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Investment Perspectives

An Update on Short-Term High Yield Bonds

Short-duration high yield bonds continue to offer several advantages in an uncertain market environment.

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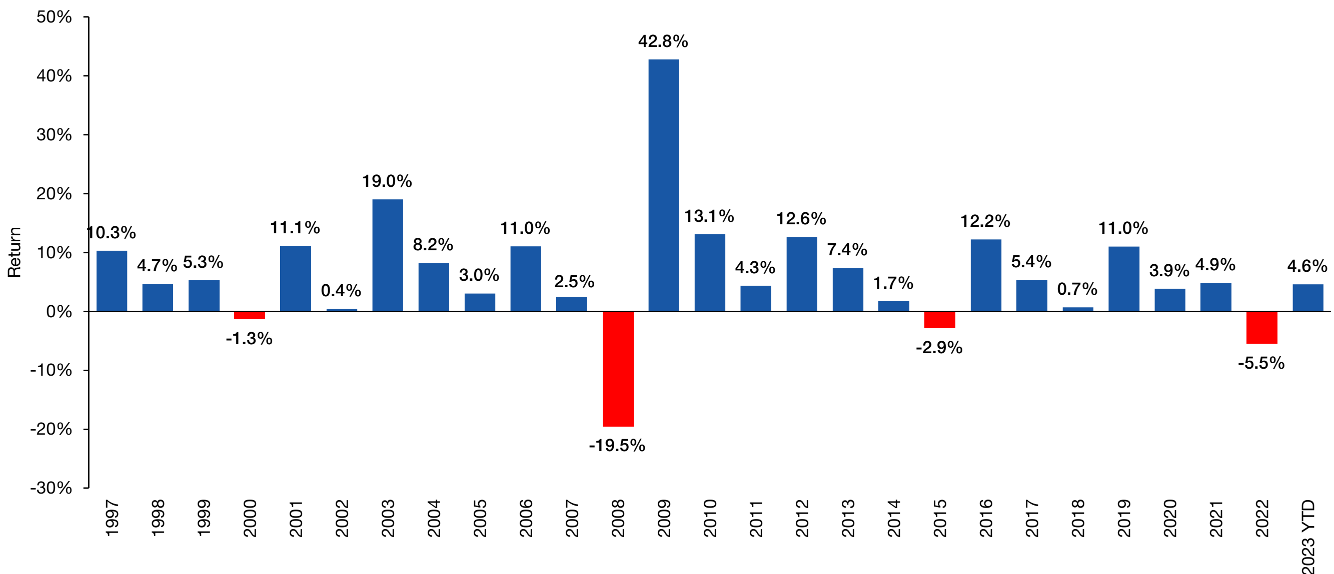
Here, we present an updated version of a paper originally published in February 2023 that highlighted five visuals that argue for short duration high yield. Six months later, we believe short high yield remains an appealing strategy to take advantage of particularly attractive front-end yields, most notably in an up-in-quality cohort of the high yield market that could be insulated from credit worries that investors may traditionally have had in lower-rated credit.

1. Evidence for a Bounce Back in Returns after Rare, Tough Years Like 2022

In 2022, there were few asset classes where investors could hide. The good news from Figure 1 is that looking to the historical return stream for the ICE BofA 1-5 year BB/B Index provides some comfort for forward-looking investors. Negative return years have been quite rare and are typically followed by several years of attractive returns, given the valuation reset. And that's regardless of the economic environment during the bounce-back year. Through the first half of 2023, this index has climbed 4.6%, on track to capture more than one-half of the start-of-year yield-to-worst (YTW) of 8.33% with some incremental price return (data source is ICE Data Indices LLC). Today's index YTW is still sitting north of 8%, and expectations for a higher-for-longer rate environment could help provide long-run historical equity-like returns over the near term, in our view.

Figure 1. Negative Calendar Years for Short High Yield Have Historically Been Followed by Positive Returns

ICE BofA 1-5 Year BB-B Cash Pay High Yield Index, December 31, 1996–June 30, 2023



Source: ICE Data Indices LLC. **Past performance is not a reliable indicator or guarantee of future results.** 2023 YTD is through June 30. The historical data shown in the chart above are for illustrative purposes only and do not represent any specific portfolio managed by Lord Abbett. Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment.

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2. Comparable Yield Relative to Longer-Duration High Yield

Next, let's look at the current valuation setup for the short-duration, high yield markets. Figure 1 shows a very simple time series of the difference in the yield-to-worst of the short-duration, high yield credit market versus the longer-duration, full high yield market, both centered on the 'BB'- and 'B'-rated part of high yield. Basically, we are looking at the higher-quality part of the high yield market and yields on shorter-duration bonds versus their longer-duration counterparts. What's interesting here is that you see a rare, and typically short-lived, phenomenon: the yield on short-duration, higher-quality, high yield bonds is actually higher than that of normal-duration high yield overall.

Figure 2. Front End Credit Yields Are Currently Above Longer Maturities

Yield-to-worst difference between the ICE BofA 1-5 Year BB-B Cash Pay High Yield Index and the ICE BofA BB-B U.S. High Yield Index, December 31, 2002–June 30, 2023

Source: ICE Data Indices LLC. Yield-to-worst refers to the lesser of a bond's (a) yield-to-maturity or (b) the lowest yield-to-call calculated on each scheduled call date. **Past performance is not a reliable indicator or guarantee of future results.** The historical data shown in the chart above are for illustrative purposes only and do not represent any specific portfolio managed by Lord Abbett. Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment.

If you look at periods covered by the 2008–09 global financial crisis (GFC) and the market volatility in early 2020 sparked by the onset of the COVID-19 pandemic, the real driver of the spike in the yields on the front end was credit spreads widening sharply, an indication of concern around distress in the credit markets. Today, you have a very different situation, with an inverted yield curve—where short-term benchmark rates exceed long-term rates. This presents a potential yield opportunity on the short end with credit continuing to hold up, with front-end credit spreads themselves behaving well, and signaling relatively low concern about corporate balance sheets coming under stress in the near term.

3. More Attractive Risk-Adjusted Returns in the Short End

Yields may be attractive but measuring risk-adjusted returns should be part of the conversation, in our view. Figure 3 shows the Sharpe ratios (a widely used measure of risk-adjusted returns) of the 'BB' and 'B' parts of the high yield market for the 0-3 year, 3-5 year, and 5-year-plus maturities within those rating categories.

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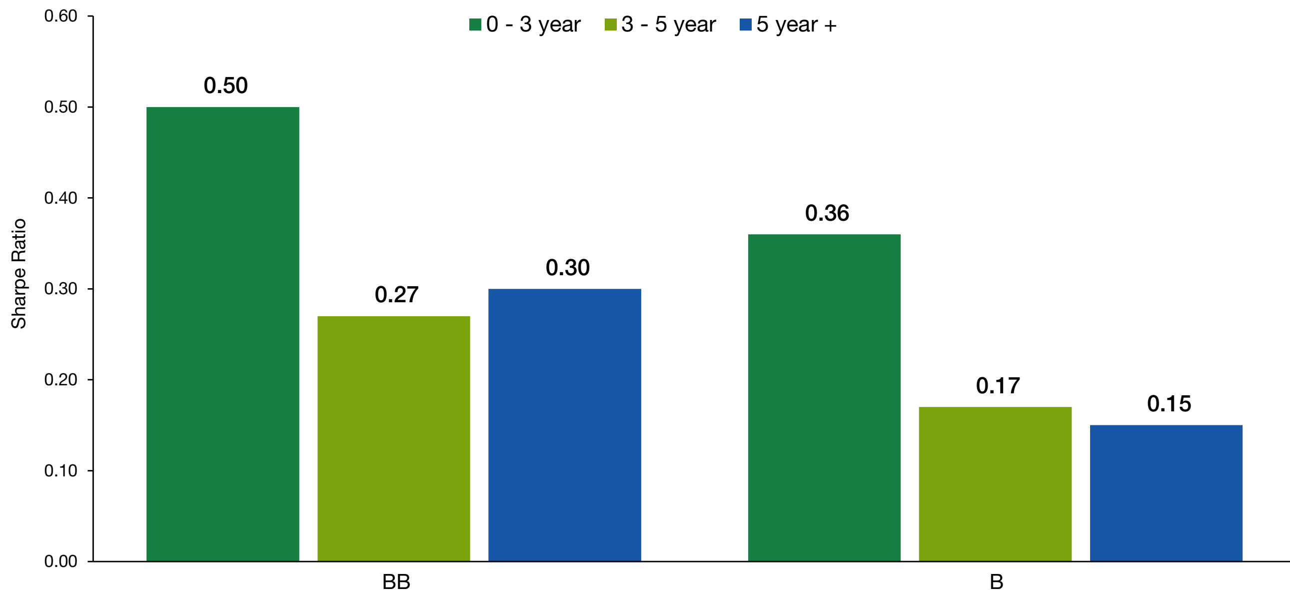
Figure 3. Over Time, the Short End of Higher-Quality High Yield Has Provided Compelling Risk-Adjusted Returns

Sharpe ratio by maturity for indicated ratings categories within the high yield index, December 31, 1996–March 31, 2023



Source: ICE BofA Indices, LLC. and Lord Abbett. Data as of 3/31/2023. "High yield index" refers to the ICE BofA US High Yield Index. Sharpe ratios based on rating and duration buckets in the ICE BofA U.S. High Yield Constrained Index. The Sharpe ratio was developed by Nobel laureate William F. Sharpe as a measure of risk-adjusted performance. It is calculated by taking an asset class's (or portfolio's) excess return above the risk-free rate and dividing it by the standard deviation of its returns. The greater the Sharpe ratio, the better the risk-adjusted performance has been.

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4. Same Spreads, Lower Risk

There's another dimension to the short-duration high yield story, as shown in Figure 4 on the next page. What you see in the left panel is that the shape of the spread curve, both in 'BB' and 'B' bonds, over the various maturity categories, is rather flat.

Put another way, averaged through time, spreads in the front end of the curve are largely the same as those you get in longer-duration credit, in both 'BB's and 'B's. This is noteworthy because if you look at the right panel of Figure 4, you will see that default rates grow, albeit in a non-linear fashion, when you hold credit for a longer time frame. That makes some intuitive sense. Typically, there aren't a lot of things that can go wrong with a company over a one-, two-, or even three-year period. But then, the longer you hold onto credit, there's the higher potential for three outcomes: the company gets upgraded to investment grade, has its rating cut to a lower tier of speculative grade, or defaults. These trends illustrate another attractive characteristic of short duration high yield in the current environment, with a similar level of default risk priced into front end spreads as those spreads move further out the maturity curve.

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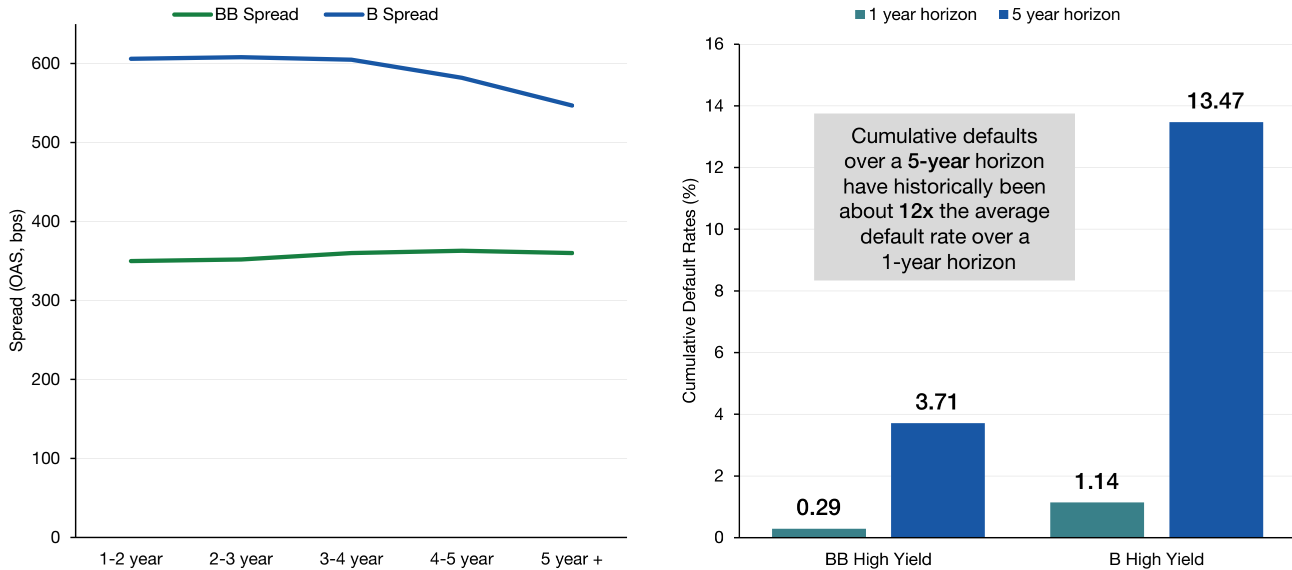
Figure 4. Through Time, Short Duration High Yield Has Had Similar Credit Spreads Relative to Longer-Duration High Yield

Average index option-adjusted spreads by rating and maturity, 1997–2022 (left panel); cumulative default rates, by rating, 2011-2020



Sources: ICE Data Indices, LLC. and Moody's Study of Corporate Defaults, 1970-2020. Spread is the percentage difference in current yields of various classes of fixed-income securities versus Treasury bonds or another benchmark bond measure. A bond spread is often expressed as a difference in percentage points or basis points (which equal one-one hundredth of a percentage point). The option-adjusted spread (OAS) is the measurement of the spread of a fixed-income security rate and the risk-free rate of return, which is adjusted to take into account an embedded option. Typically, an analyst uses the Treasury securities' yield for the risk-free rate.

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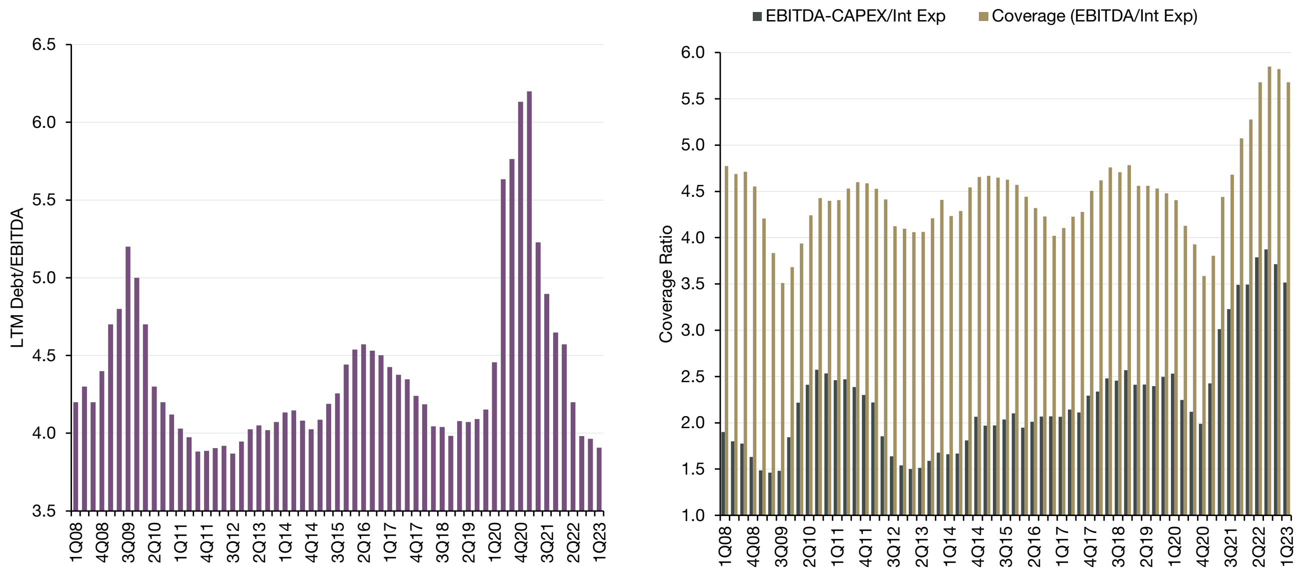
5. Solid Starting Fundamentals to Offset Economic Slowdown Worries

Finally, let's take a step back to examine the fundamentals of the broader high yield market. Figure 5 on the next page presents a couple of data series that show the high yield space at a strong point. The left panel shows the overall leverage ratio—debt divided by EBITDA (earnings before interest, taxes, depreciation, and amortization)—for the broad high yield market since 2008. And you see that following a complete recovery from the impacts of COVID-19, the ratio was near historically low levels as we exited 2022 and has held up well through the start of 2023. Even if we see a gradual deterioration in this measure during the second half of 2023 and into 2024 should economic growth slow, leverage levels could still be historically strong.

Figure 5. U.S. High Yield Credit Fundamentals: Leverage and Coverage in Solid Shape

U.S. high yield leverage (debt/EBITDA ratio), Q1 2008–Q1 2023 (left panel); U.S. high yield interest coverage (EBITDA-capex/interest expense ratio and EBITDA/interest expense ratio), Q1 2008–Q1 2023 (right panel)



Source: JPMorgan; as of latest available data for 2023 Q1 reporting period. Capex=capital expenditures. Int Exp=Interest expense. EBITDA=earnings before interest, taxes, depreciation, and amortization.

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Another important point for high yield is in the right panel, which shows the coverage ratio (EBITDA divided by interest expense), along with another key measure of a company's ability to service its debt, EBITDA minus capital expenditures divided by interest expense. As it turns out, those companies that issued fixed-rate, and not variable-rate, debt before the recent interest-rate runup are in a very good position, by not having rates, and thus interest costs, move in-step higher when benchmark interest rates rise. That's part of the reason why interest coverage ratios are staying so strong—at levels that are near the best that we've ever seen in the asset class, even after the very modest turn lower to start the year.

This strength is complemented by another long-term trend we have spotlighted in the past: the credit quality of the benchmark high yield index is near the strongest levels in its history, with 'BB'-rated bonds comprising half of the broad high yield index. The strong fundamentals likely helped keep spreads from widening more significantly over the past 18 months, even as recessionary fears climbed. In 2022, the largest spread for the broad high yield index was 600 basis points (bps); in prior periods of pronounced recessionary fears, that level would have widened to as much as 800-1,000 bps.

Summing Up

The main story of last year for credit markets was one of investors displaying increasing defensiveness. And that was due to the ever-growing uncertainty about the growth outlook that we had globally. But in the first half of this year, these concerns have eased, and we've seen multiple signs that are making us more comfortable with the short-term outlook for growth. That, in turn, is giving us some confidence to reach a little bit more for yield by moving modestly lower in credit quality from 'BB' bonds into 'B' bonds—though not fully into 'CCC' territory—given the ongoing uncertainty in the outlooks for growth and rates and their potential impact on the weakest of credits.

The bottom line: You can generate high levels of income within the short-duration, high yield market with limited duration exposure. And we've found, through conversations with investors about the asset class, that given the uncertainties mentioned earlier, the combination of high income and limited duration exposure continues to be an attractive proposition.

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A **basis point** is one one-hundredth of a percentage point.

Earnings yield is earnings per share divided by the share price, the reciprocal of the P/E ratio; when quoted as a percentage, it is used to compare yields in the equity and fixed income markets.

The **U.S. Federal Reserve (Fed)** is the central bank of the United States. The federal funds (fed funds) rate is the target interest rate set by the Fed at which commercial banks borrow and lend their excess reserves to each other overnight.

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Spread is the percentage difference in current yields of various classes of fixed-income securities versus Treasury bonds or another benchmark bond measure. A bond spread is often expressed as a difference in percentage points or basis points (which equal one-one hundredth of a percentage point). The option-adjusted spread (OAS) is the measurement of the spread of a fixed-income security rate and the risk-free rate of return, which is adjusted to take into account an embedded option. Typically, an analyst uses the Treasury securities yield for the risk-free rate.

Yield is the income returned on an investment, such as the interest received from holding a security. The yield is usually expressed as an annual percentage rate based on the investment's cost, current market value, or face value. Yield-to-maturity (YTM) represents the expected return (expressed as an annualized rate) from the bond's future cash flows, including coupon payments over the life of the bond and the bond's principal value received at maturity. Yield-to-worst refers to the lesser of a bond's (a) yield-to-maturity or (b) the lowest yield-to-call calculated on each scheduled call date.

Yield curve is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality, but differing maturity dates. The most frequently reported yield curve compares the three-month, two-year, five-year and 30-year U.S. Treasury debt. This yield curve is used as a benchmark for other debt in the market, such as mortgage rates or bank lending rates. The curve is also used to predict changes in economic output and growth.

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