High Yield Market Outlook

By Michel Ho
Senior Client Portfolio Manager, ING Investment Management

The global high yield markets experienced a very strong year in 2012 with a total return ranging from approximately 15% in U.S. high yield to 27% in European high yield. The returns were largely driven by a tightening of credit spreads, but the asset class was also helped by a further decline in interest rates. As interest rates have reached very low levels, the search for yielding asset classes has increased, which has led to strong inflows into spread assets such as investment grade corporate debt, emerging markets debt, senior bank loans and high yield.

The yield level on U.S. and European high yield benchmarks has dropped to approximately 6%, which compares very low versus the longer term average yields of around 10%. In fact the current yield levels are on an historic low level, which has led to the question whether this asset class is still attractive and not overvalued currently. In answering these questions one has to look beyond the absolute yield levels and analyze the market based on the macroeconomic environment, corporate credit fundamentals, the supply and demand outlook as well as the credit spread levels.

The macroeconomic environment has been and will continue to be dominated by the sustainability of global/European sovereign debt. Recent action by the ECB as well as the Fed has reduced the overall tail risk (such as a country's exit from the euro) and has been supportive of asset values. Economic growth has shown a mixed picture with zero growth expected for the Eurozone, solid growth within emerging markets and a pickup in growth in the U.S.

Mixed economic outlook

The U.S. economy is on an improving trend due to a recovery in the housing market and the automotive industry. We expect around 2% economic growth, taking into account a negative impact from fiscal tightening. Global growth is expected to remain below potential in 2013 particularly as a result of the low growth to even possible recession within the Eurozone.

Supportive ECB and Fed asset purchases have led to very low yields across all fixed income asset classes. We only expect the Fed to stop buying treasury bonds once the U.S. economy is on a firm footing. A stronger economy leads to improving credit worthiness which in turn will lead to a further decline in defaults.

Healthy fundamentals

Credit fundamentals have shown a strong recovery from the trough of the market in early 2009, when defaults rose to approximately 11% in November, to the current environment in which default levels have fallen below 2%. Corporate earnings have shown a rapid recovery, following the 2008 crisis, as a result of cost reduction and deleveraging. With the 2008 financial crisis fresh in the back of their minds, companies have focused on repairing balance sheets and reducing debt. Corporate leverage in the U.S. has fallen from approximately 5.2x leverage in 2009 to 3.9x at the end of 2012. This in turn has led to improved corporate health, as also evidenced by an increasing number of companies that have been upgraded by rating agencies versus those that were downgraded. This upgrade-to-downgrade ratio was steadily improving from November 2009 until December 2011 and has remained stable over 2012 as corporate fundamentals reached a healthy level.

We do not expect default rates to see a rapid rise over the next 12 to 24 months as corporate credit fundamentals are good and as the need for refinancing short-term maturities has declined to a very low level. Companies have profited from the strong inflows into high yield and have used the market liquidity to refinance short-term debt. As a result of the refinancing activities, the amount of debt outstanding with a maturity in 2013, 2014 or 2015 is very low.

From a technical perspective there has been a very large volume of new issues that have been brought to the market over the past 3 years. Volumes in the U.S. reached 368 billion US$ in 2012 and approximately 58 billion euro in Europe. The large volumes follow from the search for yield where investors have poured fresh money into the market and companies issued bonds to raise funds. The gross amount might lead to the conclusion that the market is flooded with new issues, but in reality the majority of the funds are raised to refinance existing debt. The actual net issuance in both the U.S. and Europe has been less than 40% of the amounts raised. The overall credit quality of the market has remained very stable over time as the credit quality of the new issuance market has remained relatively strong with only recently an increase in CCC-rated bond issuance.

The low-interest-rate environment and the subsequent search for yield have led to strong inflows into the asset class from both existing as well as from new participants, in particular insurance companies. The strong momentum in high yield is still supported by the inflows. We do not expect a sharp reversal in investors' sentiment soon as a lack of yielding alternatives within the fixed income space is leading to new flows.

High yield still attractively valued

This comes to the point why high yield is still attractively valued. From a yield perspective high yield is trading at historically low yields but from a credit spread perspective the market is trading more in line with historic averages. Spread levels are not at historic lows (the 20-year average spread level in the U.S. is 536 basis points versus the actual current spread level of 500 basis points) while default rates are very close to historic lows, with the average default rate in the U.S. around 4.3% versus the actual current default rate of 1.4%. Companies are generally in good health and if we compare the current credit fundamentals to the environment leading up to the financial crisis, the current spread levels are at much higher levels while corporate credit fundamentals are much better. From our point of view we still see enough room for further spread tightening.

To illustrate this view we have included a chart below which shows the development of the default rates in the U.S. high yield market and the development of the credit spreads. The chart clearly shows that default rates have fallen to record low levels while the spread levels have fallen to the long-term average spread levels.

A credit spread of about 500 basis points over treasuries still more than compensates for expected losses. For the U.S. market we expect to see approximately 2% of credit losses for the coming years as most companies have successfully refinanced the upcoming maturities, with a realized loss of around 1.4% (assume a 30% recovery rate). The spread premiums over expected losses are still at multi-year highs.

The current spread level offers investors enough extra return to counterbalance a possible rise in interest rates. A possible rise in interest rates will follow from an improvement in the overall economy, which in our view should lead to further tightening of credit spreads as defaults would decline. We expect that a rise in interest rates will be countered by a tightening in credit spreads, which would compensate or soften the impact of rising rates.

Cautious optimism

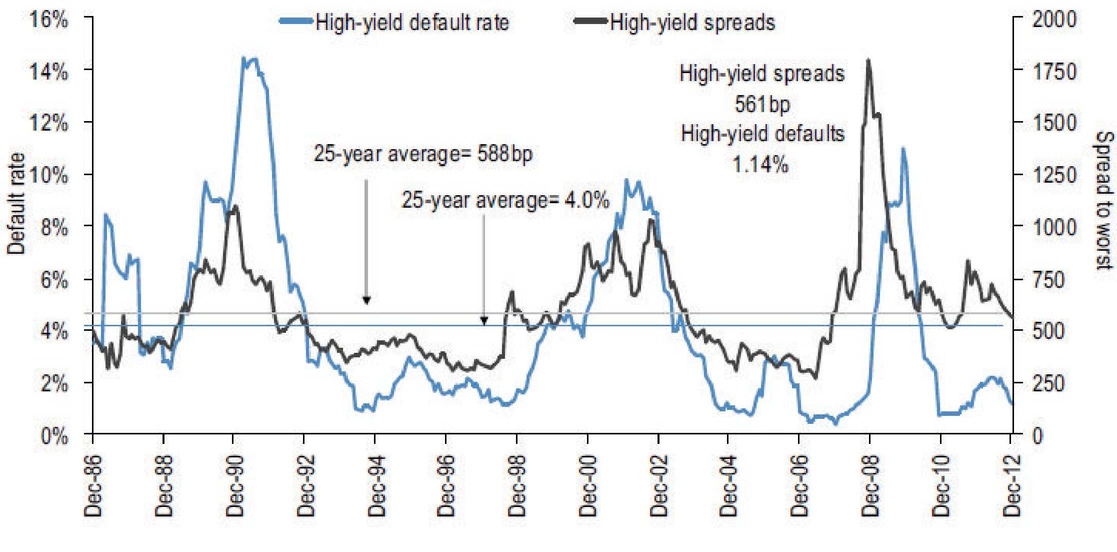
So while high yield may appear expensive on an historic yield basis, the overall spread levels are still in line with long-term averages while corporate credit fundamentals are sound. The asset class is not cheap but it is certainly not expensive either. On the short term we see continued flows into the asset class leading to further upward pressure on prices while on a longer investment horizon the asset class is more fairly valued.

The benchmark yield of approximately 6% compares very favorably to U.S. Treasury and/or German Bund rates and will soften the impact of possible rate rises. As a result we remain cautiously optimistic on the asset class.

michel.ho@ingim.com
www.ingim.ch

High-Yield Valuations: Spreads Remain Attractive

Default Rate vs. High-Yield Spreads



Note: Default rate is par-weighted. Sources: J.P. Morgan, Moody's Investors Service