Bond Market Perspectives

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Late Summer Setback

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Highlights

Multiple factors, none of them fundamental, have driven high-yield bond prices weaker in September.

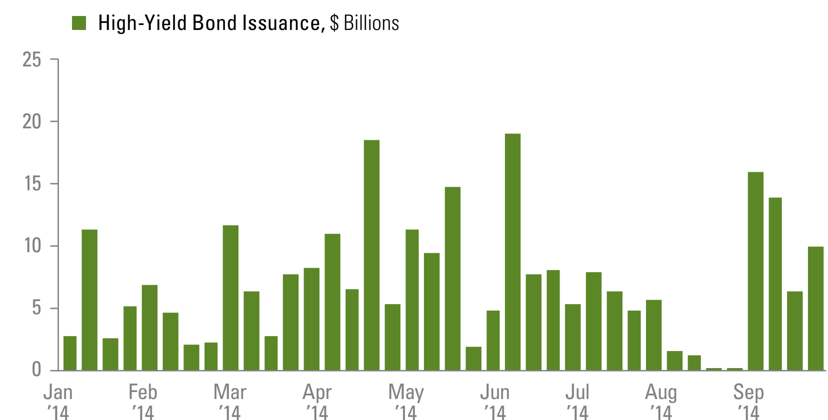
Performance versus investment-grade bonds is approaching an extreme and may signal a reversal.

The end of summer has been less than kind to the high-yield bond market. A challenging month of September for the bond market has witnessed high-yield bonds lag several of their fixed income counterparts. Lacking a fundamental catalyst, such as reduced profitability or weak economic data, performance has been driven by a series of technical and psychological factors, making current weakness more frustrating for investors.

A confluence of events conspired against the high-yield bond market in a difficult September, including:

- **New issue surge.** New issuance for the four weeks ending September 26, 2014, was the heaviest four-week stretch in 2014. Although making up for the typical low-volume summer months, the flood of new supply created a significant headwind for the high-yield market [Figure 1].

1 The High-Yield Bonds Just Witnessed the Greatest Four-Week Influx of New Issuance of 2014



Source: LPL Financial Research, Bloomberg 09/26/14

- **Weak stock markets.** When economically sensitive investments such as stocks sell off, high-yield bonds also feel the impact. However, last week's stock market downdraft witnessed an above-average impact to high-yield bonds. In fact, high-yield bonds have underperformed stocks

during the month of September 2014, which is unusual during a down month for stocks. Either stock weakness was too shallow or the high-yield market overreacted. The coming weeks may clarify.

- **Fed tapering fears.** The Federal Reserve (Fed) is on track to end bond purchases at the end of October 2014. Investors fear the absence of the Fed's liquidity in the high-yield bond market and have pushed high-yield bond prices lower.
- **Geopolitical fears.** An escalation of tensions in Syria with the start of airstrikes added an element of uncertainty, which more economically sensitive investors tend to react more negatively to.
- **China growth concerns.** The Chinese central bank's cash injection to the five largest Chinese banks in mid-September was viewed as the equivalent of an interest rate cut. The news, viewed as a response to a slowing economy, sparked China growth worries.
- **Approaching quarter end.** Month end can spur buying of higher-quality assets as companies look to boost quality for reporting purposes. Weakness in Europe and Japan, in particular, is driving demand for higher-quality bonds. The approach of quarter end coupled with a strong bounce back in high-yield bonds during August may have provided an opportune time for some investors to take profits during September.
- **Low inflation.** Low inflation in the United States and the lowest inflation readings in Europe since the end of the financial crisis, in addition to Chinese growth fears, have added to concerns about economic growth and the ability of lower-rated companies to meet their debt obligations.

High-yield bond outflows have not been a major driver of recent weakness. Although flows into high-yield funds and exchange-traded funds (ETF) are negative month to date, they are much lower compared with the heavy outflows witnessed in July through early August 2014.

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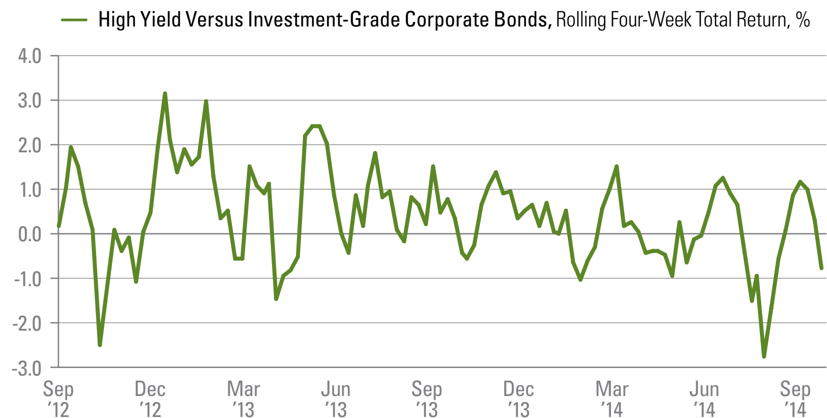
High-yield bonds have not only lagged stocks during September 2014, but also a notable gap has developed versus their high-quality counterparts in the investment-grade corporate bond market. A logical reaction to fears over corporate credit quality would likely see higher-quality corporate debt lag proportionately to lower-rated corporate debt. After all, economic fears should have an impact across all corporate debt issuers, but September's downdraft has so far impacted high-yield bonds much more.

Relative performance of high-yield bonds compared with investment-grade corporate bonds is approaching an extreme [Figure 2] and subject to a reversal. Over the last two years, the rolling four-week total return of high-yield bonds relative to investment-grade corporate bonds has matched or exceeded negative 1% on six occasions. Current underperformance is approaching this zone and history has shown that while it may be exceeded, such disparities rarely last as value-oriented buyers tend to step in and buy to help reverse performance. Over the past three weeks (not pictured), high-yield bonds have underperformed investment-grade corporate bonds by over 1%, a situation occurring only three other times over the past two years.

2 High-Yield Underperformance to High-Quality Corporate Bonds Is Reaching an Extreme



Source: LPL Financial Research, Barclays US Corporate High-Yield Index and US Corporate Index 09/26/14

Past performance is not indicative of future results.

Indexes are unmanaged and cannot be invested in directly.

If the market were truly concerned with credit quality fears, a proportionate lag among investment-grade corporate bonds would have also likely occurred, but it did not.

Extremes do not necessarily ensure positive absolute returns. If all bond prices decline, then the relative performance of high-yield bonds may improve if prices merely fall less sharply than investment-grade bonds. But the numerous factors mentioned above have created a valuation gap compared with other fixed income sectors. If the market were truly concerned with credit quality fears, a proportionate lag among investment-grade corporate bonds would have also likely occurred, but it did not.

Although short-term forces may push high-yield bond valuations cheaper still, it is unlikely to extend significantly further absent renewed deterioration in high-yield bond fundamentals. On that score, fundamental indicators remain positive:

- **A low default environment persists.** The most recently released Fed Senior Loan Officer Survey continues to indicate a greater number of banks easing lending requirements. A tightening of lending conditions usually precedes a notable increase in defaults by 12 to 18 months.
- **The U.S. economy continues to expand.** Following a 4.6% increase during the second quarter of 2014, our research indicates the economy is tracking to slightly greater than 3% growth during the third quarter. Such economic growth is likely to bolster companies' ability to repay debt obligations. Third quarter 2014 earnings reporting season begins in just over a week and will provide a better glimpse. Another mid- to high single-digit increase in corporate earnings growth would further support corporate credit quality.

3 The Average Yield of High-Yield Bonds Has Reached a One-Year High

Source: LPL Financial Research, Barclays 09/26/14

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Now cheaper valuations, in addition to fundamental factors, may also support the sector. The average yield spread has increased to 4.8% and the average yield has increased back above 6.0% to 6.3%, its highest level of 2014 [Figure 3]. While the high-yield market can be a leading indicator, we await confirmation in upcoming economic data and earnings season before drawing conclusions from the recent pullback, which we view as driven more by short-term, technical factors. In a world of high valuations across the bond market, we still find high-yield bonds attractive. ■

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Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values and yields will decline as interest rates rise, and bonds are subject to availability and change in price.

INDEX DESCRIPTIONS

The U.S. Corporate High-Yield Index measures the market of USD-denominated, non-investment grade, fixed-rate, taxable corporate bonds. Securities are classified as high yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below, excluding emerging market debt.

The U.S. Corporate Index is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate, taxable corporate bond market. It includes USD-denominated securities publicly issued by U.S. and non-U.S. industrial, utility, and financial issuers that meet specified maturity, liquidity, and quality requirements.

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