

High Yield: Can the Strength Continue?

Despite risks surrounding the direction of the global economy, high yield bonds and loans continue to offer attractive total return potential for long-term investors willing to look beyond the likelihood of near-term volatility.

The prospect of the Fed's rate-hiking cycle reaching its end, coupled with continued strength in consumer spending and the labor market, has caused credit spreads to tighten in recent weeks. Despite Europe's economic doldrums and its central bank being unlikely to cut rates until it sees a break in persistent inflation, there is a widespread sense in the US that a soft landing is achievable. But with credit spreads now trading toward the tighter end of historical averages, some investors are beginning to question whether the strength in high yield can continue. Yet, there is still value to be found in the asset class, and if investors can remain patient, potentially attractive total returns await.

Corporate Resilience

Although corporate earnings trended lower overall during the first half of 2023, earnings inflected positively in the third quarter and expectations, by and large, are for positive fourth-quarter performance that could continue through the first half of this year. That said, investors will likely see some bifurcation. Sectors that are interest rate sensitive, highly leveraged and cyclical, for example, have a higher risk of potential profit shortfalls.

Regardless of earnings at this juncture, the credit quality of the high yield market is much higher than it has been historically. While Europe has historically been more of a BB market, most US high yield issuers today are now BB as well—a seismic shift from a decade ago (Figure 1). At the same time, the lowest-rated CCC issuers account for only 11% of the market today, versus nearly 20% 10 years ago.

Encouragingly, many high yield issuers have been shoring up their financial positions over the last few years, leaving them well prepared, from a fundamental standpoint, to weather a possible downturn—particularly one that is milder than expected. Corporate net leverage remains at historically low levels in both the US and Europe, at roughly 3.55x and 3.7x, respectively, while interest coverage also looks manageable¹. Corporate profits, in the form of earnings before interest, taxes, depreciation, and amortization (EBITDA), are in many cases back to or better than pre-Covid levels. At the same time, near-term maturities remain limited, with roughly 7% of the US market coming due over the next 18-24 months². Because the majority of that debt is rated BB, the issuers likely won't face significant refinancing risks.

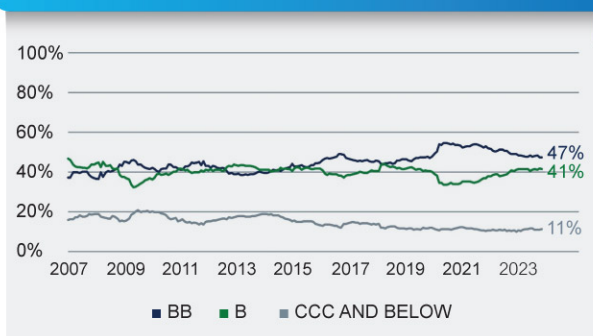
Although default rates inched up in the first half of last year due to some idiosyncratic cases, the combination of a higher credit quality profile, low leverage, ample cash cushions, and limited near-term maturities suggests they are unlikely to increase significantly—and may even hold steady or decline—in the near to medium term.

Reasons for Optimism

Given expectations for an economy more likely to suffer a head cold than the flu, the potential risks in credit vis-à-vis other major asset classes appear to be contained. Nevertheless, with volatility likely to remain elevated, investors continue to favor higher-rated (and higher-quality) bonds and loans, where investors believe yields remain compelling. Recently, in the US market, yields on BB-B bonds were hovering around 7.2%, for example, while loans were around 7.9%³. Although spreads have tightened in recent weeks, yields at these levels—in the context of a positive fundamental picture, improving default outlook, and potentially less problematic economic backdrop—pave the way for potentially attractive total returns across the asset class, especially for investors that are willing to hold on through further bouts of volatility.

Looking at loans specifically, coupons today are around 9.11%—well above the long-term average of 5.46%—as a result of the increase in short-term rates and general steadiness in stated spread⁴. For a market that has historically provided total returns in the 4%–6% range, coupons at these levels suggest strong potential for above-average total returns going forward. While yields across all fixed income markets are elevated, as mentioned, the loan asset class stands out not only for being at the top of the list, but also because the bulk of its yield is coming from contractual income that is being paid today rather than awaiting price recovery.

Figure 1: A Higher-Quality High Yield Market



Source: ICE BofA, please note the above data refers to US market. As of December 31, 2023.

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Figure 2: Elevated Yields, Contractual Income



Sources: Credit Suisse; J.P. Morgan; Bloomberg. As of December 31, 2023. Global Loans refers to Credit Suisse Global Leveraged Loan Index, EM Sovereigns refers to JPM EMBI GD Index, EM Corporates refers to JPM CEMBI Broad Diversified Index, Global HY Corporates refers to ICE BofA Non-Financial Developed Markets High Yield Constrained Index, Global IG Corporates refers to Bloomberg Global Corporates Index, US Treasuries refers to Bloomberg US Treasury Index (Non-USD returns, hedged to USD) and Global Aggregate refers to Bloomberg Global Aggregate Index.

Looking Ahead

Many macro and micro uncertainties lurk in the months ahead, any of which could derail the relatively benign outlook. From a macro perspective, the US presidential election and China's recovery are top of mind, along with ongoing conflict in Eastern Europe and the Middle East. On the micro level, the troubled commercial real estate sector, for example, could see several borrowers downgraded as their debts come due, casting a negative light on the high yield bond and loan markets overall.

As a result of the uncertainties that prevail, this is not a time to take excessive risk to earn higher returns, despite the presence of opportunity and value in the market. Baring believes that a bottom-up, credit-by-credit analysis remains crucial, particularly when it comes to potentially achieving compelling total returns going forward.

Source:

1. Bloomberg. As of December 31, 2023.
2. ICE BofA. As of December 31, 2023.
3. ICE Indices, Credit Suisse. As of December 31, 2023. BB-B yields reflect BB, Split B and B-rated market segments.
4. Credit Suisse Global Leveraged Loan Index. As of December 31, 2023.

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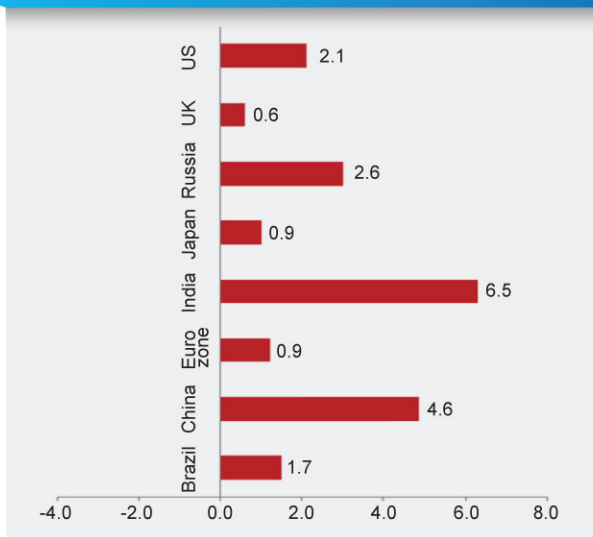
Riding the growth trend in India

Global economic growth is likely to decelerate in 2024. Given this backdrop, investors can shift their focus to India - one of the fastest-growing major economies, thanks to extensive structural reforms and improving fundamentals.

India's unique advantages

India is well positioned for continuous growth given its unique advantages, including its demographic profile, structural reforms, and digitalization efforts. According to the IMF, India's projected GDP growth rate for 2024 is estimated at 6.5%, surpassing the anticipated growth rates of the US at 2.1% and China at 4.6% (Chart 1). With its strong momentum, India is on track to becoming the world's third largest economy by 2032¹, surpassing Germany and Japan.

Chart 1: IMF GDP Projections for 2024



Source: IMF World Economic Outlook Update, January 2024. Any views expressed were held at the time of preparation and are subject to change without notice. While any forecast, projection or target where provided is indicative only and not guaranteed in any way. HSBC Asset Management accepts no liability for any failure to meet such forecast, projection or target. For illustrative purpose only.

The country's demographics play a vital role in supporting its economic growth. India's working-age population is projected to continue growing and contribute to domestic consumption until 2050². With a median age of 29 years old³, India's working population is also significantly younger compared to other major countries. This unique demographic tailwind supported by a young, skilled, and inexpensive labor force has the potential to drive India's economic growth forward.

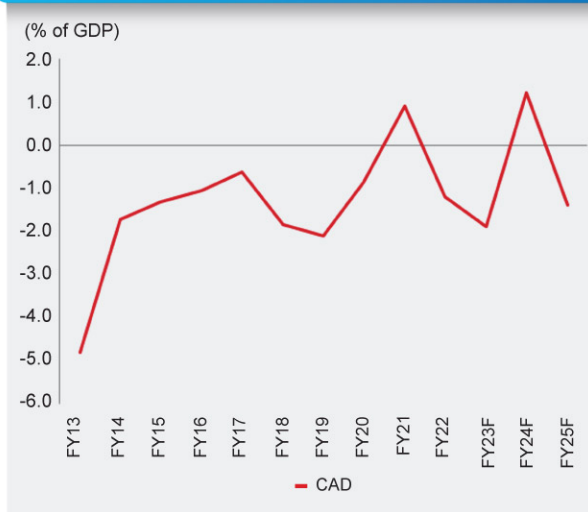
Digitalization further strengthens India's economy. With the continued focus on digital public infrastructure, the government is bridging the rural-urban gap and improving efficiencies. Digital payment transactions as a percentage of GDP in India are among the highest globally⁴. Furthermore, the rapid digitalization has been the driving force behind the growth of e-commerce, as can be seen from the growth of internet and online shopper penetration.

Indian rupee supports the growth story

India's growth story is further supported by its favorable currency outlook. INR has seen substantial improvement in its fundamentals in recent years, as evidenced by the improving current account, increasing demand for FDI, and the building up of FX reserves.

The current account deficit (CAD) is expected to shrink as India benefits from strong services exports (Chart 2). As India continues to thrive in a range of high-value industries such as pharmaceuticals, technology services, and green technology, this attracts robust global demand and helps narrow the deficit. Additionally, declining crude oil prices also contribute to the favorable situation.

Chart 2: CAD - a function of oil and import demand based on growth



Source: Bloomberg, RBI, data as of December 2023.

In recent months, investors have witnessed a growing demand for both foreign direct investment (FDI) and foreign portfolio investment (FPI) in India. The improving fundamentals of the Indian economy have attracted strong capital inflows, which in turn contribute to India's growth potential and lead to more sustainable inward investment.

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A significant FX reserve will lead to greater currency stability and credibility for central bank actions. By stabilizing the exchange rate, FX reserves promote trade activities, attract foreign investment, and maintain macroeconomic stability. Sizable reserves also provide a reasonable cushion against currency fluctuations. Such resilience instills confidence and credibility among investors, particularly in emerging markets like India. It is expected that the Reserve Bank of India will continue to build up its FX reserves which will help in mitigating currency volatility.

The Indian rupee has exhibited relatively less volatility when compared to other major currencies (Chart 3). Overall, the relative stability of the INR, coupled with India's unique macroeconomic advantages, creates a favorable environment for economic growth and investment.

Chart 3: INR's comparatively low volatility

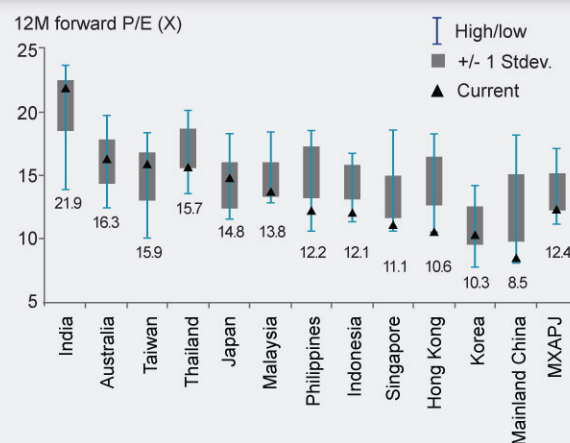
Currency vs USD	FX vs USD annualised volatility since Jan 2022
EUR	8.1%
JPY	10.3%
GBP	9.4%
AUD	11.1%
CAD	6.5%
BRL	14.8%
CNY	5.2%
INR	3.9%

Source: Bloomberg, HSBC Asset Management, data as of January 2024. Based on weekly data. Investment involves risks. Past performance is not indicative of future returns. For illustrative purpose only.

Attractive investment opportunities in Indian equities

Indian equities stand out against global and regional peers. While current valuations may not be considered cheap (Chart 4), several factors contribute to the attractiveness of Indian equities as a long-term investment option.

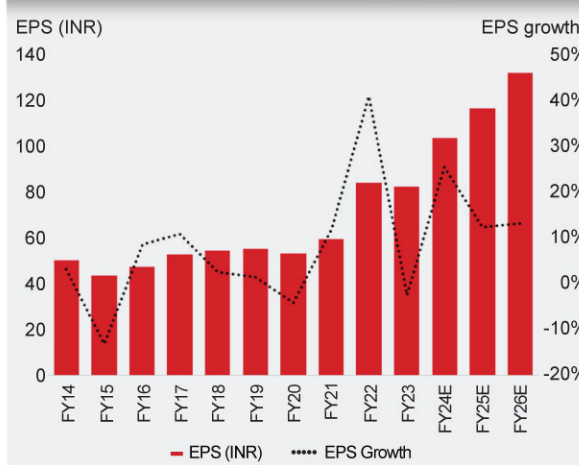
Chart 4: Forward P/E valuations



Source: Goldman Sachs, MSCI, data as of January 2024. Investment involves risks. Any views expressed were held at the time of preparation and are subject to change without notice. While any forecast, projection or target where provided is indicative only and not guaranteed in any way. HSBC Asset Management accepts no liability for any failure to meet such forecast, projection, or target. For illustrative purposes only.

Firstly, strong earnings growth in Indian companies has been a key driver of the equity market. Double-digit earnings growth is seen in Indian corporates, and the equity earnings are expected to remain strong (Chart 5). The combination of robust earnings with superior growth potential positions Indian equities as one of the most attractive investment opportunities in the region.

Chart 5: India equity earnings is expected to remain robust



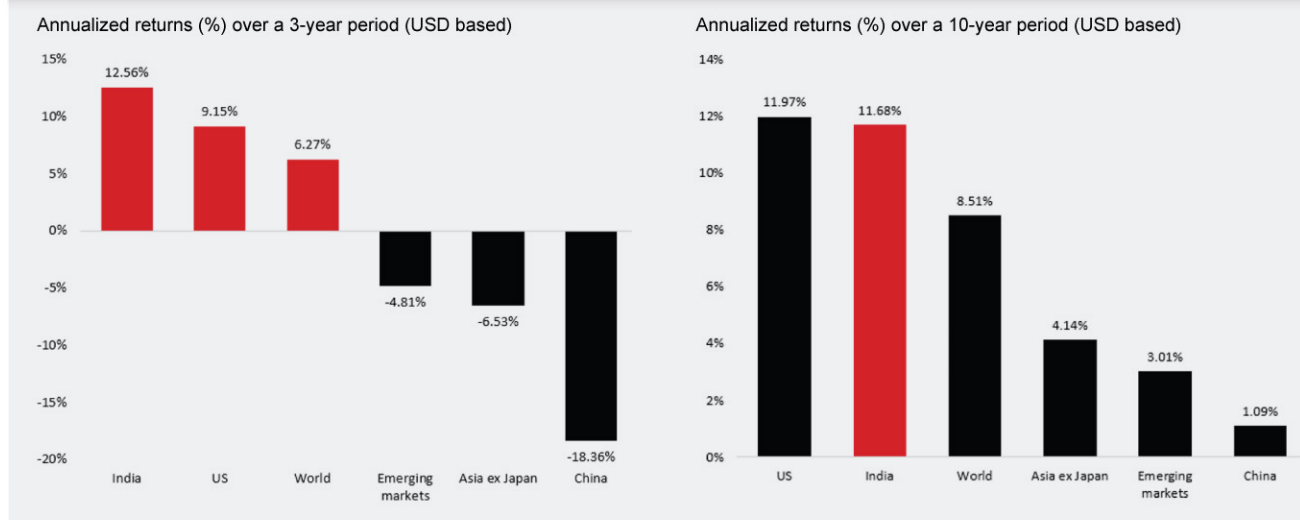
Source: RIMES, MSCI, IBES Estimates, Morgan Stanley Research, data as of December 2023. Any views expressed were held at the time of preparation and are subject to change without notice. While any forecast, projection or target where provided is indicative only and not guaranteed in any way. HSBC Asset Management accepts no liability for any failure to meet such forecast, projection, or target. For illustrative purposes only.

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Secondly, Indian equities offered higher potential returns over the long run. Annualized returns over a three-year period in India stand at 12.56%, which is significantly higher than returns of 9.15% observed in the US (Chart 6). Over a 10-year period, the annualized return of India is marginally lower than that of the US, but is still considerably higher than the rest of the world (Chart 6).

Chart 6



Source: MSCI, HSBC Asset Management, data as of December 2023. Indices used are MSCI indices of the relevant markets. Investment involves risks. Past performance is not indicative of future returns. For illustrative purposes only.

Small and mid-cap equities have led the growth within the Indian market. Over the past 10 years, India's small and mid-cap equities have delivered significantly higher cumulative total returns compared to large-cap equities (Chart 7).

Chart 7: Indian small and mid-cap equities have delivered a higher cumulative total return throughout the last 10 years



Source: Bloomberg, HSBC Asset Management, data as of 31 December 2023. Indices used: India large caps: National Stock Exchange of India Nifty 100 Total Return Index; India mid caps: National Stock Exchange Nifty Midcap 150 Index Total Return; India small caps: National Stock Exchange Nifty Small Cap 250 Index Total Return. Investment involves risks. Past performance is not indicative of future performance. For illustrative purposes only.

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Sectors with a positive outlook in India

Resilient earnings growth is the key driver of the Indian equity market performance. At HSBC Asset Management, the Indian Equity investment team has a unique focus on earnings growth opportunities. Through a bottom-up approach, equities with a competitive advantage, robust balance sheets, and effective business models are identified. It allows investors to capture quality equities with growing potential from the deep coverage of the Indian investment universe.

In the current environment, HSBC Asset Management is positive on the financials and healthcare industries within India. The financials sector, especially the lending segment, could benefit from India's positive credit cycle and growth. The strong capital positions and a granular franchise allows them to attract higher retail deposits. Digitalization further enhances efficiency and improves profitability for financial institutions. When compared to other sectors, it is also worth noting that financial stocks are available at a relatively lower premium to their historical average.

It's believed the healthcare industry presents long-term growth opportunities for investors. Quality healthcare products and services in India are highly under-penetrated, indicating significant room for expansion. With the rapid population growth and rising incomes, it is reasonable to expect strong future demand for healthcare services in India. Also, its relatively low earnings volatility with reasonable valuations could also be attractive to investors.

Source:

1. World Economic League Table 2023. A world economic league table with forecasts for 191 countries to 2037, CEBR. Data as of December 2022.
2. United Nations, HSBC Global Research, data as of May 2023.
3. World Data, data as of October 2023
4. RBI, Morgan Stanley forecasts, data as of October 2023. Note: Transactions include IMPS, UPI, PPI and Credit and Debit card POS