

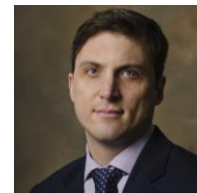


U.S. HIGH YIELD: AS GOOD AS IT APPEARS?

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U.S. high yield has performed well this year, delivering positive returns at a time when other fixed income sectors, such as Treasuries and investment-grade credit, have declined. The good performance has occurred even while money has been flowing out of the asset class. So does this mean that now is a good time to allocate heavily to U.S. high yield? I'm not convinced.

The strong performance of U.S. high yield this year has had a lot to do with two factors: strong technical factors and the rising oil price. High yields in absolute terms—around 7% on average—have kept investors interested, while issuance has been lower than expected. In fact, net new issuance (i.e., the amount of new bonds in circulation after calls, tenders, and maturities) is actually negative year-to-date. This may be partly because rising Treasury yields have pushed companies to issue loans (which have floating rates) instead of bonds, but I think the main reason is that stronger fundamentals and higher profitability have meant that many simply have not needed to issue debt. Energy companies, which are the largest component of the U.S. high yield index, have reduced their debt-to-EBITDA by 15% this year. If the price of oil remains relatively high—which we believe it will—strong performance from energy companies should continue to support the U.S. high yield sector.

There has also been an inverse relationship between credit rating and performance. Many CCC rated companies have performed better than BB rated companies because they have less sensitivity to U.S. Treasury yields. Higher-rated companies tend to be valued on their spread over Treasuries or swaps and have been hurt by the rise in Treasury yields this year. In addition, tax reforms are putting pressure on highly leveraged companies to deleverage, because there will be a limit on how much interest cost they can deduct in the future. Not all of these lower-rated companies will deleverage, but those that do will find themselves moving up the ratings spectrum.

In recognition of these tailwinds, we modestly increased our allocations to U.S. high yield during the second quarter, adding some energy, telecommunications, and idiosyncratic names and removing portfolio hedges.

Yet we remain cautious on U.S. high yield: Our relative weight in the asset class is toward the lower end of its range over the past 10 years. Spreads have tightened considerably since early 2016 as investors returned to the asset class. Our valuation models estimate that current spreads are around fair value given where we are in the economic cycle, so we do not anticipate any more spread tightening from here. On the contrary, the widening of investment-grade and emerging market spreads makes high yield appear vulnerable from a relative value perspective. As such, we are not inclined to add to the asset class at the present time. European high yield, which has wider spreads, less duration, and higher average credit quality than U.S. high yield, looks like a better value at this point in the cycle, although the weaker technical position of that market keeps us cautious through the summer.

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