DoubleLine News

High Yield Signals Trouble

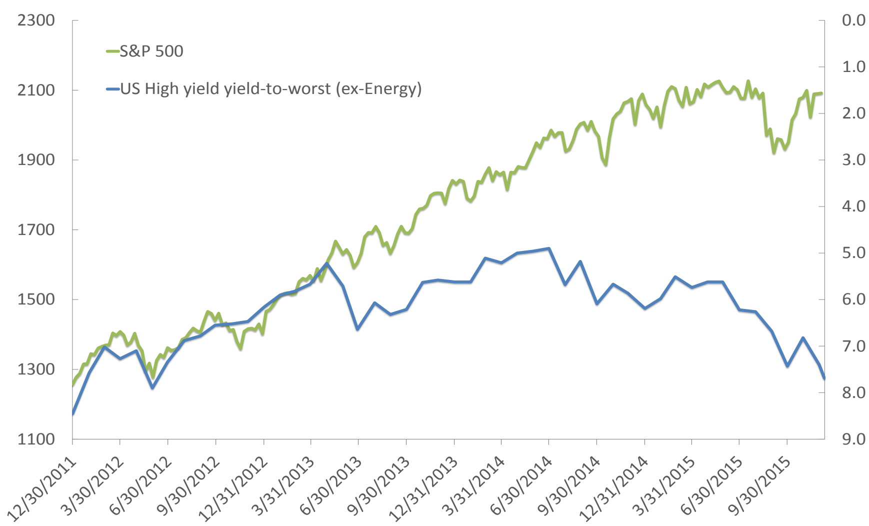
As of December 11, 2015

By: Ted Hospodar, CRPS
Hunter Downs, CFA

Over the past twelve months there has been a growing divergence between the performance of high yield corporate bonds and U.S. equities. Given the historically strong correlation between these two markets, we believe this divergence is a warning sign to market participants. High yield corporate bond spreads reached their tightest levels in June 2014 and have since continued to widen even though equity markets have continued to rally. What are investors to make of this unusual divergence between these two asset classes which are normally highly correlated?

With respect to high yield debt issued by U.S. corporations, the biggest concerns are companies whose fortunes have been battered by falling commodities prices. The Energy sector, approximately 15% of the high yield corporate market, is down 12.9% according to Barclays. However, this is not the only sector facing headwinds as shown by Figure 1, which illustrates how high yield spreads have continued to widen even without factoring in the energy sector.

Figure 1: S&P 500 Index and U.S. High Yield Spreads (ex Energy)
December 30, 2011 through December 4, 2015



Source: Datastream, JP Morgan

If oil remains below $50 per barrel and earnings of non-energy companies continue to weaken, we could see defaults pick up as contagion could spread from energy to other sectors. Also, we believe that many investors fail to appreciate the fact that the entire existence of the high yield corporate bond market has coincided with a secularly declining interest rate environment. Since the inception of the high yield corporate bond market, as we know it today, in the early 1990s, the high yield corporate bond default rate averaged approximately 4%. This creates significant uncertainty regarding what defaults could look like in a secularly rising rate environment.

The U.S. default rate, at just 2.8% in October according to Moody's, is still low, but looks set to rise given today's rapidly increasing level of distressed corporate debt. Distressed debt is typically defined as debt trading with a spread to U.S. Treasuries in excess of 1,000 basis points. The question now is how much further spreads will widen and how the market will react to a potential tightening in monetary policy. Although a tighter monetary policy cycle may just be starting, the credit cycle is much more advanced and volatility is rising. That could potentially mean a continued rough ride for high-yield corporate bonds unless economic growth picks up markedly.

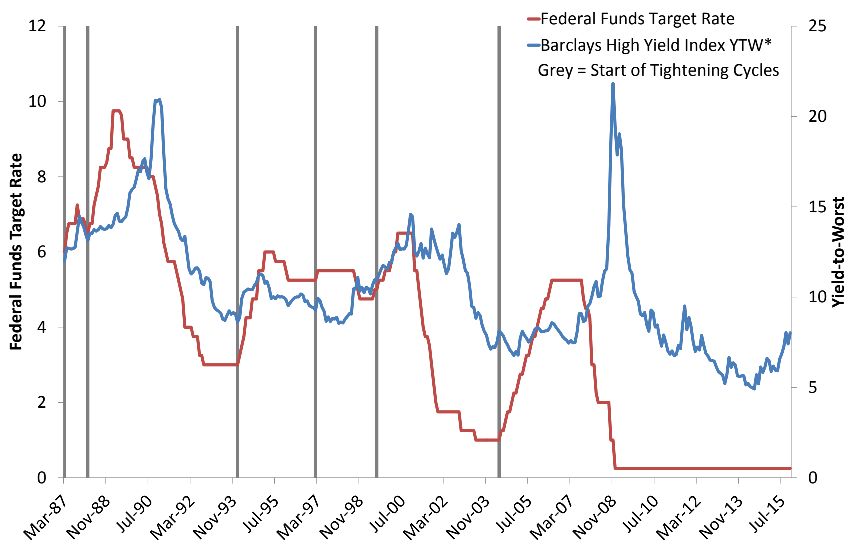
While borrowing costs for all high yield corporate issuers have risen, the difference between the yield on debt rated in the CCC tier, versus better-quality borrowings with BB credit ratings, has widened to a five-year high of

9.45% from 5.73% in March according to the Bank of America Merrill Lynch U.S. Cash Pay High Yield Index. This environment typically makes it more difficult for debt-laden companies to access capital markets. Returns have been poor in the U.S., with the Barclays U.S. High Yield Index down over 3.0% year-to-date. So even though higher yields do make the asset class more attractive to investors, but they may also reflect building headwinds.

This is not the first time high yield corporate bonds have given a sell signal. As was the case in early 2000 and late 2007, through November high yield has underperformed both investment grade corporate bonds and equities over a trailing 12-month period. If high yield corporate bonds comprise an asset class that resides between investment grade and equities in terms of volatility, then one would normally expect it to underperform either investment grade or equities, but not both.

Figure 2 provides another perspective on why one may want to strongly consider exercising caution with regard to high yield corporate bond exposure at the beginning of a tightening cycle. The graph depicts two mini-tightening cycles, represented by the end of the Federal Reserve's Quantitative Easing ("QE") program. When both QE1 and QE3 ended in early 2010 and late 2014, respectively, U.S. Treasuries proved to be better investment alternatives versus high yield bonds. In our estimation, one may want to consider reallocating out of high yield and buying U.S. Treasuries during the beginning of a tightening cycle. Support for this argument lies in lackluster global economic growth, negative corporate profit growth year-over-year, and slowing industrial production. These economic factors are not conducive to tighter monetary-policy, which could become a strong headwind for high yield bonds.

Figure 2: High Yield Credit Spread & Fed Funds Rate
March 31, 1987 through November 30, 2015



Source: Bloomberg, DoubleLine
*YTW = Yield-to-Worst

Due to attractive spreads and lower prices, many asset managers have increased their exposure to high yield corporate bonds, believing they have found attractive entry points. At DoubleLine, in addition to adhering to rigorous credit selection criteria and active management, we have continued to reduce high yield corporate bond exposure since June across our open-end multi-sector fixed income portfolios. We anticipate high yield bonds will remain an underweight in DoubleLine's multi-sector fixed income portfolios for the foreseeable future, especially as the probability of a Fed rate hike continues to grow. The probability for a December rate hike, as measured by the futures market, sits at 80% as of December 10, 2015. Higher Treasury rates and higher spreads to Treasuries means higher borrowing costs which would be a 'double whammy' for the high yield corporate bond market. As such, the unusual divergence between the high yield corporate bond market and equities appears poised to continue. Just because something is cheap doesn't mean it's a deal.

Disclaimers

Definitions

Barclays U.S. High Yield Index covers the universe of fixed rate, non-investment grade debt. Eurobonds and debt issuer from countries designated as emerging markets (e.g. Argentina, Brazil, Venezuela, etc.) are excluded, but Canadian and global bonds (SEC registered) of issuers in non-EMG countries are included. Original issue zeros, step-up coupon structures, 144-As and pay-in-kind (PIK, as of October 1, 2009) are also included.
Bank of America Merrill Lynch U.S. Cash Pay High Yield Index tracks the performance of below investment grade corporate debt currently in a coupon paying period. Eurobonds and debt issuer from countries designated as emerging markets (e.g. Argentina, Brazil, Venezuela, etc.) are excluded, but Canadian and global bonds (SEC registered) of issuers in non-EMG countries are included. Original issue zeroes, step-up coupon structures, 144-As and pay-in-kind (PIK, as of October 1, 2009) are also included.

One cannot invest directly in an index.

Important Information Regarding This Report

Issue selection processes and tools illustrated throughout this presentation are samples and may be modified periodically. Such charts are not the only tools used by the investment teams, are extremely sophisticated, may not always produce the intended results and are not intended for use by non-professionals.

DoubleLine has no obligation to provide revised assessments in the event of changed circumstances. While we have gathered this information from sources believed to be reliable, DoubleLine cannot guarantee the accuracy of the information provided. Securities discussed are not recommendations and are presented as examples of issue selection or portfolio management processes. They have been picked for comparison or illustration purposes only. No security presented within is either offered for sale or purchase. DoubleLine reserves the right to change its investment perspective and outlook without notice as market conditions dictate or as additional information becomes available. This material may include statements that constitute “forward-looking statements” under the U.S. securities laws. Forward-looking statements include, among other things, projections, estimates, and information about possible or future results related to a client’s account, or market or regulatory developments.

Important Information Regarding Risk Factors

Investment strategies may not achieve the desired results due to implementation lag, other timing factors, portfolio management decision-making, economic or market conditions or other unanticipated factors. The views and forecasts expressed in this material are as of the date indicated, are subject to change without notice, may not come to pass and do not represent a recommendation or offer of any particular security, strategy, or investment. All investments involve risks. Please request a copy of DoubleLine’s Form ADV Part 2A to review the material risks involved in DoubleLine’s strategies. Past performance is no guarantee of future results.

Important Information Regarding DoubleLine

To receive a complimentary copy of DoubleLine Capital’s current Form ADV (which contains important additional disclosure information, including risk disclosures), a copy of the DoubleLine’s proxy voting policies and procedures, or to obtain additional information on DoubleLine’s proxy voting decisions, please contact DoubleLine’s Client Services.

Important Information Regarding DoubleLine’s Investment Style

DoubleLine seeks to maximize investment results consistent with our interpretation of client guidelines and investment mandate. While DoubleLine seeks to maximize returns for our clients consistent with guidelines, DoubleLine cannot guarantee that DoubleLine will outperform a client's specified benchmark or the market or that DoubleLine’s risk management techniques will successfully mitigate losses. Additionally, the nature of portfolio diversification implies that certain holdings and sectors in a client's portfolio may be rising in price while others are falling; or, that some issues and sectors are outperforming while others are underperforming. Such out or underperformance can be the result of many factors, such as but not limited to duration/interest rate exposure, yield curve exposure, bond sector exposure, or news or rumors specific to a single name.
DoubleLine is an active manager and will adjust the composition of client’s portfolios consistent with our investment team’s judgment concerning market conditions and any particular sector or security. The construction of DoubleLine portfolios may differ substantially from the construction of any of a variety of market indices. As such, a DoubleLine portfolio has the potential to underperform or outperform a bond market index. Since markets can remain inefficiently priced for long periods, DoubleLine’s performance is properly assessed over a full multi-year market cycle.

Important Information Regarding Client Responsibilities

Clients are requested to carefully review all portfolio holdings and strategies, including by comparing the custodial statement to any statements received from DoubleLine. Clients should promptly inform DoubleLine of any potential or perceived policy or guideline inconsistencies. In particular, DoubleLine understands that guideline enabling language is subject to interpretation and DoubleLine strongly encourages clients to express any contrasting interpretation as soon as practical. Clients are also requested to notify DoubleLine of any updates to Client’s organization, such as (but not limited to) adding affiliates (including broker dealer affiliates), issuing additional securities, name changes, mergers or other alterations to Client’s legal structure.

DoubleLine Group is not a registered investment adviser with the Securities Exchange Commission (SEC).

DoubleLine® is a registered trademark of DoubleLine Capital LP.