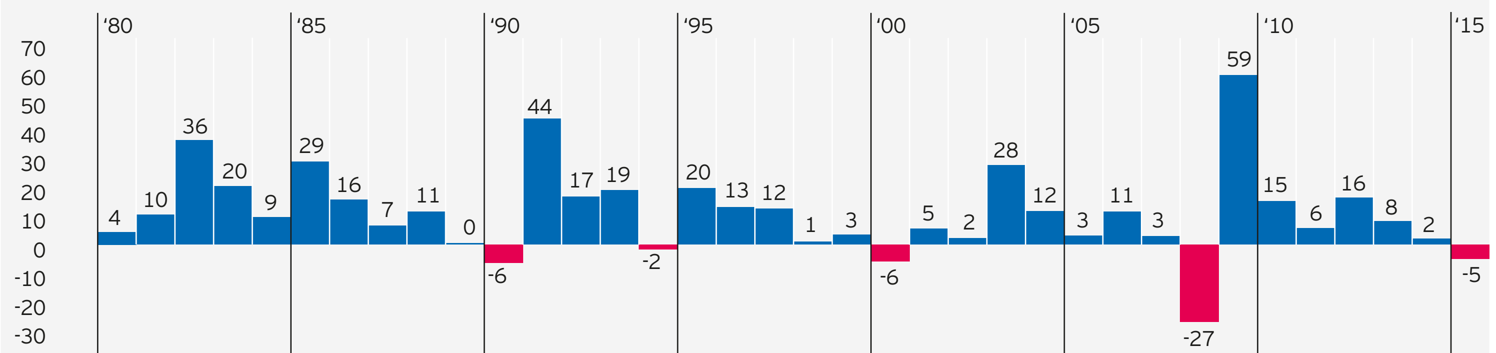
Invesco High Yield

High Yield Snapshot

Monthly high yield bond market update: February 2016

Total returns in the high yield bond market were negative in January, with the Barclays US Corporate High Yield 2% Issuer Capped Index losing 1.61% during the month. While January is normally a strong seasonal month, a widespread risk-off mentality was prevalent in the market. Continuing fears regarding Chinese growth rates and a potential for slower growth in the US caused investors to shun risk assets. This risk aversion caused spreads, as per JP Morgan, to widen to 846 basis points (bps). The five-year and 10-year Treasury yields decreased to 1.32% and 1.92%, respectively, as investors rotated into safer assets. With respect to default rates, we have updated our 2016 projections to the 5-6% range. We believe a number of energy and metals & mining companies will look to formally restructure their balance sheets. We would remind our investors that defaults are a lagging indicator and are not indicative of future total returns. For example, the high yield market enjoyed strong returns in 2009, even while defaults increased dramatically. Also, as demonstrated in the chart below, high yield has experienced five down years since 1980. Those years have typically been followed by fairly strong returns in the subsequent calendar year. Lastly, from a liquidity standpoint, we've been able to trade in normal fashion and have not had difficulties implementing our investment themes.



Source: JP Morgan High Yield Monitor, Jan. 31, 2016. High yield is represented by the JPM Global High Yield Index, from 1980 through Dec. 31, 2015. The JP Morgan Global High Yield Index is designed to mirror the investable universe of the US dollar global high yield corporate debt market, including domestic and international issues. Past performance is not a guarantee of future results. An investment cannot be made directly into an index.

Performance by ratings[1]

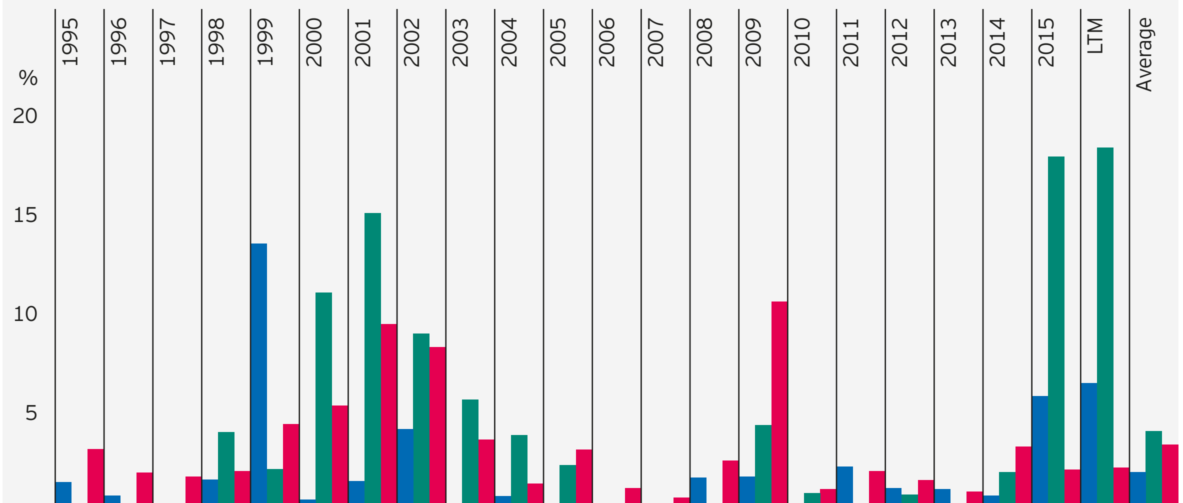
Within the ratings categories:

- BB-rated securities returned -0.91%
- B-rated securities generated returns of -1.57%
- CCC-rated securities returned -3.80%

For the full year 2015:

- BB-rated led the way at -1.00%
- B-rated underperformed the market at -4.63%.
- CCC-rated issuers struggled last 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. Both sectors have default rates well above the market rate and the metals & mining default rate is at a record high.



Source: JP Morgan, as of Jan. 31, 2016

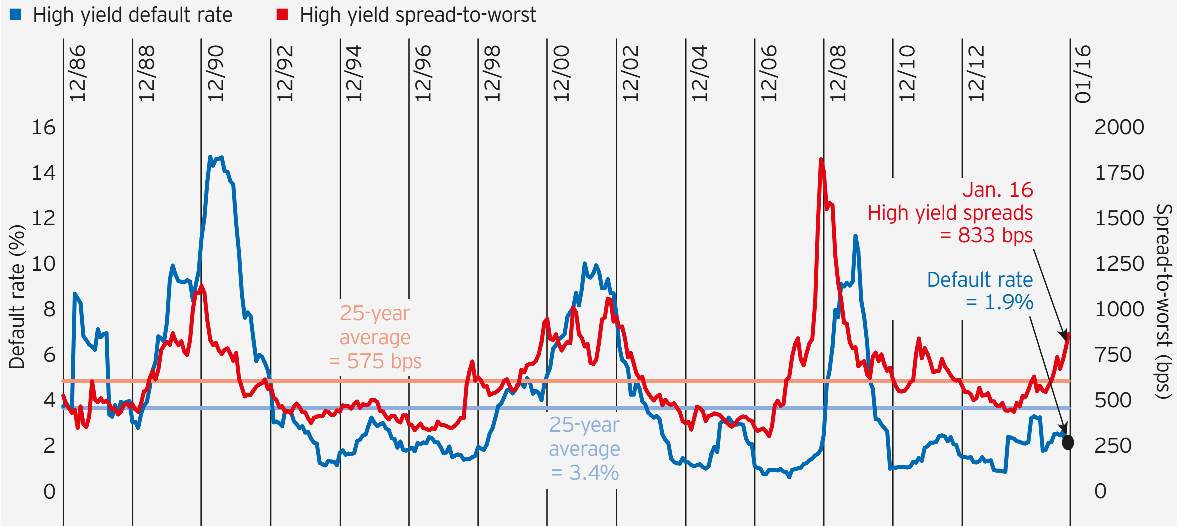
Earnings trends

Fourth quarter earnings reports are slowly being released. As for fundamentals overall, here are several themes we are monitoring:

- We are still underweight metals & mining. We think it's too early to consider owning many of the credits in this sector.
- Building products and home builders continue to demonstrate improved results. Recent home builder data supports our overweight thesis.
- While we are underweight energy overall, we have moved to a slight overweight in exploration and production credits with a heavy focus on the Permian Basin in Texas. We favor companies who operate in the Permian given the basin's attractive well economics, even in a $30 oil price environment.

Fundamentals

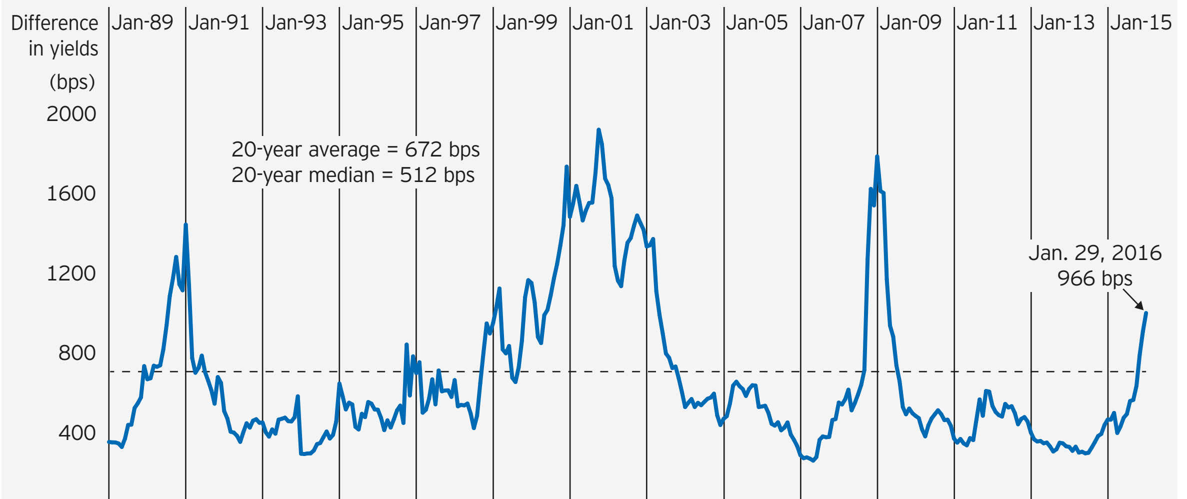
- The Barclays US Corporate High Yield 2% Issuer Capped Index finished the month with a yield-to-worst of 9.17%; a modified duration of 4.29; an option-adjusted spread of 734 bps; and an average price of 87.26.
- There were five defaults in January in the high yield market, increasing the par weighted default rate from 1.80% to 1.90%.[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.
- Even though we expect default rates to increase this year, current spread levels are 250 bps wider than the 25-year average while defaults are below their 25-year average.



Source: JP Morgan, as of Jan. 31, 2016

Technicals

- High yield mutual funds reported $3.9 billion of outflows during January (with only weekly reporting funds included). In 2015, full-year outflows totaled $16.6 billion, which was less than the record $23.8 billion of outflows in 2014.
- New issuance was only $9 billion this month compared with January 2015 when there was $22 billion in new issuance.
- New issuance was led by acquisition/LBO with only 21% being used for refinancing. In 2015, new issuance was led by refinancing activity, accounting for 43% of the total volume, followed by 38% used for acquisition-related purposes.



Source: JP Morgan, as of Jan. 29, 2016

Relative value

- The spread between B and CCC-rated bonds has widened significantly to levels not seen since the financial crisis. The lower-rated credit tier of the market continues to underperform given the greater uncertainty in the market. Weakening US growth estimates are creating fears of slower earnings for companies which in turn impacts companies with higher leverage.
- 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 (%)

	10/15	11/15	12/15	2015	1/16
Barclays US HY 2% Issuer Cap Index	2.74	-2.21	-2.52	-4.43	-1.61
Barclays US Aggregate Bond Index	0.02	-0.26	-0.32	0.55	1.38
Barclays US Treasury 5-10 Year Index	-0.59	-0.42	-0.29	1.84	2.85
JPM EMBI Global Diversified Index	2.74	-0.06	-1.39	1.18	-0.18
S&P 500 Index	8.44	0.30	-1.58	1.38	-4.96
S&P/LSTA Leveraged Loan Index	-0.18	-0.88	-1.05	-0.69	-0.65

Source: Morningstar, as of Jan. 31, 2016

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.

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

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