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“High octane” for the portfolio

Dieter Kerschbaum



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High-yield corporate bonds are currently in keen demand again, driven by the energetic steps taken by the central banks in their fight against the coronavirus crisis.

What exactly happened? Central banks are supporting the market

- In Europe, banks can deposit high-yield bonds as collateral directly with the European Central Bank if the issuer commanded an investment grade rating as of 6 April
- In the USA, the central bank directly buys such bonds if the issuer commanded an investment grade rating as of 23 March

The abrupt standstill of the entire economy created enormous losses for many companies. Even companies that had been in relatively good shape prior to the corona crisis were affected by the virus. This had an immediate impact on the credit quality and the rating. In April, May, and June, the US rating agency Moody's downgraded more than 600 companies, among them well-known names such as Ford, Renault, Lufthansa, and Kraft Heinz (Ketchup).

From “fallen angel” to “rising star”

The bonds issued by these so-called fallen angels are now traded at a risk premium, because investors require compensation for the downgraded rating in the form of higher yields. How could an investment in high-yield bonds pay off? The economic stimulus programmes and the recovering economy might lead to an improving outlook for some of the affected companies. The risk premiums (spreads) could fall again, which means bond prices would be rising. This way, the erstwhile fallen angels would become rising stars.

Companies want to cut costs for raising capital

Mario Kaudela, investment expert with Erste Asset Management, comments on the development: “Generally speaking, the most recent fallen angels are mostly solid companies whose quality has suffered a bit in the wake of corona. While the downgrade is real, it is not set in stone. Companies that have been downgraded to high-yield usually aim at returning to the investment grade segment as quickly as possible – both for reasons of reputation and finance. After all, they want to reduce their cost of capital at the earliest occasion possible. Once a company has recovered, spreads tend to fall, and the rating upgrade is usually just a matter of time.”

Expert Kaudela: “Companies want to get rid of bad ratings quickly”

Risk comes with a price

While the risk premiums on high-yield corporate bonds are far away from their historical peaks during the financial crisis of 2008, the rise in March during the corona shutdown was significant. The situation has calmed in recent months: the default rate (i.e. the percentage of companies becoming insolvent) is currently in the low single digits. However, investors have to keep an eye on them in connection with the infection rates. Now that we have entered calmer waters, yields are falling again, thus offering upward potential for high-yield bond prices.

Another reason why these bonds are attractive is the still difficult search for attractive yields in the current state of low interest rates. At the moment, high-yield benchmark bonds in Europe pay an average of 4.13% in Europe (source: Refinitiv Datastream) and of 5.95% in the USA (source: Refinitiv Datastream), respectively. In view of the continued zero interest-rate policy of the central banks and the in some cases already negative yields of credit-safe government bonds, high-yield corporate bonds offer the chance of positive rates of return.

Positive outlook for high-yield bonds

This is one of the reasons why Erste Asset Management has stepped up the allocation in high-yield bonds in mixed funds; please refer to our blog entry [“Outlook on the financial markets”](#).

What do investors have to bear in mind when investing in high-yield bonds?

Basically, it is important to check one's risk preference and to operate on the basis of a medium- to long-term horizon when investing in high-yield bonds. Instead of buying an individual bond, the principle of diversification suggests investing in a fund. If some bonds fail to perform, it is less painful when this affects only a small part of the portfolio. In order to avoid such failures altogether as much as possible, the title selection should involve the services of a professional management team as funds usually offer.

Popular fund: ERSTE BOND CORPORATE BB

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Dieter Kerschbaum

Communications Specialist Austria, Erste Asset Management