Bond Market Observations

June 2016

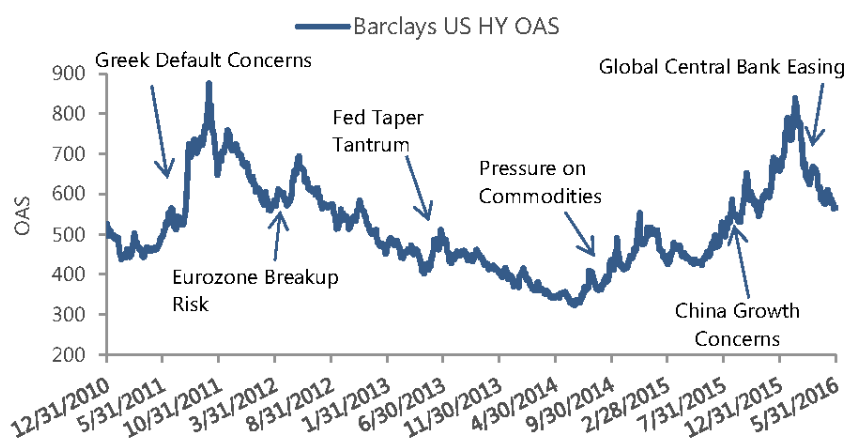
High Yield's Global Puzzle

- High Yield performance has been increasingly tied to global events, with developments in economies outside the U.S. affecting sentiment for riskier assets.
- Markets are evaluating later cycle fundamentals, which have the potential to create headwinds.
- High Yield valuations are tempting given investment grade alternatives.

The performance of U.S. risk assets is not merely tied to what happens within our borders, as is evident in the chart below. Doubts about the economic momentum of China, swings in oil and other commodity prices that are set in world markets, and skittishness induced by policy makers have left their imprint on pricing.

In our view, the near-term global landscape is littered with upcoming events potentially important to the performance of risk assets: the referendum on whether the UK stays in the European Union, national elections in Spain and Japan, and the U.S. presidential election. Technicals have been strong for risk assets on the back of easy monetary policy globally, encouraging investors to reach for income in an increasingly negative-yield world. Over the short-term, spreads may be sustainable – but for how long?

High Yield Spreads React with Global Events



Source Barclays POINT May 31, 2016

The Commodity Piece

It is important to recognize that the composition of the high yield sector has evolved over the last two years. Energy and Metals & Mining companies, with direct or indirect links to emerging markets, now comprise a larger share of the high yield universe at 13.19% and 6.11% the respectably; a 20% increase versus two years prior.

The link between high yield spreads and commodities can be most clearly seen in the relationship between the sectors' performance and oil prices. Since the summer of 2014, high yield spreads have traded directionally with oil, with an R-squared of 0.80. While the R-squared has declined to 0.70 recently, this is still significantly higher than the R-squared of 0.20 prior to the second half of 2014.

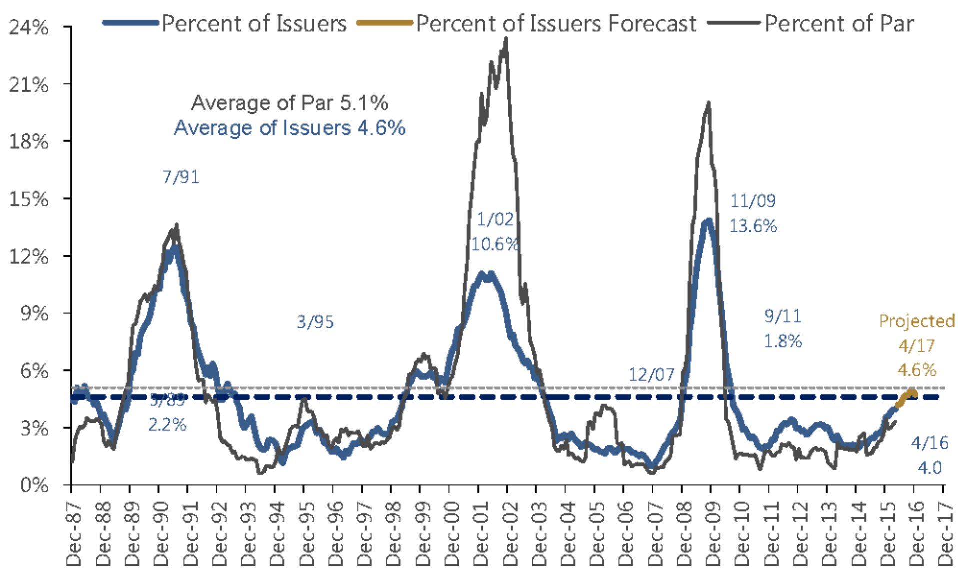
Following an 18-month decline in oil, prices have risen off the lows of February 2016 and served as a tailwind for risk assets. Unless oil again falls below $40 for a period of time, the number of fallen angels and defaults within the commodity space should be relatively contained. However, as oil now seems to be trading in a tighter range the relationship between oil and spreads may decouple.

The Fundamentals Piece

We view fundamentals as mixed at this stage of the cycle. High yield companies have seen multiple quarters of revenue declines and fundamentals have slowed. First-quarter earnings beat expectations but only after significant downward revisions and eked out modest year-over-year gains once commodity sectors are excluded.

On the positive side, while leverage has increased it has not yet reached alarming levels. The use of new issue proceeds has been split between refinancing and shareholder friendly activity, such as acquisitions or dividends. Default rates, which are rising, are projected to exceed 4.6% in the next year: a rise from sub-3% levels recently, but not the alarming 10% default rates of previous credit cycle busts. Stress in energy and commodity related companies is not only boosting higher expected default rates, but also lowering corresponding recovery rates as distressed companies compete to sell nearly identical assets, pushing sale prices lower. We continue to be cognizant of late cycle fundamentals and are focused on credit specific stories in names that can weather the credit cycle.

Moody's Global Speculative Grade Bond Trailing 12-Month Default Rate



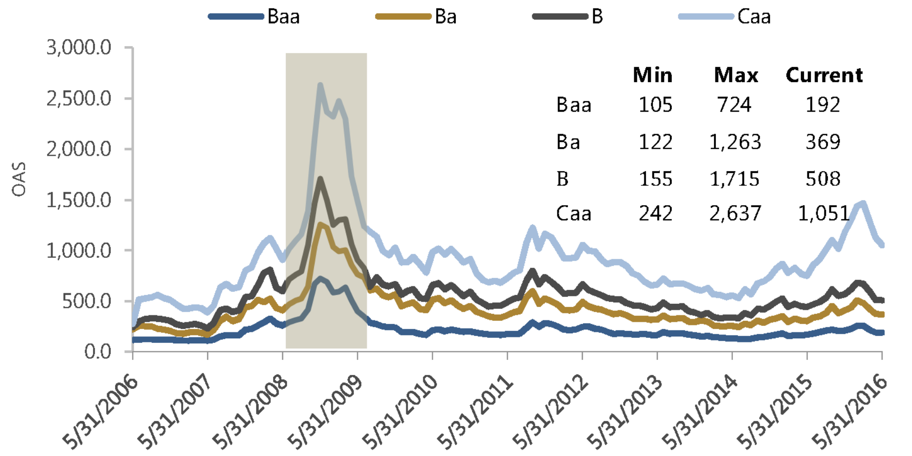
Source: Moody's as of May 31, 2016

The Valuation Piece

High yield spreads have more than recouped their underperformance during the first six weeks of the year. The move tighter has been driven by energy related sectors, which posted total returns through May of over 22% in Independent and over 16% in Midstream sectors. Even post rally, absolute spread and yield levels are attractive when compared to investment grade opportunities. Multi-sector investors with higher allocations to high yield have outperformed managers that are more conservatively positioned. As spreads have tightened, money has flowed into the sector creating a strong technical from positive fund flows. This is a positive near-term technical that could either continue or reverse quickly when risk sentiment turns.

Another tailwind for spread tightening this year has been increased accommodation by large central banks, including action by the European Central Bank, the Bank of Japan and the Chinese Government and inaction from a more dovish Fed. Easy money continues to push investors to reach for yield in a low to negative-yield world.

High Yield Spreads by Credit Quality



	Min	Max	Current
Baa	105	724	192
Ba	122	1,263	369
B	155	1,715	508
Caa	242	2,637	1,051

Source Barclays Point May 31, 2016

Putting the Pieces Together

Despite our concerns, high yield spreads have the potential to rally further on the back of high market confidence in the sector. However, the risks are asymmetric. Oil price pressures and rising defaults to near 5% could put a floor under spread tightening. On the flip side, the upside-risk to spreads remains an unknown.

Our multi-sector portfolios have only modest positions in high yield with room to add opportunistically. Rather than focusing on a beta trade, we are concentrated on credit specific stories given that we are in the later stages of the credit cycle. With a muddle-along scenario for the U.S economy as our base case, adding carry aids returns. However, we remain cautious on adding yield in less liquid sectors, such as high yield cash bonds. We expect increased volatility catalyzed by global events to offer a more attractive entry point over the medium term.

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BNY メロン・アセット・マネジメント・ジャパン株式会社
BNY Mellon Asset Management Japan Limited

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