# Bond Market Perspectives

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## High-Yield Hesitation

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### Highlights

Higher valuations, not just tapering fears, were responsible for pushing high-yield bond prices lower in October.

A low default environment will likely limit the degree of high-yield bond weakness absent a weaker economy or signs that Fed tapering may dramatically impair market liquidity.

We expect high-yield bonds to prove more resilient to rising rates but caution investors that returns may be lower over the coming year.

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

After an impressive October, the first full week of November 2013 started on a soft note for the high-yield bond market. High-yield bond prices closed lower as tapering fears re-entered the bond market following last week's stronger-than-expected employment report. The strong jobs report followed two stronger Institute of Supply Management (ISM) surveys on manufacturing and the service sector, which helped reinforce the economy's resilience and perhaps the need for the Federal Reserve (Fed) to reduce bond purchases as soon as this December in contrast to growing expectations the Fed may wait until March 2014.

Normally strong economic data is supportive of high-yield bonds, as a growing economy generally boosts the credit quality of underlying high-yield bond issuers. However, this is the second time that tapering fears have led to cheaper high-yield bond valuations despite an improving economy. In May of this year, high-yield bonds weakened when the Fed first mentioned tapering. Similarly, the first full week of November witnessed cheaper high-yield bond valuations as better economic data raised the prospect of the Fed tapering bond purchases. Will the rest of November lead to a continued cheapening of high-yield bond prices?

A closer look reveals that higher valuations, not just tapering fears, were responsible for pushing high-yield bond prices lower in both instances.

A **sub-5%** high-yield bond yield spread has been difficult to maintain since the **end of the financial crisis.**

1 The High-Yield Bond Market Hesitated With Yield Spreads Below 5%


Source: Barclays HY Index data, LPL Financial 11/08/13

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.

The average yield advantage, or spread, of high-yield bonds to Treasuries was below 5%, which coupled with tapering fears provided a one-two combination that sparked selling. A sub-5% yield spread, which indicates a more expensive valuation, has rarely been sustained in the high-yield bond market since the end of the financial crisis [Figure 1]. Following strong October performance, tapering fears and higher valuations may have motivated sellers.

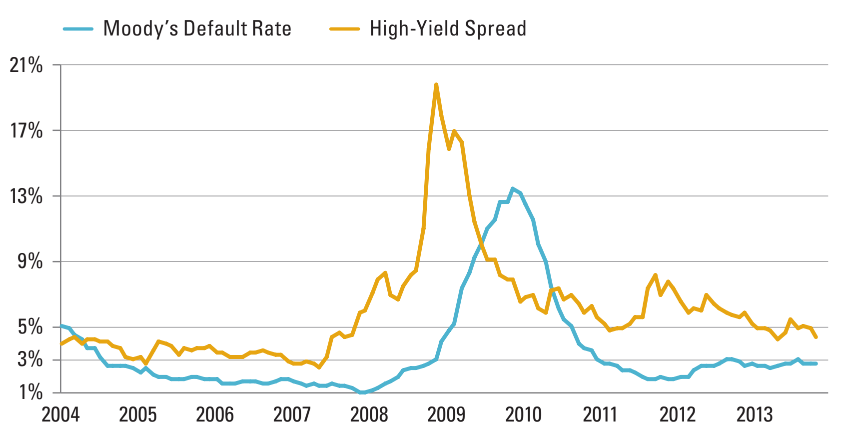
The high-yield bond market ultimately shook off tapering fears from May and might do so again now because defaults are likely to remain low. Following weakness in May and June, high-yield buyers returned in July as the average yield spread briefly reached 5.8%, the long-term average yield spread.

## Low Default Environment

A low default environment will likely limit the degree of high-yield bond weakness absent a weaker economy or signs that Fed tapering may dramatically impair market liquidity (i.e., the ease with which high-yield investors can buy and sell bonds). The default rate and high-yield bond spreads are highly correlated [Figure 2]. According to Moody's, the global speculative grade default rate, which counts the number of defaulted issuers, finished October 2013 at 2.8%, down from 3.2% a year ago, and well below the historical average of 4.5%. Moody's forecasts a modest decline to 2.4% through October 2014—in other words, the low default environment is likely to persist. On a dollar volume basis, defaults totaled only 1.7% over the past 12 months. In our view, the low default environment may translate into average yield spreads hovering near 5% for the foreseeable future.

A **low default environment** is likely to support **high-yield bond valuations**.

2 Default Rate and High-Yield Bond Spreads Are Highly Correlated




Source: Moody's, LPL Financial 10/31/13

Although signs of speculative issuance have increased in 2013, the fact that the majority of new issuance is refinance-related is generally a healthy trend.

Detractors of the high-yield bond market will highlight heavy new issuance and the prospect that 2013 new issuance may surpass 2012's robust amount. However, over 50% of new issuance is refinance-related according to Dealogic, not far from a post-recession peak of near 60%. Although signs of speculative issuance have increased in 2013, the fact that the majority of new issuance is refinance-related is generally a healthy trend. Prior to the financial crisis, less than 20% of new issuance was refinance-related.

## Lower Returns

In 2013, high-yield bonds have held to their historical pattern of being more resilient to rising interest rates. Year to date through November 8, 2013, the 10-year Treasury yield is higher by 1.0% and translated into a negative 2.2% total return for the Treasury market, as measured by the Barclays Treasury Index. In contrast, the Barclays High-Yield Bond Index is up 6.0% over the same period. However, a continued rise in high-quality bond yields may pose a headwind for high-yield bonds. Within the bond market, we expect high-yield bonds to prove more resilient to rising rates but caution investors that returns may be lower over the coming year rather than a repeat of 2013 performance. ■

## 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 indices are unmanaged and cannot be invested into directly. Unmanaged index returns do not reflect fees, expenses, or sales charges. Index performance is not indicative of the performance of any investment. Past performance is no guarantee of future results.

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.

Yield is the income return on an investment. This refers to the interest or dividends received from a security and is usually expressed annually as a percentage based on the investment's cost, its current market value or its face value.

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.

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 DESCRIPTIONS

The Barclays Capital High Yield Index covers the universe of publicly issued debt obligations rated below investment-grade. Bonds must be rated below investment-grade or high-yield (Ba1/BB+ or lower), by at least two of the following ratings agencies: Moody's, S&P, Fitch. Bonds must also have at least one year to maturity, have at least $150 million in par value outstanding, and must be US dollar denominated and non-convertible. Bonds issued by countries designated as emerging markets are excluded.

The Barclays Treasury Index is an unmanaged index of public debt obligations of the U.S. Treasury with a remaining maturity of one year or more. The index does not include T-bills (due to the maturity constraint), zero coupon bonds (Strips), or Treasury Inflation-Protected Securities (TIPS).



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