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High Yield's Compelling Recession Resilience

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Allocators are often surprised to discover that high yield bonds typically outperform stocks by a wide margin going into and coming out of recessions. In the table below (Figure 1), we compare the returns of the ICE BofA U.S. High Yield Index to the S&P 500 Index during the last four recessions and the 18-month period after each recession. The High Yield Index outperformed the S&P 500 by about 9 percentage points, 13 percentage points, and 13 percentage points per year during and after the early 1990s, early 2000s and late 2000s recessions, respectively. The only exception was the COVID-19 recession of 2020 during which the policy response from the administration, Congress and the Federal Reserve was so fast, furious, and sustained.

1 High Yield Performance During and After Recessions
As of 4/30/2022

Recession Period

July 1990 to March 1991	Recession Return (Ann)	18 Months After (Ann)	Recession + 18M (Ann)
ICE BofA U.S. High Yield	8.72	24.16	19.90
S&P 500	7.64	10.86	10.68
Excess	1.08	13.30	9.22
March 2001 to November 2001			
ICE BofA U.S. High Yield	(2.45)	7.60	3.85
S&P 500	(7.18)	(9.06)	(9.20)
Excess	4.73	16.66	13.05
December 2007 to June 2009			
ICE BofA U.S. High Yield	(2.86)	25.29	9.94
S&P 500	(24.16)	25.77	(3.00)
Excess	21.30	(0.48)	12.94
February 2020 to April 2020			
ICE BofA U.S. High Yield	(9.82)	14.81	6.11
S&P 500	(9.26)	37.88	24.59
Excess	(0.56)	(23.07)	(18.48)

Source: Bloomberg (© 2022, Bloomberg Finance LP), ICE BofA, Brandywine Global

Why is high yield more resilient in recessions?

The High Yield Index has been very resilient. It usually draws down less than the S&P 500 in recessions and then

recovers faster. One reason for this resilience is bondholders' contractual right to interest and principal payments. In general, corporate managements have to satisfy these interest and principal obligations to preserve, let alone grow, the value of the company's stock. Although cash flow and assets may be used to pay off principal, most high yield bonds are refinanced. Therefore, access to capital is usually the controlling factor. Bonds do not typically default if they can be refinanced, and there are multiple avenues available. As we approach recession, the high yield market reprices to higher yields, which attracts capital and allows managements to refinance their bonds. In addition to the bond market, managements can refinance high yield bonds in the private credit, leveraged loan, convertible bond, or equity markets.

Stock prices, on the other hand, are much more sensitive to earnings and earnings growth. Earnings usually decline materially in a recession, and it may take considerable time for investors to gain confidence in estimates of normalized earnings and earnings growth coming out of the recession. We believe that, given the unusual outperformance of the S&P 500 over high yield since the COVID-19 recession and with the current yield and price of the High Yield Index, it is even more likely that high yield outperforms during and after the next recession.

With recession likely, what is our outlook for returns and defaults?

The risk of recession is elevated, and the high yield market has repriced to higher yields. At the end of the third quarter, the High Yield Index yield was above 9.5%, which historically has been an important level. The average price was below 84 cents on the dollar. The table below (Figure 2) shows the dollar price and subsequent High Yield Index returns from prior points at which the yield breached 9.5%.

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Yield-To-Worst Pointing To Positive Long-Term U.S. High Yield Returns

Ice BofA U.S. High Yield Index

Date YTW Breached Above 9.5%	Avg. Dollar Price	Fwd 1Y	Fwd 2Y Annualized	Fwd 3Y Annualized	Fwd 5Y Annualized
11/21/2007	92.71	(30.44)	6.76	10.35	9.75
10/3/2011	92.70	20.07	13.41	11.32	8.42
1/20/2016	84.75	23.72	15.10	10.17	9.44
3/18/2020	83.16	26.62	12.61	--	--

Source: Brandywine Global, ICE BofA

Over longer time periods, two years and more, the High Yield Index has delivered strong returns from a starting point of a 9.5% yield. That 9.5% yield has been more than sufficient to compensate investors for foreseen and unforeseen risks, and we expect this time to be the same.

For the first year after the index yield breached 9.5%, returns were particularly strong with the notable exception of the Global Financial Crisis (GFC) of 2007-2009. During the GFC, credit conditions worsened over the first year after the yield surpassed 9.5%. Two years later, the High Yield Index delivered an annualized return close to 7% even though the yield was still above 9.5% at that time after peaking above 22% in late 2008. To demonstrate the resilience of high yield compared to equities, after the GFC, the High Yield Index was back above its high-water mark by late 2009. Meanwhile, the S&P 500 did not exceed its high-water mark until late in 2012.

The 2011 and 2016 episodes coincided with recession scares that did not materialize. However, the real question is not "Recession or no recession?" Instead, it is "What are expected default losses?" We expect default losses going into and coming out of a likely 2023 recession to be similar to, and possibly lower than, the default losses in 2015-2016. We expect default losses to be less than half of those experienced in the GFC.

Why do we expect default losses so much lower than the GFC? Two reasons are credit ratings and seniority. As shown below (Figure 3 and Figure 4), today's High Yield Index is much higher quality than it was before and during the GFC. Seniority has also improved since then, with a much higher percentage secured and a much lower percentage subordinated. Over time, smaller, more leveraged borrowers have migrated out of the High Yield Index into the leveraged loan and private credit markets.

3 ICE BofA U.S. High Yield Index Credit Quality

As of 9/30/2022

Rating	3/31/2001	12/31/2007	2/29/2020	9/30/2022
BB	38%	38%	51%	52%
B	51%	43%	37%	37%
CCC & Lower	11%	19%	12%	11%

Source: Bloomberg (© 2022, Bloomberg Finance LP), ICE BofA

4 ICE BofA U.S. High Yield Index Seniority Composition

As of 9/30/2022

Seniority	3/31/2001	12/31/2007	2/29/2020	9/30/2022
Secured	8%	11%	17%	27%
Unsecured	64%	74%	78%	70%
Subordinated	28%	15%	2%	2%

Source: Bloomberg (© 2022, Bloomberg Finance LP), ICE BofA

For recession protection, reallocate some equities to high yield

All year, we have been making the case for why we believe a 700-basis point spread in high yield today may be equivalent to a 900-basis point spread in prior cycles. Among other reasons, an inflationary recession should lead to lower high yield default losses and credit spreads than a credit-driven, disinflationary recession. High yield bonds are fixed-rate obligations that are being serviced with now-inflated assets and cash flows.

This allocation decision is not about calling a bottom in the high yield market. We advocate for legging into high yield now and believe that a significant portion of the expected allocation should be in place with yields at these levels. Liquidity could seize up, causing high yield spreads to widen much more than the outlook for default losses warrants, but that is something we would expect to last for no more than a few days to a few weeks. In those circumstances, we believe allocators should still be in a position to add to high yield, but if they wait for that event to get started with their allocation, they may miss the opportunity. From these levels, it is better to be early than to miss the opportunity altogether in our view. In our last blog post, With Leveraged Loans Past Their Peak, High Yield Rises to the Top, we opined that high yield was a compelling alternative to leveraged loans. Now with a potential recession looming, we believe high yield is also a compelling alternative to stocks. For allocators who want to protect against an upcoming recession, we believe they should consider reallocating some of their equity exposure to high yield.

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