

Bond Market Perspectives



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High-Yield Bonds & Oil Prices Revisited

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Highlights

With the price of oil now down 41% from a peak of \$107 per barrel on June 20, 2014, through Monday, December 8, 2014, we take another look at the impact of lower oil prices on the high-yield bond market.

Recent high-yield market weakness has already accounted for a rise in defaults from lower oil prices.

Even with weakness from rising defaults, we believe high-yield bonds may outperform their high-quality counterparts in 2015 due to their existing yield advantage.

Bond markets are off to a difficult start in December but it has been particularly challenging for the high-yield bond market, which continues to be negatively impacted by falling oil prices. In our November 11, 2014, *Bond Market Perspectives*, "High-Yield Bonds & Oil Prices," we looked at the energy sector's growing presence within the high-yield market and what that might mean for investors. With the price of oil now down 41% from a peak of \$107 per barrel on June 20, 2014, through Monday, December 8, 2014, another look at the impact of lower oil prices on the high-yield bond market is warranted.

This week, we dive deeper and attempt to quantify additional risk should oil price declines lead to defaults across the high-yield energy sector. Asking "what if?" and assessing more adverse scenarios can help assess whether a market or sector is valued attractively, expensively, or fairly.

Where the Risks Lie

Within the high-yield energy sector, lower-rated issuers (those rated CCC or below) are the least credit worthy and likely would be the first to default. Weak balance sheets and greater use of debt leverage are usually behind the lowest ratings and such companies would be less able to sustain long periods of low oil prices. Less profitable production could make it more difficult to service debt obligations and could ultimately lead to default.

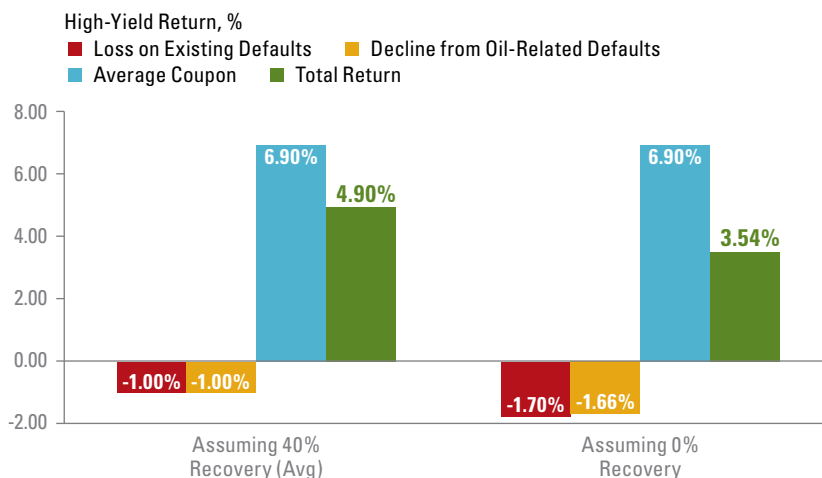
Stress Testing the High-Yield Energy Market

Testing a scenario in which 100% of high-yield energy issues rated CCC or below would default can help to assess current market valuations. Energy issuers rated CCC and lower comprise \$22 billion of the \$1.34 trillion high-yield bond market, or 1.66% of the market, according to Barclays data. Historically, investors have ultimately recovered 40% of their investment (on average) in the event of default. Therefore, multiplying 1.66% by 0.6 (100% minus 40% recovery = 60% loss) would drive the overall high-yield market down by 1.0%, all else remaining equal. This 1.0% loss is offset by interest income, which averages 6.9% (denoted by average coupon in [Figure 1](#)) for the overall high-yield market. Factoring in an existing default rate of 1.7% and subtracting the loss due to the default of oil-related companies from average income still leads to notably positive returns for the high-yield bond market [[Figure 1](#)], assuming stable prices across remaining sectors.



1 Factoring in Additional Energy Defaults Still Leads to Single-Digit Returns

The risk of increased defaults in the energy space does not warrant avoiding the high-yield space altogether.



Source: LPL Financial Research, Barclays data 12/08/14

Hypothetical return based upon existing defaults (1.70%) and an additional rise (1.66%) in defaults from high-yield energy companies. Hypothetical total return results from subtracting default loss, oil-price related defaults from average coupon interest income, and assumes no other price drivers higher or lower.

This chart is for illustrative purposes only and is not representative of any particular security.

Assuming a more severe scenario in which there is no recovery (unlikely since there is almost always demand for energy assets), we see that the overall high-yield market would fall by an additional 1.7%, again all else being equal; but the total return, though less compelling, is still positive as interest income offsets loss from defaults.

The risk of increased defaults in the energy space does not warrant avoiding the high-yield space altogether. Even after considering widespread defaults among lower-rated high-yield energy sector bonds, the overall high-yield bond market still offers a favorable potential total return compared with high-quality bonds. As noted in our *Outlook 2015: In Transit*, we expect flat bond returns, but if interest rates do not move higher, the Barclays Aggregate Bond Index may return just over 3% in 2015 according to our scenario analysis, which is still below that of high-yield bonds after considering rising defaults.

What's Priced In?

The average yield advantage, or spread, to comparable Treasury securities is one measure to help assess the attractiveness, or lack thereof, of current high-yield bond valuations. When gauging the fair value spread for high-yield bonds, there are many available tools. One that we generally prefer



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The credit ratings are published rankings based on detailed financial analyses by a credit bureau specifically as it relates to the bond issue's ability to meet debt obligations. The highest rating is AAA and the lowest is D. Securities with credit ratings of BBB and above are considered investment grade.

Because of its narrow focus, sector investing will be subject to greater volatility than investing more broadly across many sectors and companies.

Even with weakness from rising defaults, we still believe high-yield bonds may outperform their high-quality counterparts in 2015 due to their existing yield advantage.

is to look at the default rate on high-yield bonds (which accounts for credit-quality risk) plus a buffer known as a liquidity premium. Historically, this buffer has averaged 2.2% (and is merely the actual yield spread minus the default rate), but it can be much higher or lower depending on how much extra yield investors require, over and above the default rate, to compensate for uncertainty. A liquidity premium compensates investors for the risk that these securities are less liquid, thus harder to turn into cash. Adding these two components together provides a rough estimate for the fair value yield spread.

The average yield spread (as of Monday, December 8, 2014) of the high-yield market is 4.8%, according to Barclays High-Yield Index. Removing the 2.2% liquidity premium leaves a market-implied 2.6% default rate. As the current U.S. high-yield default rate is just 1.7%, we have 0.9% worth of additional yield spread that is priced into the market for energy sector defaults. In other words, recent high-yield market weakness has already accounted for a rise in defaults from lower oil prices.

We discussed earlier that at historical recovery rates, if all lower-rated energy issuers defaulted on their obligations, the overall high-yield market would fall by 1.0%. The extra 0.9% spread from above indicates the market has in effect already priced in defaults of 90% of all CCC and lower-rated high-yield energy issues. Although a greater number of defaults are priced in, markets often overreact and further weakness may still occur. However, the existing buffer may limit the degree of additional downdrafts.

The high-yield market has priced in a cushion against defaults but not an overly generous one, so we find the market fairly to slightly attractively valued. Nothing occurs in isolation, and if higher-rated B and BB rated bonds weaken, the average yield spread may widen a bit further. Conversely, many energy issuers may have hedged oil exposure via futures contracts, thus limiting their exposure to fluctuating oil prices, at least over the short to intermediate term. In addition, other high-yield sectors may benefit from lower oil prices, and offset energy-related weakness. Lower oil prices could be a benefit to the transportation sector directly and for the broader economy through increased consumer spending.

Conclusion

The high-yield market has already priced in a significant increase in defaults in response to the sharp drop in oil prices. The average yield spread shows the high-yield market has gone a long way to price in widespread defaults in the lowest-rated tiers of the energy sector. Even with weakness from rising defaults, we still believe high-yield bonds may outperform their high-quality counterparts in 2015 due to their existing yield advantage. ■



IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results. All indexes are unmanaged and cannot be invested into directly.

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

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.

High-yield/junk bonds are not investment-grade securities, involve substantial risks, and generally should be part of the diversified portfolio of sophisticated investors.

Futures contracts are contractual agreements, generally made on the trading floor of a futures exchange, to buy or sell a particular commodity or financial instrument at a predetermined price in the future.

INDEX DESCRIPTIONS

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The Barclays U.S. Corporate High-Yield Index measures the market of USD-denominated, noninvestment-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 markets debt.

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