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Investment Perspectives

Fear Not Fed Easing with Short-Duration High Yield Bonds

A U.S. Federal Reserve (Fed) easing may be likely. A look to prior easing cycles suggests normalization of the yield curve does little to dent the attractive risk-adjusted returns of the strategy.

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KEY POINTS

- Historically, short-duration high yield has provided a better risk-adjusted return to the broad high yield market.
- Examining the asset class during previous easing cycles shows that short-duration high yield kept pace or outperformed the full-duration high yield market.
- Today's yield curve normalization is more reflective of a return to trend like growth and inflation, and not a more serious downturn, in our view. Credit can perform just fine given the backdrop.

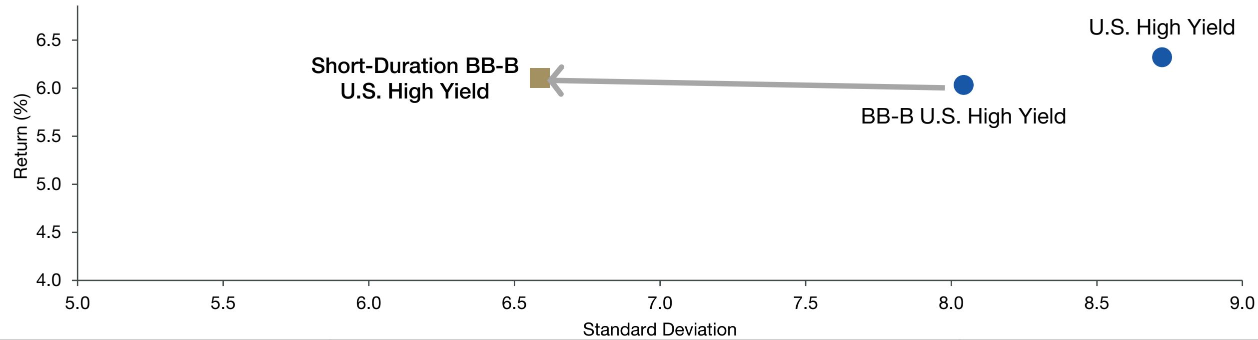
With a string of softer inflation and labor market readings this past month, the case for Fed easing starting with the September meetings has become stronger. As a result, the yield curve has further normalized from its inversion that has otherwise persisted since mid-2022, as measured by the yield difference between two-year and 10-year U.S. Treasuries. Over this period, many fixed-income investors had taken advantage of the opportunity to shorten portfolio duration while still achieving equal or better fixed-income credit yields than available further out the curve.

The growth in investors' allocation to short-duration high yield strategies (as well as bank loans, to a lesser extent) over the last couple of years is no exception. But with the yield curve set to normalize, and potentially further steepen from here, many investors are left wondering how short-duration approaches in leveraged credit might perform once the Fed starts to ease. Is this the time to extend duration in this credit asset class? Or exit high yield outright?

From Figure 1, we can compare the risk-adjusted returns of full-duration and short-duration approaches to the U.S. high yield market over the long term. When compared to either a full-duration BB-/B-rated approach or a more inclusive market opportunity that includes CCC-rated bonds, short-duration high yield historically provided similar annualized returns with approximately 25% lower volatility. Of course, during that period, the Fed had undertaken four separate easing campaigns of various magnitudes.

Figure 1. Over the Long Term, Short-Duration High Yield Provided Similar Returns to Broad High Yield or Just BB-B, with Less Volatility

Returns, standard deviation, and Sharpe ratios over the 10-year, 20-year, and since inception periods for high yield bond indices, December 31, 1996-June 30, 2024



	10 Year			20 Year			Since Inception 12/31/1996		
As of June 30, 2024	Return	Standard Deviation	Sharpe Ratio	Return	Standard Deviation	Sharpe Ratio	Return	Standard Deviation	Sharpe Ratio
Short Duration BB-B U.S. High Yield	4.08	5.96	0.45	5.87	6.95	0.63	6.11	6.95	0.61
BB-B U.S. High Yield	4.24	7.33	0.40	6.23	8.27	0.59	6.03	8.04	0.50
U.S. High Yield	4.21	7.70	0.38	6.53	9.06	0.58	6.32	8.72	0.50

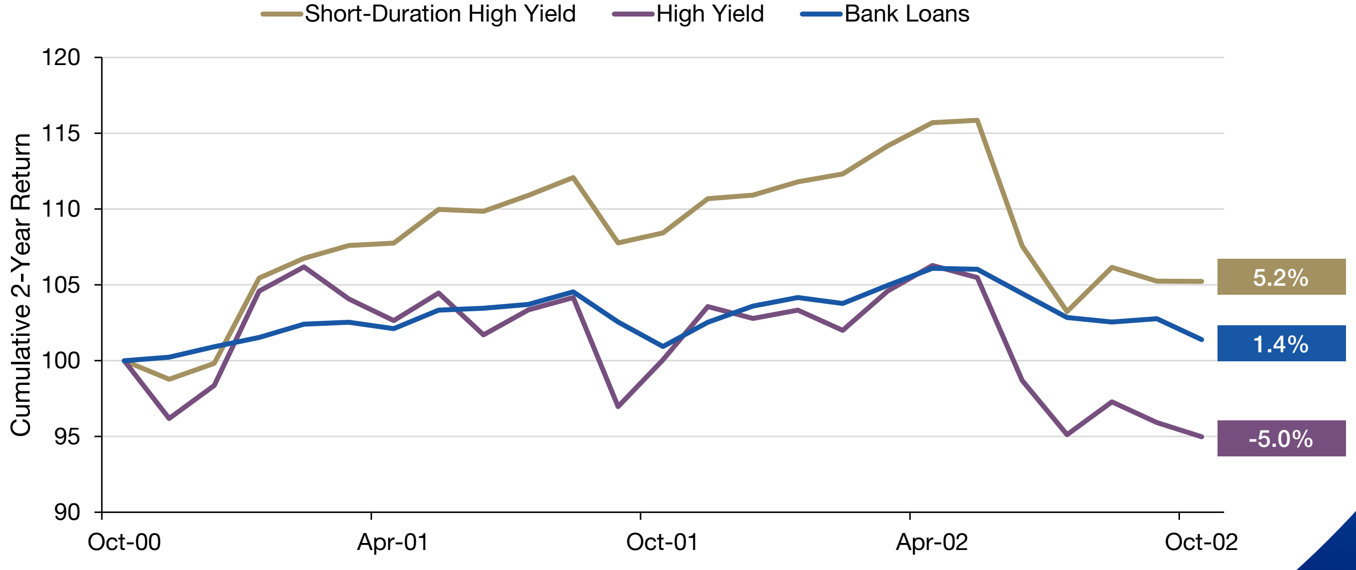
Source: Morningstar. Data as of June 30, 2024. **Past performance is not a reliable indicator or guarantee of future results.** The historical data shown in the chart above are for illustrative purposes only and do not represent any specific portfolio managed by Lord Abbett. Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment. Short-Duration BB-B U.S. High Yield represented by the ICE BofA U.S. High Yield BB-B 1-5 Year Index, BB-B High Yield represented by the ICE BofA U.S High Yield BB-B Index, and U.S. High Yield represented by 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.

As noted, the period since 1996 has witnessed a variety of macroeconomic environments, four Fed easing campaigns, and differing starting fixed-income yields on offer. That provides a rich set of data points to compare leveraged credit performance during easing cycles. In Figure 2, we present four different time event studies, each comparing the ensuing two-year cumulative total return of short-duration high yield, bank loan, and high yield indices, starting three months prior to the first Fed easing of each respective cycle.

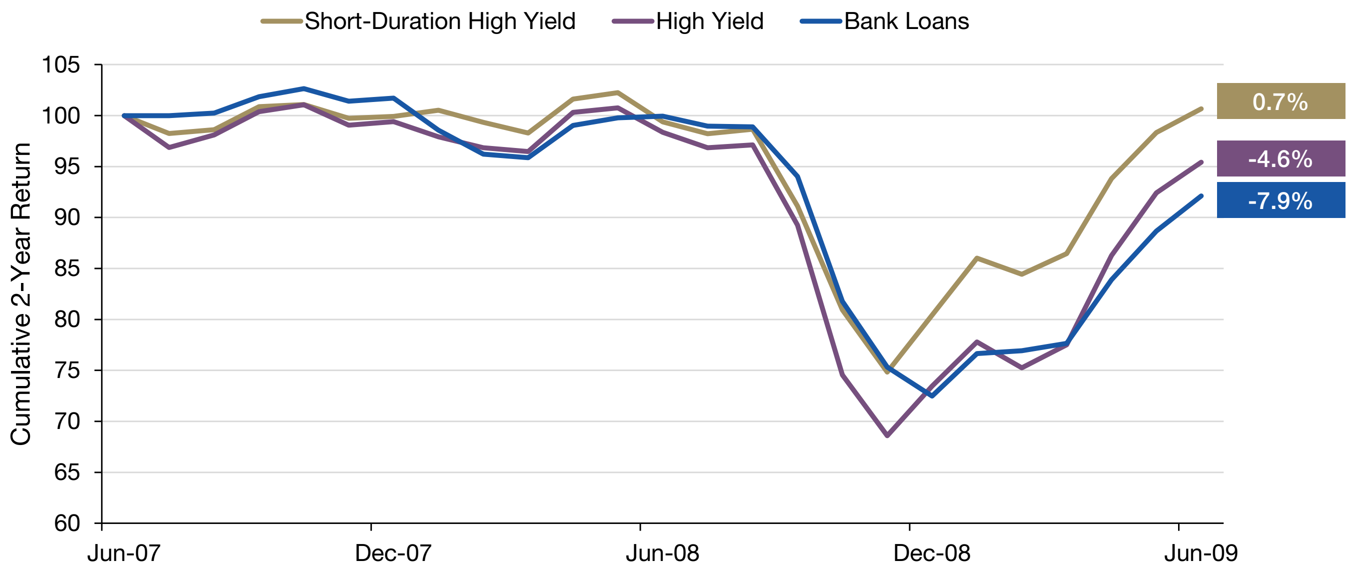
Figure 2. Short-Duration High Yield Performance Compares Well When the Fed Eases

Cumulative two-year total return of short-duration high yield, high yield, and bank loan indexes for the periods shown

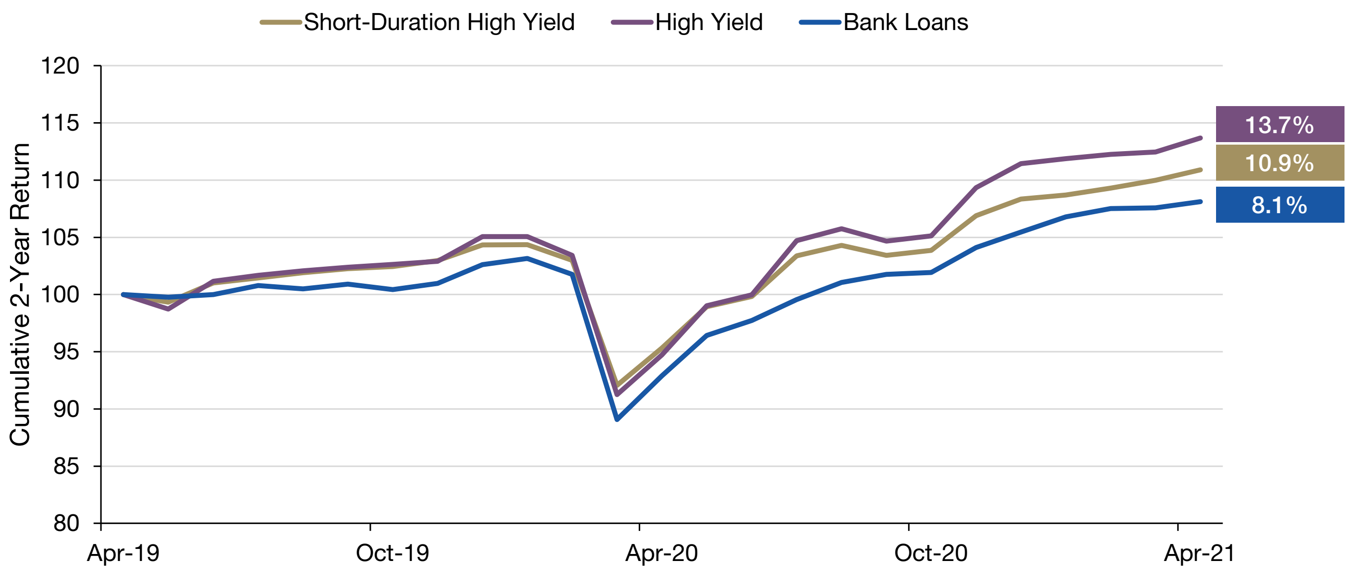
2001 Easing Cycle: Easing started January 2001. Period shown is October 31, 2000-October 31, 2002.



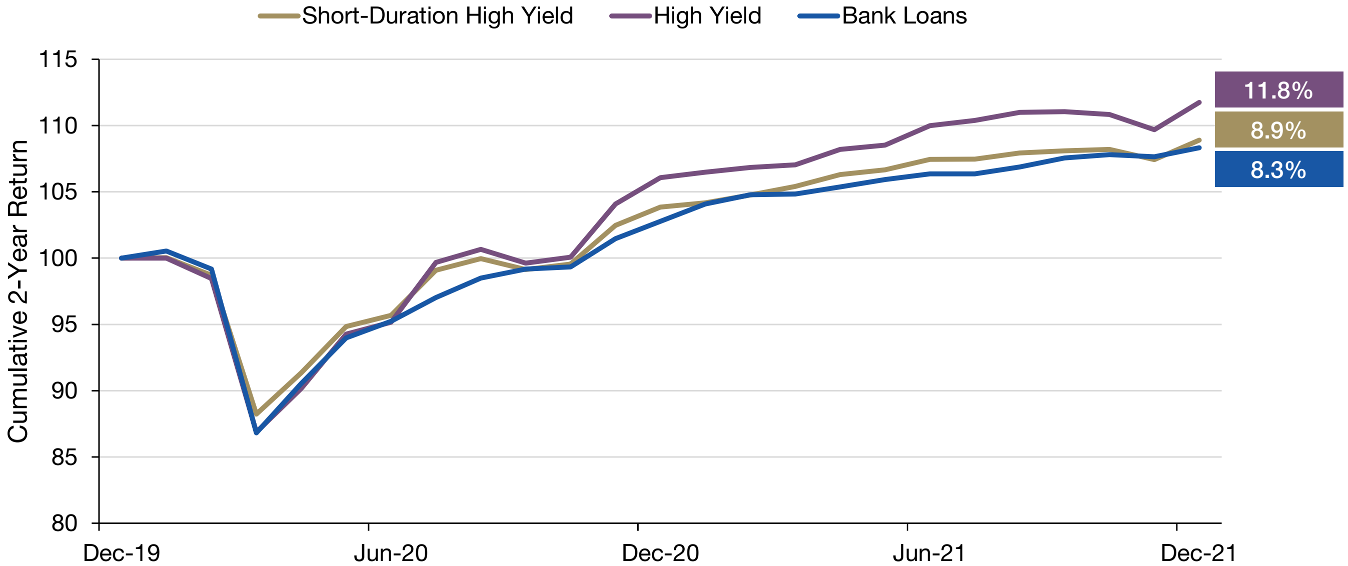
2007 Easing Cycle: Easing started September 2007. Period shown is June 30, 2007-June 30, 2009.



2019 Easing Cycle: Easing started July 2019. Period shown is April 30, 2019-April 30, 2021.



2020 Easing Cycle: Easing started March 2020. Period shown is December 31, 2019-December 31, 2021



Source: ICE BofA 1-5 year BB/B Cash Pay High Yield Index, ICE BofA U.S. High Yield Constrained Index, Credit Suisse Leveraged Loan index, and Lord Abbett. **Past performance is not a reliable indicator or guarantee of future results.** For illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment. Indexes are unmanaged, do not reflect the deduction of fees and expenses, and are not available for direct investment.

Some observations follow:

2001 Cycle: Short-duration high yield outperforms materially. The early 2000s recession witnessed an extended period of elevated default activity, and yet short-duration high yield dominated the entire period, despite credit concerns across the quality spectrum brought about by the length of the recession. Of the four easing cycles we can study, this period comes closest to a "garden-variety" recession not otherwise associated with a banking crisis or external bolt from the blue, such as the Global Financial Crisis (GFC) and COVID-19 pandemic.

2007 Cycle: A similar outperformance by short-duration high yield. The 2007-2009 period differed materially from the early 2000s just based on the intensity of the GFC and follow-on coordination of fiscal, monetary, and regulatory responses, and yet the outcome was the same. Default and distress were much higher during 2008 when compared to the early 2000s, with the trailing 12-month default rate spiking to 16.3% but quickly falling thereafter, according to J.P. Morgan data[1]. The portion of the high yield market trading at distressed levels, as measured by the proportion of the high yield market trading at a credit spread of 1,000 basis points or higher, during that same period spiked to 90% in late 2008.

2019 (and 2020) Cycles: Splitting the difference between full-duration high yield and bank loans. The quick pivot by the Fed in 2019, given the intensity of the risk markets' turn lower in the fourth quarter of 2018, saw high yield recovering well through 2019 as a recession was avoided, only to be met with the COVID-19 pandemic in early 2020. Admittedly full-duration high yield ultimately did modestly outperform over the two-year periods following the 2019 and 2020 easing campaigns, as the Fed dropped its target policy rate to 0% in early 2020 in response to the global pandemic. But short duration kept pace or outperformed bank loans through the entire period due to its incremental duration exposure, or increased sensitivity to changes in interest rates.

What Makes this Potential Easing Cycle Different?

Looking back to the four easing cycles of the past 20+ years, it's hard to find a true parallel to the easing cycle we may be about to embark upon. Each of these prior cycles represented the Fed responding to a crisis or material economic slowdown already in the making. While we continue to be vigilant for signs of subpar growth by monitoring high frequency data, we characterize the current easing cycle to be more of a "normalization" of credit and monetary policy conditions rather than the need to proactively mitigate the impact of an outright recession or crisis already in motion. That also argues for the potential for a less aggressive easing cycle ahead compared to the ones studied above.

There are a couple of other conditions that may continue to favor shorter-duration exposure, while still being supportive of high yield over other higher-rated fixed income:

- The recency of the inflation threat and long-tailed structural economic changes, such as onshoring of supply chains, spending on energy transition initiatives, and demographic shifts that may be pro-inflationary, could keep the threat of higher-for-longer rates a reality in most investors' minds. Additionally, the potential for inflationary cycles to last longer than many might expect could result in a steeper yield curve that may favor shorter-duration fixed-income approaches. Investors typically look to be compensated for inflation volatility by demanding term premium—compensation for longer-term interest-rate uncertainty—typically resulting in an upward sloping Treasury yield curve. During the period of quantitative easing, this premium evaporated, but we see reasons for it to emerge again now.

- Relative to the entry point of other easing cycles, credit fundamentals and the quality of high yield issuers' balance sheets in aggregate are quite different today. Specifically, balance sheet leverage and interest coverage ratios remain close to their historic best levels, according to J.P. Morgan[2], and issuers remain exceptionally focused on refinancing over issuing debt for mergers and acquisitions (M&A), capital spending, and debt-financed share buybacks and dividends that are more equity-investor friendly. Issuers have also exploited robust capital market liquidity to push forward maturities through 2026 to 2027 and beyond. To the extent investors worry about upcoming maturities as a trigger to a more intense default wave, we don't see those conditions in place.

Summing Up

Every monetary policy cycle is different, but history can serve as a guide. Despite the recent flares of volatility, our base case remains one of credit-supportive macroeconomic growth buttressing corporates' ongoing fiscal discipline. As the yield curve normalizes and regains an upward sloping shape, we find the ingredients for attractive risk-adjusted returns in short-duration high yield firmly in place, consistent with the observations from prior easing cycles.

[1]J.P. Morgan North American Credit Research, Monthly Default Monitor, 2024, July 1, 2024

[2]J.P. Morgan North American Credit Research, US High Yield and Leveraged Loan Strategy Report, August 13, 2024

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The value of investments in equity securities will fluctuate in response to general economic conditions and to changes in the prospects of companies and/or sectors in the economy. While growth stocks are subject to the daily ups and downs of the stock market, their long-term potential as well as their volatility can be substantial. Value investing involves the risk that the market may not recognize that securities are undervalued, and they may not appreciate as anticipated. Smaller companies tend to be more volatile and less liquid than larger companies. Small cap companies may also have more limited product lines, markets, or financial resources and typically experience a higher risk of failure than large cap companies.

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Treasuries are debt securities issued by the U.S. government and secured by its full faith and credit.

Income from Treasury securities is exempt from state and local taxes.

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

Capital market liquidity generally is a measure of the ability to convert an asset or security into cash. An efficient capital market may also mean a liquid capital market.

Duration is a measure of the sensitivity of the price (the value of principal) of a fixed-income investment to a change in interest rates. Duration is expressed as a number of years.

The U.S. Federal Reserve (Fed) is the central bank of the United States.

Easing monetary policy or Fed easing is when the central bank lowers short-term interest rates through policy changes to the federal funds rate and discount rate. The central bank **tightens policy** or makes money tight by raising short-term interest rates through policy changes to the discount rate and federal funds rate.

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.

Interest coverage ratio is calculated by dividing a company's earnings before interest, taxes, depreciation, and amortization by interest expense. The ratio measures a company's ability to pay the interest on its outstanding debt.

Leverage ratio is a financial metric that measures how much of a company's capital is derived from debt, such as loans. Leverage ratios are also used to assess the ability of a company to meet its financial obligations.

Macroeconomics is generally the study of economy-wide phenomena such as inflation, price levels, rate of economic growth, national income, gross domestic product (GDP), and changes in unemployment.

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.

The ICE BofA 1-5 Year High Yield Index is an unmanaged index comprised of U.S. dollar-denominated, high yield debt securities publicly traded in the U.S. domestic market with between one and five years remaining to final maturity.

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