



## Fixed Income:

# Time for a Fresh Look at High Yield

Despite recession fears, we believe the asset class continues to offer a compelling opportunity to investors.

Contributor



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**Chart 1. The 10-year Treasury Yield Recently Dipped to the Lowest Level Since 2016**

Data for the period January 4, 2016–August 28, 2019



Source: Bloomberg. Data as of August 28, 2019.

The historical data are for illustrative purposes only, do not represent the performance of any specific portfolio managed by Lord Abbett or any particular investment, and are not intended to predict or depict future results. Investors may experience different results.

**Past performance is not a reliable indicator or guarantee of future results.**



## In Brief

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- A recent sharp rally in U.S. Treasury yields might imply that investors are worried about the potential for a U.S. recession.
  - But one corner of the fixed income market is not signaling a downturn, in our view: U.S. high yield, where spreads versus U.S. Treasury bonds have actually tightened this year.
  - However, current spreads suggest that the asset class remains attractively valued relative to fundamentals, in our opinion.
  - We think that the wide dispersion in returns among sectors and rating categories within high yield argues for a selective, professionally managed approach to the asset class.
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Recent activity in the U.S. Treasury bond market—namely, the sharp decline in bond yields and [the inversion of the yield curve](#)—has led to a good deal of [pessimism about the outlook](#) for the markets and the U.S. economy. The yield on the 10-year Treasury note recently broke through 1.50%, a decline of 175 basis points (bps) from the recent high of 3.24% less than 10 months ago (see Chart 1). The last time the 10-year yield moved below 1.50% was in late June 2016, as rates tumbled in response to investor panic after the initial Brexit vote.

However, as we have pointed out on other occasions, [an inversion in the U.S. yield curve is not necessarily a reliable indicator of an imminent U.S. recession](#). Other economic indicators are not giving the same signal as the yield curve. Recent data reports from the Conference Board on leading economic indicators and consumer confidence, along with widely followed GDP forecasts from the U.S. Federal Reserve Bank of Atlanta, suggest that a U.S. recession is unlikely in the near term, barring some external shock.

Along with the indicators mentioned above, we would note that one area of U.S. fixed income is also not signaling a recession, in our view: the U.S. high-yield bond market. One might expect that a massive rally in Treasury rates would be accompanied by significant spread widening in high yield, indicating broad credit issues that would typically accompany a severe economic slowdown. But as Chart 2 shows, that has not been the case. While there have been periods of modest spread widening during periods of escalating U.S.-China trade war rhetoric, overall high yield spreads have tightened by over 125 basis points from the high levels reached at the beginning of the year.

While the dramatic fall in U.S. Treasury yields might be what one would expect in a difficult economic environment, the spread tightening in high yield is more representative of the credit fundamentals that we see supporting the asset class. For one thing, the U.S. economy has continued to grow at a steady pace, supported by a strong consumer benefitting from a healthy labor market and increasing corporate earnings. Meanwhile, default rates for high yield bonds remain near multi-year lows, based on data from J.P. Morgan.



### Chart 2. Despite Recession Fears, U.S. High Yield Spreads Have Tightened This Year

Spread versus U.S. Treasuries, August 22, 2018–August 28, 2019



Source : Bloomberg, ICE Data Indices. Spread data based on ICE BofAML U.S. High Yield Index. Data as of August 28, 2019.

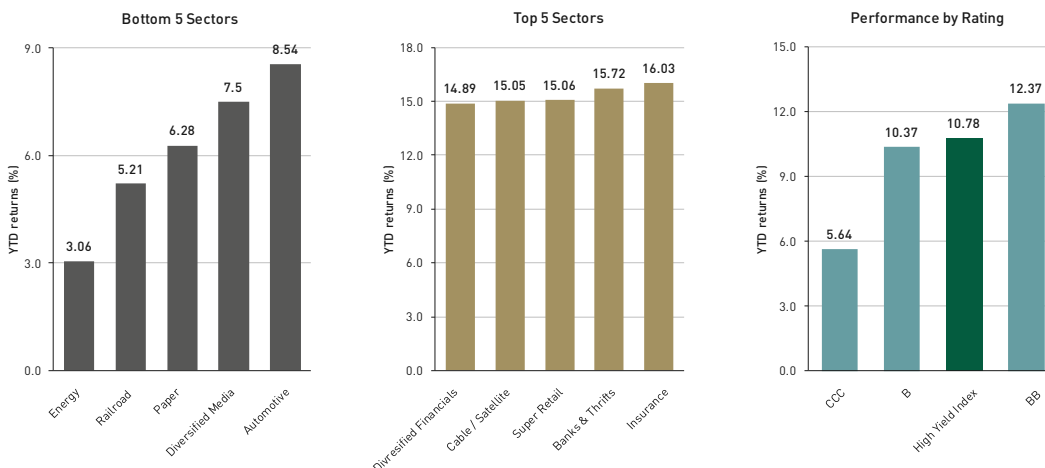
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But not all parts of the high yield market have participated equally in the recent strength. A review of high yield index returns by sector shows nearly 1,300 bps of dispersion between the top and bottom sector (see Chart 3). In our view, this highlights the importance for active high-yield managers of employing a top-down macro view that can help position a portfolio towards areas with the best opportunities, and rigorous bottom-up credit research to help avoid some of the troubled credit in the market.

### Chart 3. The U.S. High Yield Sector Has Featured a Wide Dispersion of Returns

Year-to-date returns (through August 27) for sectors and rating categories within the ICE BofAML U.S. High Yield Index



Source: ICE Data Indices. Data as of August 27, 2019.

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Looking at returns by credit rating will also show dispersion, with the 'BB'-rated segment outperforming 'CCC'-rated bonds by a wide margin, as investors have favored the higher-rated and larger, more liquid names in the market. This has led to the spreads on 'CCC'-rated bonds over 'BB'-rated issues to be the widest in more than three years. Should recession fears fade (a development we expect to be aided by upcoming U.S. data releases), the lower-rated portion of the market may present a compelling opportunity, since bonds in this rating category have not fully participated in the rally to date. We think the wider spreads currently on offer for 'CCC' bonds create the potential for greater excess returns going forward.

### Beyond High Yield

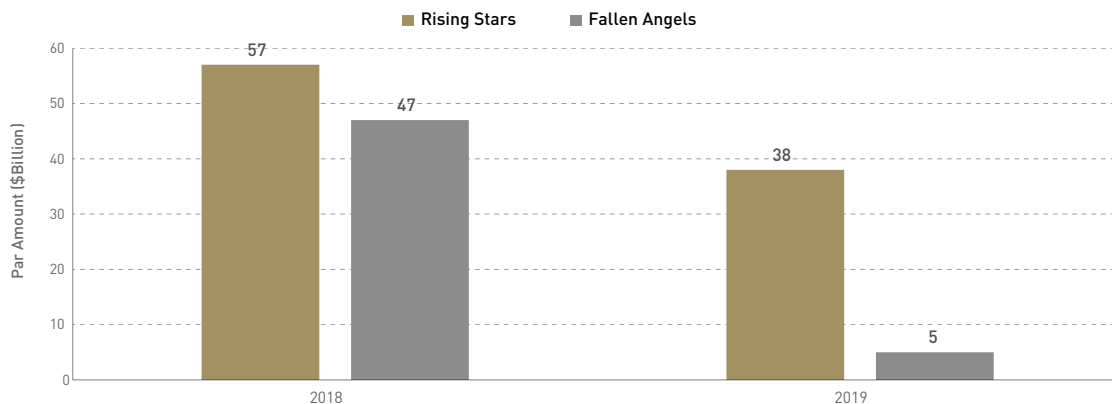
The spread compression in corporate credit is not just a high-yield phenomenon: investment-grade corporate bond spreads, as measured by the Bloomberg Barclays U.S. Corporate Bond Index, have also tightened meaningfully, by over 30 bps year to date. In fact, investment grade corporates have outperformed high yield corporates year to date. While high yield spreads have tightened more, the longer duration of the investment grade index (7.7 years versus 3.5 years effective duration, as of July 31, 2019), has led to higher total returns for the investment grade index as yields plummeted.

Within investment grade, what may be surprising to many is the fact that 'BBB'-rated corporate bonds have led the way with the most spread tightening and the highest return year to date. Earlier this year, 'BBB' corporates were often cited in many financial-media commentaries as the biggest area of risk; in April, we noted that we thought those fears were overblown. The concern had been that a large portion of these 'BBB'-rated credits would become "fallen angels" and get downgraded to high-yield status.

But in reality the amount of fallen angels actually has been outpaced by "rising stars" (high yield bonds upgraded to investment grade) for the second consecutive year. For the year to date through August 23, the \$5 billion par value of fallen angel bonds has been dwarfed by \$38 billion in rising stars.

### Chart 4. "Rising Stars" Have Outpaced "Fallen Angels" Again in 2019

Par amount of debt upgraded from below-investment grade to investment grade ("Rising Stars") versus debt downgraded from investment grade to below-investment grade ("Fallen Angels") for the indicated periods



Source: J.P. Morgan Credit Research. Data as of August 23, 2019. Data for 2019 is year to date through August 23.

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### Two Approaches for Investors

With many economic indicators pointing to steady U.S. growth, along with additional help from what appears to be very accommodative U.S. Federal Reserve policy, we believe U.S. high yield has the potential to continue to perform well. While spreads have tightened year to date, they remain about 100 bps higher than the lows reached last fall, suggesting that valuations remain attractive given the strong underlying credit fundamentals. However, given the wide dispersion of returns in the sector, and the potential for market volatility, we believe an unbiased, active approach is vital to navigating this market.

Those who may not want a full allocation to high yield may wish to consider a more diversified multi-sector strategy that includes an allocation to high yield, as well as investment grade corporate bonds, securitized products and government-related securities. This approach may allow investors to participate in a potentially positive environment for high yield, but with the flexibility to adjust allocations to react to shifts in the market environment.



**A Note about Risk:** The value of investments in fixed-income securities will change as interest rates fluctuate and in response to market movements. Generally, when interest rates rise, the prices of debt securities fall, and when interest rates fall, prices generally rise. High-yield securities, sometimes called junk bonds, carry increased risks of price volatility, illiquidity, and the possibility of default in the timely payment of interest and principal. Bonds may also be subject to other types of risk, such as call, credit, liquidity, interest-rate, and general market risks. Longer-term debt securities are usually more sensitive to interest-rate changes; the longer the maturity of a security, the greater the effect a change in interest rates is likely to have on its price. Lower-rated bonds may be subject to greater risk than higher-rated bonds. No investing strategy can overcome all market volatility or guarantee future results.

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**Treasuries** are debt securities issued by the U.S. government and secured by its full faith and credit. Income from Treasury securities is exempt from state and local taxes.

A **basis point** is one one-hundredth of a percentage point.

**Spread** is the percentage difference in current yields of various classes of fixed-income securities versus Treasury bonds or another benchmark bond measure. A bond spread is often expressed as a difference in percentage points or basis points (which equal one-one hundredth of a percentage point).

**Yield curve** is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality, but differing maturity dates. One such comparison involves the two-year and 10-year U.S. Treasury debt. This yield curve is used as a benchmark for other debt in the market, such as mortgage rates or bank lending rates. The curve is also used to predict changes in economic output and growth.

The **Bloomberg Barclays U.S. Corporate Bond Index** includes all publicly held issued, fixed-rate, nonconvertible investment-grade corporate debt. The index is composed of both U.S. and Brady bonds.

The **ICE BofAML U.S. High Yield Index** is a capitalization-weighted index of all US dollar denominated below investment grade corporate debt publicly issued in the U.S. domestic market.

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