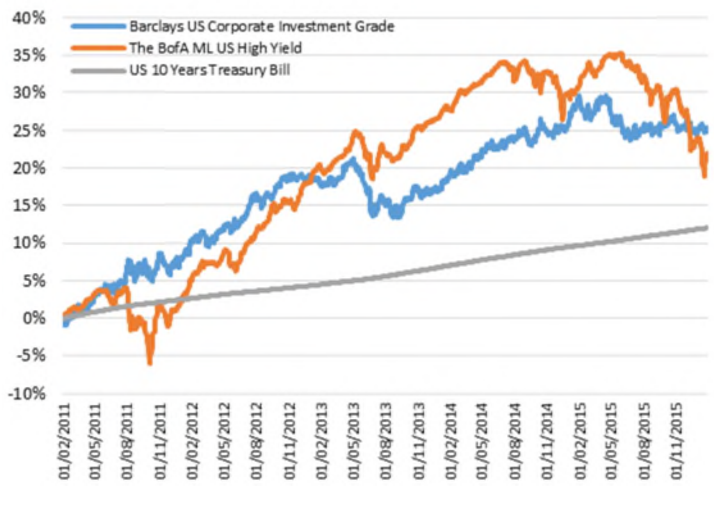
Equity markets have endured their toughest start to a calendar year since 2008, with the FTSE World Index finishing the month of January down 5.5% and continuing to trade lower at the start of February. Falling oil prices, further worries about China's economic slowdown, softer corporate earnings and weakening commodity markets have all been cited as factors contributing to the sell-off. Even the safe haven status of UK and US government bonds was challenged in 2015 as these assets suffered a technical bear market. However, whilst government bonds have rallied in 2016 in a "flight to quality", other elements of the fixed income market have continued to suffer, most notably the high yield (junk) bond sector.

Many investors argue that the high yield market is a good bellwether for the general economy, as high yield bonds are typically issued by companies that are earlier stage or higher risk and therefore more sensitive to changes in the economy. In this respect high yield should not really be considered as an asset class that will protect a portfolio in times of stress, as it will behave more like equity than a government bond.

In the face of potential rising interest rates and also uncertainty surrounding the Chinese demand story, we reduced our exposure to the high yield sector throughout 2013 and 2014, as these bonds were becoming more expensive relative to safer 'investment grade' credit.

Given the recent weakness in markets and the expectations for further volatility throughout 2016, we thought it prudent this month to analyse the dynamics of this high yield market and to determine if there is now value again in buying the sector after such a torrid run.



Treasuries have continued their upward march whilst recently investment grade is flat, but high yield has tumbled in value since May 2015.

What is high yield debt?

High yield bonds are issued by companies with lower credit ratings who want to borrow money to typically expand or to recapitalise their business in some way.

The high yield bond sector is riskier than some other companies' debt and encompasses all bonds that are rated below BBB by Standard & Poor's, the ratings agency. Their risk ratings categories are as follows:

Risk & yield increase

AAA	Investment Grade
AA	Investment Grade
A	Investment Grade
BBB	Investment Grade
BB	High Yield
B	High Yield
CCC	High Yield
CC	High Yield
C	High Yield
D	Default

Investors rightly demand a higher interest payment for taking higher risk. With high yield, the risk is materially higher than with investment grade bonds and therefore investors can expect to be paid between 150-300 basis points (1.5%-3%) more each year as a result.

Over the past five years the high yield bond market has doubled in size as expansive monetary policy through Quantitative Easing (which involves printing new money and using it to buy up debt, thereby increasing asset prices) and ultralow interest rates have made it the perfect environment for companies wishing to borrow at dirt cheap rates, with no end of investors queuing up to buy their bonds.

High yield now comprises roughly 15% of the overall corporate bond market, with a value of circa $1.3 trillion. 75% of this is listed in the US and 25% in Europe (the UK has historically had very low levels of high yield debt).

What are the constituents of the high yield market?

Companies in the high yield Sector cover the spectrum of industry sectors and categories, including industrial manufacturers, media firms, energy explorers, housebuilders and finance companies. Typically they all have high levels of debt relative to their earnings and cash flow.

High yield debt is typically broken down into one of the following categories:

Fallen Angels - entities that used to carry higher ratings, before falling on hard times. The most notable of these include Ford Motor Company and more recently Tesco, which saw its rating downgraded to high yield by Moody's.

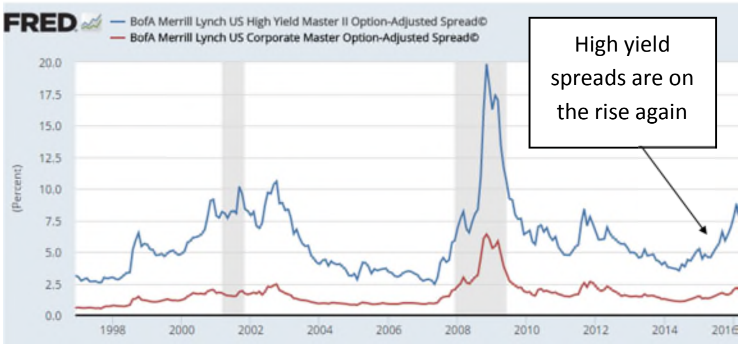
Rising Stars - start-ups that have not as yet achieved the operational history, the size or capital strength to receive an investment grade rating. They typically wish to borrow capital to expand.

Leveraged Buyouts (LBO) – a company that uses high yield bonds to acquire a public corporation from its shareholders.

Capital Reorganisations - some companies have existing debt packages that they wish to re-finance, perhaps because they can borrow at cheaper rates than before or because they wish to increase/decrease the amount of debt on their balance sheets.

Why has the high yield market suffered?

At present the yield on the Merrill Lynch high yield index is 9.70% whereas twelve months ago it was trading at 5.80%. This is a huge spike which indicates that investors have sold the sector significantly, forcing down prices and forcing up the yield of the sector as a whole. Investors are now being paid 8.43% per annum more for owning high yield bonds than for owning US Treasuries. This time last year that gap (spread) was only 4.31%.



Comparing high yield and investment grades bonds shows the full extent to which spreads are currently rising.

Why has sentiment to the sector changed so significantly over the past twelve months?

US interest rate hikes

Fixed interest investments usually perform poorly when interest rates are rising. This is because the risk free rate (cash) becomes more valuable as rates rise because more interest is paid for holding cash and as a result the value of other forms of fixed interest goes down. However, historically the sensitivity of high yield bond prices to an interest rate hike has been quite low. This is because in general interest rates are increased when the economy is showing signs of strength. This should be reflected in improving corporate balance sheets and as such the chances of a corporate bond default should be lower during this phase of the cycle. The US interest rate cycle turning upwards should therefore not really have much negative impact on the US high yield market. Actually, rates being held lower for longer could perversely affect the market more because it may indicate weakness in the economy and therefore indicate a greater risk of default.

Oil and other commodity price declines

We believe that this is the single biggest contributor to the decline in the high yield market. Since 2010, oil and gas companies have issued more than $2 trillion worth of bonds and energy companies now make up more than 15% of the US high yield debt market. The collapse in the oil price from $60 to $30 over the past twelve months, along with gold and base metal price declines, has therefore had a significant impact on high yield bond prices because the fear is that companies in these sectors will default or even go bust as their revenues disappear. As a result, the price of energy sector bonds fell by circa 20% in 2015 and to put this into perspective the second worst performing sector was industrials at 6%.

What a difference a sector makes – The chart on the left shows default rates (9%) and yield spread (12%) for the US Energy and mining sector. In comparison the entire high yield market (right) has default rates of less than 2% and a yield spread of only 6%.

A staggering 56% of the high yield bonds issued by the energy sector are now yielding over 10% and when yields start to edge above 15% then it becomes more difficult for companies to service their debt.

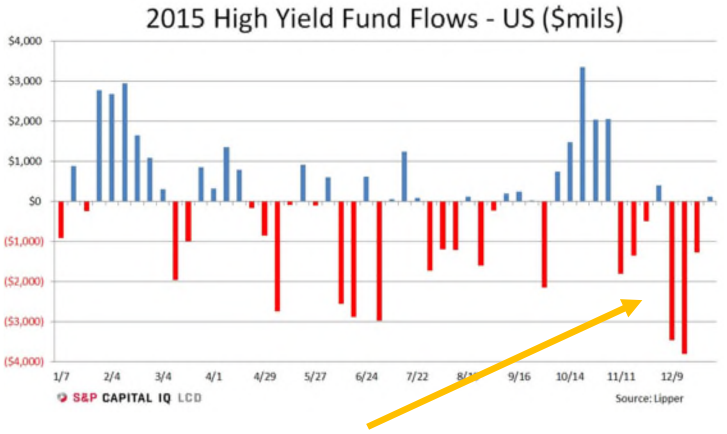
No wonder then that the high yield market as a whole has been dragged down by these sectors of the economy.

Default rates

The ‘default rate’ reflects the percentage of bonds issued that are currently unable to meet their debt obligations. This currently sits at 2.4%, which is significantly below the long term average of 4.0%. However, the current ‘spread’ of high yield bonds over US treasuries suggests that the market thinks that default rates will rise significantly to 7% in the next year. The energy and metals/mining sectors comprise 79% of the volume of all defaults since the start of the third quarter of 2015 and account for 70% of all of the defaults in 2015. It is likely that default rates will rise, however arguably the market has already overshot and that expectations for defaults is currently too pessimistic.

Fund flows

As was the case for equities with high dividends, historically low interest rates after the financial crisis spurred investors to seek alternative sources of income and high yield debt offered very attractive returns – part of the reason for the doubling in size of the market over the past five years.



Significant outflows over the last few months of 2015 has affected both values and liquidity concerns in the sector.

However, bonds have always been less ‘liquid’ (easily saleable) than equities and selling pressure in the illiquid high yield market is currently causing problems. The use by retail investors of index tracking funds has led to increases in the volume of bonds being bought over the past few years but there has been no real test yet for a large volume of bonds being sold due to momentum moving against the market.

Recent outflows of capital from the market are not significant in comparison to the overall scale of the market, with $9 billion being pulled from US high yield mutual funds in 2015. However, $5.1 billion was pulled out in the two weeks ending December 28th. This move was epitomised by the closure of Third Avenue Management’s credit fund, which was forced to close due to a wall of redemptions from one of its high yield bond funds. Described as the biggest mutual fund close since 2008, this fund had significant exposure to very illiquid distressed level debt (76% rated CCC+) and was forced to close to redemptions and gradually look to return money to investors.

As an increasing number of funds are forced to meet redemption requests this is forcing prices down, in some cases significantly.

We believe that fund flows will have a very important part to play on the future of the high yield market over the next couple of years but that the impact of flows on current pricing has not been that significant thus far.

Where next for the high yield sector?

The high yield market has clearly experienced significant volatility over the past twelve months, most notably in the US, but does the current yield now represent good value? The last time high yield spreads surpassed 800bps was in late 2011 during the midst of the European crisis, when the world wasn’t sure whether or not the European Union would survive. Both equity and high yield markets at that time were also in “risk-off” mode as they are today, but a recession in the US was not occurring or even imminent. During that period, high yield spreads peaked at 861bps in October 2011 and strong returns were generated by the sector in the ensuing twelve months.

Perhaps therefore, as with deliberations over equity market valuations, the most important factor is whether or not the US will experience a recession imminently. Whilst it is clear that the economic fundamentals have weakened we believe that the US will stave off a recession and that outside of energy and commodity names, yields currently compensate investors for the credit risks taken in the high yield sector. Defaults are likely to rise from the 2.5% global high yield annual rate, but with yields as high as they are (8% higher than government bonds) there is probably value in holding these assets for the time being.

Perhaps however more emphasis should be placed on liquidity risks than credit risks at present, as corporate bond market asset growth has been accompanied by a shrinking of the investment banks’ ability and willingness to hold bonds on their balance sheets.

Whilst we believe that we will not see a proliferation of closures like Third Avenue, such headlines will weigh on sentiment for the next few months. Whilst individual bonds may be good value, it is impossible to predict or account for irrational selling pressure from inexperienced investors and this may prove more important in the short term.

It is for this reason that the exposure that we currently own for clients is in a highly diversified fund that has a low weighting to both the US energy sector and to distressed debt. Given that high yield as an asset class is amongst the riskiest forms of fixed interest, we prefer to ensure that we own the more defensive end of the market, where we can still receive generous yields by taking a lower risk.