The Case for High Yield vs. Equities

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In an environment where risk assets are increasingly beholden to macro developments, this post assesses the relative value of global high yield bonds vs. global equities. As macro uncertainty rises and falls, absolute yields and spreads in global high yield offer an attractive entry point, suggesting that the sector has the potential to generate equity-like returns with far greater resiliency than stocks. Our assessment is based upon the following:

- Historical performance vs. equities and prospective returns
- relative valuations vs. equities
- performance in volatile markets
- credit fundamentals
- and allocation conclusions.

Historical performance vs. equities and prospective returns

We start with a comparison of the historical performance for global high yield and global equities as observed in Figure 1. Since 2001, global high yield outperformed equities not only in terms of absolute return, but with less volatility, resulting in better risk-adjusted returns and a higher Sharpe ratio.

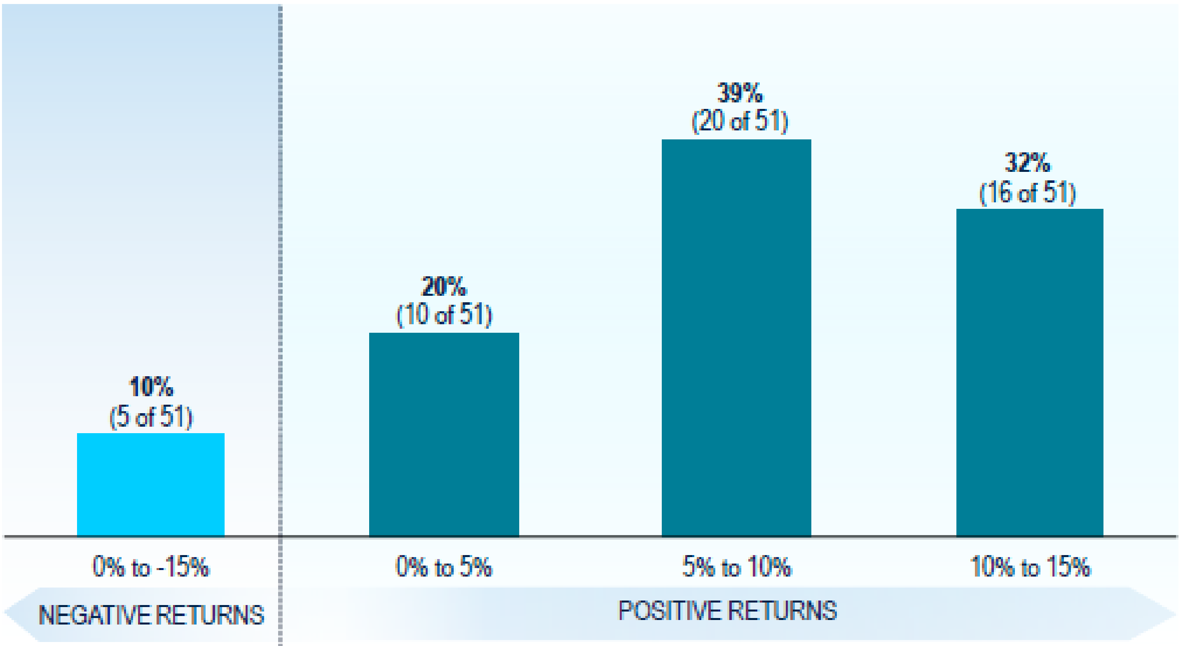
FIGURE 1: Tale of the Tape - Since 2001, global high yield has outperformed global equities in both absolute and risk-adjusted returns (monthly returns).

	High Yield	Equities
Average return (%)	6.86	6.60
Annualized volatility	0.09	0.14
Risk-adjusted returns	0.77	0.46
Sharpe Ratio	0.58	0.34

Source: Historical performance calculated using monthly USD-hedged returns from February 28, 2001 to March 31, 2025. Risk measured by volatility = standard deviation. Historical monthly performance (table) using USD-hedged returns. High yield represented by ICE BofA Developed Markets High Yield Index and equities by MSCI World (USD Hedged) Index.

Looking ahead, the global high yield market's current yield level of more than 7% provides an attractive entry point for investors. In fact, since 1987, periods when yields were between 7-8% have indicated positive returns 91% of the time over the following 12 months (Figure 2).

FIGURE 2: Since 1987, when starting yields were between 7% and 8%, global high yield bonds generated positive forward 12-month returns in 91% of periods, with returns of 10-15% being the most prevalent.



Source: Calculated by PGIM using data from Bloomberg, as of March 31, 2025. Yield-to-worst monthly data for Bloomberg Global Corporate High Yield Index. 61 periods since index inception in 1987 in which the YTW for the Index was between 7% and 8%. An investment cannot be made directly in an index. Past Performance is no guarantee of future results.

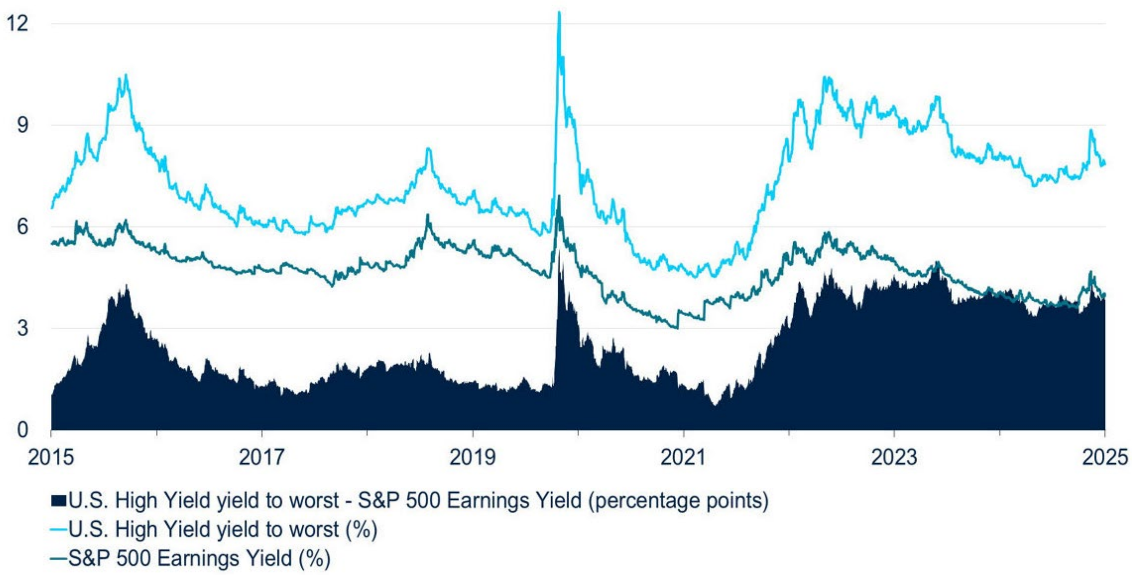
Relative Valuations vs. Equities

The post-COVID bear market in interest rates lifted bond yields to levels not seen on a sustained basis since the pre-GFC period. In contrast, rising equity prices have outstripped earnings growth, leading to progressively more expensive equity valuations. This decrease in equity attractiveness can be quantified as either a high P/E multiple or a low earnings yield (E/P ratio).

Comparing the yield on U.S. high yield bonds with the earnings yield on U.S. stocks, we arrive at a crude relative valuation metric, as shown in Figure 3. The increase in rates in 2022 - in the context of rising equity-price multiples and falling earnings yields - has pushed this differential well above average levels to around 4 percentage points. In short, higher equity prices and the increase in rates drove a wedge between high yield and equity valuations that places high yield's relative attractiveness in the top quartile over the past decade (Figure 3).[1]

Those seeking to justify current equity valuations could cite the potential for higher-than-normal earnings growth. However, we see that as an unlikely outcome given our base case expectation for further economic moderation across developed economies (click here for more detail on our global economic scenarios).

FIGURE 3: The gap between yields in U.S. high yield and the S&P 500's earnings yield extended to the 78th percentile, underscoring the attractiveness of high yield vs. equities.



Source: Bloomberg

Performance in Volatile Markets

Like all risk-based assets, high yield is not immune to periods of risk-off drawdowns. To that end, Figure 4 displays the high yield and equity drawdowns since 2000. We find that global high yield's drawdowns - which averaged 11% - were not only far shallower than global equities' 26% average drawdown but were also followed by much swifter recoveries to pre-drawdown levels. For example, the trough-to-recovery period in global high yield averaged slightly more than seven months, while equities' trough-to-recovery period averaged 18.5 months.

FIGURE 4: Global high yield displays shallower drawdowns and faster recoveries relative to global equities.

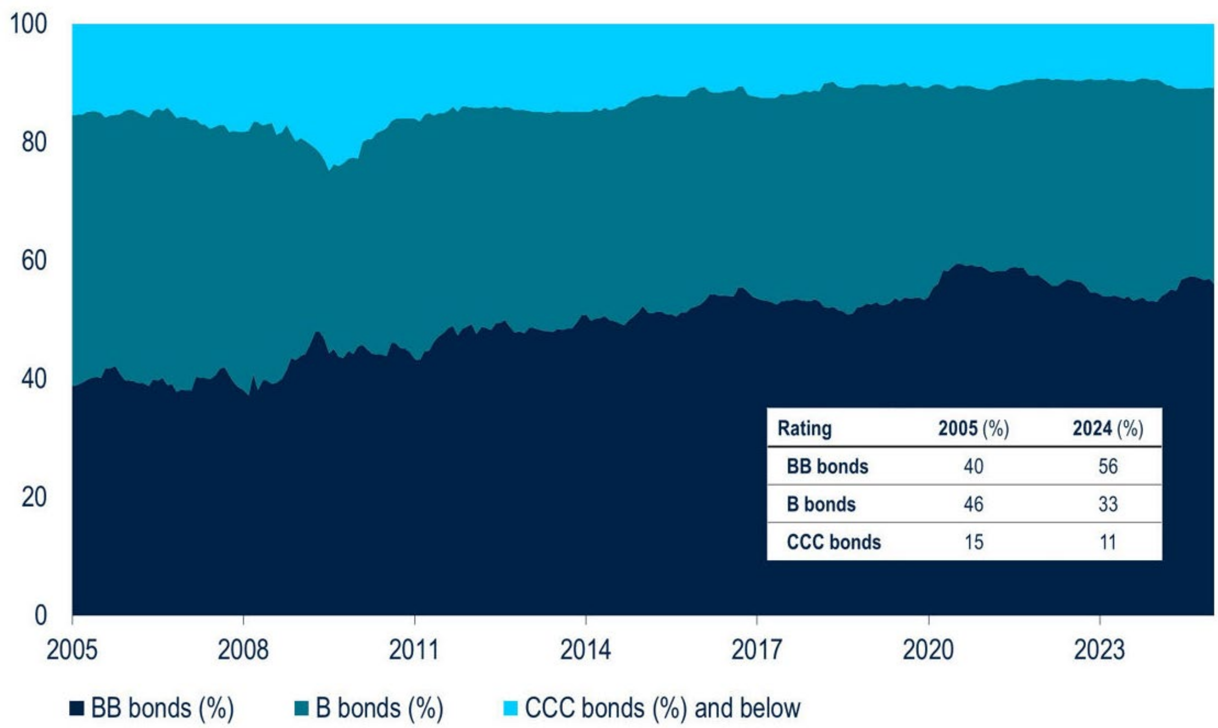
Source: High yield represented by ICE BofA Developed Markets High Yield Index and equities by MSCI World (USD Hedged) Index. Our analysis includes drawdowns of 10% or greater. The drawdowns analyzed include 2001-2005, 2007-2013, 2015-2016, 2018-2019, 2020, 2022-2023.

Credit Fundamentals

While credit fundamentals are backward looking, high yield issuers continue to operate with strong balance sheets as gross leverage remains solidly below pre-COVID levels. Furthermore, interest coverage is notably higher than pre-COVID levels, and credit rating upgrades continued to outpace downgrades through Q1 2025.

Furthermore, the quality profile of the high yield market remains on a trajectory of secular improvement. As the top-end, BB-rated segment of the high yield market rose from around 40% pre-GFC to 55% at present, the share of the B- and CCC-rated segments declined, leading to a significant improvement in the market's average credit quality.

FIGURE 5: The quality profile of the global high yield market has strengthened in recent years as the share of BBs has risen from just below 40% in 2005 to more than 50% while the share of Bs and CCCs declined.



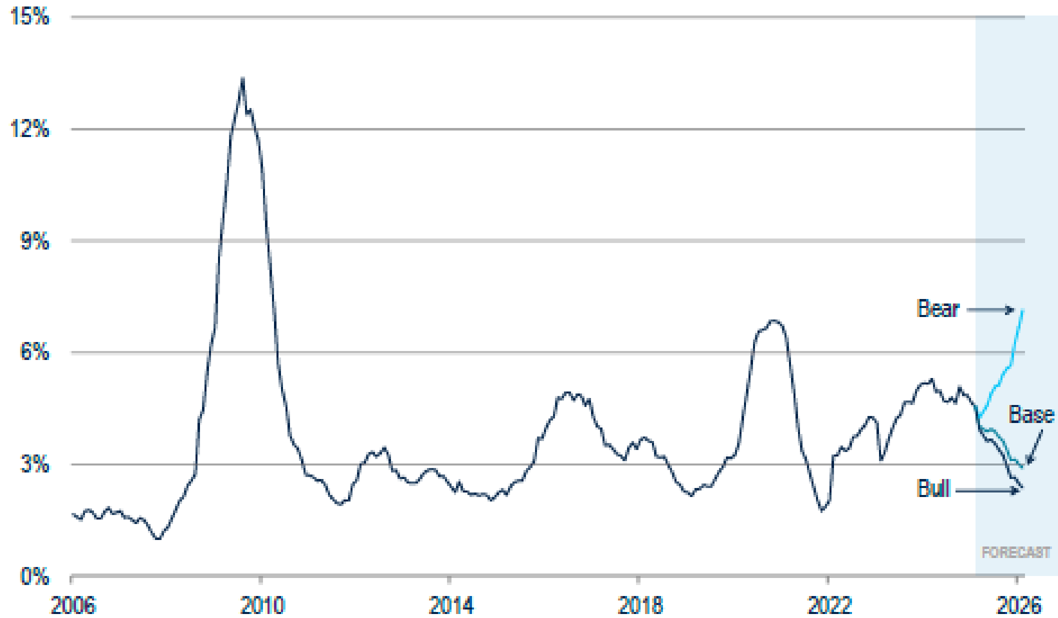
Rating	2005 (%)	2024 (%)
BB bonds	40	56
B bonds	46	33
CCC bonds	15	11

Source: As of January 31, 2025. Source: ICE BofA Developed Markets High Yield Constrained Index. Based on market value percent.

In terms of potential trade-related effects, our global credit research team indicates that some companies are guiding expectations lower for the second half of the year. However, our analysts also relay that most issuers continue to generate positive cash flow, and management teams remain focused on balance sheet optimization, operating efficiencies, and reductions in capital expenditures and costs. While this caution may not energize equity holders, it serves as another point in the relative value proposition of global high yield vs. global equities.

Discussion of credit metrics within the leveraged finance space invariably turns to defaults, and after a benign experience in 2024, we expect a further decline in global defaults in 2025 and into 2026. Figure 6 is based on the issuer-weighted default rate - which is higher than the frequently cited par-weighted default rate - as it excludes liability management exchanges that have kept the par-weighted default rate near historically low levels. Our default forecasts in our base case and optimistic scenarios indicate a reduction of more than 50 bps in the default rate into 2026, continuing the historically the low-default conditions of recent years. In our pessimistic scenario, we expect a 200 bp increase in defaults in the coming year.

FIGURE 6: Our base-case default forecast indicates a further decline in the issuer-weighted default rate.



Source: Moody's Ratings Service as of April 2025

Conclusion - High Yield Appears Well Positioned For Strong Performance

While a high level of macro-economic uncertainty remains, if history is any guide, high yield bonds may be a more reliable return generator than equities. Yields are high, relative valuations are favorable, and credit trends remain above average. And in the event the environment turns exigent, high yield drawdowns have typically been far less severe than those in equities and followed by much swifter recoveries. With the performance of risk assets remaining highly subject to macro developments, high yield appears well positioned to generate strong performance in absolute and in risk-adjusted terms.

1. It is also in the top quartile if one were to extend the timeframe back to 2005.

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