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EYE ON THE MARKET

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COMMENTARY ON SPECIFIC MARKET ISSUES AND ACTIONABLE IDEAS TO CONSIDER

SELL OFF IN HIGH-YIELD BONDS:

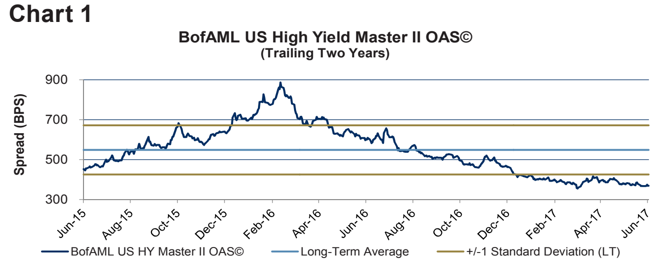
Is it time to worry?

Bloomberg L.P., published an article on June 1, 2017, focusing on investors exiting high-yield bond exchange-traded funds ("ETFs") during the month of May. High-yield strategies invest in bonds issued by companies that have low credit ratings. In turn, they pay higher interest payments to compensate investors for the increased risk of defaulting on payments relative to higher quality company debt. Eye on the Market ("EotM") will further examine the recent outflow and, more importantly, the potential impact on investors in this space.

MARKET STRESS OR A BLIP

The two largest high-yield bond ETFs experienced redemptions of nearly $2 billion this past May, the highest level in nearly a year. U.S. high-yield bond mutual funds also experienced $677 million in redemptions during the month of May and $8.7 billion in redemptions year to date. In the past, a sell off this magnitude would typically result from a major market-moving event, such as the default by a borrower. The current market environment remains relatively unchanged, as Chart 1 shows that credit spreads for high-yield bonds remain low. Credit spreads represent the difference between the yield on a U.S. Treasury security and the yield on a lower-rated bond of similar maturity. In the opinion of EotM, this is a sign investors are not requiring a risk premium to invest in high-yield bonds. While market sentiment may remain neutral, narrow credit spreads indicate limited upside potential for investors in the high-yield space at this point in time outside of the coupon they are receiving.

Chart 1



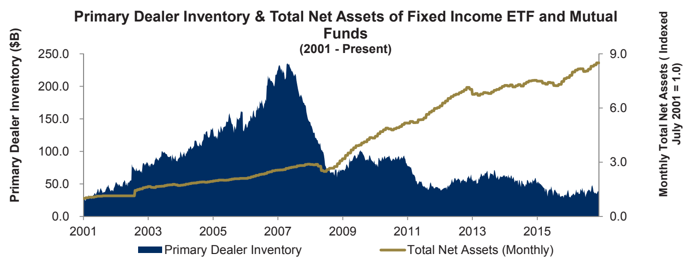
Source: St. Louis Federal Reserve and Raymond James. All data is as of June 2, 2017. The Bank of American Merrill Lynch High Yield Master II Index is an unmanaged representation of the performance of below investment-grade U.S. domestic bonds. It is not possible to invest directly in an index.

HEADING FOR THE EXIT?

EotM believes that a month's worth of data does not represent a trend. It also does not provide investors with insight around how mutual funds and ETFs that invest in bonds with less market liquidity (trade less frequently) will behave when there is a prolonged market sell off. This brings up a concern EotM has discussed around liquidity risk – when the ability to buy and sell securities becomes challenged. For example, if a homeowner chooses to sell her home with a listing price of $400,000, she may be willing to accept an offer of $390,000 — a 2.5% discount from her asking price. If the market is orderly, she can sell her home within this price range without leaving her house on the market for too long. In the event that there is a dislocation in the market, she may struggle to sell her home or be forced to accept a price that is deeply discounted from her asking price.

The challenge around liquidity in the fixed-income market place has been further compounded by a change in the role investment banks and other financial institutions play in the fixed-income markets. Historically, these firms would help ensure the market remained orderly by holding a variety of fixed-income securities in their inventory. Since the financial crisis, this has dramatically fallen as firms respond to regulatory requirements and alter the businesses they are in. Chart 2 shows how meaningful this decline has been. At its peak, primary dealer inventories were at $235 billion in late 2007, and have declined to $38 billion as of the end of May 2017. This equates to a decline of nearly 84%. During that same period, assets in fixed-income strategies have grown from $276 billion to $2.46 trillion over the 16+ years referenced — an increase of 750%.

Chart 2



Source: New York Federal Reserve, Morningstar Direct. All Dealer Inventory data is as of May 24, 2017 while Fund Total Net Asset data is as of April 30, 2017. Total Net Assets represent monthly totals for the following: Bank Loan, Corporate Bond, High Yield, Intermediate-Term Bond, Multisector Bond, and Short-Term Bond categories as defined by Morningstar for both ETFs and Mutual Funds.

KNOW WHAT YOU OWN

Investors should understand that one of the risks of investing is liquidity risk. While many packaged products, such as mutual funds and ETFs, offer daily liquidity, the actual securities may or may not be able to be bought and sold. EotM strongly encourages investors to keep in mind that high-yield bonds pay a higher interest payment for a reason. At a recent meeting, Federated Investors, Inc.'s head of the domestic high-yield group, Mark Durbiano, warned that "Investors can always sell. It may not be at a price they want, but they can always sell."

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SIDE NOTE

One of the oldest bonds still paying interest was issued on May 15, 1648. The Water Board of Lekdijk Bovendams in the Netherlands issued a perpetual bond to finance repair work on a water way. It was issued paying 5% in perpetuity. This illustrates that an investor needs to understand both the willingness and ability of a borrower to pay them back, potentially forever.