative Returns	Recovery Year	Year of Negative Returns	Recovery Year	Year of Negative Returns	Recovery Year	Beginning of Year of Negative Returns	Beginning of Recovery Year
1990/1991	Decreasing	Decreasing	Increasing	Decreasing	Increasing	Increasing	Increasing	Decreasing	Above	Above
1994/1995	Increasing	Flat	Flat	Decreasing	Decreasing	Increasing	Decreasing	Increasing	Below	Below
2000/2001	Increasing	Decreasing	Increasing	Decreasing	Decreasing	Increasing	Increasing	Increasing	Below	Above
2002/2003	Decreasing	Decreasing	Increasing	Decreasing	Increasing	Decreasing	Decreasing	Decreasing	Above	Above
2008/2009	Decreasing	Flat	Decreasing	Increasing	Increasing	Increasing	Increasing	Increasing	Above	Above
2015/2016	Increasing	Increasing	Decreasing	Increasing	Decreasing	Decreasing	Increasing	Increasing	Below	Above
2018/2019	Increasing	Decreasing	Decreasing	Increasing	Decreasing	Decreasing	Decreasing	Increasing	Below	Below

Source: Amundi, ICE BofA, US Federal Reserve, Bureau of Labor Statistics, Moody's

Changes in the US Federal Reserve's Federal Funds Target Rate

On an annual basis, changes in the federal funds rate do not strongly correlate with high yield index performance during the negative return year and recovery year.

- During years of negative returns, the federal funds target rate increased during four years (1994, 2000, 2015, 2018) and decreased during three years (1990, 2002, 2008).
- During recovery years, the federal funds target rate decreased in four years (1991, 2001, 2003, 2019), increased in one year (2016) and was flat two years (1995, 2009).

Inflation Direction

Price stability is one of the objectives of the Fed. The direction of inflation does not appear to have significant predictive value of recovery returns⁶.

- During years of negative performance, inflation increased during three years (1990, 2000, 2002), was flat one year (1994) and fell during three years (2008, 2015, 2018).
- During recovery years, inflation increased during three years (2009, 2016, 2019) and fell during four years (1991, 1995, 2001, 2003).

5. As determined by the National Bureau of Economic Research

6. US CPI Urban Consumers Year Over Year, US Bureau of Labor Statistics

Unemployment Direction

Full employment is the Fed's other objective. The direction of employment does not appear to have significant predictive value. During years of negative returns, unemployment increased during three years (1990, 2002, 2008) and decreased during four years (1994, 2000, 2015, 2018).

Declining Defaults

A reasonable theory would be that negative high yield performance is due to a trajectory of increasing defaults and, when defaults begin to descend, returns become positive. However, the evidence is inconclusive regarding the direction of defaults and is perhaps supportive of the theory that defaults are more of a lagging indicator than a leading indicator⁷.

- During losing years, defaults increased during four years (1994, 2000, 2008, 2015) while defaults decreased during three years (1990, 2002, 2018).
- During recovery years, defaults increased four years (2001, 2009, 2016, 2019) while defaults decreased during three years (1991, 1995, 2003).

High Spreads at End of Negative Year

The bond spread, or the difference in yield between the high yield bond and that of a risk-free US Treasury, indicates the premium investors receive for taking that issuer's default risk. Generally, the magnitude of the spread at the end of the negative year seems to have some predictive value for the following year's return⁸. The two years of negative returns ending the year at the highest spreads (2008 and 1990) posted the highest returns during the following year. Many investors assume spread tightening of individual issues is how the spread of the high yield market tightens, and in general it is the major driver as investors reduce default projections. However, index spreads can be reduced by multiple ways in high yield: spread tightening, defaults of very high spread bonds, issuance of lower spread bonds and downgrades.

However, 2000, which posted the third-highest spread, had the worst recovery year return at 4.48%, which ranked 7 out of 7. Although 2001's 4.50% return was certainly positive, it was below the market's yield-to-worst. Interestingly, spreads tightened and yields fell during 2001; however, the high default rate of 11.70%⁹ may have weighed on the magnitude of returns.

Changing Quality Mix

Decreasing credit quality makes sense intuitively as a driver of negative returns. Increasing credit quality for the index as measured by the CCC¹⁰ percentage makes less sense as a driver of index returns during following years, as the CCC percentage can be reduced by upgrades, defaults and dilution through higher quality issuance.

- Significant increases in the weight of CCC-rated bonds in the index have been very noticeable in two losing years (2001, 2008). However, a decreasing percentage of CCC-rated bonds has also been associated with losing years (2002).
- Decreasing CCCs have also been associated with large gains in the years following losing years (2009) and other years (2010).

7. Source: Moody's trailing 12-month US speculative grade default rate for US bonds used after 1996 and Moody's North America one-year default rate used prior to 1996.

8. ICE BofA US High Yield index, with the spread calculated by subtracting the Bloomberg Generic US Treasury Note yield from the yield to worst (yield to maturity for 1990) for 1995 and earlier due to lack of data availability.

9. Moody's Speculative Grade trailing 12 months default rate

10. Note that AAA-rated bonds, including US Treasury bonds, are considered the safest by the three primary bond rating agencies: Fitch, Moody's, and Standard & Poor's. "AA" follows, and then "A". Grades go as low as "D" for Fitch and Standard & Poor's. The lowest rating Moody's grants is "C".

Above / Below Average Spread at Beginning of Year

Looking at annual data, the spread-to-worst on the ICE BofA US High Yield Index has averaged 5.68% from 1990 through 2021. The seven losing years had an average spread at the beginning of the years of 5.58%, slightly below average for all the years. The seven recovery years had an average spread at the end of the prior (negative) year of 8.73%.

Although we would tend to believe that higher spread and higher yields should lead to a greater probability of strong returns, we note that the 8.73% spread leading into the recovery year was enormously influenced by 2008 and that this average spread is only about one standard deviation higher than the average for the full sample. It is interesting that the year that ended with the tightest spread (2.82%, in December 1997) was followed by a positive return year.

Conclusion

During each year's fourth quarter, portfolio managers and strategists expend incredible effort seeking to predict returns for the coming year. Our methodology of analyzing the seven negative years of high yield bond returns is in line with those efforts. In every calendar year following a year of negative US high yield returns, high yield bonds posted positive returns. But why?

Apart from a loose observation that higher spreads should lead to better returns, we have not uncovered a common driver. While our research is inconclusive, the fact remains that in the 40 years for which U.S. high yield index data has been available, negative performance has not repeated for two years. With the understanding that past performance is no guarantee of future results, investors may wish to consider incorporating high yield bonds into their portfolios in 2023 as a potential source of income.

Definitions

Duration measures a bond's or fixed income portfolio's price sensitivity to interest rate changes.

Credit Spread: The difference in yield between a corporate bond and the sovereign issues (US Treasuries, in the case of US dollar corporate bonds).

Negative Performance Year – a year in which the ICE BofA US High Yield Index produced a return less than 0.

Recovery Year – the year following a Negative Performance Year.

Spread Tightening: A decline in the relative yield of bonds of similar maturity but different credit quality. In this paper, spread tightening refers to high yield bond yields falling relative to yields of US Treasury bonds of similar duration.

Spread-to-Worst – the amount the Yield-To-Worst of a corporate bond exceeds the yield of a US Treasury with the same maturity or call date.

Standard Deviation – Measures the dispersion of a dataset relative to its mean and is calculated as the square root of the variance. .

Yield-to-Worst – as many corporate bonds have pre-defined call schedules with different call prices, the Yield-To-Worst is the lowest yield. It is a conservative way of calculating a bond's yield.

Indices are unmanaged and, unlike fund returns, do not reflect any fees or expenses. It is not possible to invest in an index.

The ICE BofA Merrill Lynch US High Yield Index tracks the performance of US high yield bonds.

The ICE BofA Merrill Lynch US High Yield B, BB and CCC Indices track the performance of US high yield bonds of varying credit qualities.

The ICE BofA Merrill Lynch Global High Yield Index tracks the performance of global high yield bonds.

The ICE BofA Merrill Lynch Global High Yield B, BB and CCC Indices track the performance of global high yield bonds of varying credit qualities.

The ICE BofA Merrill Lynch US Investment Grade BBB Index tracks the performance of BBB-grade quality US Corporate Bonds.

The ICE BofA European Currency High Yield Index tracks the performance of European high yield bonds.

The ICE BofA Merrill Lynch Emerging Markets High Yield Index tracks the performance of global high yield bonds.

Important Information

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