ClarkCapital MANAGEMENT GROUP

Portfolio Perspectives

5 Reasons to Hold High Yield in 2015

The high yield market was bloodied in the second half of last year, primarily due to the collapse in energy prices. While yields and spreads backed up, broader-based credit remained firm, suggesting that it was an isolated problem due to the collapse of the energy market. We believe that the high yield market will reward investors who adopt a tactical approach. Below are five reasons we anticipate a reemergence of opportunities in the high yield space in 2015:

1. Credit Spreads Offer Value

After a solid year for Treasuries and sub-par year for high yield bonds in 2014, credit risk seems to be priced for a recovery as the strengthening economy offers support to lower quality fixed income. In mid-December, credit spreads widened to their highest levels since late 2012. Credit spreads moved from 222 to 525 basis points, up 136%. That compares to a rise of 138% during the U.S. debt showdown in 2011.[1] The outsized move in spreads set up a nice entry point into high yield.

Barclays U.S. Corporate High Yield Average DAS

Source: Bloomberg

This is not a recommendation to buy or sell a particular security. Please see attached disclosures.

2. Improving Economy Will Keep Defaults Low

Default rates have historically tracked the fed funds rate with about a two-year lag. Given that the Fed is only going to begin hiking rates this year, we shouldn't see any meaningful increase in defaults. In addition, analysis looking at bank lending standards vs. default rates shows that easing of lending standards has tended to lead defaults by around four quarters. Recent bank lending surveys in both Europe and the U.S. show further net easing in lending to corporates, which should, at the very least, mean we don't see a material rise in default rates. Combined with a strengthening economy, we believe all these factors provide support to high yield.

3. Historical Performance of High Yield in Rising Rate and Fed Tightening Environments

The key characteristic that makes high yield an attractive asset class is its historical non-correlation to Treasuries. This attribute can provide excellent diversification benefits to a fixed income allocation. As evidence, there have been four periods when the 10-year Treasury yield has risen more than 1% since 2005. The average return of the Barclays Corporate High Yield Index was 20.76% compared to a 6.95% decline in the 10-year Treasury.[2]

Since 1980, the Fed has embarked on a new rate hike cycle seven times. The table below from Ned Davis Research summarizes performance of Treasuries, Barclays Aggregate Bond Index and high yield around the first Fed rate hikes since 1980. It is clear that all three sectors historically declined, leading up to the first rate hike with high yield declining only modestly. Following the first rate hike, all three sectors typically advance. In the past, high yield was a clear winner which was likely due to their lower correlation to Treasuries and leverage to the economic cycle.

Median Performance of Selected Bond Sectors
Before and After Initial Fed Rate Hikes Since 1980

	% Gain X-Months Before				% Gain X-Months After			
	12	9	6	3	3	6	9	12
U.S. Aggregate	2.25	1.32	0.15	-1.82	2.54	4.18	3.68	6.80
Treasuries	3.12	3.72	-0.20	-1.13	2.62	3.74	3.73	7.06
High Yield	10.33	6.27	1.78	-0.31	0.95	7.99	9.02	11.49
				All Negative	All Positive			

Fed Funds Target Rate used since 1989, Discount Rate used prior.

Data Source: Barclays

Source: Ned Davis Research

4. High Yield Market Adjusting to the Drop in Oil

The high yield market took the decline in energy on the chin as 15% of the market is energy related. From the July 1st high in oil to the bottom on December 12th , the Barclays Corporate High Yield Index declined -4.44 %.[2] Since then, through February 27, 2015, the index is up +4.16%.[2] It seems that the market recognized that lower energy prices help the other 85% of the high yield market.

5. High Yield Mean Reversion

The year 2014 was one of the weakest non-recession years for U.S. corporate credit. With an annual total return of 2.45%[2] according to the Barclays index, last year's performance is the worst since the Great Recession. Excluding recession years, total returns were lower only three times over the last 30 years: in 1999 and 1994, which saw the Fed tighten monetary policy, and 1998 in the aftermath of the Russian debt crisis. These episodes suggest that barring a recessionary scenario, episodes of underperformance often reverse.

We are not the only one who thinks this. Byron Wien, Vice Chairman of Blackstone Advisory Partners, mentioned in his list of Ten Surprises for 2015 that he expects a very good year for high yield bonds. He said, "The year-end 2014 meltdown in the high yield market, as a result of the collapse in the price of oil, creates a huge buying opportunity. The spread between high yield and Treasuries is cut in half, and high yield becomes the best performer of the various asset classes as the U.S. economy continues to grow with no recession in sight." [4]

To sum up, we expect high yield to rebound from a difficult 2014. There could certainly be bouts of high volatility in high yield related to its historical correlation to equities. It is for that reason that we believe there may be benefits in using a tactical approach to investing in high yield.

Sources: [1.] Bloomberg; [2.] Morningstar; [3.] Ned Davis Research; [4.] Blackstone.com

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Chief Investment Officer

As Clark Capital's Chief Investment Officer, Sean oversees all of the Firm's investment activities and heads the firm's portfolio team. Sean joined the firm in 1993 and is responsible for asset allocation and investment selection for Navigator Investment Solutions as well as directing ongoing market research and contributing to the development of proprietary products. Sean is a member of the Clark Capital Board of Directors, the Investment Committee and the Executive Committee. He graduated from the University of Delaware, earning a B.S. and an M.A. in Economics. Sean is a Chartered Financial Analyst and a member of the CFA Institute (formerly AIMR) and the Financial Analysts of Philadelphia, Inc. Sean is considered an industry expert and is often asked to appear on CNBC and Bloomberg television to share his views on the market. In addition, Sean has been featured in a number of articles in nationally distributed business journals and newspapers.

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