SEVEN MORE REASONS TO GO GLOBAL IN HIGH YIELD

With both the U.S. and global high yield markets turning in another strong set of quarterly returns, we thought we would address some of the commonly held myths in the high yield market today. Our broad concern is that investors perceive the high yield asset class as a panacea for generating income with limited downside risk, particularly in the U.S.

As we illustrate below, certain pockets of the high yield market currently exhibit full valuations, especially in the U.S. Moreover, many beneficial trends in credit fundamentals and market technicals for the U.S. high yield market may be at or nearing an inflection point. Although global high yield still offers attractive opportunities, when pockets of the market begin to exhibit frothy characteristics, concentrating investment in sectors with full valuations or allowing benchmark allocations to guide your investment decisions can be a risky approach. For those interested in maintaining high yield exposure through the business cycle, consider a flexible global high yield strategy with a disciplined value approach.

1. U.S. FUNDAMENTALS ARE IMPROVING

This is the standard claim for those that peddle the asset class. The claim, however, is wrong; fundamentals improved through 2011 and market prices responded accordingly. But since late 2011, net and gross leverage have increased (see figure 1). This deterioration in credit fundamentals since late 2011 should encourage investors to position conservatively with regard to quality, especially in the U.S.

1Q 2013

Figure 1 Leverage in U.S. High Yield Corporates
High Yield Median Gross and Net Leverage

Source: Morgan Stanley Research

Note: Gross Leverage - Total Debt/LTM EBITDA, Net Leverage - Net Debt/LTM EBITDA. For each quarter, the values presented on this chart represent the median leverage for the set of companies that held a high yield rating at the end of that quarter.
2. COVENANT QUALITY IS IMPROVING IN THE LOAN MARKET

Loan covenant quality is as poor as we saw in 2006 and 2007. Weaker covenants are often a prelude to weaker returns.

**Figure 2** Underwriting Standards Appear Weaker in the Loan Market than the High Yield Market
Cov-Lite Issuance Near All-Time Highs; 1987-2012

![Graph showing cov-lite volume and % of all institutional loans over time](source: Morgan Stanley, S&P LCD)

3. U.S. SPREADS OFFER PLENTY OF VALUE

Spreads are dependent on the state of the economy; simply looking at a chart of high yield spreads without a perspective on the state of the economy is meaningless. Our own valuation models that incorporate fundamental macroeconomic data (including default rates and valuations in U.S. risk-free assets) indicate that risk premiums may be more than one standard deviation or approximately 120 basis points overvalued today.

**Figure 3** U.S. High Yield Risk Premiums Appear Overvalued
Based on the State of the Economy; Merrill Lynch HY Spreads Model

![Graph showing standardized residual and ml hy oas spreads](source: Thomson Datastream)
4. YIELDS DO NOT MATTER; SPREADS DO

We have already highlighted our concerns on the valuations of spreads in the high yield asset class. More troubling, low yields often imply low returns; some initial work by Martin Fridson, a financial expert with LCDNews, provides a sobering outlook for the U.S. high yield asset class over the next several years: expected annualized returns of 1.4% for the 2013–2016 time period with an optimistic case of 6.2% annualized returns.

Figure 4 High Yield Bond Yields and Returns are Correlated
YTM and Annualized Returns; 4-Year Periods from 1980-2009*

![Figure 4 High Yield Bond Yields and Returns are Correlated](source: Bloomberg, Bank of America Merrill Lynch)

* Bank of America Merrill Lynch High Yield 100 Index

5. AVOID EUROPEAN HIGH YIELD BECAUSE OF BANK DELEVERAGING

Contrary to what many investors believe, bank deleveraging in Europe is occurring at a conventional post-crisis pace, and the continent is well-positioned to facilitate the deleveraging process in an orderly manner. Capital markets are filling the leveraged finance role traditionally held by European banks, avoiding the negative system-wide economic effects typically associated with bank deleveraging. Once high yield investors overcome the initial fear and uncertainty regarding the upcoming period of bank deleveraging in Europe, we believe investors will eventually pay more attention to the positives offered by European high yield markets: efficacious central bank support and established legal principles for protecting credit investors.

Figure 5 Deleveraging following historical precedents in Europe
2012-2020

![Figure 5 Deleveraging following historical precedents in Europe](source: Bloomberg, Morgan Stanley Research)

Note: US LDRs are loans to total deposits (not core).
6. FINANCIALS ARE A BIG WEIGHT IN THE INDEX; ONE NEEDS TO OWN THEM

Financial institutions now represent almost 12% of the Barclays Global High Yield index and 10% of the Barclays High Yield Index. Most of these issues represent Tier 1 and Tier 2 capital; recent precedent in Europe may treat these instruments as “bail-in-able.” Caveat emptor for benchmarkers.

7. RISK TAKING IS ALWAYS REWARDED IN HIGH YIELD

Many asset allocators are chasing the “hot dot” in the high yield market. Many U.S. high yield managers have outperformed by taking risk at historically low yields and relatively overvalued spreads. These managers tend to take heavy allocations in lower quality segments of the market, which also carry the most risk. Historically this approach has ended in large losses and sharp underperformance.

Figure 6 Peer Group Analysis, Top 10 Pre-Recession Managers

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<tr>
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<th>AVERAGE PERCENTILE RANK</th>
<th>MEDIAN RANK</th>
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<tbody>
<tr>
<td><strong>Technology &amp; Telecomm Bubble</strong></td>
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<tr>
<td>Pre-Crisis (12/98 to 12/00)</td>
<td>14%</td>
<td>15%</td>
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<tr>
<td>Crisis/Post Crisis (12/00 to 12/02)</td>
<td>40%</td>
<td>35%</td>
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<tr>
<td><strong>Great Financial Crisis</strong></td>
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<tr>
<td>Pre-Crisis (12/02 to 12/06)</td>
<td>6%</td>
<td>5%</td>
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<tr>
<td>Crisis/Post Crisis (12/06 to 12/08)</td>
<td>78%</td>
<td>85%</td>
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<td><strong>European Sovereign Crisis</strong></td>
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<tr>
<td>Pre-Crisis (12/08 to 12/10)</td>
<td>6%</td>
<td>6%</td>
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<tr>
<td>Crisis/Post Crisis (12/10 to 3/12)</td>
<td>71%</td>
<td>85%</td>
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Sources: OECD, Morgan Stanley Research

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