The Fed has hiked – what now for high yield?

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In their March meeting, the Federal Reserve (Fed), as expected, hiked rates, but it was about as dovish as a rate hike could be.

The Fed indicated a cautious approach and a gradual path of tightening ahead, which was shallower than markets had expected and hence the US 10-year Treasury rallied, with yields moving back below 2.5%. Inflation needs to be kept in check – it has been on the rise and is expected to go higher on anticipated Trump policies and tax reform. If other countries respond to US protectionism by also increasing tariffs, then inflation can be expected to be higher still.

Income a key factor for returns

With this in mind, real returns in fixed income will be hard to come by, but US high yield bonds stand out as it is debatable how rates-sensitive this sector is given the current yield still averages just over 6%. In recent history, the 'taper tantrum' showed us that high yield does respond negatively to rate hikes, at least initially, as asset allocators change weightings. However, when volatility in rates remains, high yield does tend to recover quickly and offer some protection with the potential to outperform investment grade. High yield therefore remains attractive due to the income it provides.

Keep interest rate sensitivity low

Given the rates outlook, longer duration (i.e. being more sensitive to movements in interest rates) is best avoided: US high yield already has a relatively low duration of around 4 years and within the asset class we recommend avoiding long duration bonds especially in the rates-sensitive double-B segment where yields are lower. We believe attention would now be best focused on better-yielding bonds in the single-B tier of short to medium duration, an area of the yield curve where the 'roll down' (as a bond moves towards maturity, the income decreases and the value of the bond increases) is also quite attractive.

Underlying default level remains low

Another factor to consider is credit quality and defaults have been increasing to close to 5%. However, the majority of recent defaults have been in the energy sector where bonds have been rallying of late on a recovery in commodity prices. Filtering out this separate energy default cycle, defaults remain at very low levels, at just over 2%. The US is currently in the late-stage of the credit cycle and going into an expansionary phase. There is a risk of a consumer-led US recession, but for the time being this looks remote with a shift from monetary to fiscal policies in the US.

An increase in M&A could be beneficial

In our models, we are factoring in a deterioration of credit quality and forecasting the default rate to rise moderately to 4%, but remain below the long-term average. This would still allow for some spread tightening, indicating that potentially higher defaults are already priced into spreads. Another mitigating factor is that merger and acquisition (M&A) activity is on the rise in the expansionary phase of the credit cycle and often

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high yield issuers are often the target, meaning their bonds are potential beneficiaries. That said, of course, some degree of spread tightening will be needed to offset against any future rate hikes.

Europe has favourable fundamentals looking forward

Taking the above into account, there is still a good probability of positive real returns in US high yield, but the total return will be dominated by income. Yields in European high yield are lower overall, but spreads compare favourably and Europe is both lagging in the credit cycle, has not started a rate hike cycle and is still benefiting from quantitative easing. Therefore, for European investors, European high yield bonds, in our view, are a good alternative and might even outperform US high yield (note: investors need to take into account that although US yields are higher in absolute terms, for a European investors after hedging back to euros this relative advantage is eroded).

Central bank policy remains supportive in Europe

In Europe we also have a preference for single-B as the European Central Bank's indirect impact on the double-B tier has driven yields down significantly. Importantly, the average duration of European high yield is around half a year shorter, and the average rating better, than US high yield.

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