

March 13 2018

HIGH YIELD HESITATION

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KEY TAKEAWAYS

Despite some year-to-date headwinds, fundamentals remain solid for high yield and may point to stability for the asset class going forward.

Investor outflows from high yield are catching headlines, but after such strong two-year performance, they may say more about what high yield has done, rather than what it will do.

Lower-quality fixed income can serve unique purposes within portfolios, but should be used at the margins of high-quality fixed income for suitable investors.

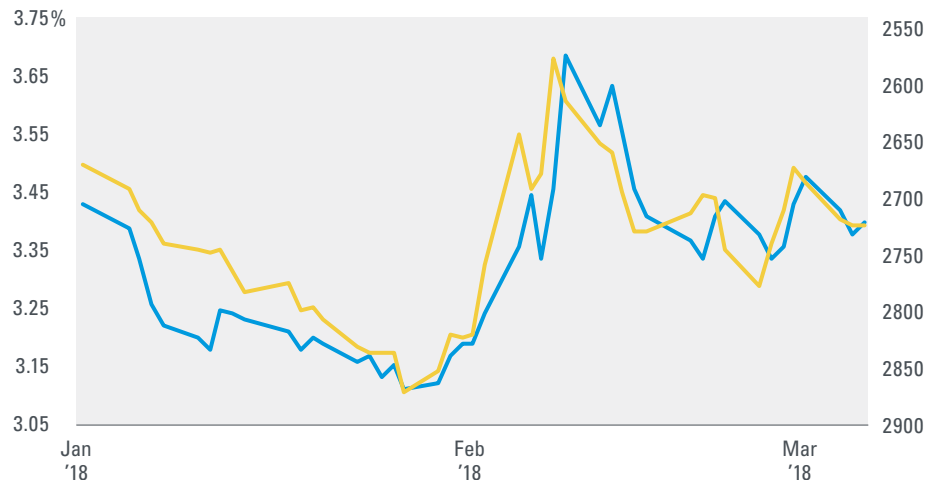
High yield has faced some headwinds thus far in 2018, but fundamentals remain solid. Additionally, weakness has mostly been equity-market driven, and generally not tied to specific concerns around credit. Worries over a more aggressive Federal Reserve (Fed), increased deficit spending, and thus, higher interest rates could negatively affect fixed income investments broadly, including high yield. Spreads have widened, and subsequently recovered, in sympathy with equities thus far in 2018. **Figure 1** shows the extent to which equities and high-yield spreads can move in tandem.

FUNDAMENTAL BACKING

Under the hood, fundamentals point to a well-behaved market. High-yield dispersion, the difference in yields between the lowest- and highest-quality

1 BROAD-BASED RISK-OFF MOVES AFFECTED HIGH YIELD AND EQUITIES YEAR TO DATE

- High-Yield Spread (Left Scale)
- S&P 500 Index Level (Right Scale, Inverted)



Source: LPL Research, Bloomberg 03/08/18

Indexes are unmanaged index 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.

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 (yield advantage), the greater the difference between the yields offered by each instrument.

segments of the high-yield spectrum, can be viewed as a proxy for market stress or concern. When markets are under stress, market participants sometimes liquidate their lowest-quality holdings first, as they believe those are the most susceptible to further price declines. Consequently, higher dispersion can potentially point to fundamental concerns by investors. This dispersion is still well contained within the high-yield market at this time.

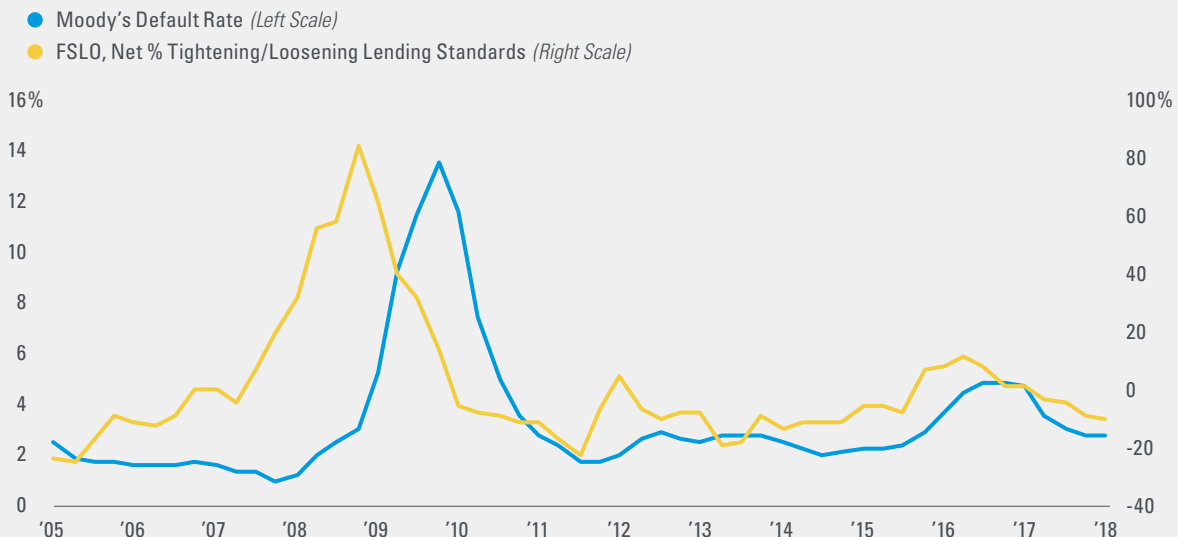
The Fed Senior Loan Officer Opinion Survey, which shows the net percentage of banks that are tightening or loosening lending standards to medium- and large-sized companies, exhibited further net loosening in the most recent data point, which is another sign of fundamental stability for high-yield and lower-quality fixed income overall. This is one of our preferred leading indicators for defaults, and tends to lead default activity by about a year [Figure 2].

FACTORING IN FLOWS

Investor flows and sentiment can be an important gauge, and a helpful angle in the analysis of any asset class or investment. Flows have been leaving high-yield funds on a net basis year to date. While this is not a positive development in and of itself, it is important to remember that this was the case during much of 2017 as well, and spreads actually tightened over that period. In our view, flows only become truly impactful if they push valuations to levels outside of what we would deem a fair value range for the asset class.

Additionally, outflows from asset classes can occur for very different reasons. Flows out of high yield occurring in 2014 and 2015 were rational, as investors were concerned about energy-related weakness within high yield. Those worries were warranted, as high-yield energy weakened

2 LENDING STANDARDS TEND TO TIGHTEN BEFORE AN INCREASE IN DEFAULTS



Source: LPL Research, Bloomberg 03/08/18

FSLO – The Federal Reserve Senior Loan Officer Survey

Moody's is an independent, unaffiliated research company that rates fixed income securities. Moody's assigns ratings on the basis of risk and the borrower's ability to make interest payments.

materially during oil's plunge, leading to many defaults within that space. With that specific problem largely behind us, what is causing high-yield outflows now? The answer may come down to just how well high yield has done over the last couple of years.

As a result of oil-related weakness, high-yield indexes declined substantially, bottoming out on February 11, 2016 (just before the price of oil plummeted on February 16, 2016). Over the 516 trading days since then (February 11, 2016 through March 6, 2018), the Bloomberg Barclays U.S. High Yield Bond Index has outperformed the broad Bloomberg Barclays U.S. Aggregate Index by an impressive 31% [Figure 3].

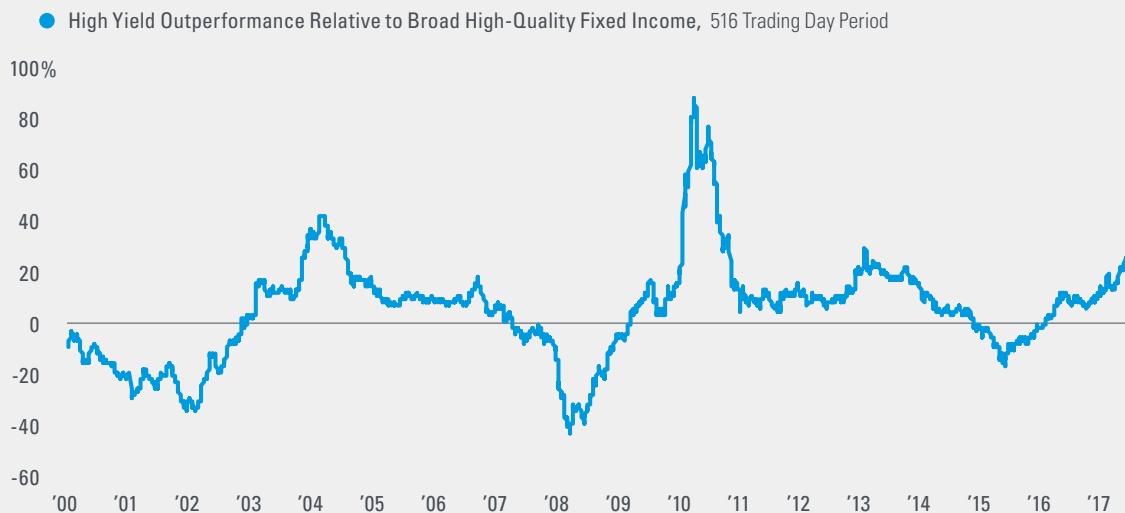
Greater outperformance over a time period of that length has only occurred twice in the last 20 years. At levels of relative outperformance like this, it is only rational to expect investors to rotate out of such a dramatic winner and into other investment

options. The recent rise in yields has also created a more attractive entry point for high-quality fixed income. Buying high-quality fixed income is much more appealing when the 10-year Treasury is yielding 2.80–2.90%, as it is currently, relative to the less than 1.4% it yielded in mid-2016.

REDUCED RETURN POTENTIAL

Despite the positive fundamental story, the relatively low spread of high yield limits the return potential of the asset class. The spread of high yield over comparable Treasuries is highly correlated with its future returns. This matches intuition: spreads at high levels do not historically stay elevated for long, potentially leading to spread tightening and capital appreciation, in addition to yield. With spreads low, as they currently are, spread tightening becomes more elusive and yield drives the majority of the return.

3 HIGH YIELD'S OUTPERFORMANCE SINCE OIL'S BOTTOM IS IMPRESSIVE



Source: LPL Research, Bloomberg as of 03/08/18

Chart represents the outperformance (or underperformance) of the Bloomberg Barclays U.S. High Yield Index relative to the Bloomberg Barclays U.S. Aggregate Index over a rolling 516-day period.

CONCLUSION

Equity-related headwinds reared their heads this year, but we believe fundamentals remain in decent shape for high yield and lower-quality fixed income broadly. Loosening lending standards, still declining defaults, and even lower default forecasts all point to potential stability for high yield in the near future. Given the fundamental backing, current spread levels are near our estimate of fair value for the asset class.* However, spreads at these levels point to a lower return environment than

in the recent past, and argue for caution as the business cycle ages.

Additionally, headwinds remain for fixed income broadly. Higher levels of growth and inflation, greater deficit spending, and a more aggressive Fed may pressure fixed income, both high and low quality. High yield, and lower-quality fixed income overall, can still be a good yield vehicle or a supplement to high-quality fixed income, but we believe it should mainly be used at the margins for suitable investors. ■

*Please see our [Outlook 2018: Return of the Business Cycle](#) publication for additional descriptions and disclosures.

IMPORTANT DISCLOSURES

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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.

INDEX DESCRIPTIONS

The Bloomberg Barclays U.S. Aggregate Bond Index is a broad-based flagship benchmark that measures the investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS, and CMBS (agency and non-agency).

The Bloomberg Barclays U.S. High Yield Bond 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, and Fitch. Bonds must also have at least one year to maturity, have at least \$150 million in par value outstanding, and must be U.S. dollar denominated and nonconvertible. Bonds issued by countries designated as emerging markets are excluded.

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