High-Yield Bonds in Rising Rates

It’s high yield and not high quality that tends to perform better in the bond markets as rates start to rise, says Morgan Stanley’s Richard Lindquist.

There are times when it might not pay to play it safe in the bond market, and one of those times is now, according to Richard Lindquist, a senior high-yield bond fund manager at Morgan Stanley Investment Management. When the Federal Reserve hikes rates, it’s the lower-quality bonds that tend to be the better-performing, fixed income assets, he argues, and that’s already evident. Since Donald Trump was elected in early November, U.S. Treasury bonds have suffered a dramatic sell-off, in anticipation that his fiscal spending plans will prompt more Fed rate hikes next year.

Between November 8 and December 31, 2016, U.S. Treasuries in aggregate have returned -2.63%, and investment-grade bonds have returned -1.82%. High-yield bonds, meanwhile, have returned 1.75%. And within the high-yield market, it’s the bonds on the lowest rung of the rating ladder—the single-B and triple-C names—that have performed the best.1

“If you are going to be in fixed income, then I believe the high-yield market will be one of the better places to be, and within that, the lower-rated credits,” argues Lindquist. U.S. high-yield bonds feel the impact of rising rates like other higher-quality bonds, but usually less so. That’s largely because they’re more influenced by the equity markets; their maturities are shorter and their coupons higher, says Lindquist.

1 U.S. Treasury Aggregate; IG: Bloomberg Barclays Corporate Index; HY: Bloomberg Barclays Corporate High Yield Index.
The Equity Factor
High-yield corporate bonds tend to see the initial round of rate hikes as a good thing, because it’s an improving economy that prompts them. “After the election, we saw much of the sector-based rotation occurring in the equity market spill over to our market,” says Jack Cimarosa, a senior member on Lindquist’s team. “Rentals, construction and basically anything tied to infrastructure traded well.”

The Shorter, the Better
The longer a bond’s maturity date, or duration, the more sensitive it is to rate moves. High-yield companies generally have shorter maturities than their higher-quality competitors. The duration of the Bloomberg Barclays U.S. Corporate High Yield Index is 4.13 years, for instance, compared with 7.10 years for the Bloomberg Barclays Investment Grade Corporate Index.²

Greater Potential for Income
Having a high yield means a higher coupon or interest payment. Since total returns are the price moves of a bond plus coupon payments, then the higher the coupon, the more able the bond is to absorb any decline in dollar price caused by a rate hike. The Corporate High Yield Index’s yield is around 6.12%, versus 3.37% for the Barclays Investment Grade Index.³

Going Down the Rating Ladder
To get the bigger coupons, Lindquist’s team focuses on the middle market—companies with $150 million to $1 billion in total debt. These companies are smaller and their bonds less traded than bigger deals, but they offer better yield.

“The rating agencies—falsely, we believe—give credit for size, so middle-market bonds are always slightly lower-rated than we feel they should be,” says Lindquist. He also prefers to overweight the lowest-rated parts of the market—single-B and triple-C names—where the yields are highest.

“Going into weaker credits would be a harder decision to make if defaults were rising, but we believe defaults will be contained, and might even fall over the next six to 12 months,” he says.

The entire high-yield market’s default rate is around 5.65%, but just 2.0% if energy, metals and mining sectors are stripped out.⁴

*Yield to Worst is the lowest yield an investor can expect when investing in a callable bond. A callable bond is one which gives the issuer the option to redeem the bond at a set date before maturity.

Source: Bloomberg Barclays Capital and JPMorgan

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DISPLAY 1
Attractive Yields with Low Duration

<table>
<thead>
<tr>
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<th>Yield to Worst* (YTW)</th>
<th>Duration in Years</th>
<th>YTW per Unit of Duration</th>
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</thead>
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<tr>
<td>U.S. High Yield</td>
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<td>6.1</td>
<td>0.0%</td>
</tr>
<tr>
<td>European High Yield</td>
<td>4.1</td>
<td>4.1</td>
<td>0.1%</td>
</tr>
<tr>
<td>Emerging Markets Sovereign</td>
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<td>6.1</td>
<td>0.1%</td>
</tr>
<tr>
<td>U.S. Mortgages</td>
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<td>6.1</td>
<td>0.0%</td>
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<tr>
<td>U.S. Investment Grade</td>
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<td>4.1</td>
<td>0.6%</td>
</tr>
<tr>
<td>U.S. Treasuries Aggregate</td>
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<td>4.1</td>
<td>0.8%</td>
</tr>
<tr>
<td>European Investment Grade</td>
<td>1.9</td>
<td>4.1</td>
<td>1.2%</td>
</tr>
</tbody>
</table>

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² Date: As of December 31, 2016.
³ As of December 31, 2016.
⁴ Moody’s Investors Service, as of December 31, 2016.
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The Bloomberg Barclays Pan-European High Yield Index covers the universe of fixed-rate, sub-investment-grade debt denominated in euros or other European currencies (except Swiss francs). This index includes only euro- and sterling-denominated bonds, because no issues in the other European currencies now meet all the index requirements. To be included, the bonds must be rated high-yield (Ba1/BB+ or lower) by at least two of the following rating agencies: Moody’s, S&P, Fitch. If only two of the three agencies rate the security, the lower rating is used to determine index eligibility. If only one of the three agencies rates a security, the rating must be high-yield. Bonds must have at least one year to maturity and an outstanding par value of at least €500 million euros. The index does not include non-rated bonds, and it excludes debt from entities in countries that are designated as emerging markets.

The JP Morgan Emerging Markets Bond Index Global (EMBI Global) tracks total returns for traded external debt instruments in the emerging markets, and is an expanded version of the EMBI+. As with the EMBI+, the EMBI Global includes U.S. dollar-denominated Brady bonds, loans and Eurobonds with an outstanding face value of at least $500 million.

The Bloomberg Barclays Mortgage Index covers the mortgage-backed, pass-through securities of Ginnie Mae (GNMA), Fannie Mae (FNMA) and Freddie Mac (FHLMC). This index is the mortgage-backed securities, fixed-rate component of the Barclays U.S. Aggregate Index.

The Bloomberg Barclays U.S. Corporate Index is a broad-based benchmark that measures the investment-grade, fixed-rate, taxable, corporate bond market.

The Bloomberg Barclays U.S. Treasury Index includes public obligations of the U.S. Treasury.

The Bloomberg Barclays Euro Aggregate Corporate Bond Index measures the investment-grade, euro-denominated, fixed-rate bond market of corporate issues. This index is the corporate bond component of the Bloomberg Barclays Euro Aggregate Bond Index.

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