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FUND INSIGHTS

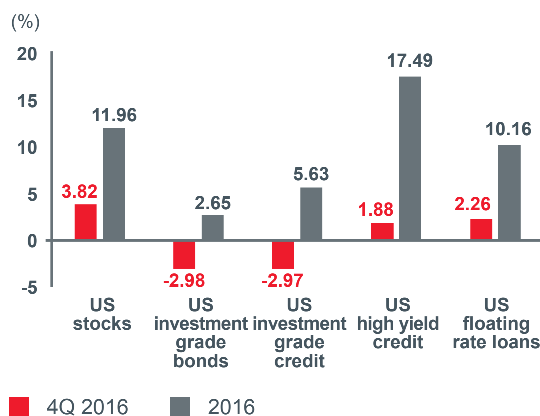
# US HIGH YIELD BOND REVIEW AND OUTLOOK

EASTSPRING INVESTMENTS –
US HIGH YIELD BOND FUND (THE "FUND")
FEBRUARY 2017

## FED, WHITE HOUSE DRIVING MARKETS

The bifurcation between the Federal Reserve and other global central banks continued to be a major theme through Q4 2016, with the Fed choosing to raise its base interest rate target by a quarter percentage point in December.

**Fig.1. Q4 and 2016 total returns**




Source: Morningstar Direct, as at 30 December 2016. As measured by the QTD and YTD total returns of the following indices: S&P 500 Index, Bloomberg Barclays US Aggregate Index, Bloomberg Barclays US Credit Index, Bank of America Merrill Lynch US High Yield Index and the S&P/LSTA Leveraged Loan Index. See disclosures for full descriptions. Indices are unmanaged and cannot be invested in directly. The index returns shown do not include any transaction costs, management fees, or other costs. The indices provided in this chart represent the investment environment existing during the time periods shown. The information provided is for comparison purposes only to reflect general market conditions. Index returns represent past performance and are not indicative of any specific investment. Past performance of the indices is no guarantee of future results.

Other major economies continued to keep their central bank rates low in order to further spur inflation and growth.

The results of the US presidential election further drove differentiation between the US and other major economies, as expectations for some form of fiscal stimulus and an eased regulatory environment drove up growth projections for the US and added to ongoing inflationary expectations. These factors combined to ultimately push US Treasury yields higher through the quarter.

By the end of December, 5 and 10-year US Treasury yields increased 79 bps and 85 bps, respectively, to 1.93% and 2.45%;[1] reaching the highest levels since 2014.

US economic data continued to strengthen throughout the quarter, collectively reflecting ongoing, yet modest expansion.

This was widely viewed as supportive of high yield assets, as risk appetites shift towards risk-on assets and yield hungry global investors continue to invest in US high yield.

Further, US high yield is commonly viewed as inversely correlated with Treasury returns, and more closely correlated to equity returns, particularly small cap stocks. Therefore, in a rising rate environment, US high yield would be expected to outperform.

## SPREADS TO COMPRESS FURTHER

As a result of the Republican sweep of both chambers of Congress and the White House, a broadly pro-business, anti-regulatory agenda is forecast to be implemented over the next several years.

Industries that have been subject to increased regulation over the last eight years saw a rebound through the latter part of the quarter – financials outperformed on the likelihood of a lessening regulatory environment while energy outperformed off the back of OPEC action.[2]

Further, consistent with Republican policies regarding the Affordable Care Act (ACA), pharmaceuticals and biotech both rebounded due to likely restrictions on drug pricing that were expected under a Clinton administration not emerging.[3]

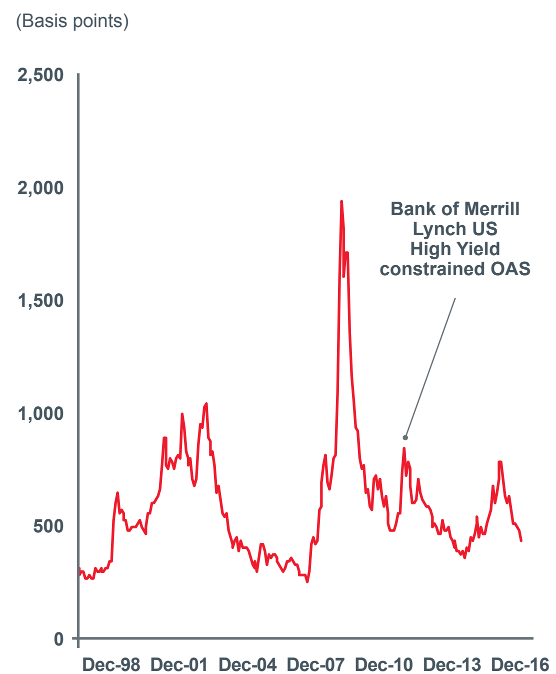
Hospitals though saw more negative sentiment due to ACA reform that could impact care-giving institutions. One area of policy that remains uncertain is the potential for increased trade barriers, which would likely impact technology and manufacturing firms and could cause inflationary pressures.

The combination of the above factors helped high yield credit index spreads tighten 75 bps, to 422 bps above duration-matched Treasuries.[4] While spreads generally tightened throughout the quarter, there was a noticeable short-lived widening around the presidential election. Spreads ended the quarter near year to date tight levels.[5]

Spread compression has also continued between sectors and between ratings brackets. The Fund has therefore been able to move up in issue quality as spreads between ratings have compressed, as the premium to be in lower bounds has dissipated.

If dislocation of sector spreads were to reappear we would look to examine this as an opportunity to selectively reposition back down the credit ratings ladder. The Fund has further continued to examine fallen angels, which continue to be an area within which we believe we can generate value for clients.

**Fig.2. US high yield option adjusted spread**




Source: Datastream, Bank of America Merrill Lynch, as at 30 December 2016.

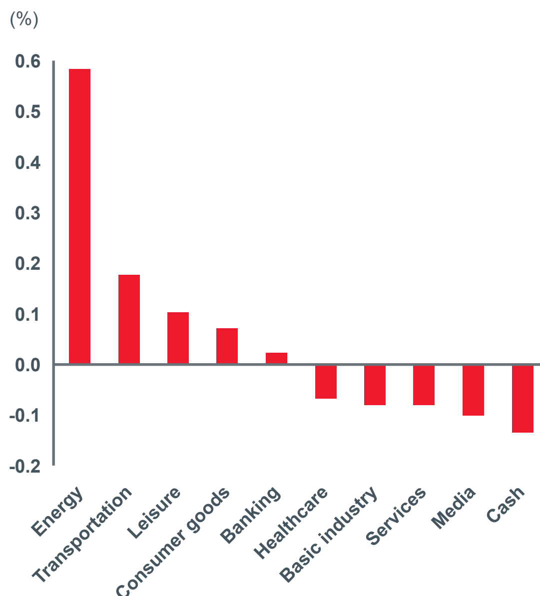
## ATTRIBUTION[6]

When considering the broad strategies and themes which contributed positively to the Fund throughout Q4, sector selection was a significant factor. Metals and energy exposures and particularly fallen angels within those sectors were strong contributors to the total return of the Fund.

However, within the Fund, certain idiosyncratic exposures detracted from overall performance, including sector allocations in healthcare, which resulted largely following political events regarding potential reform of the ACA.

The overarching strategic decisions were predominantly driven by an increasingly positive economic outlook and raised growth expectations, and derived from expected political policy changes following the US presidential election in November.

**Fig.3. Year-to-date attribution**




Source: Eastspring Investments, as at 31 December 2016.

## OUTLOOK

Considering shifting policy expectations as a result of the Trump administration, we are lifting our GDP growth outlook slightly to 2.5-3.0% over the next year and portfolio positioning may modify accordingly.

The precise balance of growth continues to remain uncertain, pertaining to when various regulatory and taxation policies are implemented and the potential for fiscal stimulus and infrastructure spending.

If growth or inflation pick up at an increasing pace, this could encourage the Fed to normalise rates at a faster pace, acting as a headwind. This level of growth is less supportive of duration sensitive fixed income assets, while certain segments, such as high yield, are less susceptible. However, the specific rate and pace of Fed rate increases remain highly uncertain. It is very difficult to attempt to time specific rate increases, and we prefer to maintain sector rotation and credit selection while minimising rate risk.

Ongoing dollar strength and potential trade policy changes also could act as headwinds to our growth outlook. However, personal consumption, the largest engine of US GDP growth, was solid through the quarter, thanks in large part to lower unemployment and overall healthy household balance sheets.

Furthermore, tightening, but broadly accommodative monetary policy should continue to support consumer spending and the housing sector. The rebound in the commodities sector should further drive high yield as domestic oil and gas production continues to rise, although the strong dollar could begin to act as a headwind.

It is broadly expected that the default rate will continue to fall from current levels, which should act as a positive indicator for high yield assets, and as inflation begins to gather pace this should again be supportive of high yield debt issuing firms.

Our biggest concerns are macroeconomic and geopolitical-related and are not specific to the high yield market. Higher than expected inflation and interest rates also pose a risk; while high yield is much less vulnerable than investment grade, a sharp uptick could damage total return, nonetheless, and/or cause general market disruption.

Overall, 2017 total returns will probably be off the highs we saw in 2016 but the asset class should be supported both by the reduction in regulatory environment and lowering of corporate taxes that is expected to be driven by the Trump administration, while the economic backdrop provides further tailwinds, even within the rate hiking cycle that will continue through this year. Therefore the Fund remains broadly neutral in positioning.

## Sources

[1]Federal Reserve, as at 3 January 2017.

[2]Barclays. Global 2017 Credit Outlook, as at 2 December 2016.

[3]Barclays. Global 2017 Credit Outlook, as at 2 December 2016.

[4]Barclays and Bank of America Merrill Lynch. Based on the Bloomberg Barclays US Credit Index and the Bank of America Merrill Lynch US High Yield Index, as at 3 January 2017.

[5]Barclays. Based on the Bloomberg Barclays US Credit Index OAS, as at 21 December 2016.

[6]As of 31 December 2016, based on Q4 attribution results. Past performance is not necessarily indicative of the future or likely performance of the Fund. A full attribution report for the measurement period presented above and a description of the related calculation methodology are available upon request.

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