High Yield in Variable Markets

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KEY TAKEAWAYS

- After a first quarter of increased volatility and a shift higher in the yield curve, investors are wondering how HY might perform going forward.
- The outlook for high yield remains favorable given persistent global growth and strong corporate earnings. Low expected defaults and negative net issues should provide technical support to the high yield market.
- Three characteristics currently support the high yield credit market—negative correlations to US Treasury rates, excess spread and higher relative yield per year of duration—and should contribute to its resilience in a rising rate environment.

The low market volatility of 2017[i] may have lulled some investors into an unrealistic assessment of how risk assets can behave in more "normal" late cycle market environments. In early 2018, when economic data indicated the pace of inflation may be increasing beyond Federal Reserve (Fed) expectations, yields rose along the curve, pressuring fixed income bonds that were priced against US Treasurys.

Time will tell if this reassessment of risk is a one-off event or a symptom of an evolving economy adjusting for unprecedented quantitative tightening, but as long-term high yield investors, our focus remains on whether the economic environment continues to support a low default rate environment. We expect the backdrop of healthy global growth and strong corporate earnings to continue to support high yield company cash flows and their leverage profiles over the next 12 to 18 months.

What Happened in Q1 2018?

With regard to first-quarter performance, it is instructive to consider the technical backdrop of the high yield market. A considerable amount of 2017's high yield bond new issuance was priced with very tight spreads to Treasurys, reflecting investor willingness to accept marginal premiums in their hunt for higher relative yields and the lack of supply in the new issuance market. But as the US Treasury yield curve was repriced in early 2018, BB-rated debt—relative to other lower-quality credit tiers—felt the brunt of selling due largely to its relatively tighter spreads and higher interest rate sensitivity (higher duration). In contrast, the lower-quality single-B and CCC-tier bonds outperformed relative to their BB-rated counterparts as they benefited from additional spread (relative to higher-quality BB bonds), which helped insulate price movements from changing Treasury yields. Excess spread, combined with sound underlying credit fundamentals, continued to draw the attention of yield-seeking investors.

Looking Forward

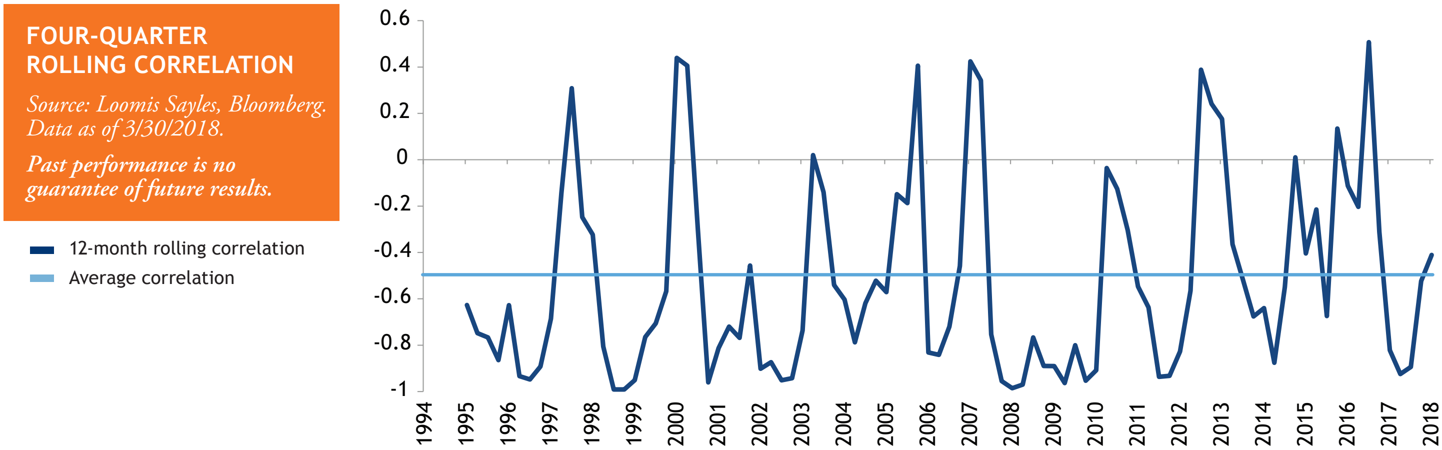
It is one thing to look back and explain past performance, but investors want to know how high yield might perform going forward in a potentially rising rate environment. Consider the following high yield characteristics for some indication.

1. **High yield should continue to have a negative average correlation with 5-year Treasurys.** The following chart depicts the correlation between the option-adjusted spread of the Bloomberg Barclays High Yield Bond Index relative to the 5-year Treasury yield—a proxy for the high yield market's duration. The periods of positive correlation are infrequent and brief and also tend to revert back to their long-term average of -0.53.

FOUR-QUARTER ROLLING CORRELATION

Source: Loomis Sayles, Bloomberg. Data as of 3/30/2018.

Past performance is no guarantee of future results.



2. **The excess yield offered by high yield credits can help insulate performance from rising interest rates.** The table below lists the 10 largest increases in the 5-year Treasury yield since 1991. In all but one of the periods, the high yield index posted a positive total return.

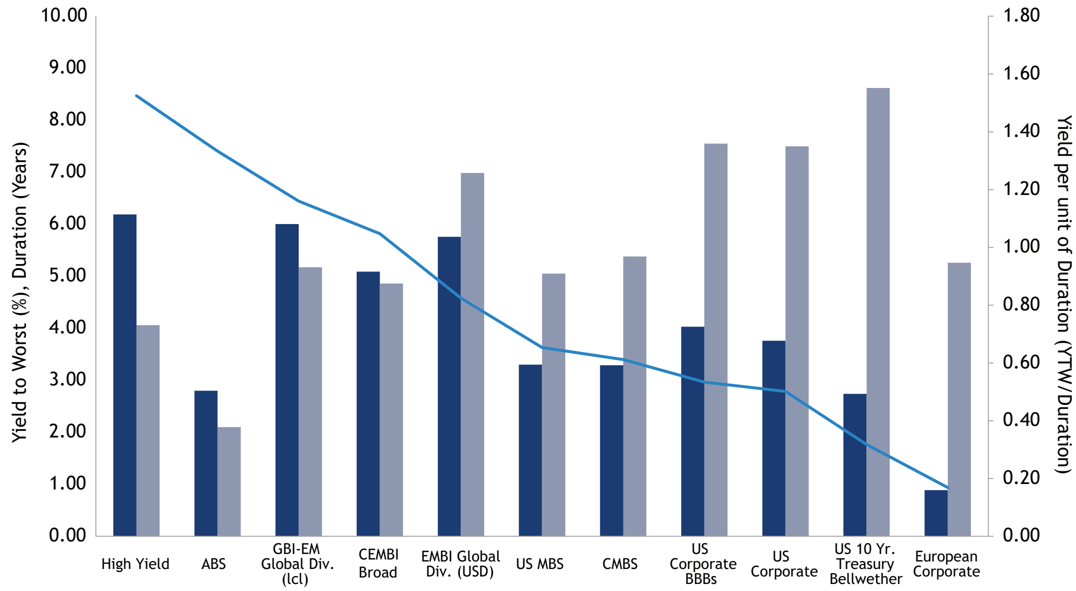
START DATE	END DATE	NOMINAL YIELD CHANGE	HY INDEX PERIOD PERFORMANCE	HY STARTING OAS
1/31/1994	12/30/1994	2.81%	-3.13%	329
6/30/2003	5/31/2006	2.62%	28.63%	584
9/30/1998	1/31/2000	2.47%	4.12%	565
6/30/2016	2/28/2018	1.64%	15.17%	594
1/31/1996	3/31/1997	1.52%	10.65%	364
10/31/2001	3/29/2002	1.33%	4.96%	882
7/31/2012	9/30/2014	1.18%	17.81%	595
12/31/2008	12/31/2009	1.13%	58.21%	1662
10/29/2010	3/31/2011	1.11%	4.53%	575
3/31/2008	5/30/2008	0.98%	4.69%	781

Source: Loomis Sayles, Bloomberg, data as of 3/30/2018.[ii]

3. **Relative to other fixed income assets, we believe high yield has an attractive yield per unit of duration.** As investors compare asset classes for their income-producing properties, high yield should continue to be a favorable relative option.

YIELD PER YEAR OF DURATION

Source: Loomis Sayles, Bloomberg. Data as of 3/30/2018.



	High Yield	ABS	GBI-EM Global Div. (lcl)	CEMBI Broad	EMBI Global Div. (USD)	US MBS	CMBS	US Corporate BBBs	US Corporate	US 10 Yr. Treasury Bellwether	European Corporate
YTW	6.19	2.80	6.01	5.09	5.76	3.30	3.29	4.03	3.76	2.74	0.89
Duration	4.06	2.10	5.18	4.86	6.99	5.05	5.38	7.55	7.50	8.62	5.26
Yield Per Unit of Duration	1.52	1.33	1.16	1.05	0.82	0.65	0.61	0.53	0.50	0.32	0.17

Credit Research is Key—In Any Environment

The dramatic low volatility and interest rates of 2017 are probably behind us. That said, over the short to medium term, we continue to expect the positive macroeconomic environment to overwhelm the negative effects of higher base rates. This should foster a favorable operating environment for high yield companies and thereby a continued low default rate. As we outlined in High Yield Credit Investing Late in the Cycle, applying a disciplined strategy supported by comprehensive credit research should help us identify those high yield companies positioned to outperform in the current late cycle landscape. We will be using this research capability to watch for building excesses and vulnerabilities that can materialize as the cycle progresses.

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Endnotes

[i] *Volatility is represented by the VIX Index, a measure of market expectations of near-term volatility conveyed by S&P 500 Index (SPX) option prices. The 2017 VIX average was 11.09—30% below its previous 5-year average.*

[ii] *The ten worst periods of rising rates have been defined as the non-overlapping periods of worst cumulative rise in 5-year US Treasury yields (Source: Bloomberg) from the trough in yield (using a 3-year look-back period) during the period of analysis (1/31/1994 to 3/31/2018).*

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