Morgan Stanley

INVESTMENT MANAGEMENT

High-Yield Bonds in Rising Rates

FIXED INCOME | GLOBAL FIXED INCOME | INVESTMENT INSIGHT | 2017

It's high yield and not high quality that tends to perform better in the bond markets as rates start to rise, says Morgan Stanley's Richard Lindquist.

PORTFOLIO MANAGER

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There are times when it might not pay to play it safe in the bond market, and one of those times is now, according to Richard Lindquist, a senior high-yield bond fund manager at Morgan Stanley Investment Management.

When the Federal Reserve hikes rates, it's the lower-quality bonds that tend to be the better-performing, fixed income assets, he argues, and that's already evident. Since Donald Trump was elected in early November, U.S. Treasury bonds have suffered a dramatic sell-off, in anticipation that his fiscal spending plans will prompt more Fed rate hikes next year.

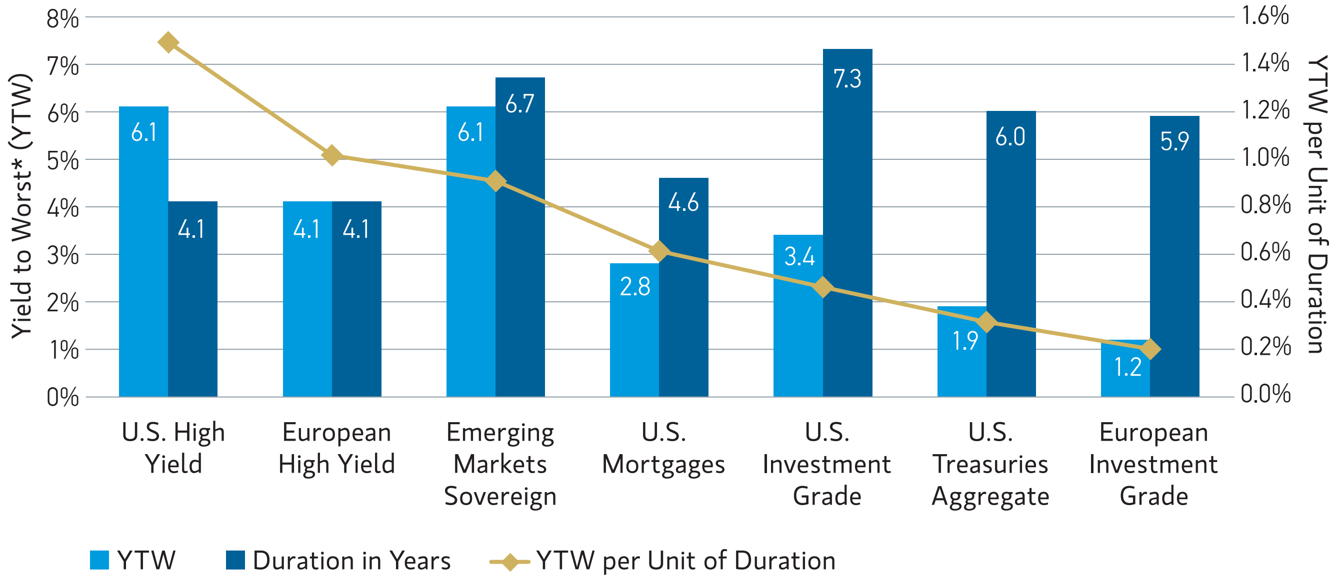
Between November 8 and December 31, 2016, U.S. Treasuries in aggregate have returned -2.63%, and investment-grade bonds have returned -1.82%. High-yield bonds, meanwhile, have returned 1.75%. And within the high-yield market, it's the bonds on the lowest rung of the rating ladder—the single-B and triple-C names—that have performed the best.[1]

"If you are going to be in fixed income, then I believe the high-yield market will be one of the better places to be, and within that, the lower-rated credits," argues Lindquist. U.S. high-yield bonds feel the impact of rising rates like other higher-quality bonds, but usually less so. That's largely because they're more influenced by the equity markets; their maturities are shorter and their coupons higher, says Lindquist.

[1] U.S. Treasury Aggregate; IG: Bloomberg Barclays Corporate Index; HY: Bloomberg Barclays Corporate High Yield Index.

DISPLAY 1

Attractive Yields with Low Duration



*Yield to Worst is the lowest yield an investor can expect when investing in a callable bond. A callable bond is one which gives the issuer the option to redeem the bond at a set date before maturity.

Source: Bloomberg Barclays Capital and JP Morgan

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The Equity Factor

High-yield corporate bonds tend to see the initial round of rate hikes as a good thing, because it's an improving economy that prompts them. "After the election, we saw much of the sector-based rotation occurring in the equity market spill over to our market," says Jack Cimarosa, a senior member on Lindquist's team. "Rentals, construction and basically anything tied to infrastructure traded well."

The Shorter, the Better

The longer a bond's maturity date, or duration, the more sensitive it is to rate moves. High-yield companies generally have shorter maturities than their higher-quality competitors. The duration of the Bloomberg Barclays U.S. Corporate High-Yield Index is 4.13 years, for instance, compared with 7.10 years for the Bloomberg Barclays Investment Grade Corporate Index.[2]

Greater Potential for Income

Having a high yield means a higher coupon or interest payment. Since total returns are the price moves of a bond plus coupon payments, then the higher the coupon, the more able the bond is to absorb any decline in dollar price caused by a rate hike. The Corporate High Yield Index's yield is around 6.12%, versus 3.37% for the Barclays Investment Grade Index.[3]

Going Down the Rating Ladder

To get the bigger coupons, Lindquist's team focuses on the middle market—companies with $150 million to $1 billion in total debt. These companies are smaller and their bonds less traded than bigger deals, but they offer better yield.

"The rating agencies—falsely, we believe—give credit for size, so middle-market bonds are always slightly lower-rated than we feel they should be," says Lindquist. He also prefers to overweight the lowest-rated parts of the market—single-B and triple-C names—where the yields are highest.

"Going into weaker credits would be a harder decision to make if defaults were rising, but we believe defaults will be contained, and might even fall over the next six to 12 months," he says.

The entire high-yield market's default rate is around 5.65%, but just 2.0% if energy, metals and mining sectors are stripped out.[4]

[2] Date: As of December 31, 2016.

[3] As of December 31, 2016.

[4] Moody's Investors Service, as of December 31, 2016.

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Chart Source: U.S. High Yield refers to the Bloomberg Barclays U.S. Corporate High Yield Index. European High Yield refers to the Bloomberg Barclays Pan-European High Yield Index. Emerging Markets Sovereigns refer to the JP Morgan EMBIG Index. U.S. Mortgages refers to the Bloomberg Barclays U.S. Mortgage-Backed Sectors Index. U.S. Investment Grade refers to the Bloomberg Barclays Corporate Index. U.S. Treasuries Aggregate refers to the Barclays U.S. Treasuries Aggregate Index. European Investment Grade refers to the Bloomberg Barclays Euro Aggregate Corporate Index.

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