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Q&A
With portfolio manager
David Daigle

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In this Q&A, Capital Group Global High Income Opportunities portfolio manager David Daigle shares his outlook on the corporate high-yield bond market, including his view on valuations and the potential impact of US interest rate rises.

David Daigle is a fixed income portfolio manager at Capital Group. He has 19 years of investment experience, all with Capital Group. As an investment analyst at Capital, David covers wireless communications and building products. Earlier in his career at Capital, David covered multiple industries including healthcare, technology, and transportation. He holds an MBA with honors from the University of Chicago Booth School of Business and a bachelor's degree in business administration from the University of Vermont. David is based in New York.

How do you see current valuations within the corporate high-yield market?

Yields on corporate high-yield bonds have widened from around 5% at the end of June 2014 to nearly 9%.[1] Initially, this widening was driven predominantly by the decline in energy and commodity prices, but more recently we have seen weakness across a broader selection of industries, including telecommunications, healthcare and industrial companies.

This rise in yields and spreads has been inconsistent with movements in underlying US Treasury yields or equity markets. Equity markets are still close to post-financial crisis highs, and yields on US Treasury bonds remain broadly similar to levels seen 18 months ago.[2] Historically, the high-yield market has generally shown a positive correlation with equity markets and a negative correlation with rates markets, although in certain environments, rates and spreads have been positively correlated, as we saw during the 'taper tantrum' in 2013.

On the equity side, stability in broad indices has masked a severe deterioration in parts of the market, particularly among companies in commodity industries. Approximately 20% of the high-yield index consists of commodity-related companies, while the exposure is much lower for the S&P 500 Index.[3] If there is a continuation either of the weakening of the equity or rates markets, or of the significant pressure on commodity prices, weakness in the high-yield market is likely to continue too. However, if equity markets and rates markets are reasonably stable and commodity prices bottom, the high-yield market should do very well.

What is your view on the technical factors affecting the high-yield market?

In the high-yield market, flows in and out of the asset class can often be volatile and the market can be subject to pronounced movement due to its relatively small size. Flows are often triggered by macroeconomic events or returns on the high-yield market, and we must manage our high-yield portfolios with an awareness that flows will be volatile and will impact liquidity and pricing. If, for example, the US Federal Reserve (Fed) raised interest rates more aggressively than expected over the next year, it could precipitate outflows from fixed income funds, but conversely, if the Fed raised rates more slowly than expected, we could expect inflows.

1. 8.7% of Barclays US Corporate High Yield 2% Issuer Capped Index as at 31 December 2015. Source: Bloomberg
2. The yield on the benchmark 10-year US Treasury note fell 27 basis points in the past 18 months, from 2.48% as at 30 May 2014 to 2.21% as at 30 November 2015. Source: Bloomberg
3. 18.9% of Barclays US Corporate High Yield 2% Issuer Capped Index and 7.1% of the S&P 500 Index as at 20 November 2015. Source: Bloomberg

Another technical factor that impacts the high-yield market is the volume of new issues coming to market. Generally, rising yields and spreads will act to slow issuance, and falling yields and spreads will lead to greater issuance. With the increase in yields in 2015, new issue volumes have slowed, allowing the market to offset some of the asset class outflows. With yields at current levels, issuance in 2016 is likely to be down again, which will be a technical positive for the market in 2016.

What are your expectations for returns within the high-yield sector?

Current valuation and technical factors should both be supportive for this year, and I expect returns in US dollars of 6%-7% in 2016. This return forecast is predicated on relatively stable equity and rates markets, slower new issue volumes, and an increase in defaults (specifically among commodity companies).

What do you see being the impact of potential US interest rate rises?

If the Fed raises rates gradually, and generally in line with market expectations, then any impact on the high-yield market should be muted. However, if the Fed acts more aggressively, as it has often done historically, then the high-yield market will be adversely impacted in two ways: directly, by increases in rates, which drive yields higher, and indirectly, by anticipated outflows from fixed income asset classes, including high yield.

The path that the Fed takes will depend on labour market and inflation trends in the US, but will also be affected by external factors. For example, instability in markets outside the US, including in China and other large economies, will likely have an impact on the Fed's monetary policy decisions. I expect the Fed to raise rates slowly and cautiously in 2016.

How are you positioned to minimise the impact from higher US rates and potentially wider spreads?

I have maintained a relatively low interest rate duration of 3.7 years for my portion of the Capital Group Global High Income Opportunities strategy, compared with 4.3 years for the index.[4] With a shorter duration, we can to some extent insulate the strategy from adverse rate or spread movements, and be prepared for better investment opportunities if yields rise due to either rate increases or spread widening.

Some investors view leveraged loans as an attractive asset class given the current market environment. Do you share this view?

Leveraged loans have held up relatively well compared with high-yield bonds over the past 18 months, but this has not been due to the reasons people expected, i.e. because of rate increases, but rather because of their seniority in the capital structure. Most leveraged loans have interest rate floors, and until Libor rises above the floor (typically 125 basis points), investments in loans will not benefit from rising rates. In 2016, it is unlikely that Libor will exceed the floor, and so there will be no effective yield increase from rising Libor rates.

4. Data as at 31 December 2015. Index referred to is the Barclays US Corporate High Yield 2% Issuer Capped Index. Source: Bloomberg

Leveraged loans and high-yield bonds are fundamentally different structures, and will perform differently in various scenarios. With leveraged loans, investors are getting the benefit of lower exposure to rising Libor rates and a secured ranking in the capital structure, but give up call protection and some amount of liquidity. With many high-yield bonds now trading well below par, leveraged loans will have a more difficult time outperforming high-yield bonds.

Could you comment on your outlook for the energy sector, a significant component of the corporate high-yield market?

I have had a relatively low exposure to the energy sector for some time, but increased this exposure over the past year by investing in a diverse portfolio of companies within the energy industry. Valuations are much more attractive than they were 18 months ago, and commodity prices have adjusted downward significantly. It is difficult to predict the path of commodity prices, but the range of outcomes is much more favourable today.

While the energy sector may continue to suffer from volatility in the near term, prices should eventually rebound as supply adjusts to the new price reality. An substantial amount has been invested in these sectors over the past decade, and it will take time to work through this supply overcapacity. However, the cost of capital is now so high that capital spending projects are being curtailed, which should eventually lead to a reduction in supply and upward pressure on prices.

Do you have a preference for any credit quality group at the moment?

As is typical in weakening markets, higher-credit-quality issues have generally performed well, with BB-rated bonds outperforming B-rated and CCC-rated bonds in 2015. However, CCC-rated bonds are now trading at their widest relative spreads in more than a decade, and there are currently plenty of CCC-rated bonds that we find attractive. We need to be cautious with B-rated bonds, as a downgrade to CCC will exert significant pressure on bond prices in this environment. We are also finding interesting opportunities in select "fallen angels", or investment-grade bonds that have recently been downgraded to high yield.

Default rates are often questioned in high-yield mandates. What would be your view on how the default rate should be approached?

It is important to remember that there will always be some risk of defaults occurring in a high-yield mandate. High-yield default rates ended 2015 at around 1.8%[5], which means an average of two issuers out of 100 will default in any given year. Although we strive to minimise defaults, what is most important is minimising permanent capital losses on our investments. We will occasionally hold a bond through an event of distress with the expectation that the ultimate recovery value will exceed the price at which we could liquidate the position.

5. As at 31 December 2015. Source: JPMorgan

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