High-Yield Strategies Offering Investors Antidote to Rising Interest Rates

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Just as market watchers look to high-yield credit spreads for color around the economy's direction, many are also gravitating to the asset class as an answer to a hawkish Fed

By all accounts, the earnings reported in the first quarter represented one of the best starts to any year in recent memory. According to data from FactSet, nearly eight out of every ten S&P 500 companies posted positive EPS surprises, while the blended earnings growth rate during the first three months of the year approached nearly 25%. But the surging corporate fundamentals, in hindsight, belie the shaky performance of U.S. equity markets, unsettled by see-sawing volatility ever since the year began. Those who have been paying attention to high-yield credit spreads, however, likely recognized the underlying strength in business conditions, underscoring the role of high-yield bonds as a gauge to assess and capitalize on broader economic strength.

To be sure, the spread between high-yield and investment-grade bonds is a well-recognized leading indicator among professional investors and economists. As yields climb for non-investment-grade bonds, it signals that lenders are seeking more compensation to accommodate for the risk of default. It also marks a willingness among corporate borrowers to pay a premium for capital and an acknowledgement of rising economic and business uncertainty. So as high-yield spreads widen, it will typically send ripples throughout the capital markets, suggesting that business conditions are beginning to deteriorate. This was what happened ahead of the global financial crisis, when spreads started climbing two quarters before the recession took hold.

Today, however, spreads remain compressed compared to historical averages, and the negative correlation to economic growth provides a sense of comfort that business conditions will remain favorable, at least over short- and medium-term time horizons. Not to be overlooked, the relative calm in the movement of credit spreads – when juxtaposed against the volatility of equities – highlights the role of the high-yield asset class as an antidote to the threat posed by rising rates.

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In many ways, investors tend to think of high-yield as a hybrid asset class. The same way stock investors analyze company fundamentals, high-yield managers will factor in the same considerations in assessing credit risk or when buying bonds on the secondary market at a discount to par value.

Of course, as a steady and consistent source of interest, high-yield shares some obvious characteristics with more traditional debt instruments, be it investment grade bonds or U.S. Treasurys that make regular coupon payments. Among fixed income investors, though, one of the biggest distinctions is the tendency for high-yield investments to perform well whether interest rates are rising or falling.

An economic proxy shielded from rate risk

Several factors contribute to the high-yield market's agnosticism to the interest rate regime. The most prominent driver traces back to the negative correlation between spreads and the economy. When the Fed raises rates, it invariably signals underlying strength in business conditions. This is particularly important for speculative-grade credits that are more susceptible to default during periods of distress.

The other catalyst – also distinguishing the high-yield market from other categories of fixed income – is that the shorter duration of speculative-grade bonds provides a cushion to rate hikes through shorter maturities.

A rising-rate environment can also highlight the differences between an actively managed strategy versus an ETF. The former, for instance, can tilt a portfolio toward bonds with even shorter effective durations. This further neutralizes the impact of rising rates and allows the manager to amplify risk in other areas, augmenting yields and improving risk-adjusted returns. ETFs, on the other hand, may offer investors a beta play as inflows rotate into high-yield. However, passive strategies are generally constrained in pursuing the alpha opportunity available through optimizing portfolio positioning toward shorter durations and improving the yield to call. Moreover, the impact of an actively managed strategy can become even more pronounced by the "activist" class of fund managers who can negotiate covenants and coupon payments, while providing more coverage in restructurings when the economy turns and default risk rises.

Given the most recent moves of the Federal Open Market Committee, it appears that the current ascending path will hold steady for the foreseeable future. While rates were left unchanged following the May meeting, new Fed chief Jerome Powell in March raised the outlook for next year to call for three quarter-point hikes in 2019. Even as the Fed didn't change its current forecast for two additional hikes this year, the market as of mid May was roughly split on the likelihood for a potential fourth hike in 2018.

In addition to providing investors with cover in a rising-rate environment, high-yield bonds also provide a natural hedge against potential changes in the direction of monetary policy. Readers of FOMC meeting minutes, for instance, will recognize that committee members consider gross issuance as well as the movement of credit spreads as part of their interest rate decisions – again, underscoring the role of high-yield as a leading indicator. And before Powell was even nominated as Fed chair last, he had demonstrated an appreciation for how activity in the high-yield market can provide deeper insight into the health of the broader capital markets.

Much of volatility in the equity markets in 2018 has been attributable to concerns over rising rates. In fact, the notion that earnings drive the markets is being tested, and some have argued that the phenomenal corporate performance has merely buoyed equities in the face of rising rates. When the 10-year Treasury yield eclipsed 3% in April – a "psychologically" significant level – the Dow Jones U.S. Stock Index went on a losing streak for four straight trading sessions. Meanwhile, among more traditional fixed income investors, the news represented an inflection point marking a transition from safe haven to risk asset.

Make no mistake, this was a non-event for high-yield investors, particularly those who have toggled into credits with shorter effective durations. So while observers will be tracking both the economy and Fed closely in the coming months, the high-yield market can provide answers to the two most prominent questions – the direction of the economy and where to find coverage in a rising-rate environment.

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