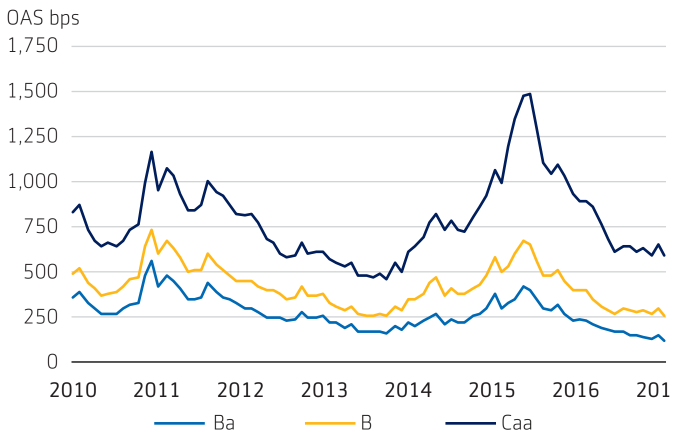
Tighter spreads disguise wider opportunities

As an asset class, high yield corporate debt looks expensive. Whether its Ba or Caa-rated, junk bond spreads have compressed inside long-term averages (Exhibit 1). For some, these spreads are taken as a sign that the high yield market is fully valued, and devoid of investment opportunities. But despite the steady, low volatility, and persistent drive towards tighter credit spreads and lower yields, there is meaningful turbulence beneath the surface.

Idiosyncratic opportunities are on the rise

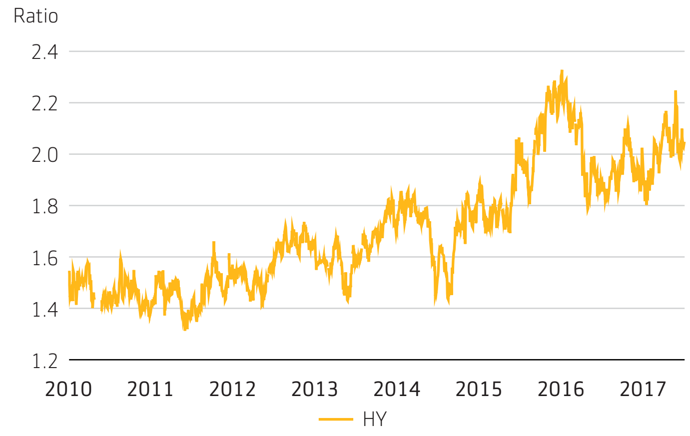
While a positive macroeconomic and monetary policy backdrop has buoyed financial asset prices and suppressed volatility, the current environment disguises growing divergences between and within asset classes. Based on spread levels, Exhibit 2 illustrates rising dispersion among the high yield companies in the Markit iBoxx USD Liquid High Yield Index. In other words, the difference between the bonds with the widest spreads and the bonds with the tightest spreads has widened this year to be approximately two times the median spread inside the index. Sector-and-company specific issues are causing some corporate paper to widen relative to the median, even while the index itself is rich on a spread basis. These are the types of divergences where active fixed income managers can potentially generate alpha by identifying and allocating to value opportunities.

Exhibit 1: High yields spreads by credit quality



Source: Barclays Live, as of October 2017
Note: US Corporate High Yield Index Ba, B, and Caa components

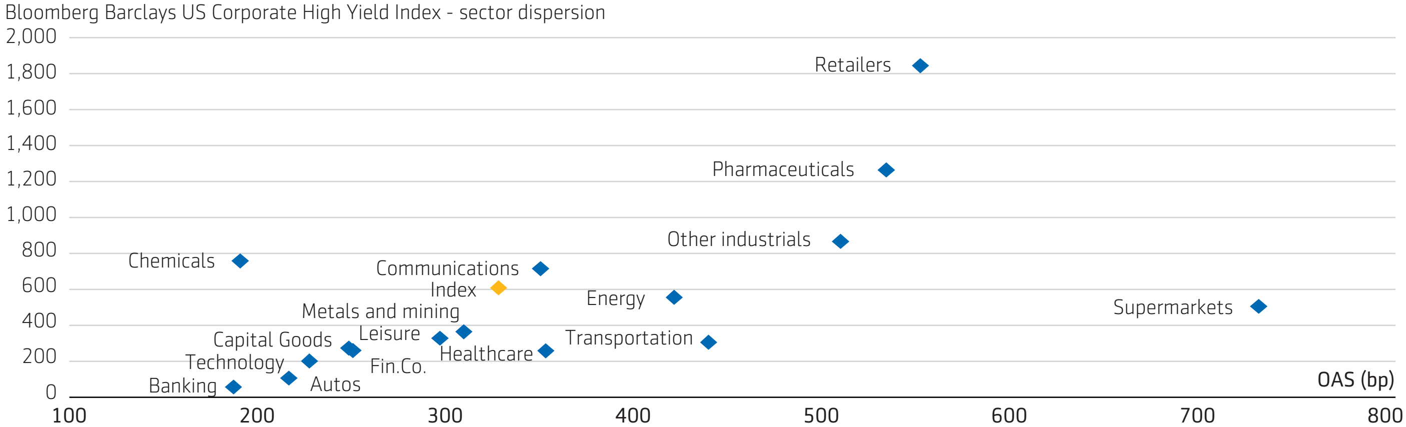
Exhibit 2: High Yield Index Dispersion Rising



Source: Goldman Sachs Global Investment Research as of October 2017
Note: Spread differential between the 90th and 10th percentiles, or the inter-decile range, normalized by the median spread level across all the bond constituents of the Markit iBoxx USD Liquid High Yield Index

Rising dispersion suggests the market is beginning to differentiate between winners and losers, penalizing those companies that disappoint or that face sector-specific or company-specific risks. As you can see in Exhibit 3, the retail sector has been the most affected. This reflects the oft-cited *Amazon effect* on a number of issuers in that sector. We have also seen certain individual issuers in the pharmaceutical space under pressure, resulting in increased dispersion.

Exhibit 3: Mapping sectors by dispersion and overall sector spread



Source: Barclays Live, as of October 2017

In addition, we also see a substantial gap between the non-distressed and distressed segments of the market. (Exhibit 4) This presents an opportunity for active, research-intensive strategies. By avoiding those non-distressed names that are at risk for significant widening, or conversely, identifying those names in the distressed segment of the market that may present opportunities, active managers can potentially add value.

Exhibit 4: Bifurcated high yield market

	% of Par Amount	% of Market Value	YTW	OAS
Non-Distressed	94.1%	95.9%	5.3%	306bps
Distressed	5.9%	4.1%	23.3%	1,934bps

Source: Bloomberg, as of November 2017. Note: Distressed defined as bonds with OAS greater than 1000 bps; values are averages unless otherwise noted.

Taking advantage of the opportunity

The improving macroeconomic backdrop, combined with a low level of implied forward default rates suggests that the overall credit environment remains supportive of staying invested in high yield assets. With growing idiosyncratic risk in a market that is increasingly differentiating between winners and losers, we believe smart, well-research security selection can add value. This environment creates an excellent opportunity for active managers who use a research intensive process to invest in high yield credit. Go anywhere, high conviction and opportunistic strategies may offer even greater potential to take advantage of these relative value opportunities at both the sector and company-specific level.

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