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High Yield Market Update

For professional investors only

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A cocktail of negative headlines has lead to market turbulence. Headlines on sovereign stress in Europe, disappointing debt ceiling discussions in the US and the downgrade by S&P that followed, disappointing macro news and some companies missing earnings estimates have been dominating the news and caused hefty market reactions. In this note we want to share with you the impact the string of events had on High Yield markets and update you on our view on this market segment.

What happened?

The rating on long-term sovereign debt of the US has been cut from AAA to AA+. Although S&P's decision to do so did not come as a surprise to the market, it fuelled further uncertainty among investors. Timing of the news was rather unfortunate and it turned out to be the straw that broke the camel's back. High Yield markets are not the most liquid markets by nature and, as sentiment turned sour on the back of the negative headlines, liquidity deteriorated significantly. After a few weeks of sluggish trading at the second half of July, brokers' trading books were already fully packed and did not have much room to absorb a further sell-off by investors. Triggered by a weekend of bearish press reports a large number of retail clients started to sell their holdings in mutual funds. As there was virtually no one able to absorb the sudden supply this resulted in an unprecedented collapse of the high yield bond markets. Luckily comments made by Bernanke on Tuesday did not disappoint markets too much and were able to stabilize the markets somewhat.

Macroeconomic outlook: double dip unlikely

Despite the renewed worries about the US economic recovery we still believe that a double dip scenario is unlikely. In our latest credit quarterly outlook we warned for the rubber band syndrome that many US economists are suffering from. In our view the economy will not just bounce back easily after a soft patch because of pent up demand or investment plans. We are in a phase of a multi year debt adjustment and the government has not even started this process of debt reduction themselves. A sustained period of below par growth still seems to be the most likely outcome for both the US and Europe. If anything increased uncertainty will further fuel conservative behavior by corporate management. Mergers and acquisitions will be postponed, company cash balances are likely to remain high or will solely be used to reduce leverage further. This is good news for the investor in corporate bonds.

Our view on high yield remains unchanged

We firmly believe high yield bonds offers an interesting asset class for investors and should be part of portfolio for any long-term investor. We do not only like the high yield market because of its attractive risk-return characteristics compared to other asset classes. Especially long-term investors are able to collect the liquidity premium that a smaller market segment offers by nature. Periods of elevated illiquidity like now can even offer an interesting buying opportunity for those, more contrarian, long-term investors. Those who dare to invest now are able to buy attractive assets at extremely attractive levels. Additionally, the high yield market is in general less sensitive to somewhat weaker macroeconomic news we have recently seen. Less so than equity markets, high yield does not necessarily depend on strong economic growth as the oxygen for solid positive total returns. This dependency is much stronger for the equity markets. Cash flow generation, leverage and profit margins are the most relevant factor to judge the ability of issuers to pay back coupon and notional in the corporate bond market. As free cash flow generation is very healthy, many companies are cash rich, profit margins are still at impressive near record levels, we expect defaults to remain at their current low level. As this argument might not hold for companies that are highly levered, we continue to be very cautious with CCCs, the only segment of the high yield market that, similar to the equity markets, needs economic growth in order to survive.

The announcement by the Federal Reserve to keep rates at their current low levels for at least another 2 years bodes well for the total return potential offered by high yield. In combination with spread levels back at around levels last seen in August 2009 at 650bp, good prospects for spread compression, low default rates, total returns could reach double digit levels over the next 12 months.