Heartwood
Investment Management

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Investment Insight

Weekly Insight

High yield rebounds with oil, but can it last?

US high yield bonds have rebounded strongly this year, after falling out of favour with investors in the second half of last year. The 12% appreciation of the high yield market since mid-February marks a significant turnaround, given concerns in the last few months around worsening credit fundamentals – higher levels of debt and potential for default - particularly as oil prices slumped to new lows.

High yield has now outperformed most other asset classes this year, including the S&P 500, the FTSE 100, 10-year US treasury bonds and both emerging market debt and equities. Year-to-date the high yield index has returned 7% to 29th April, 2016, as measured by the Bank of America Merrill Lynch US High Yield Index. The sectors that have seen the strongest performance are energy and metals and mining, with returns of 13% and 19.57%, respectively, in the year-to-date ended 29 April, 2016.

Commodity prices lift sentiment

Much of the improvement has been due to the rebound in commodity prices, dovish central bank policy and reduced concerns about US recession risks and global growth. A strong indicator of the recovery in sentiment is the amount of distressed debt (bonds trading at 1000 basis points over US Treasuries) has halved since 11th February, from 20% of the US High Yield market to 10%. As a result of the better tone in credit markets, demand for high yield funds has outstripped supply since mid-February, providing another underpin to the asset class.

Default activity has picked up this year, totalling $31.4 billion through to April, with most of the affected issuers in the energy sector [Source: JP Morgan]. Firmer oil prices are improving the longer-term default outlook, which has risen over the last year to a near six-year high, though outside of commodity-related sectors the expected default rate remains below historic averages.

High yield energy continues to offer value

Our portfolios have benefitted this year from holding an exposure to US high yield energy bonds through the Legg Mason Western Energy High Yield Credit Fund. In fact, it has been one of our best performing instruments in the year-to-date, having rebounded very strongly from the lows in early February.

We intend to maintain this position for the time being, as we continue to believe that we are being paid to hold it on a risk reward basis, given the current level of yield spreads. In particular, we are encouraged by energy companies' proactive response to supply/demand pressures through aggressive restructuring, asset sales, job cuts and capital expenditure cuts. These measures are giving breathing space to many companies, as well as much needed capital. While earnings expectations have been revised lower across all sectors, energy companies' results in aggregate have surprised positively in the first quarter, including major names such as BP, Statoil and Total.

Longer-term macro risks will challenge high yield issuers

More generally, the current environment of low interest rates and moderate growth should continue to support the high yield asset class in the short term. However, we do see more risks on the horizon for the US economy over the medium term, particularly as manufacturing data has yet to show a convincing trend of recovery; at the same time, core inflation is creeping higher. Though we are under no illusion that the longer-term outlook could be more challenging for high yield issuers, we continue to believe that high yield energy is one of the few areas of the market that offers value and where the yield cushion is sufficient to absorb the potential for capital loss.

David Absolon
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Risk Warnings:

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