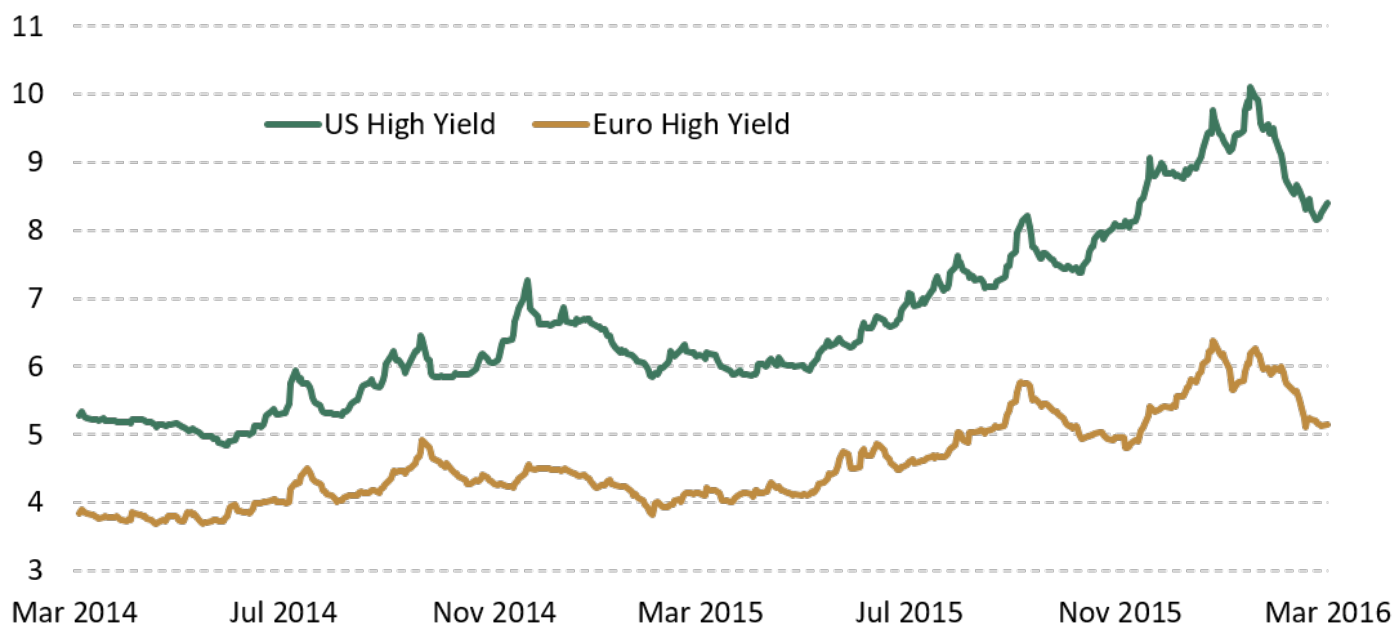


## Fast & Furious Start for Global High Yield, But Still Time to Buy?

The first quarter has been a roller coaster ride for credit. In three short months, investors were first jarred by the worst start of the year for global high yield, followed quickly by one of the best starts for a year. While the volatility was not unexpected, the velocity of the rally has been surprising. U.S. high yield (HY) continued its sell-off at the beginning of the year, with spreads widening out close to 200 basis points (bps) to breach 10% yield on Feb 11, 2016. The high yield weakness was a continuation of the overall widening trend that began with the historic yield lows from the summer of 2014, when average yield for U.S. HY was 4.8%, and European HY was at 3.7% (see [Chart 1](#)).

**Chart 1: U.S. HY (BAML Index) and European HY (BAML Index Spreads) 4/2014 to 3/2016**



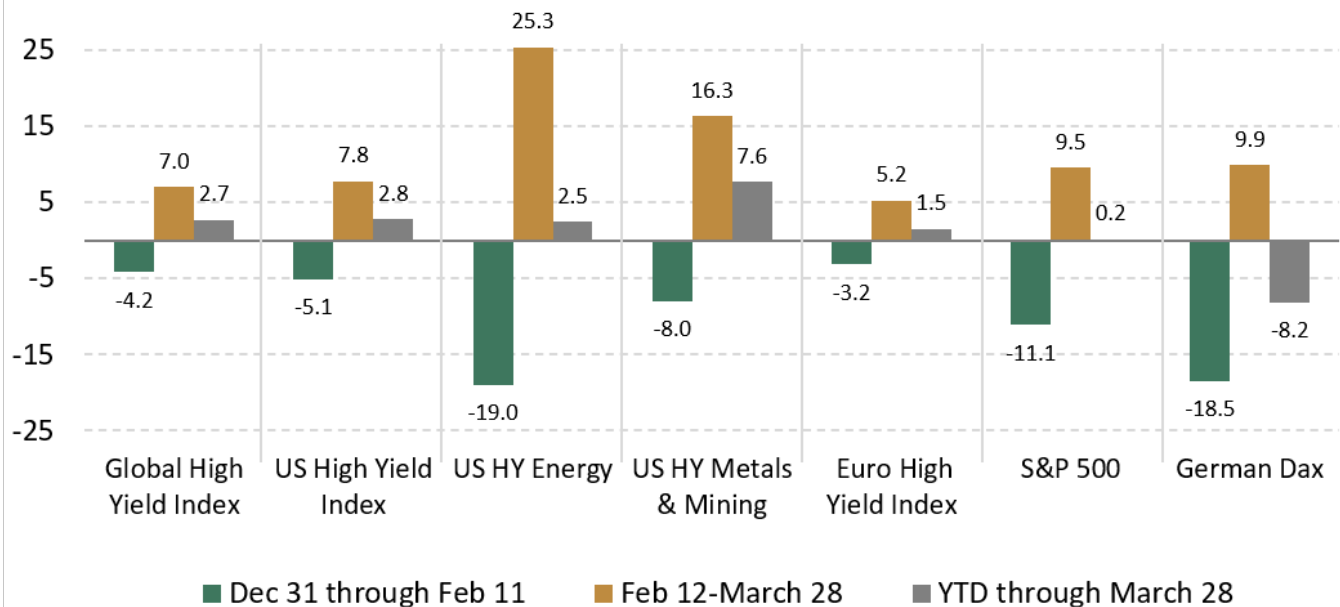
Source: Bloomberg (© 2016, Bloomberg Finance LP)

## Is High Yield Still a Buying Opportunity?

Most of the price correction centered on the more commodity related or stressed part of the U.S. HY market. If the sell-off was painful for investors who endured it, the first quarter rally may be just as painful for investors who missed it. Credit spreads at the beginning of February were already pricing in recessionary levels and higher default probabilities. With the combination of additional accommodative monetary policy from the major central banks, some U.S. dollar (USD) weakness, and some commodity price recovery, markets were positioned

for a reflationary move off the lows in mid-February.

**Chart 2: Recent Returns of Different Sectors** As of 3/28/2016

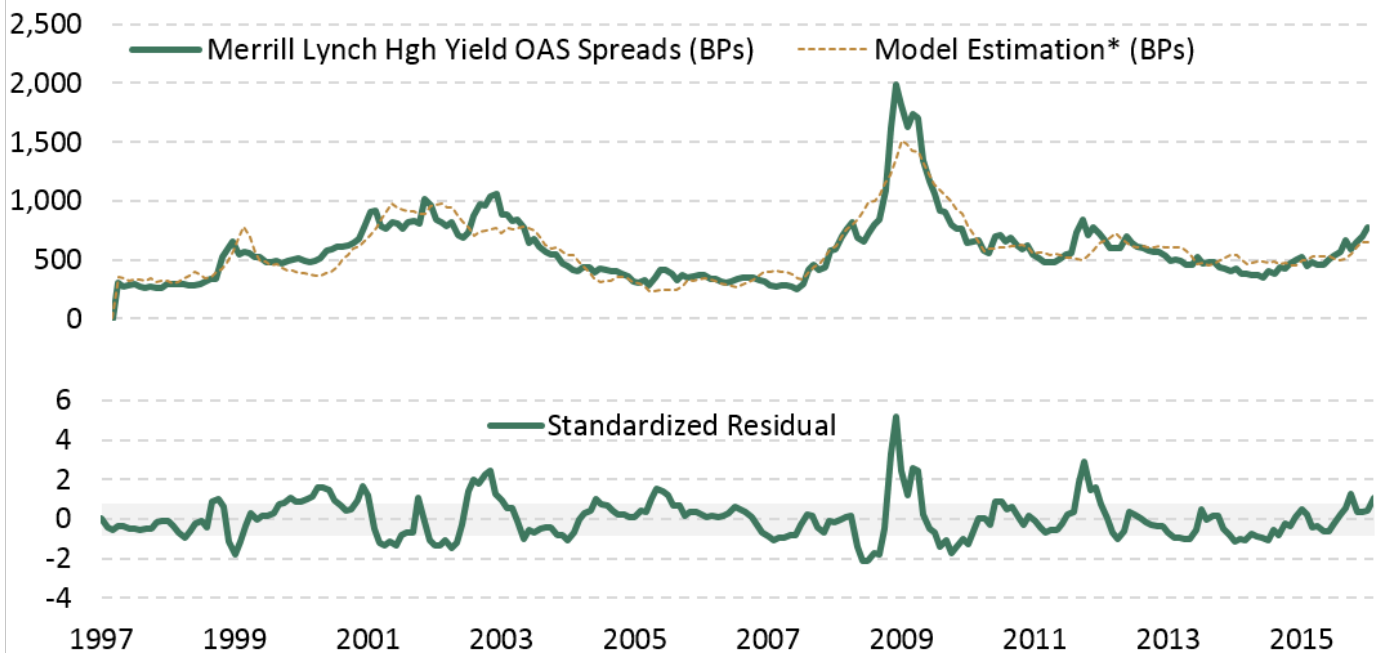


Source: Bloomberg (© 2016, Bloomberg Finance LP) and Bank of America Merrill Lynch

From Feb 12 through March 28, global HY rallied over 7% driven by U.S. HY within the energy and metals and mining sectors (see [Chart 2](#)). Considering the big rally, is HY still a buying opportunity?

Based on our multi-factor spread model, which uses 12-month trailing default rates, Federal loan survey data, industrial production, capacity utilization, and 5-year Treasury data, U.S. HY spreads are currently slightly cheap (see [Chart 3](#)).

**Chart 3: High Yield Spread Model** As of 2/29/2016

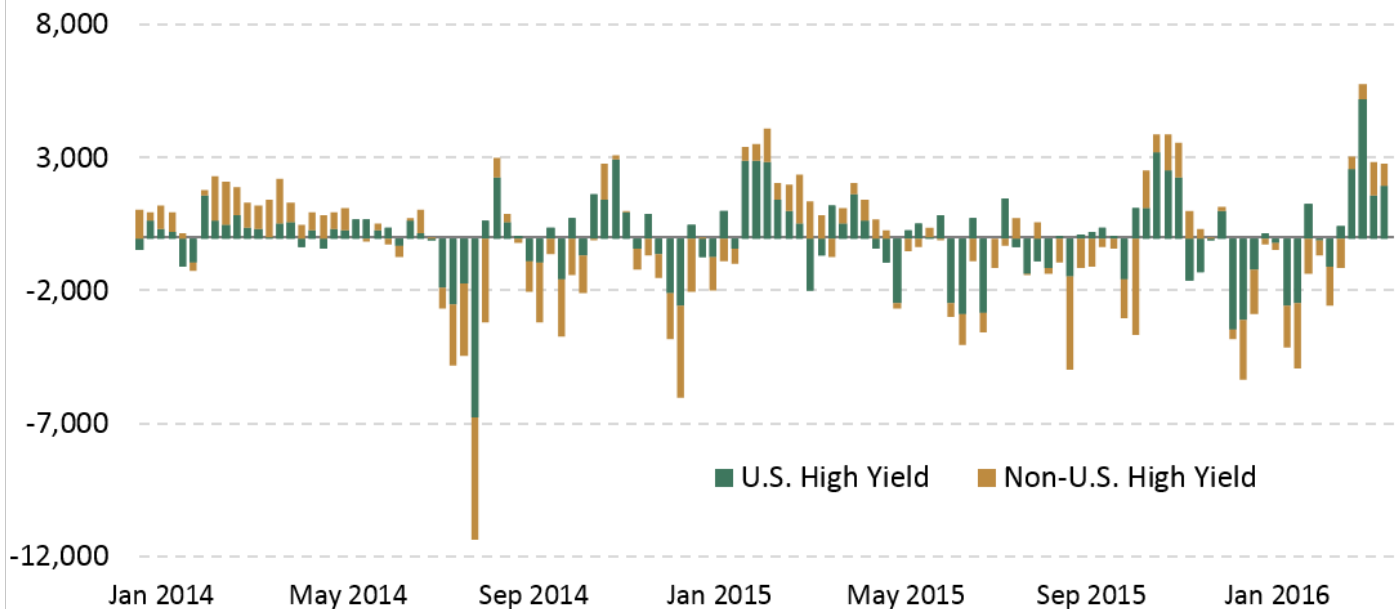


*\*Based on Fed loan survey, industrial production, capacity utilization, 12-month trailing default rate, and 5-year treasury*  
*Source: Thomson Datastream*

Even with the recent rally from February's lows, valuations continue to be relatively attractive, in our view. However, for a sustained rally, both fundamental and economic data need to improve. Many of the same issues which we have written about in our [past high yield blog posts](#) still persist: deflationary risks, too much leverage, [decreasing corporate profitability](#), concerns over [central bank policy actions](#), the presence of the later stage of the [U.S. credit cycle](#), and the continued rise of geopolitical risks.

Technical characteristics have improved in the short term, considering the record inflows globally for HY, the uptick in primary new issuance, and the positive side effects of the expansion of eligible assets for the European Central Bank's (ECB) purchase program into European non-financial investment grade (IG) corporate debt. In light of the record amount of global bonds currently trading in negative yield territory, it is not surprising to see inflows coming into higher-yielding sectors, such as HY and emerging markets. Over a recent four-week period, U.S. HY has gained a net \$11.5 billion from retail flows, the largest ever influx within a 4-week span for the asset class (see [Chart 4](#)).

Chart 4: Fund Flows



Source: Bank of America Merrill Lynch

## A Leg Up from the ECB

To further fight deflation and encourage lending, the ECB on March 10 announced the expansion of its current quantitative easing (QE) program. Additional policy tactics include the cutting of all key policy rates, the introduction of a new round of long-term refinancing operations, and the inclusion of corporate bonds in the central bank's purchase program. This development has already driven record IG corporate issuance and forced investors to focus on cross-over credit along with higher-quality European high yield. The new purchase program, referred to as the Corporate Sector Purchase Program, will start in June. Market expectations are for about €400 billion of corporate bonds to be considered eligible (i.e. non-financial, non-hybrid, corporate bonds established within the eurozone), although full details of implementation are not available yet. However, market consensus estimates that only about €5 billion in corporate purchases will likely be included per month out of the extra €20 billion of asset purchases, given market trading liquidity. We expect the rally in credit spreads to have already priced in some of the positive technical effects of a large additional buyer in the market. Another leg up for the strong performance will depend on continued fundamental credit improvement and better-than-expected implementation of the ECB's purchase program.

## In the U.S., Recalling the late 1990s

While the U.S. technically has not been in a recession, the asset price volatility and global market environment that we have seen is reminiscent of the late 1990s. From July 30, 1998, to mid-October 1998, after the Russian default and Long-Term Capital Management (LTCM) hedge fund debacle, U.S. HY spreads widened out over 300 bps to an average yield of 11.1%, posting negative returns of -8.7% during those few months. From this wide point, U.S. HY posted a 5.2% return in November. For the next 12 months after this recovery from the lows, the total return recorded was 1.7%. If this volatile time period stands as a reference for today's environment, investors may be wondering if U.S. HY will follow the same pattern.

In a negative yield world, the carry trade found in owning higher-yielding corporate bonds can be quite powerful. Even an average yield for Global HY of around 8% can make an attractive entry point for investors willing to weather through the volatility. We believe total returns likely will remain positive for the next 12 months unless spreads widen again by over 200 bps (see [Table 1](#)).

**Table 1: Hypothetical Total Return Matrix %**

		High Yield Risk Premium Spread Move						
Current YTW	8.00	-1.50	-1.00	-0.50	0.00	0.50	1.00	1.50
Risk-Free Benchmark Rate Move	-0.50	15.8	13.9	11.9	10.0	8.0	6.1	4.1
	-0.25	14.8	12.9	10.9	9.0	7.0	5.1	3.1
	0.00	13.9	11.9	10.0	8.0	6.1	4.1	2.2
	0.25	12.9	10.9	9.0	7.0	5.1	3.1	1.2
	0.50	11.9	10.0	8.0	6.1	4.1	2.2	0.2

Source: Bank of America Merrill Lynch; Brandywine Global Investment Management, LLC calculations

## Strapped In for the Ride

Since the only thing we know with certainty is that uncertainty will remain ahead, we continue to position our high yield strategies defensively, prepared for a bumpy ride. We are focused on higher-quality, high yield credits and IG corporate bonds that we believe can successfully navigate around the obstacles of weaker global growth and rising default trends. This year, we expect volatility across asset classes will continue given the deflationary risks, the large debt overhang, and the lingering questions about the efficacy of negative rates and other unconventional monetary policies. Fiscal and structural changes need to occur to manage through the large debt overhang globally and to help sustain growth across both the developing and emerging worlds. We prefer higher-quality, high yield European issuers and/or U.S. credits in non-cyclical, more resilient sectors, which we believe can weather through this challenging environment.

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