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Featured G

Are High Yield Floating Rate Notes Poised for Takeoff?

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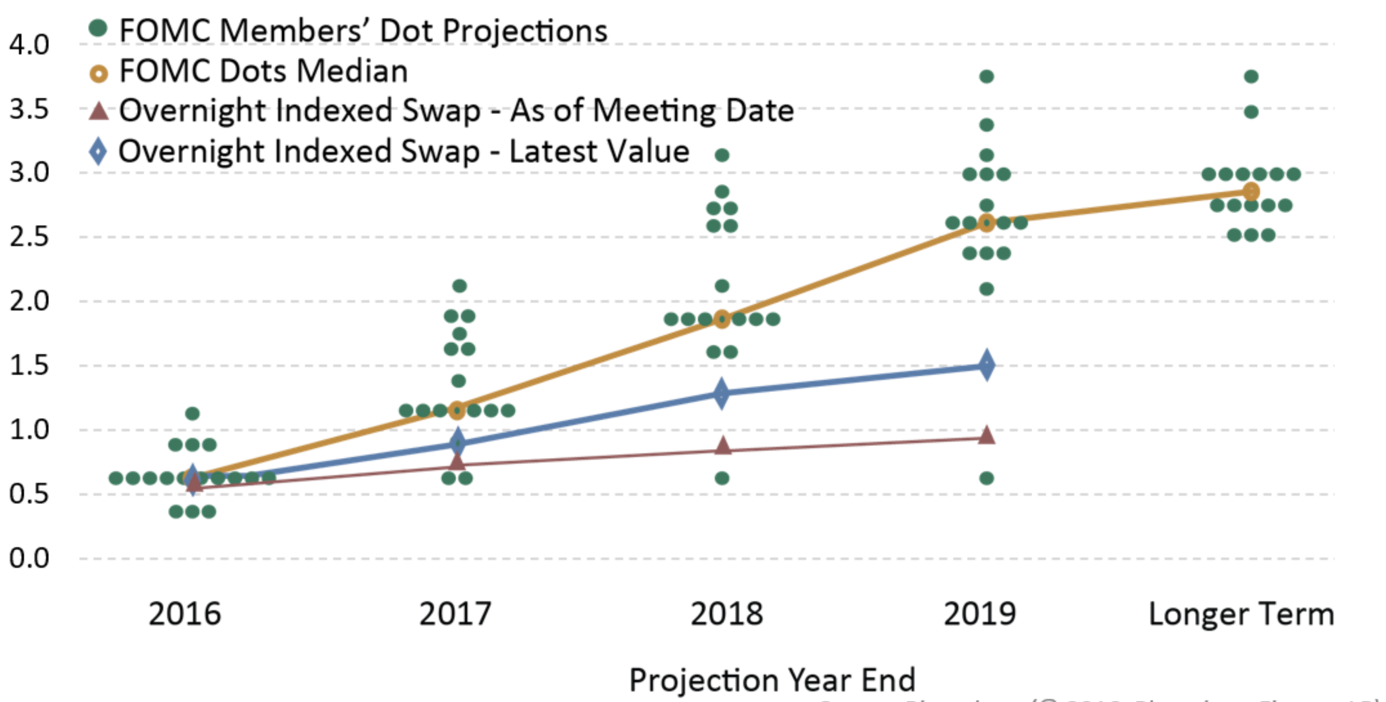
The high yield asset class has benefited from historically low interest rates over the last few years. However, the Federal Reserve (Fed) seems determined to raise rates, judging from the current 94% market probability for a 25 basis point (bp) hike at the December meeting.[1] When rates do rise, it is important to consider the effects that a selloff in duration and a potential European Central Bank (ECB) taper could have on the high yield (HY) market. Looking beyond December, the Federal Open Market Committee (FOMC) expects rates to rise to 2.5% by the end of 2019 (see Chart 1). While the current market outlook is somewhat lower, expecting a rise to only 1.5% by year end 2019, market expectations have been increasing lately, evidenced by the difference between the overnight indexed swap (OIS) rate as of the September Fed meeting versus more recent values.

Chart 1: FOMC Rate Projections versus Market Expectations

Implied Fed Funds Target Rate, As of 9/21/2016; OIS Latest Value, As of 11/10/2016



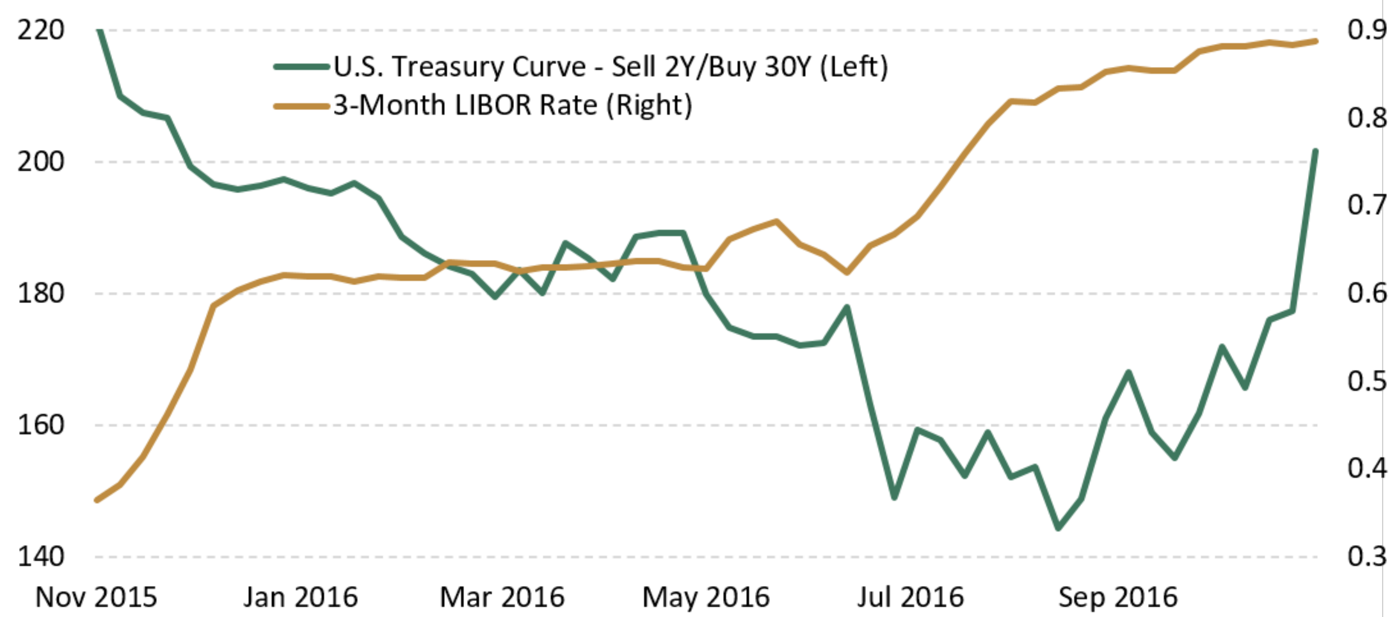
Source: Bloomberg (© 2016, Bloomberg Finance LP)

Since late June, the U.S. Treasury curve has started to significantly steepen (see Chart 2). Duration has been selling off since July, with yields on the U.S. 10-year Treasury recently breaching 2% for the first time since January 2016 and the implied forward yield curve suggesting further weakening. Meanwhile, LIBOR rates have been increasing since 2015. One of the factors driving this uptick has been the new U.S. money market fund rules that came into effect in October. These reforms, which require a fund to float its unit value—or mark to market—rather than fix its net asset value (NAV) at $1.00, will likely mean greater volatility as capital moves from prime money market funds to government-only funds which are not subject to varying NAVs. In

anticipation of these redemptions, funds are investing shorter term, driving term funding rates higher.

In this environment of rising Fed rates, yield curve steepening, duration selling off, and an increase in LIBOR, we expect floating rate notes (FRN) that can take advantage of these conditions should outperform the traditional fixed-term high yield bond.

Chart 2: U.S. Treasury Yield Curve Steepens as LIBOR Rates Rise *As of 11/11/2016*



Source: Bloomberg (© 2016, Bloomberg Finance LP)

Recent Issuance of Floating Rate Notes

Over the last few months, there has been a noticeable increase in FRN issuance, especially in Europe. What is also notable is the size of these issues (see Table 1). In recent years, the FRN market was accustomed to smaller deal sizes, with most of the issuance going to collateralized loan obligation (CLO) structures. Now, it is not uncommon to see deals of between EUR/USD 500mm to 1bn. With the market growing in size, we should see participation from a broader base of investors and increased liquidity.

Table 1: Larger Deal Sizes Characterize Recent Issuance

Issuer	Currency	Size	Coupon	Maturity
Synlab	EUR	940mm	Euribor +350bps	07/2022
Guala Closures	EUR	510mm	Euribor +475bps	11/2021
Reynolds	USD	750mm	LIBOR +350bps	07/2021

Source: Bloomberg (© 2016, Bloomberg Finance LP)

Risk/reward characteristics

Table 2 shows the characteristics of the Global FRN High Yield Index and compares them to other high yield and bond indices. The yield, spread, and composite rating are very similar to the Global High Yield Index. The most significant difference is seen in the duration of the two indices. The reason why duration is not zero for the Global FRN High Yield Index is due to the fact that coupons tend to be reset quarterly, so they are actually fixed for a certain period of time. One can also see just how small the face value of the FRN index is, but as we have seen from Table 1, recent new issues have featured significantly larger deal sizes.

Table 2: Characteristics of High Yield and Bond Indices *As of 11/10/2016*

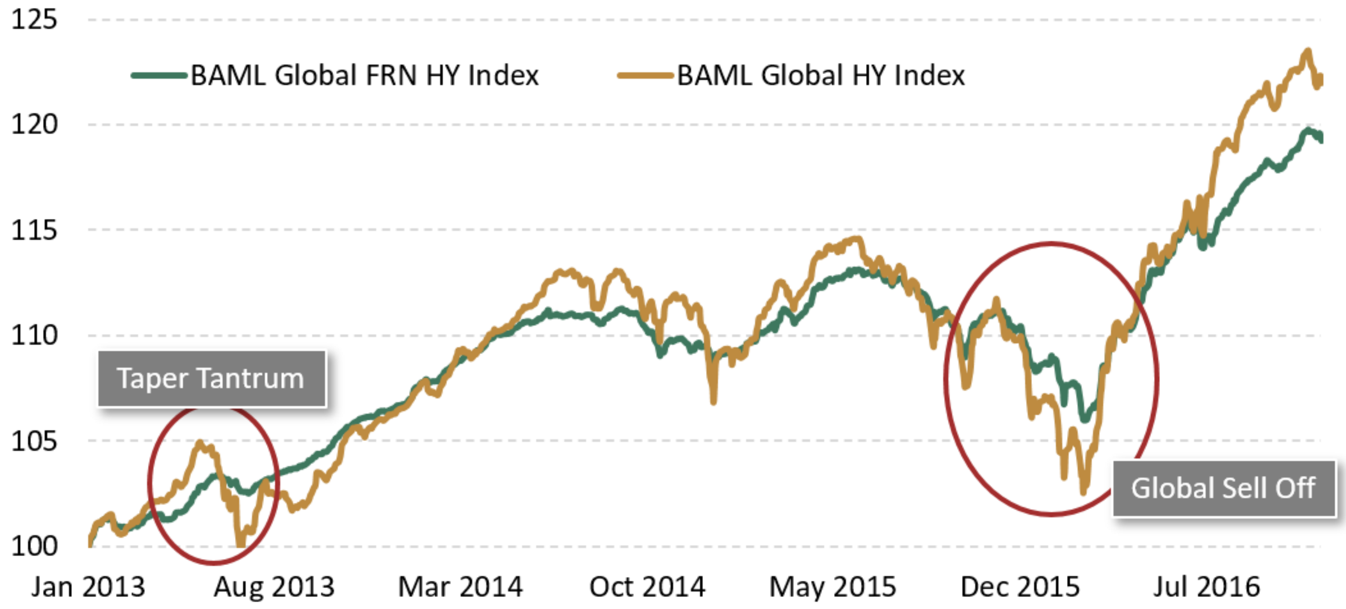
Index	Global High Yield	Global FRN High Yield	US High Yield	Euro High Yield	World Gov Bond	Global Corporate
Modified Duration	3.9	0.1	4.0	3.4	7.8	6.4
YTW	6.1	5.1	6.5	3.6	1.3	2.5
Spread	505	496	505	396	11	127
Composite Rating	B1	B1	B1	BB3	AA2	A3
Face Value	$2 Trillion	$21 Billion	$1 Trillion	$313 Billion*	$28 Trillion	$9 Trillion

**USD equivalent. The euro-denominated face value is €293 billion.*
Source: Bank of America Merrill Lynch

By having limited exposure to duration, FRNs have the potential to outperform traditional HY in times when duration is selling off and rates are rising, which can be seen by comparing the Global High Yield and Global FRN High Yield indices since 2013 (see Chart 3). The taper tantrum in June 2013 and the global selloff in January 2016 both show FRNs outperforming the broader market.

Chart 3: Global High Yield FRNs Outperformed Global High Yield as Duration Sold Off

Rebased to 100; As of 11/9/2016

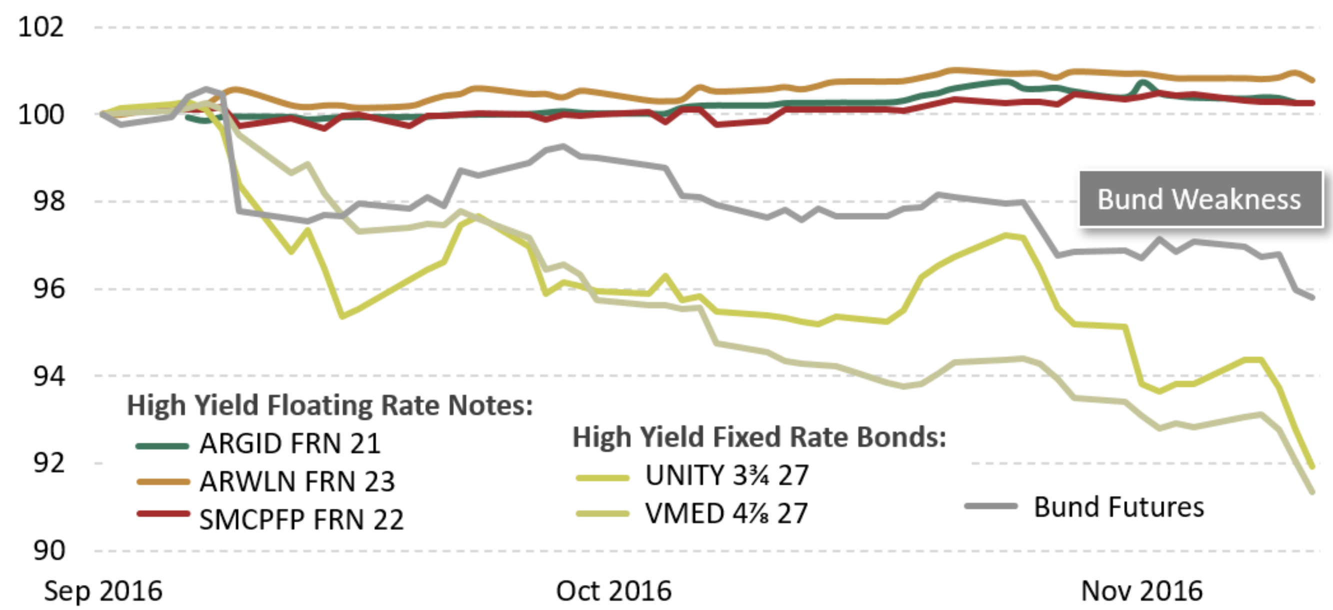


Source: Bloomberg (© 2016, Bloomberg Finance LP) and Bank of America Merrill Lynch indices

Since the beginning of September when we started to see German bund weakness, several FRNs with effectively zero years of duration actually gained slightly in value, while longer-dated, fixed-rate high yield bonds lost value due to elevated duration (see Chart 4).

Chart 4: As Bond Weakness Emerged, Some FRNs Gained Slightly

Rebased to 100; As of 11/11/2016



Source: Bloomberg (© 2016, Bloomberg Finance LP)

Conclusion

A selective allocation to FRNs can add diversification benefits over traditional high yield and other fixed-rate bonds, particularly under certain market conditions. Given their limited duration exposure, FRNs can potentially generate significant outperformance in times of duration weakness. Similarly, reduced allocations when rates are falling would be justified. Lastly, the recent surge in new issuance, which we expect to continue, should provide an expanded opportunity set and increased liquidity.

William Vaughan initiated the concept and contributed significantly to this article. He is a research analyst on the Global Credit team and is based out of the London office of Brandywine Global Investment Management (Europe).

[1]Source: Bloomberg; as of November 16, 2016

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