Could the Surprising Performance of High-Yield Bonds Continue?
December 22, 2016
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In a surprise to most investors, myself included, high-yield bonds outperformed large-cap stocks for the year to date through November 30, 2016.

15.2% BofA Merrill Lynch High Yield Master II Index
7.6% S&P 500 Index

Returns year to date through November

Past performance is no guarantee of future results.

Index definitions

Moreover, high-yield bonds outperformed investment-grade debt during the fixed-income sell-off after the presidential election in November. The BofA Merrill Lynch High Yield Master II Index ended November with a -0.39% return, as compared with a -2.37% for the Bloomberg Barclays U.S. Aggregate Bond Index, a broad measure of the investment-grade bond market.

Looking at high-yield performance in another way, spreads—the difference in yield between high-yield bonds and comparable maturity U.S. Treasuries—fell steadily from the beginning of the year. Spreads are now close to their long-term average, pushed lower in part by investors’ continuing hunger for yield in what is still an historically low-yielding environment.

The yield differential between high-yield bonds and comparable maturity Treasuries has narrowed, supporting high-yield prices.

Sources: Bloomberg, BofA Merrill Lynch.
Dates: 1-29-07—11-30-16
* 100 basis points equals 1.00%

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Strong fundamentals could support the income return going forward
The high-yield bond market received support from relatively low default rates. Although the U.S. speculative-grade default rate hit a six-year high of 4.79% in September, according to S&P Global Fixed Income Research, most of the weakness was in the energy sector because of continued low prices for oil and natural gas. Excluding energy and natural gas companies, ratings agency Standard & Poors calculated that the U.S. default rate was a significantly lower 2.44%.

**The three Rs dominated high-yield bonds issuance in 2016—**

- redeeming existing bonds
- repaying banks
- refinancing outstanding debt

—allowing companies to lower costs or extend maturities.

Just as encouraging is how companies used the money they raised in the high-yield bond market. Throughout 2016, what I call the **three Rs** have dominated—most issuance has been to redeem existing bonds, repay banks, or refinance outstanding debt. This means that companies aren’t increasing debt, but rather lowering costs or extending maturities. Historically, the high-yield bond market has tended to run into problems when a number of bonds near maturity at the same time or when companies suffer a liquidity squeeze because bank lines are cut off. The **three Rs** could provide future support for the high-yield market, even at these low yield levels.

On the whole, I remain positive on the high-yield market, although I don’t expect the same level of appreciation going forward. I continue to think we’ll see mid-single digit returns—earning the coupons and not losing much to bankruptcies outside of the energy sector. But bond prices are relatively high, with the average price of the market falling just under par (which is 100). I therefore don’t see much of an opportunity for capital appreciation going forward.

**Outlook**

Macroeconomic conditions seem to put the high yield bond market in a 1% to 2% world. U.S. economic growth ranged between 1% and 2% from the second quarter of 2015 to the second quarter of 2016, and I think it’s possible that growth could remain in that general range in the near term. Likewise, U.S. Treasury rates are falling within the range of 1% of 2%, with the exception of short-term Treasury bills, and the U.S. inflation rate has remained below 2%. Against that backdrop, Federal Reserve (Fed) Chair Janet Yellen telegraphed that the Fed remains data dependent. The Fed is likely wary of raising its key rate too quickly for fear of sparking an adverse market reaction that could bleed into the real economy.

In such an environment, I would be more willing to pick up additional yield by purchasing a longer-duration bond than take on default risk by going down in quality. At the end of the day, generating good returns in the high-yield bond market is about collecting income and protecting principal. Although I don’t foresee a near-term credit crisis, a substantial rise in interest rates might be even more unlikely.

**Original blog post**

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