INVESTMENT WEEK
19 August 2013 www.investmentweek.co.uk

How will liquidity withdrawal impact global high yield bonds?

Andrew Lake, head of high yield at Mirabaud Asset Management, assesses if the high yield bond sector has become more susceptible to short-term market moves

The recent volatility in the US 10-year treasury over the last three months – moving from 1.63% to 2.74% and settling around 2.55% – and the knock-on effect on both gilt and bund yields (see chart 1) raised fears we were somehow going to repeat 1994 and experience another high yield market collapse as a result of rapidly rising interest rates.

In fact, the situation is rather different today.

It is, however, the central bank interventions which for better or worse are impacting the way high yield bonds behave at this point in the cycle. The question remains whether high yield will continue to benefit from a gradual uptick in economic growth, with subdued inflation and low interest rates, or whether its characteristics have fundamentally changed to make it more susceptible to short-term market moves?

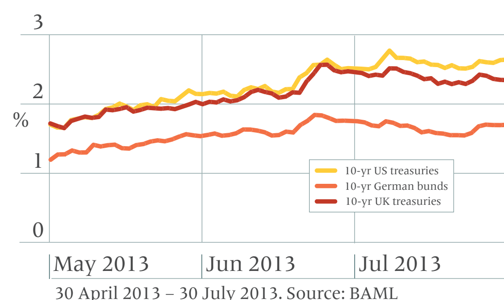
Comparison

Normally it is argued that high yield is a lower volatility returning asset class to equities, with the coupon providing the spread buffer to reduce interest rate sensitivity, and the longerterm return almost entirely coming from income.

At this point in the cycle, given it is an idiosyncratic credit product, investors should be comfortable that high yield will continue to perform versus other fixed income asset classes, particularly if growth and inflation remain subdued.

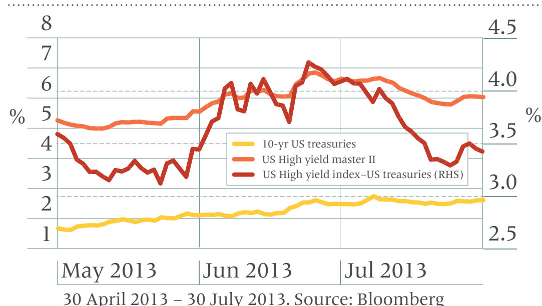
Over the past five years however, investors have been forced to move into higher yielding products like high yield, emerging markets and equities as central banks and the Federal Reserve, in particular, have injected huge amounts of liquidity into the system and artificially suppressed interest rates for a prolonged period. This has resulted in lower absolute yields versus historical averages but spreads that are not far off historical averages. Will the drivers of high yield performance change as a result and will it be spreads or yields that drive market movements in the future?

Chart 1: US and European government bonds move in tandem despite differing business cycles



30 April 2013 – 30 July 2013. Source: BAML

Chart 2: High yield initially tightened versus treasuries until outflows drove market movements



30 April 2013 – 30 July 2013. Source: Bloomberg

Shortened horizon

High yield is driven by sentiment, liquidity, fundamentals, interest rates and defaults in no particular order. What has become apparent, at least over the last few months, is the market's

investment horizon has shortened dramatically and become almost entirely focused upon each data point and how that might in turn influence Fed action.

It has also meant that in Europe, where the struggle out of recession is only just beginning, government bond rates have moved in tandem with the US, despite an increased likelihood of a more accommodative policy in the US for a greater period of time.

ETF impact

Exacerbating this short termism has been the growth in the ETF market, which has brought both advantages and disadvantages to the high yield market. They are an easy way of gaining short-term exposure to the asset class, but the resultant volatility presents issues for markets with less liquidity like high yield.

It was clear from the beginning of the market sell-off in May, as a consequence of Bernanke's first comments on tapering, that high yield behaved as it was supposed to – at least initially. It moved tighter as the government curve moved wider but then we began to see large and sustained outflows (see chart 2).

This, combined with an inability for investment banks and other market participants to take on too many of the bonds available as a result of smaller balance sheet risk, saw the market move down sharply. Thus, liquidity drove market volatility – not concerns about interest rates.

The argument only short duration funds can weather rising treasury yields would seem to hold true given their outperformance during the most recent bout of market volatility, but only if you believe it was as a result of rates and not liquidity.

It is unlikely the biggest ETF bonds are also held in short duration funds, hence there would have been little of the performance impact as a result of ETF redemptions seen in more mainstream high yield funds.

Duration

If one looks at duration at the worst of the high yield market over the last three years, it has not actually moved significantly and in fact remains low by historical standards, with a modified duration to worst of 3.88 years.

There are, however, certain parts of the market that are now more duration sensitive, particularly recent issues in the US. Europe has a far larger proportion of BB's (twothirds versus one-third in the US), which reduces the overall market spread.

At some point this will result in some interest rate effect should we see strong growth and inflation, but that is quite some way away yet.

In the US, despite the lower BB exposure, spreads on the whole are much tighter and duration longer so the market is much more affected by movements in treasuries.

Interestingly, it was US high yield bonds that significantly underperformed European high yield bonds when the market began to trade off, thus emphasising an active asset allocation process is very beneficial – especially if one believes Europe and the UK will ultimately be successful in de-coupling from US treasuries.

This would seem to be counter-intuitive given that the US growth trajectory is more embedded and thus credit should do better in the US than in Europe.

Benefits

Recent high yield market moves would seem to suggest that the traditional benefits of high yield – interest rate insensitivity and an idiosyncratic risk profile – have dissipated.

QE has changed the way investors have reacted over the last few years to risk assets. While this has had an impact, one can argue liquidity and short-term sentiment are in ascendancy at present. With low default rates and spreads to treasuries back over 500bps, the traditional advantages of high yield remain in place, particularly in this part of the economic cycle.

Reprinted with permission by The Reprint and Licensing Centre. (www.rl-centre.com / 0207 501 1085).
Not to be reproduced without authorisation.