Bond Market Perspectives

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Giving Credit to High-Yield Credit

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Highlights

High-yield bond valuations remain elevated for a good reason — strong credit quality and low defaults continue to support the sector.

A closer look at underlying credit quality indicates high-yield bond prices may remain well-supported for most of 2014.

We still find lower-rated high-yield bonds and bank loans offering some attractive opportunities in the bond market for 2014.

1 High-Yield Bond Spreads Remain Near a Post-Recession Low

Source: LPL Financial Research, Barclays High-Yield Corporate Bond Index 03/21/14

Past performance is no guarantee of future results.

The Federal Reserve (Fed) reintroduced interest rate risk in the bond market last week. Corporate bonds, particularly lower-rated high-yield bonds, weathered the rise in rates better than most sectors. Bond prices overall are generally higher so far in 2014, and high-yield bonds remain expensive relative to history, but that does not mean that the sector cannot still offer value for investors. Credit quality is generally good, funding conditions are favorable, and defaults may remain low — all of which support higher-than-average valuations. High-yield bond valuations must also be taken in the context of a bond market with limited opportunities. High-yield bonds and lower-rated debt may still offer attractive opportunities in the bond market.

The earnings reporting season for the fourth quarter of 2013 (with results released over the first quarter of 2014) broadly showed that the fundamentals underlying corporate America remain strong. Fourth quarter earnings increased by nearly 10% on an annualized basis, an acceleration versus the third quarter of 2013 and an improvement from the mid-single-digit pace of the prior several quarters. Revenue growth improved at a much more modest 1.0% annualized growth rate but is still supportive of good credit metrics underlying corporate bonds. Please see the discussion below for a closer look at these important indicators of corporate credit quality.

Good credit quality metrics and low defaults may help support corporate bond valuations in 2014 — a trend that may continue. However, the combination has led to the lowest yield advantage, or spread, of high-yield bonds relative to Treasuries since the end of the financial crisis [Figure 1]. The lower (or narrower) the yield spread, the more expensive the valuation. The current average yield spread of 4% is below the 5.8% long-term average.

It is not uncommon for high-yield spreads to stay narrow for an extended time. After a period of improving credit quality, the gains achieved by corporate bond issuers have lasting impacts leading to long periods of stable credit quality [Figure 2]. In a typical credit cycle, as credit quality weakens and/or default risks increase, usually in response to a weakening economy, yield spreads widen and high-yield bonds historically underperform as investors demand greater yield compensation. Once the economy rebounds, yield spreads contract as credit quality improves and risks subside. At a certain point, additional credit quality improvements are difficult to achieve, and credit quality merely remains stable.

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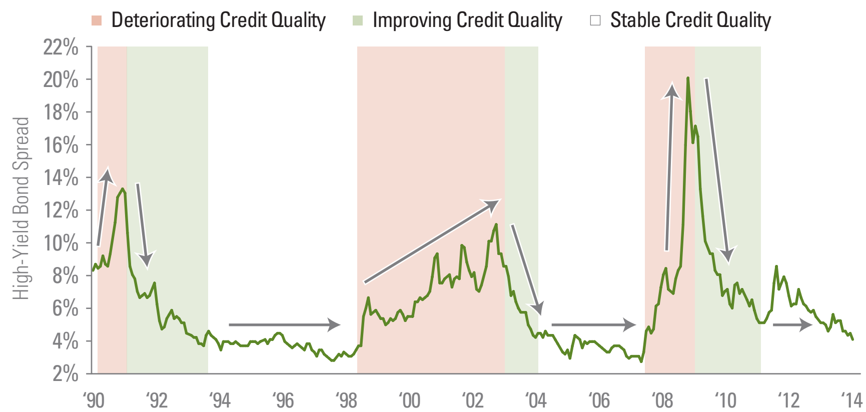
2 The Stable Portion of the Credit Cycle Can Last for Years



Source: LPL Financial Research, Barclays 03/21/14

The average high-yield spread narrowed to 3% or below at prior high-yield bond market peaks, more than a percentage point below the current level.

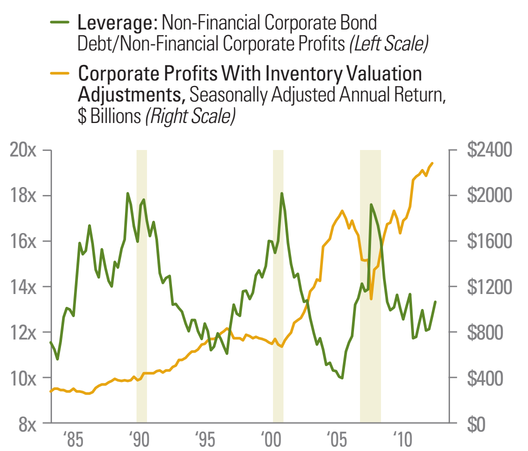
Periods of stable credit quality can persist for years. Stability persisted for approximately six years during the 1990s and nearly four years in the past decade (2000–09). Note that the average high-yield spread narrowed to 3% or below at prior high-yield bond market peaks, more than a percentage point below the current level. While we do not think such a narrow yield spread can be achieved in the current cycle due to the lower level of overall interest rates, the current level of yield spreads may persist for most of 2014 and perhaps beyond.

Credit Quality

Using data from the Fed's Flow of Funds database, we can take a closer look at broad corporate credit quality metrics for non-financial corporations that may help reveal whether the stable portion of the credit cycle may be approaching an end. The degree of financial leverage, measured by the amount of debt relative to corporate profits, among corporate bond issuers is a focal measure for investors, since highly leveraged corporations are more likely to default and may cause corporate bond prices, especially high-yield bond prices, to rise. The current level is below peaks witnessed during the past several recessions (early 90s, early 2000s, 2007–09) but is on the rise, which is a negative for corporate bond investors even though corporate profits are at all-time highs [Figure 3].

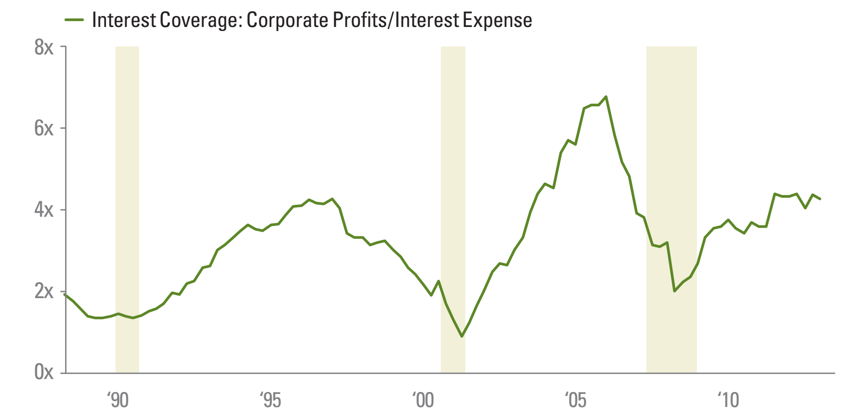
But looking at leverage alone does not reveal the whole picture. The cost to service that debt is important and quite manageable [Figure 4]. Non-financial corporations can cover their interest payment obligations several times over. Although interest coverage metrics have likely plateaued, it still indicates a substantial ability for the timely payment of interest income to investors.

3 Corporate Leverage Is on the Rise



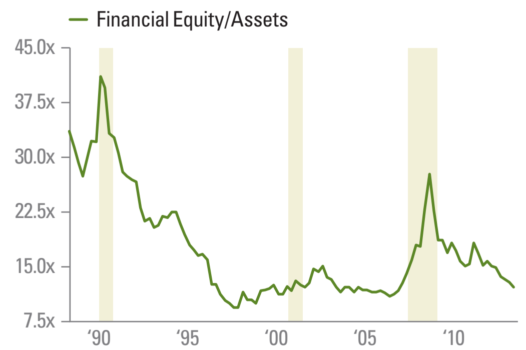
Source: LPL Financial Research, Haver, Federal Reserve Flow of Funds 03/21/14

4 Interest Coverage Remains High



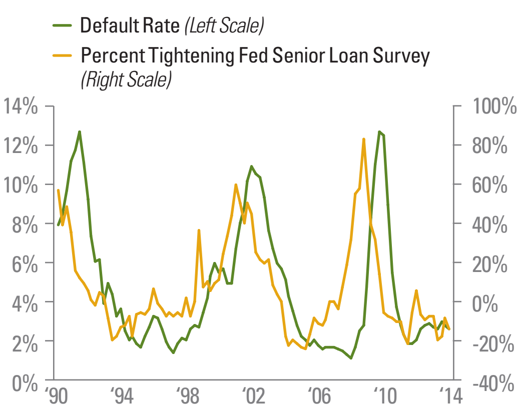
Source: LPL Financial Research, Haver, Federal Reserve Flow of Funds, Bureau of Economic Analysis 03/21/14

5 Leverage Among Financials Continues to Decline



Source: LPL Financial Research, Haver, Financial Company Equity/Assets 03/21/14

6 Easing Credit Standards Should Help Keep Defaults Low



Source: LPL Financial Research, Moody's, Federal Reserve 03/21/14

Financial regulation has forced banks to bolster bank balance sheets, and financial system leverage, as measured by the market value of their equity relative to assets, remains low [Figure 5].

Leading Indicators

Aside from credit quality, funding conditions generally remain healthy. The ability to obtain funding at a critical juncture can override credit quality metrics—either good or bad. The Fed's Senior Loan Officer Survey reveals the percentage of banks that are either tightening or loosening lending standards. The survey can be a leading indicator of defaults [Figure 6], which in turn can have a dramatic impact on high-yield bond valuations. Thanks to an expanding economy, most banks are easing lending standards as they compete to win new loan business, which should help keep defaults low.

On the negative side, the desire for yield in a low-yield environment has led to companies issuing debt with weaker investor protections, known as covenants. Since late 2013, Moody's rating agency has reported several times that covenant protections are near historic lows based upon their proprietary rating scale. Poorly underwritten new bond structures do not immediately impact the high-yield bond market and usually require a catalyst. Still, weak covenants and more speculative issuance can sow the seeds of a future rise in defaults and a decline in high-yield bond prices. The timing of such an event is difficult to predict but historically occurs from months to years after such a surge and depends on the health of the economy as well as the ease of obtaining funding in the marketplace.

Conclusion

News of corporate bond defaults in China has caused some investors to refocus attention on elevated high-yield bond valuations here in the United States. But China's issues are unique and a result of its own debt bubble, fueled by speculative deals often backed by commodities. Domestic high-yield bond valuations, on the other hand, remain high for a reason—backed by good credit quality and low defaults, both may continue and should help support the sector. An increase in more speculative issuance may pose a future risk but does not override current investment merits. An expanding economy and easier lending standards provide an additional boost. With bond market valuations still broadly expensive, the added yield of high-yield bonds will likely enable the sector to be one of the more attractive options for investors in 2014. ■

INDEX DESCRIPTIONS

The Barclays U.S. Corporate High Yield Index covers the USD-denominated, non-investment grade, fixed-rate, taxable corporate bond market. Securities are classified as high-yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below. The index excludes Emerging Markets debt. The index was created in 1986, with index history backfilled to January 1, 1983. The U.S. Corporate High Yield Index is part of the U.S. Universal and Global High Yield Indices.

The Barclays Municipal Bond Index is a market capitalization-weighted index of investment-grade municipal bonds with maturities of at least one year.

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