



Market Commentary

Independent Credit Research – Leveraged Finance – March 2011

HIGH YIELD IN A RISING RATE ENVIRONMENT

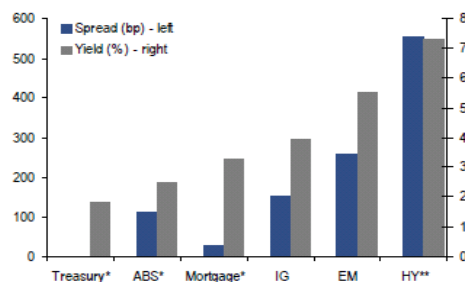
We have all witnessed a major move in Treasury rates over the last four months. The inflation concerns do seem to be real, as commodity prices are spiking on all fronts (see our recent piece, [“Get Active”](#)). However, generally we see spiking inflation during booming economic times, giving the Federal Reserve room to tighten rates and slow down the economy. Yet, the current predicament is that we are seeing soaring commodity costs during a time of domestic economic malaise. Does the Fed risk slowing the economy further by tightening rates? So far, they don’t seem to see a need to address inflation and are instead focused on stimulating the economy by keeping rates low. But the markets are pointing to a different course, pushing Treasury rates up 93 bps since Nov 1st.¹

All of this causes concern by many that we are in the early stages of a rising interest rate environment. The traditional thought is that as interest rates rise, bond prices fall. But looking at history, the high yield market has defied this widely held notion. Let’s examine the four main reasons why high yield bonds have historically performed well during times of rising interest rates.

1) *Higher coupons in the high yield space help cushion the impact of rising interest rates.*

High yield bonds, as the name would suggest, have traditionally offered among the highest coupons/yields of various fixed income instruments. The following chart graphically depicts both yields and the spread over Treasuries for several fixed income products.²

Reach for Yield: Spreads and Yields for Various Fixed Income Asset Classes



* Citi US BIG Treasury, ABS, and Mortgage Indices.

** HY spread and yield are spread-to-worst and yield-to-worst.

Source: Citi Investment Research and Analysis

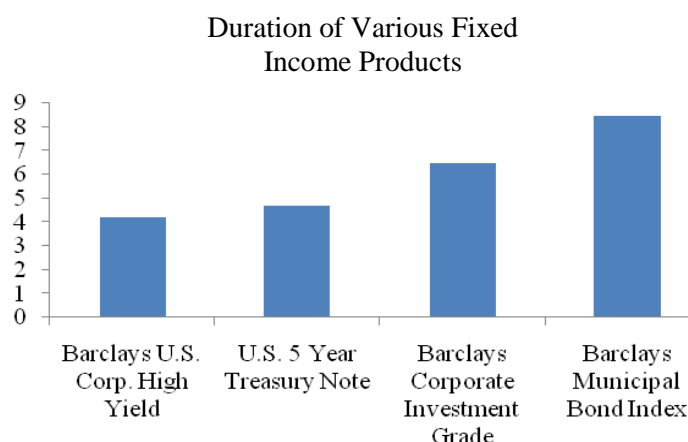
¹ Data gathered from Bloomberg for the period 11/1/10-3/1/11. Yields on the U.S. Generic Government 5 Year.

² Anderson, Michael, Jason Shoup, and Omer Erkovan. “High Yield and Leveraged Loan 2011 Outlook.” Citigroup Global Markets. January 14, 2011, p. 4. “Citi US BIG” is the Citigroup US Broad Investment-Grade Bond Index, a market capitalization weighted index that includes fixed-rate Treasury, government sponsored, mortgage, asset backed, and investment-grade issues (BBB or Baa3) with a maturity of one year or longer. “HY” is the Citigroup High-Yield market index, which includes cash-pay, deferred-interest, and Rule 144A bonds with a remaining maturity of at least one year, a minimum outstanding of \$100mm, and a speculative-grade rating by both Moody’s Investor Service and Standard & Poor’s. “EM” is the Citigroup Global Emerging Market Sovereign Bond Index, consisting of Brady bonds and US dollar-denominated emerging market sovereign debt issued in the global, Yankee, and Eurodollar markets, excluding loans.

So, let's think about this intuitively for a minute. If you own a bond with a yield of 4.0% and interest rates move up 1%, that would obviously have a meaningful impact as we are talking about 25% of your total yield. However, if you are at a yield of 8.0% on a bond and interest rates move that same 1%, that impact is significantly less. So the higher the yield, the less the interest rate sensitive the bond.

2) *High Yield bonds have shorter durations than other asset classes in the fixed income space.*

Duration is a measure of sensitivity to changes in interest rates that incorporates the coupon rate, maturity date, and call features of a bond. The fact that high yield bonds are typically issued with five to ten year maturities and are generally callable after the first few years, as well as that they offer higher coupon rates, provides the high yield sector with a shorter duration versus other asset classes. We've profiled some duration comps below:³



3) *The prices of high yield bonds have historically been much more linked to credit quality than to interest rates.*

Historically interest rates are increasing during a strengthening economy and a strong economy is generally favorable for corporate credit and equities alike. Due to the nature of the high yield bond market, the major risk on the minds of investors is default risk (not interest rate risk), causing them to be much more concerned with the company's financials and credit quality than interest rates. When the economy is expanding, profitability, financial strength, and credit metrics often improve as well. So a stronger economy would undoubtedly be a positive from a credit perspective and would indicate lower default rates, meaning improved prospects for the high yield market.

4) *High yield bonds are negatively correlated with Treasuries.*

High yield bonds have a zero to slightly negative correlation with Treasuries, meaning that as Treasury prices go down due to yields (interest rates) increasing, high yield would theoretically experience no change or the opposite change (increase) in pricing. Additionally, while high yield is still positively correlated to investment grade, it is a fairly low correlation; yet, we see a strong correlation between investment grade and Treasuries.⁴

³ Barclays Capital U.S. High Yield Index covers the universe of fixed rate, non-investment grade debt (source Barclays Capital). U.S. 5 Year Treasury Note is the on-the-run Treasury (source Bloomberg). Barclays Corporate Investment Grade Index consists of publicly issued U.S. corporate and specified foreign debentures and secured notes that meet the specified maturity, liquidity, and the quality requirements (source Barclays Capital). Barclays Municipal Bond Index covers the long-term, tax-exempt bond market (source Barclays Capital). All data as of 2/22/11. The Modified Adjusted Duration is a measure of interest rate sensitivity based on the Yield to Maturity date.

⁴ Acciavatti, Peter, Tony Linares, Nelson R. Jantzen, and Alisa Meyers. "2010 High Yield-Annual Review." J.P. Morgan North American High Yield Research. December 2010, p. 106.

Correlations among various asset classes
 Twenty-five years ended November 30, 2010

	5-year Treasury	10-year Treasury	LB Aggregate	Invst. grade bonds	High-yield bonds	S&P 500	Wilshire 500	Russell 2000	Gold
10-year Treasury	0.95								
LB Aggregate Bond Index	0.91	0.93							
Investment-grade bonds	0.72	0.78	0.91						
High-yield bonds	-0.05	-0.01	0.24	0.45					
S&P 500	-0.03	0.01	0.17	0.28	0.57				
Wilshire 5000	-0.06	-0.01	0.15	0.27	0.59	0.99			
Russell 2000	-0.16	-0.10	0.04	0.18	0.61	0.82	0.88		
Gold	0.06	0.06	0.05	0.08	0.03	-0.12	-0.09	-0.03	
US Inflation	-0.14	-0.19	-0.14	-0.15	0.01	-0.03	-0.03	-0.04	0.04

Sources: J.P. Morgan; S&P/LCD; Bloomberg.

Given these low or negative correlation rates versus other asset classes, especially the more interest rate sensitive asset classes such as investment grade, an allocation to high yield bonds can help serve to improve portfolio diversification and potentially lower risk.

Those are nice thoughts, but let's look at some hard data as to how high yield has actually performed in a rising rate environment. A recently J.P. Morgan piece concluded, "In 14 of the last 30 years, the 5-year Treasury yields have increased, and in each of those 14 years, high yield has *outperformed* its higher rated counterpart."⁵ The actual numbers show that over those 14 years where we saw Treasury yield increases (i.e., interest rates rose), high yield had an average return of 14.1% (or 10.6% if you exclude the massive performance in 2009).⁶ This compares to only a 4.9% average return (or 3.9% excluding 2009) for investment grade bonds over the same period.

Year	J.P. Morgan		Change in 5 Yr Treasury Yield
	J.P. Morgan High Yield Bond Index Return	Investment Grade Corp Bond Index Return	
1980	4.3%	0.5%	2.21%
1981	10.4%	2.3%	1.38%
1982	36.3%	35.5%	-3.82%
1983	20.3%	9.3%	1.38%
1984	9.4%	16.2%	-0.46%
1985	28.7%	25.4%	-2.58%
1986	15.6%	16.3%	-1.68%
1987	6.5%	1.8%	1.59%
1988	11.4%	9.8%	0.73%
1989	0.4%	14.1%	-1.30%
1990	-6.4%	7.4%	-0.15%
1991	43.8%	18.2%	-1.75%

⁵ Acciavatti, Peter, Tony Linares, Nelson R. Jantzen, and Alisa Meyers. "2010 High Yield-Annual Review." J.P. Morgan North American High Yield Research. December 2010, p. 105. Emphasis added.

⁶ Data sourced from: Acciavatti, Peter, Tony Linares, and Nelson R. Jantzen. "2008 High Yield-Annual Review," J.P. Morgan North American High Yield Research, December 2008, p. 113. "High-Yield Market Monitor," J.P. Morgan, January 5, 2009, January 5, 2010, and January 3, 2011. 2008-2010 Treasury data sourced from Bloomberg (US Generic Govt 5 Yr). The J.P. Morgan High Yield bond index is designed to mirror the investible universe of US dollar high-yield corporate debt market, including domestic and international issues. The J.P. Morgan Investment Grade Corporate bond index represents the investment grade US dollar denominated corporate bond market, focusing on bullet maturities paying a non-zero coupon.

Year	J.P. Morgan High	J.P. Morgan	Change in 5 Yr Treasury Yield
	Yield Bond Index Return	Investment Grade Corp Bond Index Return	
1992	16.7%	9.1%	0.06%
1993	18.9%	12.4%	-0.79%
1994	-1.6%	-3.3%	2.62%
1995	19.6%	21.2%	-2.45%
1996	13.0%	3.7%	0.83%
1997	12.5%	10.4%	-0.50%
1998	1.0%	8.7%	-1.17%
1999	3.4%	-1.9%	1.80%
2000	-5.8%	9.9%	-1.37%
2001	5.5%	10.7%	-0.67%
2002	2.1%	11.0%	-1.57%
2003	27.5%	7.9%	0.51%
2004	11.5%	5.3%	0.36%
2005	3.1%	1.7%	0.71%
2006	11.5%	4.3%	0.38%
2007	2.9%	5.3%	-1.26%
2008	-26.8%	-1.8%	-1.89%
2009	58.9%	17.5%	1.13%
2010	15.1%	8.9%	-0.67%

So if your belief is that rates will rise, it seems probable that high yield could outperform other fixed income asset classes, as this data shows it has historically. While no one has the crystal ball to accurately predict whether rates will go up further or stabilize at current levels, we see high yield as an attractive alternative in the current environment. Because of its lower sensitivity to interest rates than other fixed income alternatives and the seemingly attractively yield currently being offered, we believe an allocation into the high yield asset class could provide stand alone returns, as well as potential diversification benefits and risk reduction within a portfolio.

Peritus I Asset Management Disclosure:

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