When extraordinarily low yields have left investors nearly starved for income, U.S. high yield bonds may offer the best way to fill the void. For investors comfortable with the potential default risk associated with high-yield bonds, we believe the U.S. high yield sector opens up a "needle in a haystack" opportunity, unless interest rates globally rise sharply.

Even after this year's rally through September 30—during which the BofA Merrill Lynch U.S. High Yield Master Index gained 15.3% and the European Currency High Yield Constrained Index rose 8.2%—the yield for the U.S. high-yield sector remains about 200 basis points higher than the European high-yield sector.

The driving factor behind this spread was the very sharp decline in the price of oil, particularly at the end of 2015. With energy issues accounting for about 14% of the U.S. high yield sector vs only 6-7% of the European high yield sector, the spread between the two regions widened considerably in 2015. Since then, however, oil prices appear to have stabilized. Yet, as Display 1 shows, the spread between European and U.S. high yield sectors remains wide.

The yield differential was justified... As oil prices fell, default rates in the energy sector rose sharply in 2015. Whereas the overall U.S. par default rate for high yields was 5.26% in August, it was markedly higher in the energy sector at 21.67% (Display 2).

Source Bank of America Merrill Lynch
There are indications, however, that the default rate may have reached a peak. The distress ratio—the number of distressed securities divided by the total number of speculative-grade issues—peaked in May and has since declined. And, in fact, BofA Merrill Lynch forecasts the default rate to peak in Q4 2016 at 5.9% in November 2016, and then gradually fall back to its long-term average of 4.5% in Q2 2017.

...but is no longer

We believe the spread, initially justified, now presents an opportunity. We believe that, the distress ratio is coming down because commodities have improved, the global economy is reasonably healthy and the oil price has stabilized. The risk of oil prices falling again seems to be significantly lower than it was last year, as oil producers discuss restricting output. Even with skepticism as to whether they can succeed in controlling production, at least it’s unlikely that they’re going to start pumping madly at this point.

At the same time, the global economy continues to chug along. The IMF recently announced a 3% global growth rate, which makes a sudden drop in demand unlikely. With a combination of reasonable growth, stable demand, and either a decreased or constant supply, the price of oil is likely to remain roughly in its current range, if not higher. And a stable oil price suggests that we are likely to see a less negative outlook for default rates.

The 11-month lag

We have found that the energy sector default rate is negatively correlated with the price of oil (meaning it generally moves in the opposite direction of oil prices). This relationship holds true with a fairly standard lag of about 11 months. In other words, it has taken about 11 months for the fall in oil to cause a rise in defaults. Given that the price of oil bottomed on February 11, 2016, we might then expect defaults to peak 11 months later—or right about the end of 2016.

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2 Distressed securities include securities already in default, under bankruptcy protection, or in distress and heading toward such direction. A generally acceptable guideline is that bonds trading with a yield in excess of 1000 bps over the risk-free rate of return, such as the U.S. Treasuries, are considered distressed.
The stabilization of the oil market, combined with a healthy global economy, reinforces the notion that default rates may well be at or near their peak. If they do begin to decline, the spread between U.S. and European high yield issues will likely normalize toward historical levels.

Display 3 shows the option-adjusted spreads (OAS) on different high yield indices. As expected, the improvement in global markets has brought spreads down, but there has been a laggard: U.S. high yield. Whereas the OAS on emerging markets vs U.S. and emerging markets vs EU has compressed to levels that prevailed before the oil price drop in June 2014, the U.S. vs EU spread remains elevated. If we expect this to revert to a more historical level, or to decline commensurately with the other two, it would indicate that there is still some upside potential.

This difference is likely due to continued concerns about the energy sector and its outlook. But the evidence we have, in terms of oil prices and producer behavior, all suggests that the oil price is probably stable rather than falling.

**Drilling down into the oil price**

The requirement for this spread trade to work is that oil prices don’t drop—they don’t have to go up, just remain stable—so it’s worth drilling down into the cause of the fall in 2014 and 2015. It appears that OPEC tried a deliberate strategy of bankrupting the non-OPEC producers, most notably in Russia and the U.S. This was a policy that worked in the past, because the long timescale of exploration and capital investment meant that if high cost producers could be put out of business for a significant period of time, they simply wouldn’t be able to restart their operations once they closed them down.

The shale oil revolution changed that. Shale oil can be turned on and off much more quickly. And so OPEC’s strategy backfired. It did cause default rates to rise, but as soon as prices climb to levels where it becomes profitable for shale oil producers—probably somewhere in the $50 range, and dropping due to constant technological improvements—they will be able to ramp up production again. In addition, oil producers’ budgets generally assumed a price of oil at $100 or above. With two years of significantly lower prices, many energy producers—including the traditional swing producer, Saudi Arabia—have been under budgetary pressures that make any cuts in production quite painful, regardless of price.

The end result was simply that OPEC lost its ability to control the price of oil. Without OPEC’s cartel influence, oil prices are being set by economic considerations like the marginal cost of production, which is why we think there’s a fair amount of stability within a volatile range for oil prices at the present time.

**The cushion of the coupon**

The potential opportunity we see in U.S. high yield derives largely from the larger “coupon cushion” offered by higher coupons in the U.S. The cushion comes into play when rising interest rates cause a decline in the bond’s value: An investor will lose money on the bond position but still collect the coupon assuming that the issuer does not default on their obligation to pay the income. This can help offset the blow from rising rates. The coupon cushion could generally be defined as the percentage point rise in yield that would cause a price decline large enough to wipe out one years’ worth of income on the bond.

The coupon cushion is 1.5% in the U.S., but it’s only 1.1% in Europe—meaning there is more room for yield to widen in the U.S. before income is wiped out.

**Issuance**

As we’ve discussed in recent articles, this is a poor time for high quality bonds. If you avoid governments, you naturally look at high-grade corporate bonds, but their large volume is potentially saturating the market. Looking at high yield, on the other hand, new issuance in 2016 so far is about 12% lower than same period in 2015, most of which is for refinancing. This low issuance—again, most likely due to concerns about the energy sector—may provide support to the price level in the current low-yield environment. And while fund flows into
U.S. high yield have been positive YTD, they are nowhere near extreme levels.\(^3\)

Across major regions, here are our views:

**U.S.: UPBEAT OUTLOOK FOR HIGH YIELD**
If U.S. high yield credit presents an opportunistic needle in a haystack of low yield, how much should investors worry about the pending U.S. elections? We expect the spread to hold regardless of who wins, and our expectations follow the polls in giving Hillary Clinton the better odds. But a Donald Trump presidency would likely be somewhat more positive for the energy sector. He appears to be more supportive of traditional energy sector than Clinton, given that he shows little regard for the issue of climate change. Also, Harold Hamm, the chairman of Continental Oil, was mentioned as a potential candidate as his energy secretary. So in the less-likely event that Trump wins, the outlook for the U.S. energy sector could be marginally better.

**EUROPE: A RISKIER PROPOSITION**
While the very visible risks to the U.S. energy sector are decreasing, the risks for European high yield may actually be growing. The ECB may soon be cutting back on its QE program, and the European financial sector faces the fallout on a number of fronts: Deutsche Bank is facing steep fines and banking system reforms—including recapitalization and consolidation, particularly in Italy—also weigh heavily. These factors, though they affect mostly investment-grade bonds, add uncertainty and stress to European credit. If these risks are rising as the risks of default in the U.S. energy sector are falling, this again makes the case for more U.S. exposure versus Europe.

**EMERGING MARKETS: LESS VULNERABLE**
The IMF has recently raised the growth rate for emerging markets, and the outlook for them looks better than it has been for a while. The IMF sees them as being less vulnerable to economic setbacks than developed markets.

**JAPAN: WEAKENING YEN**
In Japan, the weakening yen helps the export sector. There is also the possibility of more stimulus. On the negative side, the benefit of low energy prices has played out and is now being whittled away by the appreciating yen.

**CHINA: ON TRACK**
China’s economy continues on track, confirmed in part by the latest positive PMI report. With the population in rural areas of China spending over 30 percent of their budget on food\(^4\), a sharp or sustained rise in food prices has the potential to cause serious problems. So far, though, food inflation remains in check, and the government shows no sign of losing control.

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\(^3\) Source: EPFR as of September 28, 2016

\(^4\) Washington State University, Washington State Magazine; sm.wsu.edu/researcher/wsmaug11_billions
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