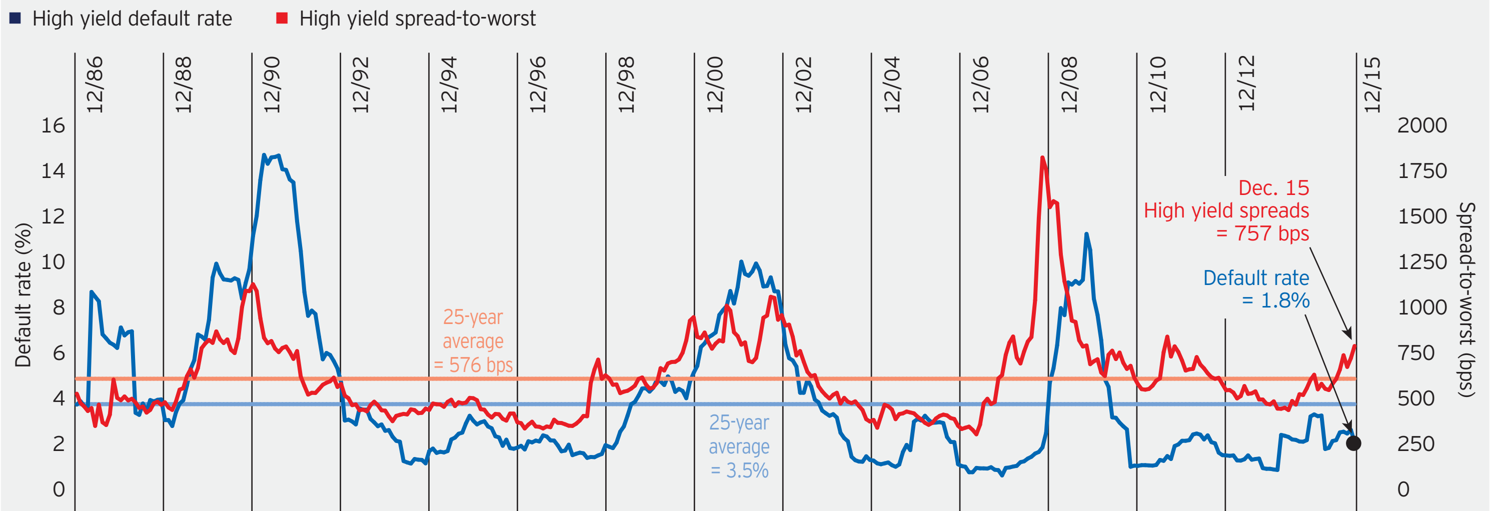
Invesco High Yield

High Yield Snapshot

Monthly high yield bond market update: January 2016

Total returns in the high yield bond market were negative in December, with the Barclays US Corporate High Yield 2% Issuer Capped Index losing 2.52%. The normally strong seasonal performance did not occur, as a risk-off mentality was quite prevalent. With the energy sector leading the way, most sectors generated negative returns. The lowest credit tier of the market (CCC-rated bonds) continued with weak performance, as investors seemed reluctant to add higher beta credit risk prior to year-end. Regarding spreads, the high yield market, as per JP Morgan, widened to 771 basis points (bps). High yield bond yields in the US ended at 9.28%, a level that hasn't been seen in years. The five-year and 10-year Treasury yields increased to 1.76% and 2.27%, respectively, as investors reacted to the US Federal Reserve's decision to raise rates by 0.25%. While default rates remain well below historical averages, we expect default rates to increase in 2016, as a number of energy and metals & mining companies will likely look to restructure their balance sheets. However, we do believe there is value to be found in this market through careful credit selection. While we note increased media focus on trading liquidity given the closure of a specialized, distressed portfolio, the normal par high yield market continues to trade roughly $50 billion per week in volume. We have not had difficulty implementing our investment themes in the portfolios.

Defaults remain below long-term average as spreads widen



Source: JP Morgan, as of Dec. 31, 2015

Performance by ratings[1]

Within the ratings categories:

- BB-rated securities returned -1.88%
- B-rated securities generated returns of -2.46%
- CCC-rated securities returned -4.46%

For the full year:

- BB-rated led the way at -1.00%
- B-rated underperformed the market at -4.63%
- CCC-rated issuers struggled this year with a return of -11.25%

We note the weak performance in the energy and metals & mining sectors has weighed on returns in the CCC rating category. Given poor fundamentals, we expect this trend to continue over the coming months.

Earnings trends

We are awaiting fourth quarter earnings reports. However, in general, we expect Q4 to look similar to Q3 in that the known trouble spots will still be under pressure. As for fundamentals overall, here are several themes we are monitoring:

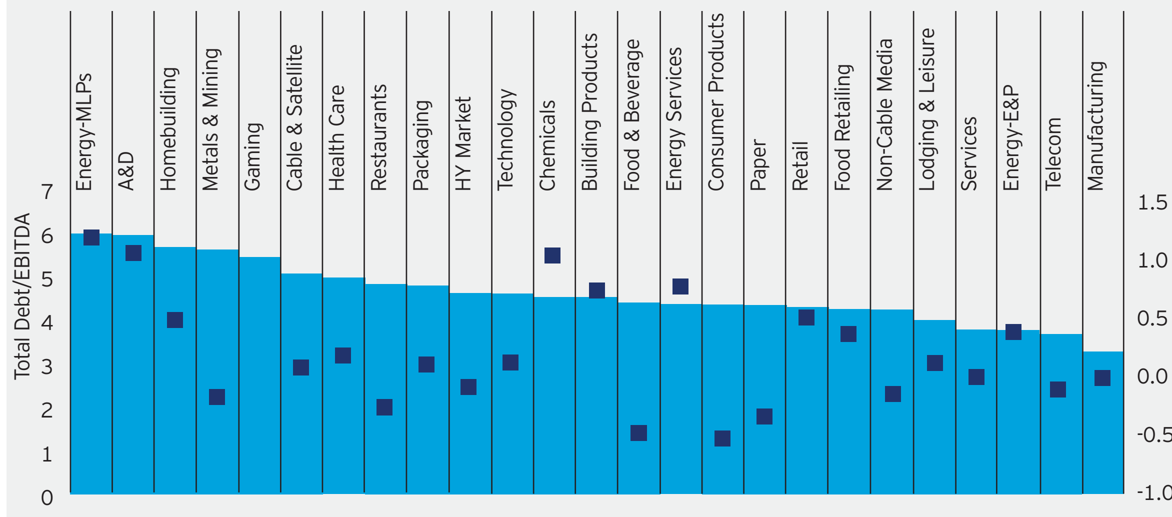
- We are still underweight metals & mining. We see little fundamental improvement in the coming months.
- Building products and home builders continue to demonstrate improved results. Despite the recent Fed rate move, we see continued gains in this sector.
- We are slightly underweight energy, specifically the exploration and production segment of the sector. Within the sector, we find the most value in higher rated credits with exposure to the Permian Basin in Texas. We think M&A will be a theme in 2016 and this is the most likely area to generate investor interest.

Fundamentals

- The Barclays US Corporate High Yield 2% Issuer Capped Index finished the month with a yield-to-worst of 8.74%, a modified duration of 4.34, an option-adjusted spread of 660 bps, and an average price of 89.10.
- Although there were five defaults in December in the high yield market, the par-weighted default rate decreased to 1.82% because the default by Caesars Entertainment Corp. dropped off the 12-month rate. Defaults (ex-commodities) are expected to remain below the long-term average default rate of 3.6% through 2017.[2]
- Credit metrics for the overall market continue to reside in a healthy zone, in our opinion.
- While leverage remained fairly stable throughout the year, there is divergence at the sector level. Some sectors, particularly commodity-dependent sectors, have shown unintentional re-leveraging, while others have increased leverage through M&A.

Sector trends indicate idiosyncratic risk

Current total leverage (lhs) Year-over-year change (rhs)

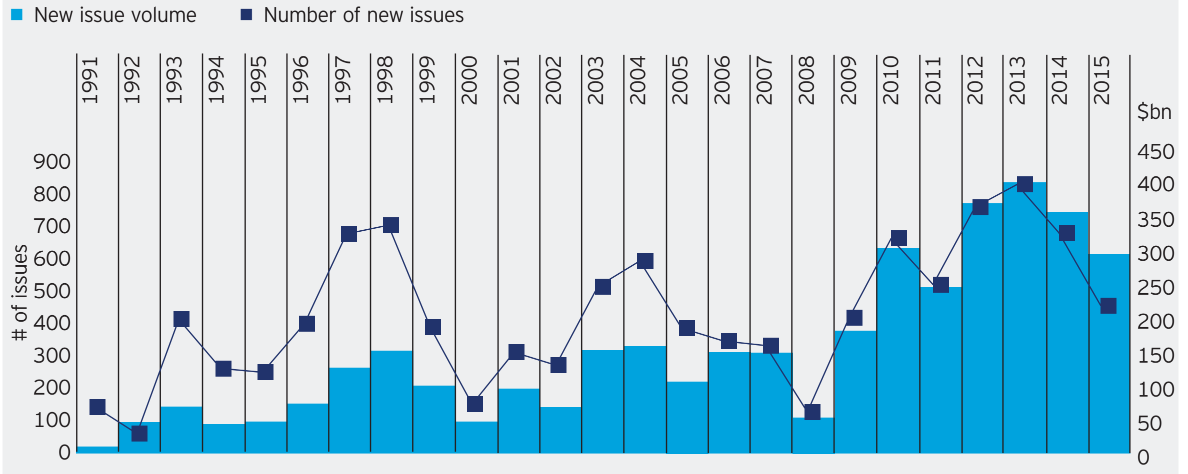


Source: Wells Fargo, as of Nov. 30, 2015

Technicals[2]

- High yield mutual funds reported $8.3 billion of outflows during December (with only weekly reporting funds included). Full-year outflows totaled $13.4 billion, which was less than the record $23.8 billion of outflows in 2014.
- New issuance was only $5 billion this month, bringing the full-year total to $293 billion, down 18% from a year earlier.
- For the year, new issuance was led by refinancing activity, accounting for 43% of the total volume, followed by 38% used for acquisition-related purposes. This compares with 54% and 26%, respectively, during 2014.

High yield new issuance down for second consecutive year



Source: JP Morgan, as of Dec. 31, 2015

Relative value

- The spread between high yield and investment grade is greater than the historical median, creating an opportunity for yield pick-up given a manageable default risk.
- High yield offers a relatively lower duration and a higher coupon, which reduces its sensitivity to interest rate movements.
- The escalation of risk premiums due to declines in commodity prices and pressure on the energy sector has created value in the overall market.

Index returns (%)

	2014	9/15	10/15	11/15	12/15	YTD
Barclays US HY 2% Issuer Cap Index	2.46	-2.57	2.74	-2.21	-2.52	-4.43
Barclays US Agg Bond Index	5.97	0.68	0.02	-0.26	-0.32	0.55
Barclays US Treasury 5-10 Year Index	6.42	1.35	-0.59	-0.42	-0.29	1.84
JPM EMBI Global Diversified Index	7.43	-1.29	2.74	-0.06	-1.39	1.18
S&P 500 Index	13.69	-2.47	8.44	0.30	-1.58	1.38
S&P/LSTA Leveraged Loan Index	1.60	-0.65	-0.18	-0.88	-1.05	-0.69

Source: Morningstar, as of Dec. 31, 2015

1 Barclays
2 JP Morgan

About risk

Fixed-income investments are subject to credit risk of the issuer and the effects of changing interest rates. Interest rate risk refers to the risk that bond prices generally fall as interest rates rise and vice versa. An issuer may be unable to meet interest and/or principal payments, thereby causing its instruments to decrease in value and lowering the issuer's credit rating. Junk bonds involve a greater risk of default or price changes due to changes in the issuer's credit quality. The values of junk bonds fluctuate more than those of high quality bonds and can decline significantly over short time periods. Businesses in the energy sector may be adversely affected by foreign, federal or state regulations governing energy production, distribution and sale as well as supply-and-demand for energy resources. Short-term volatility in energy prices may cause share price fluctuations. Investments focused in a particular industry or sector, such as the industrials sector are subject to greater risk, and are more greatly impacted by market volatility, than more diversified investments.

Important Information

All data provided by Invesco unless otherwise noted. Data as of Dec. 31, 2015, unless otherwise noted.

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