PICTET 1805

High yield bonds 'carry' the day

A Pictet Asset Management outlook

Superior carry, refinancing, diminishing defaults, cash rich companies, M&A[1] activity and positive flows provide, in our view, an attractive risk reward profile for high yield bonds.

High Yield Bonds

Savers are being penalised by exceptionally low rates of return as European governments and central banks maintain loose monetary policies. Government bonds look unattractive and the stuttering recovery in Europe may falter if the ECB withdraws liquidity. Yet central banks will be cautious to raise rates to fight rising inflation for fear of the impact on the still fragile banking sector.

We judge the case for the high yield bonds relatively attractive:

- The superior carry, compensates investors for higher risk[2], and underpin performance. Despite anticipated volatility, we forecast high single digit returns from the asset class in 2011.
- In our opinion high yield bonds are fairly valued, based on their historical average, but we feel there is scope for some further spread tightening this year - profiting investors.
- Our analysis shows companies to have strong cash-flows and improved balance sheets, resulting in defaults nearing historical lows. We forecast that they will remain close to these lows for the next two years.
- Slow growth, low interest rates and moderately rising inflation – our forecast for Europe in 2011 – may lead investors to the returns offered by high yield bonds.

However high yield bonds are a risky asset. A deepening of the European sovereign debt crisis would unsettle investor sentiment consequently undermining the asset class with the result of falling returns.

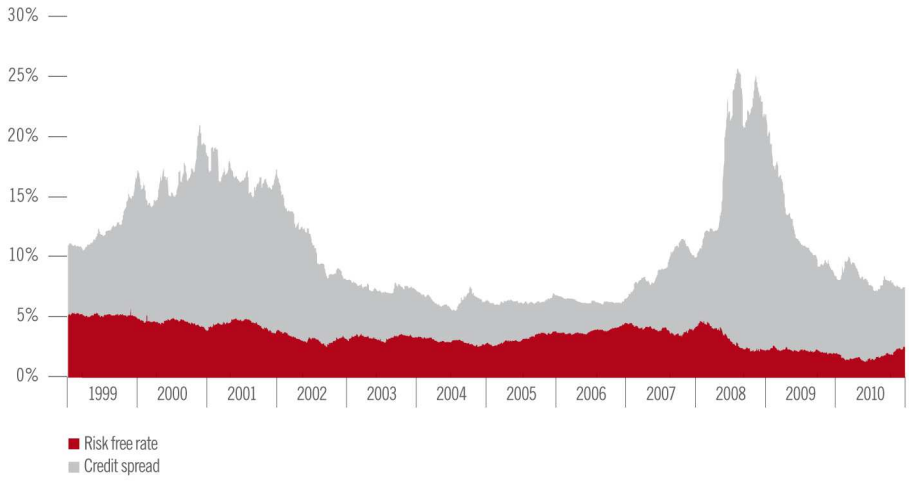
Coupons will drive stable performance

Most of the positive returns from high yield bonds will be from the higher carry that these instruments offer. Our current view is that investors will be well rewarded for the additional risk associated with high yield bonds. However we do not anticipate spread tightening to be a major performance theme in 2011. We have come a long way from the exceptionally wide – over 2200bps - spreads at the end of 2008 returning to the historical norms 400 – 500bps. Currently standing at around 520bps (fig 1), we consider there may be some further marginal tightening towards the fair value range, but the benefits to investors will be relatively small.

[1]*merger and acquisition*

[2]*Higher risk relative to investment grade debt and government bonds.*

FIG. 1 – EURO HIGH YIELD EXCESS SPREAD 1999 - 02.2011



Source : Pictet Asset Management, Bloomberg, Merrill Lynch

Issuance is increasing

Companies are replacing maturing bank debt with bond issuance. Banks are still reluctant to lend. As a result over 36 per cent of issuance in 2010 was to refinance maturing bank loans, compared to just 14 per cent during the 2006 – 2009 period. 2010 was a record year for high yield bond issuance as banks were less willing to lend, forcing companies to seek finance elsewhere. Stricter regulation has discouraged banks to lend to high yield companies and so we anticipate a further expansion of the high yield market in 2011.

A combination of refinancing and strong cash-flow has resulted in companies which are cash rich, with improving fundamentals. The net leverage position of companies is on the whole being reduced.

A decline in the number of defaults

Post crisis, company management has embraced a more prudent stance with the desire to improve balance sheets, a reduction of net financial leverage (fig 2) and subsequent improving credit ratings. A direct consequence is lower defaults (fig-3), which is good for High Yield Debt.

FIG. 2 – NET LEVERAGE ON DECLINE

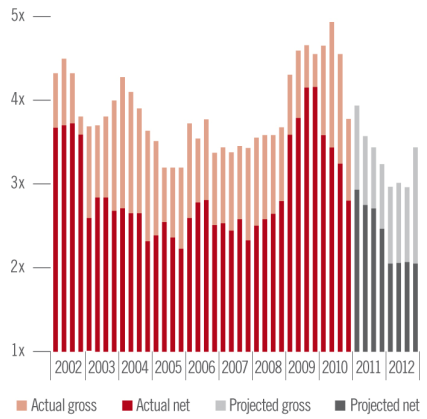
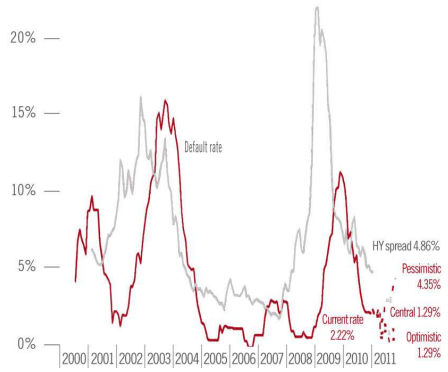


FIG. 3 – EUROPEAN HY DEFAULTS VS SPREADS



Source : Company data, Bloomberg, Morgan Stanley Research, Moody's Investors Services

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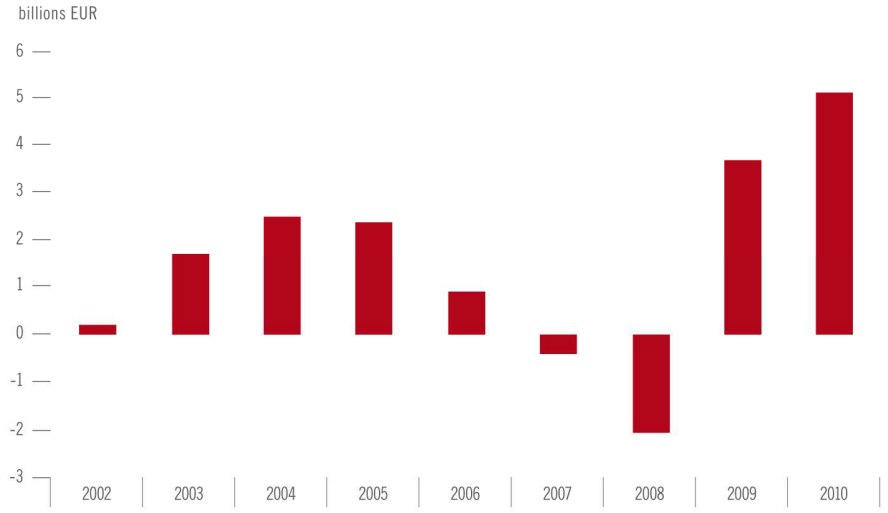
Opportunities in High Yield
Furthermore with more free capital M&A activity is sure to follow. M&A is typically good for high yield bond holders. If an investment grade company purchases a high yield company the result is often an upgrade in the acquired company's rating.

All the factors described previously have in turn boosted the attractiveness of the asset class, leading to positive flows.

Ravenous yield hunters stalk riskier assets
The asset class rallied strongly in 2010, driven to some extent by positive investor demand. We do not envisage 2011 to be a reversal of this trend. High yield bonds provide an alluring income stream to investors at a time when yields on other assets are low and we expect demand to continue. Furthermore low growth in Europe – which we are predicting in the later part of the year - may indeed bring more investors into the high yield bonds as they switch from other low yielding asset classes.

FIG. 4 – MUTUAL FUNDS HISTORICAL FLOWS



Source : Pictet Asset Management, Lipper FMI

High yield bonds are a risky asset and we would caution that a market shock such as a European sovereign default – although we believe it unlikely and future restructuring is already priced into the market - could reverse spread tightening. The impact may be significant and would in all likelihood exceed the positive contributions from the carry.

However on balance we still find the current case for high yield bonds appealing.