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HIGH YIELD: FINALLY NEAR FAIR VALUE

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KEY TAKEAWAYS

Recent bank lending standards data provide further support for high-yield fundamentals.

Spreads have widened since July lows, as high yield expressed caution regarding geopolitical tensions.

Valuations are near fair value, given forward-looking default estimates.

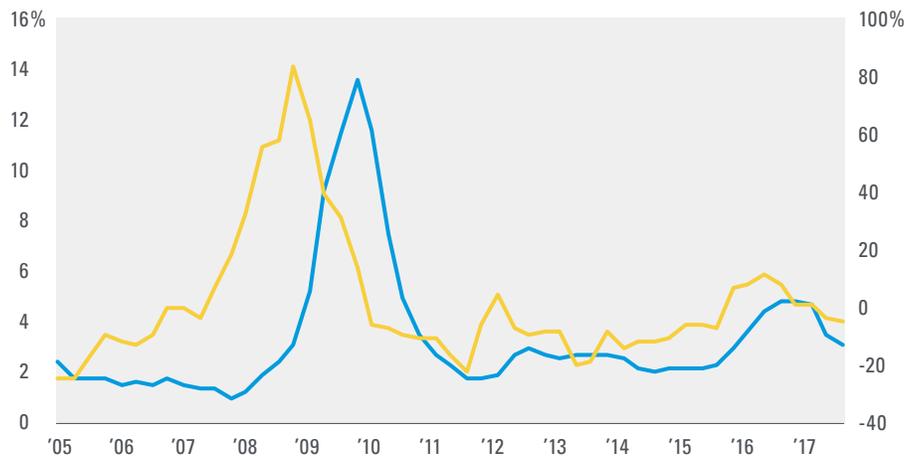
High-yield fundamentals remain stable and leading indicators of default continue to improve, helping to corroborate the lower default expectations currently projected by rating agencies. Given the positive economic backdrop, default forecasts, and the widening of spreads over the last six weeks, we believe the high-yield market is priced near fair value and anticipate further stability assuming no new risks are introduced.

EASING LENDING STANDARDS

Defaults are declining and appear to be confirming the lower default forecasts for 2017 made by rating agencies early in the year. Forward-looking indicators also appear to be endorsing this sense of optimism. The Federal Reserve Senior Loan Officer Survey (FSLO) indicates whether banks are tightening or loosening lending standards for medium- and large-sized companies. The FSLO has historically been a good leading indicator of default rates [Figure 1], as it stands

1 LOOSENING LENDING STANDARDS IS POSITIVE FOR DEFAULT RATES

- Moody's Default Rate (Left Scale)
- FSLO, Net % Tightening/Loosening Lending Standards (Right Scale)



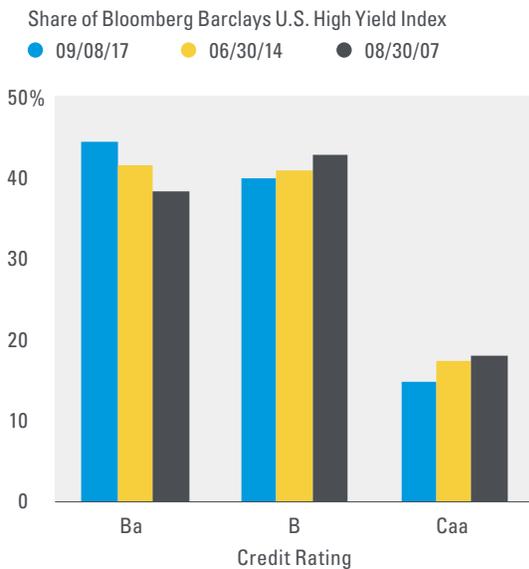
Source: LPL Research, Bloomberg, Moody's, Federal Reserve 09/11/17

FSLO – The Federal Reserve Senior Loan Officer Survey

Moody's is an independent, unaffiliated research company that rates fixed income securities. Moody's assigns ratings on the basis of risk and the borrower's ability to make interest payments.

to reason that companies that can get a new loan will generally not default on an old one. As the modified adage goes, “a rolling loan gathers no loss.” As of July 31, 2017, banks were loosening lending standards on a net basis even more quickly than in the previous reading on April 30, 2017, which was the first net loosening since July 2015.

2 HIGH-YIELD MARKET IS HIGHER QUALITY THAN IN THE PAST 10 YEARS



Source: LPL Research, Barclays 09/08/17

Credit ratings are published rankings based on detailed financial analyses by a credit bureau specifically as it relates to the bond issuer’s ability to meet debt obligations. The highest rating is AAA, and the lowest is D. Securities with credit ratings of BBB and above are considered investment grade.

CREDIT QUALITY ALSO ACCOUNTS FOR TIGHT SPREADS

In addition to relatively positive fundamentals for high yield, improved overall market credit quality may also warrant tighter spreads than seen historically. The U.S. high-yield market is higher in quality than during recent spread lows in mid-2014 and even more so than the market 10 years ago [Figure 2]. The highest-rated portion of the high-yield market represents over 6% more of the market than it did 10 years ago. All else equal, a higher-rated market should require less additional compensation from investors, potentially contributing to spreads below historical averages.

WHAT’S FAIR VALUE?

Although it is impossible to know precisely what the “fair value” is, certain assumptions can be used to gauge how tight spreads are relative to other critical indicators within the market. Using forecasts of the coming year’s default rate and assumptions of recovery rates in the event of a default, we can estimate what will be lost in total due to defaults in the market. Adding in a historically derived “liquidity premium,” which reflects the risk that a bond cannot be traded quickly without materially impacting the market price, can help approximate fair value for high-yield spreads.

For the first time this year, the market is currently somewhat on the cheap side of our fair value

3 HIGH YIELD PRICED NEAR FAIR VALUE

Forecast Default Rate	X	Estimated Default Loss*	=	Total Default Loss	+	Liquidity Premium**	=	Fair Value Spread	vs.	Current Spread
2.20%		65%		1.43%		2.20%		3.63%		3.81%

Source: LPL Research, Moody’s, Barclays, Bloomberg 09/11/17

*Par value minus 35% estimated recovery rate. Par value is the nominal value of a bond, share of stock, or a coupon as indicated in writing on the document or specified by charter.

**High-yield spreads compensate investors not only for default risks but for liquidity risk, which can be termed the “liquidity premium.” Liquidity risk is the risk that a bond cannot be traded quickly without materially impacting the market price.

estimate (assuming default forecasts prove accurate). Per Moody's, the high-yield default rate was 3.1% at the end of July 2017, and is expected to fall to just 2.2% in July 2018 on a trailing 12-month basis. The current spread already more than compensates investors for the default risk over the next year, including the liquidity premium [Figure 3]. However, a change in variables, such as lower than expected recovery rate on defaults over the next year, could shift the estimate materially.

RISK RELATIONSHIPS

Equity markets, however, remain a key driver of high-yield performance going forward. Spreads are still tightly correlated with equity market movements. High yield will not behave like high-quality fixed income, especially in times of market

stress. Generally speaking, high-quality bonds protect against equity market weakness while high yield participates in that weakness. This is a double-edged sword, however, and given healthy market fundamentals, high yield should be poised to perform well if equity markets continue to rise.

CONCLUSION

The July reading for the FSLO, which showed a further net loosening of lending standards by banks, is a good indicator of fundamental strength within high yield, and corroborates the tight spreads within the market. Valuations are finally near fair value, and potentially slightly cheap given optimistic default forecasts, leading us to maintain our expectation for high yield stability over the remainder of 2017, absent an equity market sell-off. ■

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results. All indexes are unmanaged and cannot be invested into directly.

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Because of their narrow focus, specialty sector investing, such as healthcare, financials, or energy, will be subject to greater volatility than investing more broadly across many sectors and companies.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values and yields will decline as interest rates rise, and bonds are subject to availability and change in price.

High-yield/junk bonds are not investment-grade securities, involve substantial risks, and generally should be part of the diversified portfolio of sophisticated investors.

Government bonds and Treasury bills are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value. However, the value of fund shares is not guaranteed and will fluctuate.

Yield spread is the difference between yields on differing debt instruments, calculated by deducting the yield of one instrument from another. The higher the yield spread, the greater the difference between the yields offered by each instrument. The spread can be measured between debt instruments of differing maturities, credit ratings, and risk.

INDEX DEFINITION

The Bloomberg Barclays High Yield Bond Index covers the universe of publicly issued debt obligations rated below investment grade. Bonds must be rated below investment grade or high yield (Ba1/BB+ or lower), by at least two of the following ratings agencies: Moody's, S&P, and Fitch. Bonds must also have at least one year to maturity, have at least \$150 million in par value outstanding, and must be U.S. dollar denominated and nonconvertible. Bonds issued by countries designated as emerging markets are excluded.

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