The State of High Yield

By John DeVoy, CFA, VP, Multisector Full Discretion Investment Strategist

KEY TAKEAWAYS

- Investors are questioning the narrow yield spreads in the high yield market.
- Based on the market's yield advantage, technicals and fundamentals, tight yield spreads could persist—a pattern the market has seen before.
- The market's strong relative yields have continued to attract global demand while net debt issuance has turned negative.
- Lack of progress in legislative moves to spur economic growth will likely factor into Federal Reserve rate decisions.

Investors are questioning whether the tight yield spreads in the high yield bond market offer enough value at this point in the credit cycle given the length of the economic expansion, high levels of corporate indebtedness and the potential for additional Federal Reserve interest rate increases.

Should investors be concerned? Assessing the high yield market from a variety of perspectives, including yield advantage, technicals and fundamentals, should shed some light on the situation.

Let's Begin with Yield Advantage

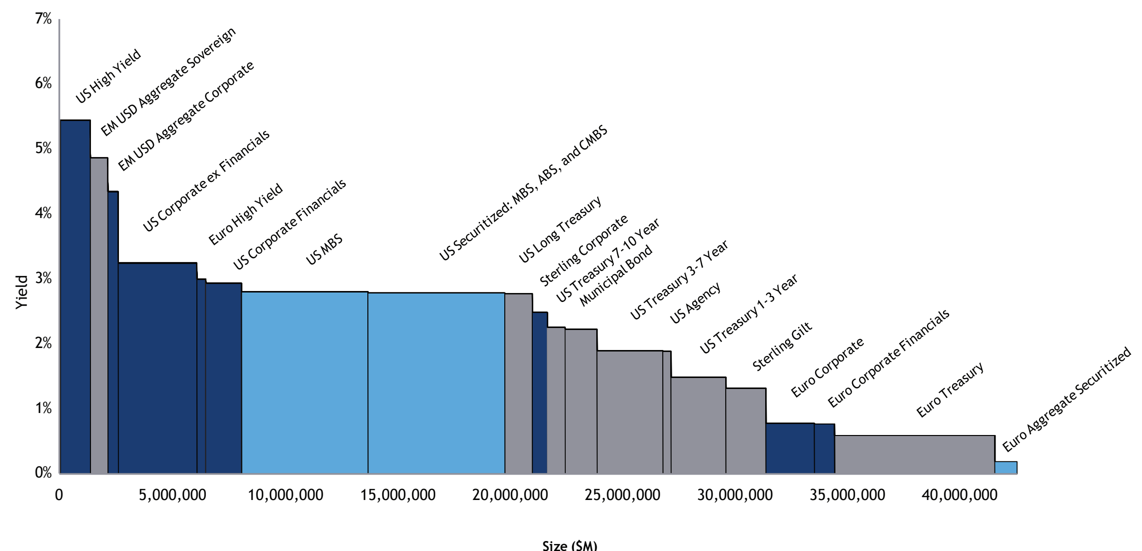
Looking across the global fixed income market, the strong relative yields of the US high yield market are likely to continue to attract strong global demand, as seen in the following chart. For investors searching for yield globally, it is one of the few games in town today.

YIELDS ACROSS GLOBAL FIXED INCOME MARKETS

Source: *Bloomberg Barclays, as of August 31, 2017.*

Size represents market value of the index. Yield represents yield to worst.

Past performance is no guarantee of future results.



- Credit
- Securitized products
- Sovereign

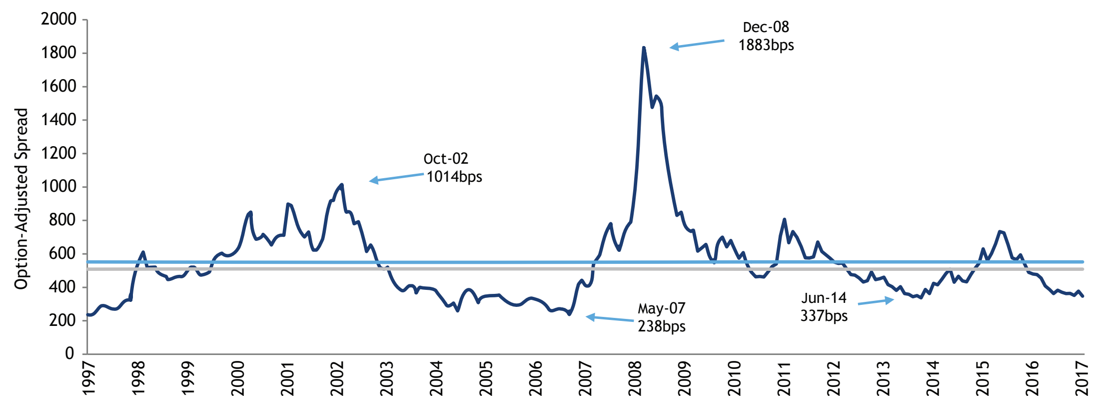
Is the Strong Demand for High Yield Bonds Likely to Continue? Data Shows It Could.

GROWTH DRIVERS

After the commodity bust and profit recession of 2015 and 2016, little progress in much-anticipated, pro-growth US legislative moves stalled the pace of the credit cycle's recovery. These developments, and a recent stretch of favorable growth data, have helped extend the credit cycle, which can support tighter spreads for a longer period. The Federal Reserve is likely to consider this, keeping the pace of interest rate increases measured and supporting a continuation of narrow high yield bond spreads for a longer period than many investors may expect—a pattern the market has experienced in the past, as seen in the next chart.

YIELD SPREADS CAN REMAIN LOW FOR LONG PERIODS

Source: *Bloomberg, data as of October 26, 2017.*



20-year average: 552

20-year median: 509

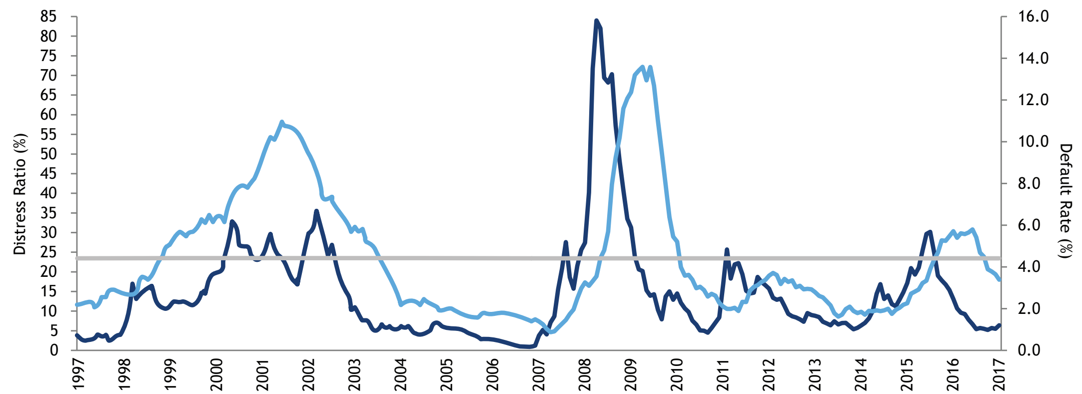
FUNDAMENTALS AND TECHNICALS (SUPPLY AND DEMAND)

While many US corporations had taken advantage of the persistently low global yield backdrop following the great financial crisis by issuing a significant amount of new debt, the pace of issuance has trended lower year over year since 2012, with net new issuance negative in 2016 (and expected to be negative again in 2017). Along with this trend, corporate leverage has finally stabilized and interest coverage in the high yield market remains strong. Global investors continue to search for yield, providing support for bond prices.

The market does not appear as rich as some might assume, especially with regard to defaults. Default rates are approaching cyclical lows and the distress ratio,[i] which can be interpreted as a reflection of market sentiment, has declined significantly since 2015.

DECLINE IN DEFAULT RATE AND DISTRESS RATIO

Source: *Bloomberg Barclays, Merrill Lynch, Moody's, history through August 2017, monthly data.*



**Percent of bonds in the Merrill Lynch High Yield Master Index with spreads greater than 1000 basis points over Treasurys.*

Mindfully Investing in the High Yield Market

Many investors are questioning the narrow yield spreads in the high yield market. While overall yields may not be as high as some periods in history, a low default rate can allow the high yield investor to retain a greater portion of the stated yield. Examined more broadly, high yield can still offer attractive yields relative to other fixed income assets. In addition, the US credit cycle appears to lack demonstrative momentum toward a downturn, which could translate into a prolonged period of narrow high yield spreads.

In our view, high yield bond investing, supported by careful research, can offer opportunities over the long term.

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Endnotes

i *Distress ratio: the number of distressed securities with yield spreads greater than 1000 basis points over Treasurys divided by the number of high yield issues.*

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