

## Is high yield high risk?

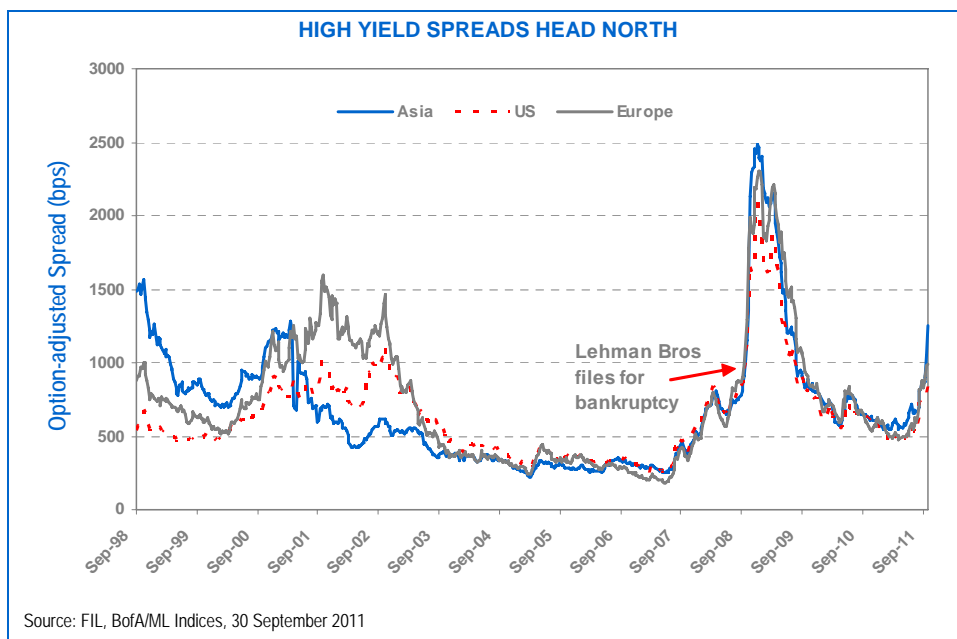
### AT A GLANCE

- Market volatility has pushed credit spreads back to historical highs, sending asset values down and pushing worry levels among high yield investors up.
- The value of high yield investments has been heavily impacted by recent 'risk on-risk off' asset allocation decisions taking place across most major markets. These one-way, herd-like actions exaggerate the real impact of tighter credit market conditions on the issuing corporations.
- Many corporates are already ahead of the game, having restructured balance sheets, sold unprofitable businesses and have secured new financing arrangements.
- The ongoing uncertainty over Europe's sovereign debt crisis and whether the global economy will fall back into recession underlies the dislocation between market prices and underlying fundamentals – a situation that creates opportunities for astute investors.

**Yields on so-called low-risk sovereign debt instruments like US Treasuries have fallen to new lows this year and the outlook for these bonds remains clouded. Their higher-yielding cousins in the corporate bond market offer better returns for the associated risk. But recent market volatility has negatively impacted bonds in this sector. This *In Perspective* reviews the fundamentals that underlie corporate issuers and questions the validity of the high risk implied by credit markets.**

### RISK LEVELS HEAD NORTH AGAIN

High yield bond spreads have risen to similar levels that were reached the day before Lehman Brothers failed. Heightened risk aversion has affected capital markets over recent months as a result of growing fears the global economy is headed for another recession, or even worse, another global financial crisis. In October, US high yield bond spreads<sup>1</sup> reached 870 basis points as investors shied away from risky assets and towards the perceived safe havens of US, Japanese or German government bonds. Prior to the Lehman Brothers collapse on 15 September 2008, the spread, or risk premium of high yield over investment grade government bonds, had only reached these levels in two other instances in history: October 1990 and November 2000. The dramatic movements over the past month have led to many questions. Are we really back at the same place as 2008? Is it Europe's turn to ignite a banking system crisis? Will China slow down and damage hopes of a recovery?



### INVESTORS ARE CONCERNED, BUT CORPORATES ARE CONFIDENT

Concerns among investors over the ability of world leaders and central banks to successfully navigate through the current conditions are valid. After all, the world has rarely seen a sovereign debt crisis of the proportion facing Europe. Here, the future of an entire region's currency is at stake. We also have a situation where central banks and governments have limited options to prime their economies for weaker conditions.

But corporations across the US, Europe and Asia are generally in much better shape than they were during the financial crisis. Many have undertaken significant adjustments to balance sheets, heavily reduced debt and sold assets to focus their core business operations. The evidence speaks for itself. Cash balances in US corporations are running at around \$1.75 for each \$1 of short term debt, while their overall leverage has fallen below the historical average of 3.6 times.<sup>1</sup>

1. BofA/Merrill Lynch, "HY Quarterly Publication", 11 October 2011

# In Perspective

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October 2011

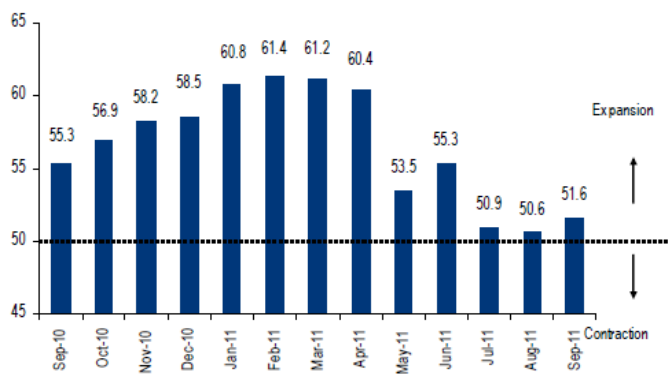
Costs have also been brought under control in line with tighter liquidity. It is clear that corporations got to a point where balance sheets were stretched, received disciplinary treatment from their lenders and reformed their ways. It is only now that some government leaders are facing the harsh realities of disciplinary action for their budget management, which is having a knock-on effect for credit markets.

## FUNDAMENTALS SUGGEST RECOVERY IS UNDERWAY

Credit spreads may have widened but this appears at odds with the fundamentals. Indicators of operating conditions in the US in particular suggest that a corporate earnings recovery is underway. The manufacturing sector has remained in an expansion phase and orders of durable goods such as televisions, cars and aircraft are well above their lows. This suggests corporations are continuing to perform well and their capacity to repay debt is improving, despite the doomsday scenario playing out in equity and bond markets.

### US MANUFACTURERS ARE EXPERIENCING BETTER TIMES...

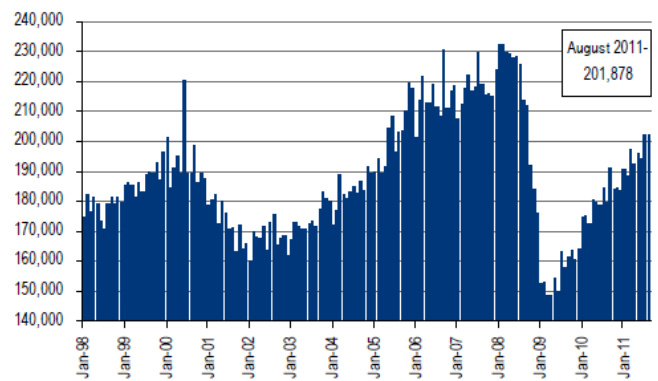
ISM Manufacturing Index – past 12 months



Source: BofA Merrill Lynch Global Research, US Commerce Department

### ...AND THE ORDERS FROM CUSTOMERS ARE RECOVERING

Durable Goods Orders



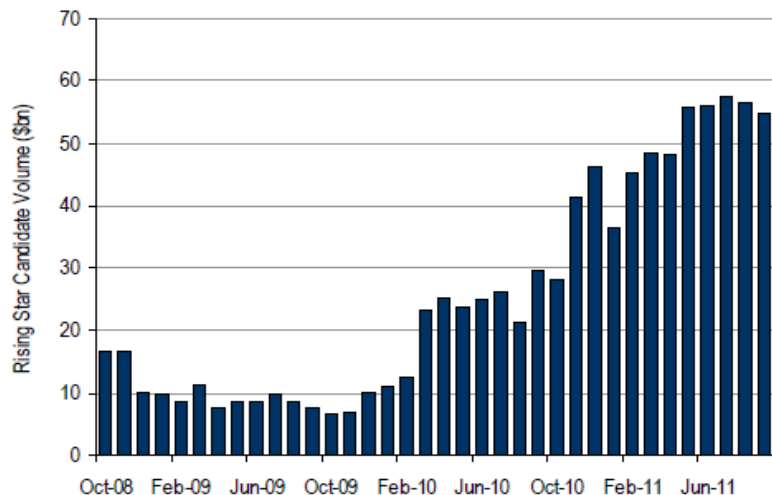
Source: Datastream, US Commerce Department

## HIGH YIELD FUNDAMENTALS ALSO STRONG

Credit market metrics also appear at odds with market valuations of high yield securities. Default rates among issuers are low and declining, while distress levels are well below their cyclical peak.

The ratings agencies agree. Rather than seeing growing risks to operations among issuers, the number of 'rising stars' – an industry term that refers to issuers under consideration for an upgrade to their credit rating, has also continued to rise.

### RISING STARS ARE SHINING



Source: Fitch, Moody's Investors Service, Standard and Poor's, BOFA Merrill Lynch Global Research



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## HIGH YIELD OFFERS FAVOURABLE RETURNS FOR ALL SEASONS

History has shown that high yield securities can generate positive total returns in slow growth, trend growth or high growth periods. In times of slow economic growth, the income yields available provide a buffer for investors. When growth is high, capital values appreciate and contribute further to total returns. High yield securities are set to maintain their fundamental appeal by virtue of the high income on offer and the low official interest rate environment which appears likely to persist for the next couple of years. Leaving aside potential capital appreciation for high yield bonds, a 9-10% income return alone compares favourably to extremely low sovereign bond yields on offer in the major economies.

As always, prudence is required when investing in high yield securities. The wide array of securities available today means investors need to be even more discerning in their investment choice. History shows that growth in capital markets tends to attract more companies to fund business ventures. Many will be successful, others may fail.

## AN OPPORTUNE TIME TO ENTER THE MARKET

Seasoned investors realise the importance of not following the herd when it comes to investment decisions. The weight of funds flowing through the world's capital markets often leads to situations where asset prices fail to reflect fundamentals. Investors who observed this dislocation and invested in high yield at the start of 2009 when credit spreads reached all-time highs saw total returns of almost 75% in European high yield and almost 80% in Asia.<sup>2</sup>

This time, markets have clearly reacted to the problems in Europe which are concerning but likely to be resolved in time. While the threat of further instability in financial markets cannot be discounted, it is important to realise that many high yield issuers have already undertaken refinancing activities and are well placed to continue their earnings recovery. Operating risks are down, credit ratings are expected to move higher, income is high and bond yield spreads are close to their highest. In hindsight, this may seem the wrong time to lose confidence in the sector.

2. BofA/Merrill Lynch, Bloomberg, based on 2009 calendar year total return of the Asian Dollar High Yield Corporate Constrained and Euro High Yield indices. Sourced 24 October 2011.

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