A recurring source of high income potential from global high yield bonds

- Despite a challenging global economic outlook, the backdrop for global high yield bonds remains favourable.
- However, investors need to be mindful of risks, and measure risk-adjusted returns.
- Credit research and risk management can add value by identifying mispriced opportunities and managing downside risk.

The quest for yield and search for stable income is a recurring theme for many investors, especially amid renewed concerns of slowing global economic growth and worries the debt crisis will spread through the Eurozone.

While developed market government bonds used to be considered a safer, income-generating asset, risk aversion has pushed down the sovereign bond yield to record low levels. On the contrary, global high yield bonds are currently delivering an attractive yield of 6.9%\(^1\). The ability to generate income has kindled significant interest in the asset class.

While global high yield bonds offer a diverse range of opportunities and the underlying fundamentals will continue to be supportive, investors need to be mindful of risks, and recognise which bonds can deliver superior risk-adjusted returns.

On the corporate front, the financial strength of corporates has improved since the 2008-2009 global financial crisis. Companies have been cutting costs and improving profitability. This helped increase liquidity and cash flow. As a result, companies are in a better position to meet funding needs and withstand a difficult environment. Company deleveraging is positive for bond holders and should support the payment of high yields and repayment of principal.

**Backdrop for global high yield bonds remains supportive**

Although problems in the Eurozone continue to cloud the global economic outlook, the underlying fundamentals for global high yield bonds have remained relatively solid. Central banks and policymakers have added liquidity to ease credit conditions, and the governments in the US, Europe and Asia have injected capital, by cutting interest rates, purchasing bonds and conducting money market operations in the past year.

**Corporate balance sheets are strong**

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The improvement in underlying fundamentals for corporates has meant that global default rates have continued to fall. As a result, global default rate for non-investment grade bonds have fallen to less than 4% currently, with almost zero defaults in Asia. The overall drop in default rates reflects an improvement in the credit markets, which is positive for high yield bonds.

These factors have created a positive environment and solid investment case for global high yield bonds and imply that the current concerns over slower global growth do not necessarily imply weaker fundamentals or negative returns from this asset class.

**Beware of extreme credit risk**

Within the global high yield universe, bonds vary significantly in terms of risk and return. This is an important consideration for high yield bonds, as avoiding credit loss is a key determinant of capturing sustainable returns.

For example, highly speculative bonds (bonds rated CCC and below) have a much higher average default risk than bonds with a higher credit rating, such as the B/BB rated bonds, despite long term performance of CCC rated bonds has been in line with B/BB rated bonds. This risk jumps significantly during specific periods of the economic cycle, and the maximum default rate for these highly speculative bonds in the last three decades has been close to 50%. This indicates that avoiding these bonds make sense.

**Identify the sweet spot – consider BB and B rated bonds**

Some bonds offer deeper value than others, by balancing risk and return. For example, bonds that are one notch below investment grade, such as BB or B rated bonds, offer attractive yields but with much lower volatility than the highly speculative bonds. This results in attractive risk-adjusted return.

**Table 1: Average returns and standard deviation of US bonds from January 1993 to September 2011**

<table>
<thead>
<tr>
<th>Index</th>
<th>Average return</th>
<th>Standard deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>BB</td>
<td>8.0</td>
<td>7.3</td>
</tr>
<tr>
<td>B</td>
<td>7.4</td>
<td>8.9</td>
</tr>
<tr>
<td>CCC</td>
<td>8.0</td>
<td>14.1</td>
</tr>
<tr>
<td>3-month Treasury-Bill</td>
<td>3.4</td>
<td>0.6</td>
</tr>
</tbody>
</table>

Source: HSBC Global Asset Management (France), based on Barclays Capital Indices, data as at 14 October 2011. Standard deviation is a measure of volatility, the higher the standard deviation, the greater price fluctuation hence more risky.

**Credit ratings at a glance**

Top three rating agencies Standard & Poor’s (S&P), Moody’s and Fitch issue bond credit rating after assessing the credit worthiness of corporate or government debt issuers. A bond is considered investment grade if its credit rating is BBB- or above by S&P and Fitch, or Baa3 or higher by Moody’s. Non-investment-grade bonds, which are facing higher credit risk than investment grade bonds, are also called high yield bonds. Bonds rated CCC and below are considered extremely speculative.

**Credit research critical to uncover opportunities**

The global high yield bond market has an approximate market size of USD1.26 trillion. Investors may be bewildered by the width and depth of this universe, which presents a myriad of opportunities across countries, sectors and credit ratings.

Intensive analysis and understanding can help uncover opportunities which lead to higher yielding and greater capital appreciation opportunities.

For example, mispriced opportunities in distressed sectors such as financials, lie in bonds that might benefit from credit rating upgrades, or even speculative bonds that may offer rare opportunities.

- One of the biggest US-based automakers was able to improve its operating results for a strong cash position and debt level in the past few years. Recently, the company was upgraded to investment grade status by Moody’s and Fitch, and this provided opportunity for price appreciation as a result.
- A facility service provider for cleaning, property, catering and security services was rated highly speculative by Moody’s. However, after it became the target of an leveraged buyout by private equity houses in 2005, its bond yield was pushed up to over 9%, and the company has demonstrated decent revenue growth with resilient margin since then.

**Active management and credit selection could add value to global high yield bond market investment**

Diversity of the global high yield universe requires fixed income investment experts to navigate the multitude of opportunities and understand risks. Leveraging global credit research platform and local knowledge, fixed income investment experts could add value by identifying mispriced opportunities that may contribute to superior long term performance.

Source:
1. Bloomberg and DataStream, global high yield bond = BofA ML Global High Yield, BB-B Constrained Index, data as at 30 April 2012.
2. Moody’s Investor Service, data as at 29 February 2012.
3. HSBC Global Asset Management (France), data from January 1993 to September 2011.
Outlook

United States

Despite decent business sentiment surveys and leading economic indicators, as well as a pick-up in its housing market and consumption trend, the recovery pattern still looks uneven given the lower-than-expected labour market data. Another area of concern is the sheer size of the US deficit that could impact the country’s economic activity. There is little prospect for tackling the problem until after the November presidential election, which will determine the future of the US fiscal policy.

Europe

Uncertainty about the Eurozone is likely to remain high and continue to weigh on investor sentiment. The victory of the pro-austerity parties in the Greek elections is positive and would alleviate market concerns and increase risk appetite. Another catalyst would be policy initiatives taken by the European government, specifically the European Central Bank (ECB). However, further clarity is needed regarding the details of the Greek bailout program and austerity measures, and markets would likely remain news sensitive.

Bonds

We believe that government bond yields will eventually rise to levels better reflecting the economic and fiscal backdrop. We do not think the economic fundamentals support current record-low yields of government bonds, thus we remain cautiously negative on this asset class. We prefer corporate bonds and emerging market debt from both fundamentals and valuation perspectives. Over time, we would expect both asset classes to outperform government bonds as investors search for higher-yielding assets, given the environment of low global interest rates.

Asia ex-Japan

We maintain our positive view on the region, as Asia’s economic growth is likely to outpace the developed world this year. The region’s policymakers have the tools to respond to global growth weakness, especially as inflation is generally moderating. Risk appetite may be capped in the near term on the Eurozone’s persistent political and debt concerns and as US data appears to be softening a little. Longer term, the challenge for most regional economies is to shift to more domestically driven sources of growth.

Japan

Despite positive signs of a recovery earlier this year driven by post-earthquake construction spending, the weak global macro backdrop dampened sentiment and led to a major sell-off in May. What’s worse, the stronger yen that tends to strengthen in periods of risk aversion, has also weighed on Japanese exporter prospects. The country’s deteriorating demographics and the absence of structural economic reform could cap long term growth rates, but we see scope for short term economic recovery, which should provide some support to the market.

Currencies

Most emerging market currencies will likely remain under pressure given overall decline in risk appetite. However, recent currency sell-off provides a good entry point for long-term investors. Resolution of the Eurozone sovereign debt crisis would be positive for the Euro, but negative for safe haven currencies such as the dollar and yen. We expect emerging market currencies to appreciate in the long run given their long term structural advantages.
Source of macroeconomic data: Bloomberg as at 31 May 2012.

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