

The wonderful benefits of High Yield in a rising rate environment

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The High Yield asset class introduces a number of positive characteristics to portfolios in a rising rate environment, namely low correlation to traditional Fixed Income, equity like performance with lower volatility and positive total returns.



Michalis Ditsas
Investment Specialist

“High Yield introduces a number of benefits to portfolios in a rising rate environment that can result in positive total return.”

It's common knowledge that rising interest rates impose challenging times on traditional Fixed Income instruments. But not all FI asset classes are born equal; High Yield bonds, even though part of the fixed income family, have historically produced consistently attractive returns through a range of market conditions. The reason behind this exists partly in the relationship between high yield, traditional fixed income and equities.

High yield's long term correlation with 5-year and 10-year Treasuries has been negative. Equivalently, the correlation to equities is positive and above 0.70, indicating that high yield returns behave more like equities than bonds (table 1). This particular characteristic emphasizes the diversification benefit of allocating to high yield as part of a strategic allocation.

Table 1: Ten-year correlation of various assets

| | 5-year Treasury | 10-year Treasury | JPMorgan MBS Bond Index | LB Aggregate Bond Index | JPMorgan JULI High-Grade Index | JPMorgan US HY Index | S&P 500 | Wilshire 5000 | Russell 2000 | JPMorgan EMBI-Global Composite | Dow Jones World EM Stock Index | Gold | US Inflation |
|--------------------------------|-----------------|------------------|-------------------------|-------------------------|--------------------------------|----------------------|---------|---------------|--------------|--------------------------------|--------------------------------|-------|--------------|
| 10-year Treasury | 0.91 | | | | | | | | | | | | |
| JPMorgan MBS Bond Index | 0.8 | 0.8 | | | | | | | | | | | |
| LB Aggregate Bond Index | 0.74 | 0.81 | 0.82 | | | | | | | | | | |
| JPMorgan JULI High-Grade Index | 0.4 | 0.49 | 0.54 | 0.81 | | | | | | | | | |
| JPMorgan US HY Index | -0.27 | -0.26 | 0 | 0.23 | 0.56 | | | | | | | | |
| S&P 500 | -0.33 | -0.32 | -0.12 | 0.04 | 0.31 | 0.72 | | | | | | | |
| Wilshire 5000 | -0.33 | -0.32 | -0.12 | 0.05 | 0.31 | 0.72 | 1 | | | | | | |
| Russell 2000 | -0.38 | -0.37 | -0.21 | -0.05 | 0.23 | 0.68 | 0.91 | 0.93 | | | | | |
| JPMorgan EMBI-Global Composite | 0.17 | 0.22 | 0.42 | 0.61 | 0.79 | 0.76 | 0.58 | 0.58 | 0.48 | | | | |
| Dow Jones World EM Stock Index | -0.21 | -0.21 | 0 | 0.19 | 0.5 | 0.8 | 0.81 | 0.81 | 0.73 | 0.75 | | | |
| Gold | 0.4 | 0.35 | 0.44 | 0.43 | 0.37 | 0.17 | 0.03 | 0.04 | 0.01 | 0.4 | 0.26 | | |
| US Inflation | -0.35 | -0.4 | -0.34 | -0.3 | -0.24 | 0.28 | 0.15 | 0.16 | 0.18 | 0.04 | 0.12 | -0.02 | |
| Leveraged loans | -0.46 | -0.44 | -0.16 | 0.01 | 0.32 | 0.89 | 0.6 | 0.61 | 0.57 | 0.54 | 0.65 | 0.01 | 0.42 |

Source

J. P. Morgan, Bloomberg. Date as of: November 30, 2017

The above behaviour is evident in table 2, where in the medium to long run high yield performs similarly to equities, but with the benefit of almost half the volatility. This indicates that investors benefit from holding high yield as a complement or substitute for equities. This is true even at the worst case scenario of a default, as high yield is senior in the capital structure vs. equities.

Table 2: Average annual returns and volatility

| | Average annual returns | | | | | |
|----------------------|------------------------|---------|---------|----------|----------|----------|
| | 1 year | 3 years | 5 years | 10 years | 15 years | 25 years |
| US dollar HY Global | 10.10% | 6.17% | 6.26% | 8.20% | 9.17% | na |
| JPMorgan US HY Index | 9.54% | 5.99% | 6.31% | 8.24% | 9.06% | 8.12% |
| S&P 500 | 22.87% | 10.86% | 13.71% | 8.29% | 9.39% | 9.69% |
| Russell 2000 | 18.32% | 11.11% | 15.00% | 8.79% | 10.82% | 9.65% |

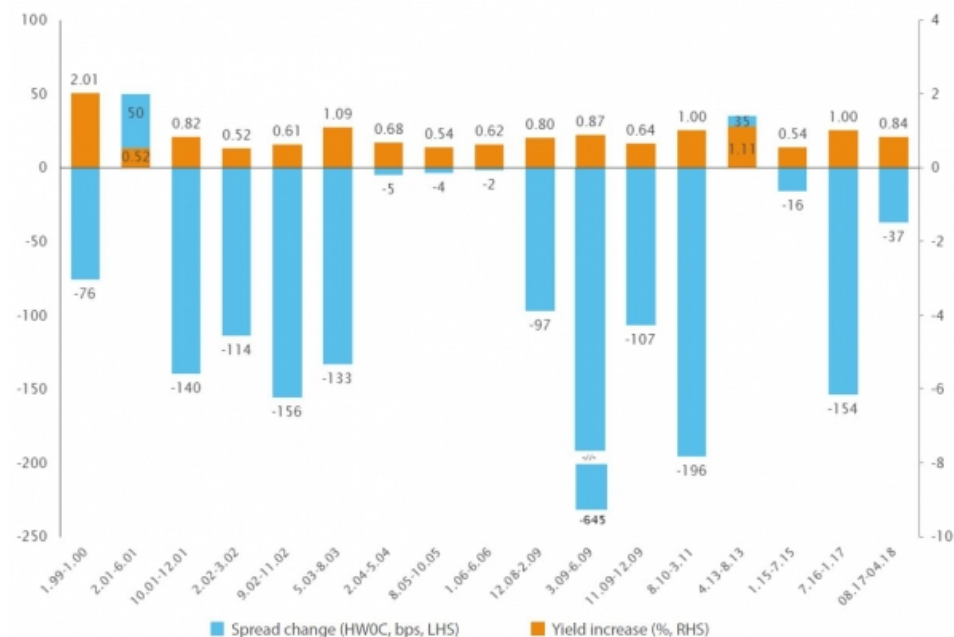
| | Average annual volatility | | | | | |
|----------------------|---------------------------|---------|---------|----------|----------|----------|
| | 1 year | 3 years | 5 years | 10 years | 15 years | 25 years |
| US dollar HY Global | 2.43% | 5.93% | 5.94% | 10.22% | 8.76% | na |
| JPMorgan US HY Index | 2.54% | 5.94% | 5.55% | 10.04% | 8.63% | 7.77% |
| S&P 500 | 9.90% | 10.10% | 9.53% | 13.09% | 13.31% | 14.18% |
| Russell 2000 | 7.71% | 14.14% | 13.93% | 19.87% | 18.30% | 18.57% |

Source

J. P. Morgan, Bloomberg. Date as of: November 30, 2017

So high yield is positively correlated to equities and exhibits less volatility, but how does it behaves in periods of interest rate hikes? Assuming a 50bps yield increase in yields and no spread tightening, the high yield market would sell-off approximately by half the amount of its duration, i.e. 2%. Historical data though shows that since 1999 there were 17 periods of rising interest rates of 50bps or more, out of which in 15 of those periods high yield bonds spreads tightened (Chart 1). More specifically, for an average yield increase of 85bps, the average spread tightening is approximately 70bps.

Chart 1: High Yield bonds posted positive returns in 15 out of 17 periods of rising rates



Source
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The reason for this result is that a rate sell-off is generally associated with an expansion in economic activity and conditions, that in turn improves credit fundamentals.

Equally important, high yield bonds provide an extra return cushion: coupons. Currently the yield to call (YTC) for the US high yield market is approximately 6.7%. Returning to the example above, when yields rise by 50bps the high yield market performance will be lowered by approximately one percent when accounting for the spread tightening. By taking into account the coupon, it would take less than two months to return enough income to offset the price decline.

History has shown that high yield performs well in rising rate environments, which is also true this year with the US high yield market posting a 2.5% return despite the multiple rate hikes by the Fed. Combine this with the positive characteristics of the sector, namely historically low default rates, declining leverage ratios, high interest coverage and low issuance and its easy to conclude that high yield can remain a positive generator of performance and an overall portfolio diversifier.

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