LPL RESEARCH
BOND MARKET PERSPECTIVES

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HIGH YIELD: FUNDAMENTAL SUPPORT

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KEY TAKEAWAYS

The most recent bank lending standards data may be supportive for high-yield fundamentals going forward.

Spreads may have found resistance near the 3.5% level, as high yield has traded sideways with equities as of late.

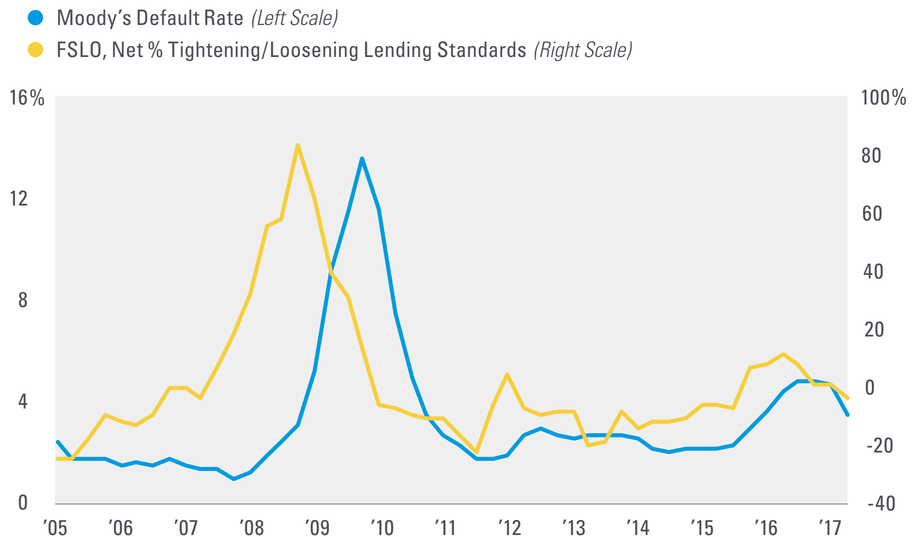
Our call for high-yield stability remains intact, but expensive valuations warrant caution.

Our mid-February 2017 call for stability in high yield throughout the remainder of 2017 is on track, as spreads are near their levels from three months ago. Fundamentals remain stable and leading indicators of default are confirming the lower default expectations currently priced into the market. Despite our expectations of stability and the standout yield of the asset class relative to high-quality fixed income, the high-yield market remains on the expensive side of fair value in our eyes and caution is warranted.

DECLINING DEFAULTS

Defaults are declining and appear to be confirming the lower default forecasts for 2017 made by rating agencies earlier in the year. Forward-looking indicators also appear to be endorsing this sense of optimism. The Federal Reserve Senior Loan Officer Survey (FSLO) has historically been a good leading indicator of default rates [Figure 1]. The survey indicates whether banks are tightening

1 BANKS LOOSENING LENDING STANDARDS SHOULD HELP PUSH DEFAULTS LOWER



Source: LPL Research, Bloomberg, Moody's, Federal Reserve 05/12/17

FSLO – The Federal Reserve Senior Loan Officer Survey

Moody's is an independent, unaffiliated research company that rates fixed income securities. Moody's assigns ratings on the basis of risk and the borrower's ability to make interest payments.

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or loosening lending standards for medium- and large-sized companies. This stands to reason: companies that can get a loan will generally not default. As the modified adage goes, "a rolling loan gathers no loss." As of April 30, 2017, banks are now loosening lending standards on a net basis for the first time since July 31, 2015. This data point is solid confirmation of the default picture continuing to improve in 2017.

CRITICAL CORRELATIONS

The price of oil played an important role in guiding the high-yield bond market over the past few years, but its importance may be waning. Now that oil has largely stabilized, and many of the weaker energy players have been shaken out of the market by way of default, markets seem less transfixed with the week-to-week price action in oil markets. The first quarter of this year was a prime example: the price of oil was down 5.8%, yet high yield rallied 2.7%. Even high-yield energy shrugged off the oil weakness, returning 2.2% during the quarter (based on the Bloomberg Barclays High Yield Energy Index).

Equity markets, however, remain a key driver of high yield performance going forward. Spreads are still tightly correlated with equity market movements [Figure 2].

This is an important chacteristic of which investors must remain cognizant: high yield will not behave like high-quality fixed income, especially in times of market stress. Over the past ten years, high yield and the S&P 500 have had a correlation of 0.61 (meaning they typically move together), while the high-quality Bloomberg Barclays U.S. Aggregate

Correlation ranges between -1 and +1. Perfect positive correlation (a correlation co-efficient of +1) implies that as one security moves, either up or down, the other security will move in lockstep, in the same direction. Alternatively, perfect negative correlation means that if one security moves in either direction the security that is perfectly negatively correlated will move in the opposite direction. If the correlation is 0, the movements of the securities are said to have no correlation; they are completely random.

2 HIGH YIELD SPREADS CORRELATED WITH EQUITY MARKET MOVEMENTS

Source: LPL Research, Bloomberg Barclays 05/12/17

Indexes are unmanaged and cannot be invested into directly. Past performance is not indicative of future results.

High-yield spread is the yield differential between the average yield of high-yield bonds and the average yield of comparable maturity Treasury bonds.

Index has a -0.22 correlation with the S&P 500 (meaning they typically move in opposite directions, albeit a weaker relationsip). Generally speaking, high-quality bonds protect against equity market weakness while high yield participates in that weakness. This is a double-edged sword, however, and given healthy market fundamentals, high yield should be poised to perform well if equity markets continue to rise.

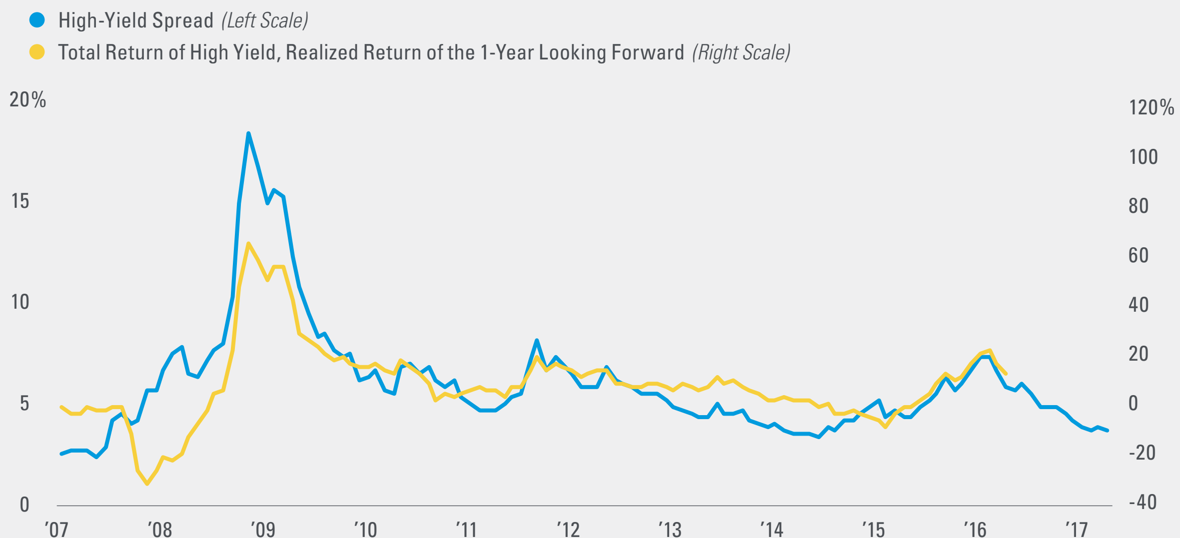
STICKY SPREAD LEVEL

High-yield spreads have decreased from a high of 8.4% on February 11, 2016 to just under 3.7% as of May 12, 2017, leading to a 28.6% total return over that same period, a truly remarkable stretch based on the Bloomberg Barclays High Yield Index. Some signs are indicating that the market may be near a resistance level where spreads currently stand. The market has been unable to maintain a spread level below 3.5% and has effectively traded sideways on a spread basis since the end of February 2017, similar to equity markets [Figure 2]. Equity market fundamentals such as earnings growth are encouraging, but another catalyst (potentially policy-driven) may be necessary for spreads to contract meaningfully from here.

RETURN POTENTIAL LIMITED

The relatively low spread of high yield limits the return potential of the asset class. The spread of high yield over comparable Treasuries is very correlated with its one-year future return [Figure 3]. This matches intuition: spreads at high levels do not historically stay elevated for long, leading to spread tightening and capital appreciation, in addition to yield. With spreads low, as they currently are, spread tightening becomes more elusive and yield drives the majority of the return. With the Bloomberg Barclays High Yield Index up 4.1% year to date through May 12, 2017, we don't anticipate this pace continuing and expect yield to be the primary driver of return through year end.

3 SPREADS HAVE BEEN A GOOD INDICATOR OF FORWARD RETURNS



Source: LPL Research, Bloomberg Barclays 05/12/17

High-yield spread is the yield differential between the average yield of high-yield bonds and the average yield of comparable maturity Treasury bonds.

Bloomberg Barclays High Yield Index is an unmanaged index and cannot be invested into directly. Past performance is no guarantee of future results.

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CONCLUSION

The April reading for the Fed Senior Loan Officer Survey, which showed net loosening of lending standards by banks, is a good indicator of fundamental strength within high yield, and corroborates (at least to some extent) the tight spreads within the market. While valuations remain elevated, we maintain our expectation for high yield stability over the remainder of 2017 absent an equity market selloff. With yield as the primary driver of returns, however, performance would almost undoubtedly be more muted than the previous year. ■

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results. All indexes are unmanaged and cannot be invested into directly.

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

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Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values and yields will decline as interest rates rise, and bonds are subject to availability and change in price.

Government bonds and Treasury bills are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value. However, the value of fund shares is not guaranteed and will fluctuate.

High-yield/junk bonds are not investment-grade securities, involve substantial risks, and generally should be part of the diversified portfolio of sophisticated investors.

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The fast price swings in commodities and currencies will result in significant volatility in an investor's holdings.

Yield spread is the difference between yields on differing debt instruments, calculated by deducting the yield of one instrument from another. The higher the yield spread, the greater the difference between the yields offered by each instrument. The spread can be measured between debt instruments of differing maturities, credit ratings, and risk.

INDEX DEFINITIONS

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The Bloomberg Barclays High Yield Bond Index is an unmanaged index of corporate bonds rated below investment grade by Moody's, S&P or Fitch Investor Service. The index also includes bonds not rated by the ratings agencies.

The Bloomberg Barclays U.S. Corporate High Yield Energy Index covers the universe of fixed rate, non-investment grade debt. Eurobonds and debt issues from countries designated as emerging markets (sovereign rating of Baa1/BBB+/BBB+ and below using the middle of Moody's, S&P, and Fitch) are excluded, but Canadian and global bonds (SEC registered) of issuers in non-EMG countries are included. Original issue zeroes, step-up coupon structures, 144-As and pay-in-kind bonds (PIKs, as of October 1, 2009) are also included.

The Bloomberg Barclays U.S. Aggregate Bond Index is a broad-based flagship benchmark that measures the investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS, and CMBS (agency and non-agency).

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