INSIGHTS

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The High Yield Bubble – Fact or Fiction

The media has often used the word "bubble" during the past few years to describe the state of various financial markets. As applied to investments, the term generally implies that speculative demand has resulted in unsustainable valuations susceptible to dramatic losses going forward. Recently, the concept has been increasingly used to describe the state of the US high yield bond market, for a few main reasons.

First, since the financial market recovery took hold in March of 2009, high yield bond investors have enjoyed an extraordinarily high cumulative return[1].

Second, a sizeable portion of the asset classes' return has been attributable to falling interest rates; a trend that many believe will soon reverse. After all, as illustrated in May[1], even a small shift in investors' perceptions about Federal Reserve policy risks causing sharply higher interest rates, and in turn, material bond losses.

Third, strong high yield performance has also been supported by record inflows into the asset class[1], including from retail investors, who often follow rather than precede good performance. Some worry that higher interest rates and/or stronger economic indicators will cause these same investors to rotate out of high yield into equities or other higher-risk investments.

While all of the aforementioned dynamics indeed point to lower returns going forward, they by no means portend a bursting bubble. When faced with the term "bubble," investors should recognize that the term has often been associated with double-digit losses within very short time periods. Not only does this type of draconian outlook seem unlikely, recent data indicates that many high yield pundits actually expect relatively positive performance going forward[1].

Investors should also recall that subsequent to 2009, the term has been used repetitively[2], since which high yield investors have been rewarded handsomely for staying put in the asset class. More importantly, however, investors should evaluate those dynamics that are generating bubble-talk in the first place. While strong performance since the financial crisis and potential shifts in interest rate and demand trends should temper return expectations going forward, the bubble concept seems misplaced when viewed relative to current market conditions.

Performance since the Financial Crisis – Spectacularly Rational

Strong performance since the financial crisis has resulted in high yield bonds reaching record low yields. While falling treasury yields have been a strong contributor to this trend, lower credit spreads - the amount of yield above comparable Treasury yields that investors demand - have also played a critical role. With credit spreads having fallen from a peak of over 18% in March 2009 to approximately 4.8% today[3], some question whether investors are irrationally accepting high risk for low return in a desperate search for yield. While tighter credit spreads certainly limit the potential for capital appreciation going forward, they have not generally become unbalanced with fundamentals. Nor have they become completely out of line with historic levels.

Defaults remain low and are expected to fall further over the next 12 months[4]; and at current levels, credit spreads remain over 200 basis points higher than the trough reached in 2007[5]. While weighing valuations against fundamentals by no means suggests outsized gains going forward, it also puts bubble talk into question.

Source: PPM America and Eastspring Investments (Singapore) Limited.

Interest Rates – Neither Friend nor Foe

Fear of rising interest rates has also fueled high yield bond bubble rhetoric. While all else held equal, higher interest rates will indeed negatively impact high yield bond prices, two important considerations mitigate the risk of a bubble-like burst.

First, although the threat of sharply higher interest rates has seemed more pronounced in recent weeks, it remains tempered by market conditions. Recent movements demonstrate this point. After rising sharply in May, Treasury yields were pushed back down following soft unemployment data in early June[6]. This push and pull pattern reflects the still-tenuous macroeconomic backdrop and the Federal Reserve's commitment to hold rates down until unemployment and inflation targets have been met. Because these metrics continue to remain well outside of the Fed's stated goals, a sharp one-directional move up in interest rates should by no means be a foregone conclusion.

The second mitigating factor is high yield's relatively low correlation to treasury yields. In fact, over the past 20 years, high yield bonds have demonstrated a negative correlation to Treasury bonds[7], meaning that unlike high grade bonds, high yield tends to perform positively when Treasury yields increase.

One reason for this relationship is that high yield bonds are more sensitive to economic conditions; and when treasury yields are increasing, economic growth is usually improving.

As such, the positive impact that improving economic conditions typically have on high yield bond prices helps cushion against the negative impact that higher interest rates have. The higher coupon payments made by high yield bonds also help mitigate losses imposed by rising treasury yields. One could argue that higher treasury yields need not necessarily coincide with an improving economy and that interest rates are much lower today than in previous cycles; but then again, many experts currently expect both higher interest rates and positive high yield returns in 2013. These arguments challenge the notion of bubble theories.

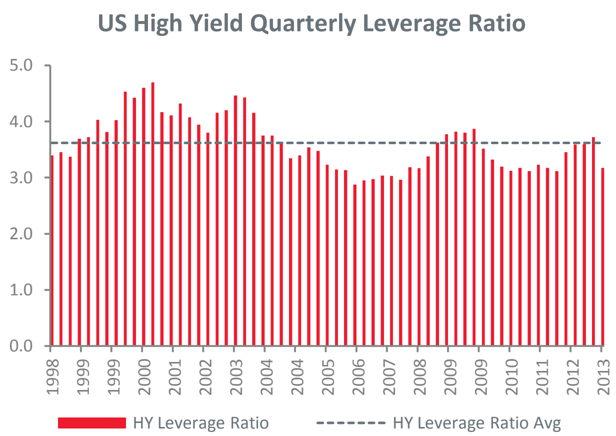
Daily Option Adjusted Spread of the BofAML US High Yield Master II Index

Source: BofA Merrill Lynch, 5 June 2013.

Demand for High Yield – The Jury is Still Out

Some bubble theorists also speculate that recent demand trends will lead to a market meltdown. They worry that strong investor demand since the financial crisis has led to increased risk tolerances[8], which in turn have led to lower lending standards and exposed investors to higher credit risks. They also worry that demand trends could quickly reverse, leaving high yield bonds vulnerable to losses caused by large outflows. While both these dynamics are worth monitoring, they by no means necessarily live up to bubble hype.

High yield company leverage has increased but remains reasonable from a historical perspective, and high yield companies have continued to exercise relatively healthy new issue practices, as measured by gauges such as call protection, maturity, use of proceeds and average quality[9]. Likewise, fears about sharp demand fallout seem overblown. True, high yield mutual funds have recently experienced sizeable outflows[10], but mutual funds comprise only 30% of the total investor base[11], and investors looking for higher-yielding, lower duration assets have few alternatives. As a whole, robust demand in recent years has perhaps left the asset class more vulnerable to cyclical shifts - but not of bubble proportions.



Source : BofA Merrill Lynch. "US HY Market Statistic: Levels." March 2013

A Bubble in Bubble Theories

The 2008/2009 financial crisis has understandably caused investors to view extraordinary performance suspiciously and watch carefully for market imbalances. As such, it is not surprising that high yield bonds have fallen victim to bubble talk. But whether the asset class is worthy of such attention is an entirely different question. True, performance is unlikely to be as strong going forward. Nor are interest rate or demand trends likely to provide as strong a boost to returns.

But all things considered, high yield seems poised for a moderation in performance rather than a full blown bubble burst.

Footnotes:

[1] BofA Merrill Lynch, "Credit Investor Survey: The love-hate relationship," 9 May 2013. As measured by results from BofA Merrill Lynch's "High Yield investor survey," which revealed that investors' net overweight in high yield-had grown fairly substantially since the previous quarter. The survey includes responses from 80 investor-types, which are clients of BofA Merrill Lynch, from the following groups: Banks, Insurance Companies, Pension Funds, Asset Managers and Hedge Funds.

[2] The New York Times. "No Safety in Numbers." March 16, 2009, Barrons. "Get Out Now!" January 5, 2009, CNN Money "Beware of the Bubbles in Bonds." May 25, 2010.

[3] Source: BofA Merrill Lynch. As measured by the BofA Merrill Lynch US High Yield Master II Index.

[4] Source Moody's Monthly Default Report, April 2013. As measured by the US Trailing US 12-Month Issuer-Weighted Speculative-Grade Default Rate and Baseline Default Rate Forecast.

[5] Source: BofA Merrill Lynch. As measured by the BofA Merrill Lynch US High Yield Master II Index.

[6] Source: ADP National Employment Report: May 2013; June 5, 2013 Press Release

[7] Morningstar Direct. As measured by the performance correlation of the BofA Merrill Lynch US HY Master II Index and the Barclays Treasury Index from 1 June 2993 to 31 May 2013. Past performance does not guarantee future returns.

[8] Fitch Ratings Credit Market Research. "Fitch U.S. High Yield Default Insight" April 2013 and The Federal Reserve "April 2013 Senior Loan Officer Opinion Survey on Bank Lending Practices." As measured by "risk receptivity, which measures how willing investors are to lend and how accommodative conditions are for borrowers. Based upon responses from 68 domestic banks and 21 U.S. branches and agencies of foreign banks, borrowers are experiencing the most accommodative borrowing conditions in two years.

[9] Bank of America Merrill Lynch. "US HY Market Statistic: Levels." March 2013

[10] Barclays Capital, "U.S. High Yield Corporate Update," 3 June 2013.

[11] Approximate. According to BofA Merrill Lynch, "2013 Credit Outlook: The Inflection Year." As measured by mutual fund assets as a percent of the Global HY market size.

Index Definitions:

Barclays Treasury Index includes public obligations of the U.S. Treasury. Treasury bills are excluded by the maturity constraint but are part of a separate Short Treasury Index. In addition, certain special issues, such as state and local government series bonds (SLGs), as well as U.S. Treasury TIPS, are excluded. STRIPS are excluded from the index because their inclusion would result in double-counting. Securities in the Index roll up to the U.S. Aggregate, U.S. Universal, and Global Aggregate Indices. You cannot invest directly in an index.

BofA Merrill Lynch US Master II Index is a market value-weighted index of all domestic and Yankee high-yield bonds, including deferred interest bonds and payment-in-kind securities. Issues included in the index have maturities of one year or more and have a credit rating lower than BBB-/Baa3, but are not in default. The BofA Merrill Lynch U.S. High Yield Master II Constrained Index limits any individual issuer to a maximum of 2% benchmark exposure. You cannot invest directly in an index.

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