Fixed Income Focus.

Assessing the outlook for high yield

High yield bonds have performed strongly in 2016, as continued support from central banks and the global search for income has led to significant inflows into the asset class. With several possible economic scenarios ahead, LGIM's Head of Global High Yield, Martin Reeves, considers what the future might hold for high yield investors.

Contribution by Martin Reeves – Head of Global High Yield

Martin is Head of Global High Yield. Prior to joining LGIM in 2011, Martin ran credit research at AllianceBernstein where he worked since 1998.

Prior to AllianceBernstein, Martin was the Head of US High Yield Research at UBK Asset Management and a chartered accountant with Ernst & Young. Martin holds an MA in Economics from Cambridge University, St Catharine's College.

Three possible scenarios

The outlook for high yield depends largely on one's view of how the global economy performs from here. We envisage three possible scenarios:

- In the event of a material slowdown in China and a recession in the USA, it is likely that all risk assets would be affected. In this scenario, however, we would expect high yield to follow historical precedent and outperform equity markets
- A second possible scenario is that the global economy continues to stumble along at a low but positive growth rate, accompanied by very accommodative central bank policy. This environment could be positive for high yield, as modestly positive growth and record low financing costs would render it attractive, with high yield bonds being a key source of income in a low yielding world
- A third path could see growth rising as monetary stimulus from around the world starts to kick in. Under such circumstances, government bonds would normally sell off and equity markets would be boosted by stronger growth, with high yield somewhere in the middle as their high income component dampens some of the underlying duration risk. But the globe's structural imbalances could play an active part this time around, with rising yields posing an immediate problem for the world's debt overhang and impacting growth prospects in turn. Such a scenario could therefore be unstable at best

What can we learn from today's low yields?

In a world where interest rates could remain lower for longer, many investors who have previously avoided high yield bonds could be drawn into the asset class. At the end of July, 25% of the Barclays Global Aggregate bond index was trading with a negative yield. Most investors need income from their portfolios, and are therefore increasingly attracted to high yield bonds.

Regulators that have previously made buying sub-investment grade bonds prohibitively expensive because of its high risk-weighted cost of capital may well be forced to reconsider their stance. In addition, it is difficult to cover the costs of running financial services companies just by buying bonds with negative yields.

Low yields may also be a warning of increasing future risk. A negative yield has generally surprised investors, and many investors have been unprepared for such an environment. So if low yields portend a recession, then as discussed, all risk assets would be likely to come under pressure. But, if low yields foretell

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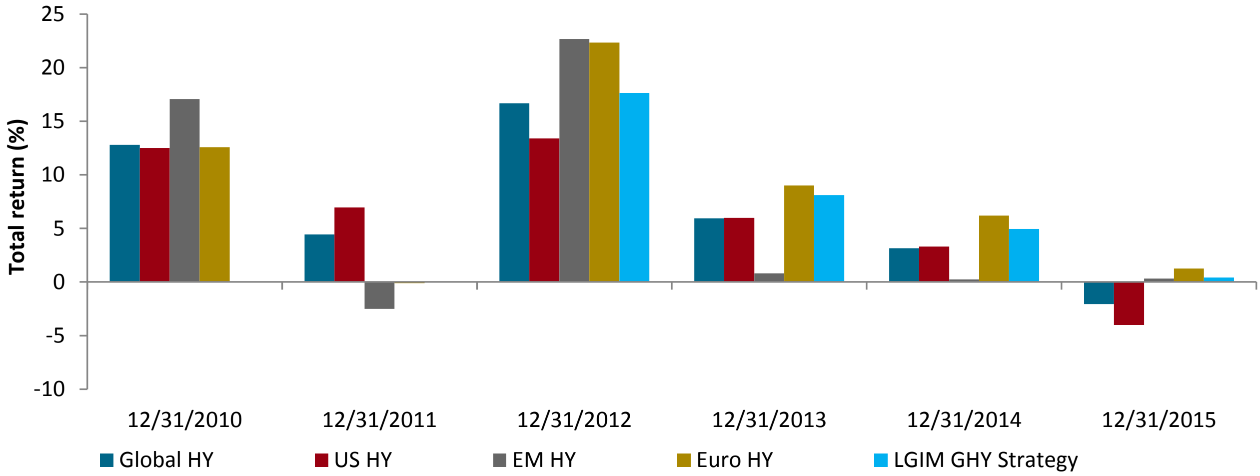
a persistent failure of central banks to create inflation, but no recession, then the outcome may be more nuanced. Although financing costs could be low, a weak nominal growth environment would put pressure on revenues, and companies with little or no ability to cut costs could struggle. Industries with overcapacity would likely be hardest hit, with revenues falling more quickly than anticipated. In particular, leveraged businesses may struggle in sectors where debt has historically been high and revenues stable. This could affect US healthcare, European cable and even grocery retailers. But there would also be relative winners from regions or sectors that have managed their debt profile, are able to cut costs and benefit from pricing power. This provides an opportunity to take advantage of industry consolidation such as the metals and mining sectors.

Keep your horizons broad

Regardless of the economic outlook, we believe that regional and industry selection will remain crucial when investing in high yield, and favour a global approach. In the current low yield environment, we believe that having the widest possible opportunity set in which to seek value makes the most sense. Figure 1 illustrates the variation of regional returns within high yield, highlighting how important it is to be dynamic and to capitalise on different returns across regions.

Figure 1. Regional returns in high yield markets



Source: BofAML high yield regional benchmarks for BB-B Non Financials (hedged to GBP). Strategy is LGIM's Global High Yield BB-B Non Financials composite (hedged to GBP). Performance shown since current investment team commenced 1 January 2012.

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