

Is Stronger U.S. Growth a Problem for High Yield?

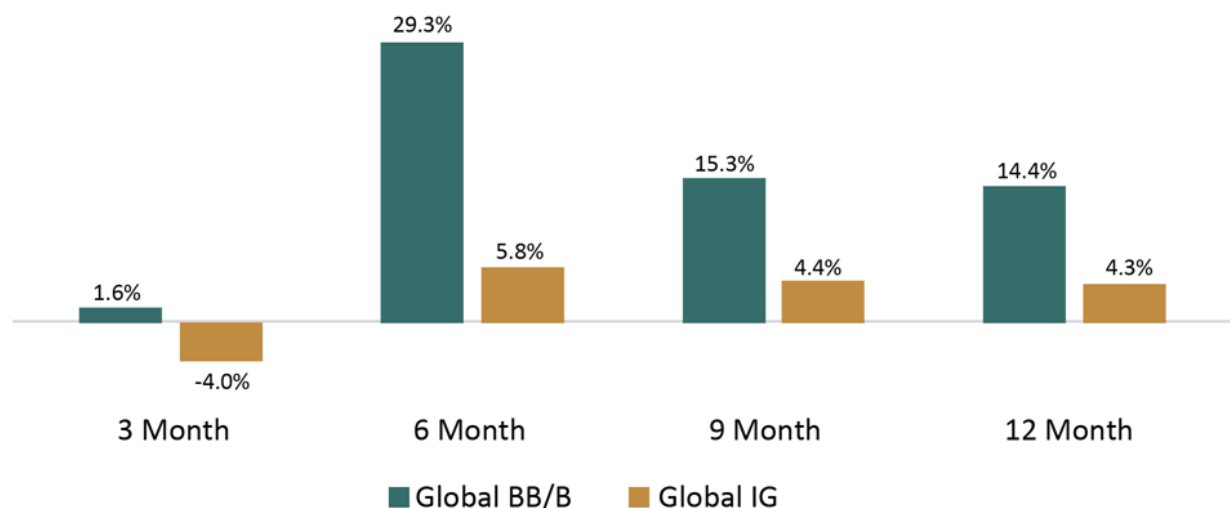
The February employment report came out this past Friday, demonstrating continued wage and jobs growth. Employment data, along with a few other indicators, confirm what we've been saying all along: the U.S. economy is stronger than expected. However, do these strong economic indicators mean a downturn in the U.S. high yield market? There are skeptics that believe a rising rate environment—and a generally strong U.S. economy—will be the death knell for the U.S. high yield market. We disagree. These strong economic indicators will also bode well for the U.S. credit market.

Rising Rate Environment

The Federal Reserve (Fed) has pledged to tighten 3-4 times this year as long as the data—including a weaker dollar—supports the case to raise rates. Following the strong jobs report, the market has now priced in a 98% probability of a 25 basis point (bps) rate hike on March 15. A rising rate environment can certainly become a potential headwind to investment grade credit and other long-dated bonds. Conversely, high yield credits usually have shorter maturities and are less susceptible to duration risk.

Chart 1 below shows how investment grade credit and the B/BB segment of the high yield market performed when the 10-year Treasury yield rose by 100bps or more over various time periods. For example, the data shown for the 3-month period illustrates how credit performed when the 10-year yield rose considerably in a short amount of time. Conversely, the 12-month timeframe offers a period where the rise in the 10-year yield was more measured. Given the relative performance of the B/BB segment, we would welcome the Fed to stick to its 2017 dot plots.

Chart 1: Annualized Returns When 10 Year U.S. Govt. Bond Increased By > 100bps



Source: Bank of America Merrill Lynch, Bloomberg, Brandywine Global

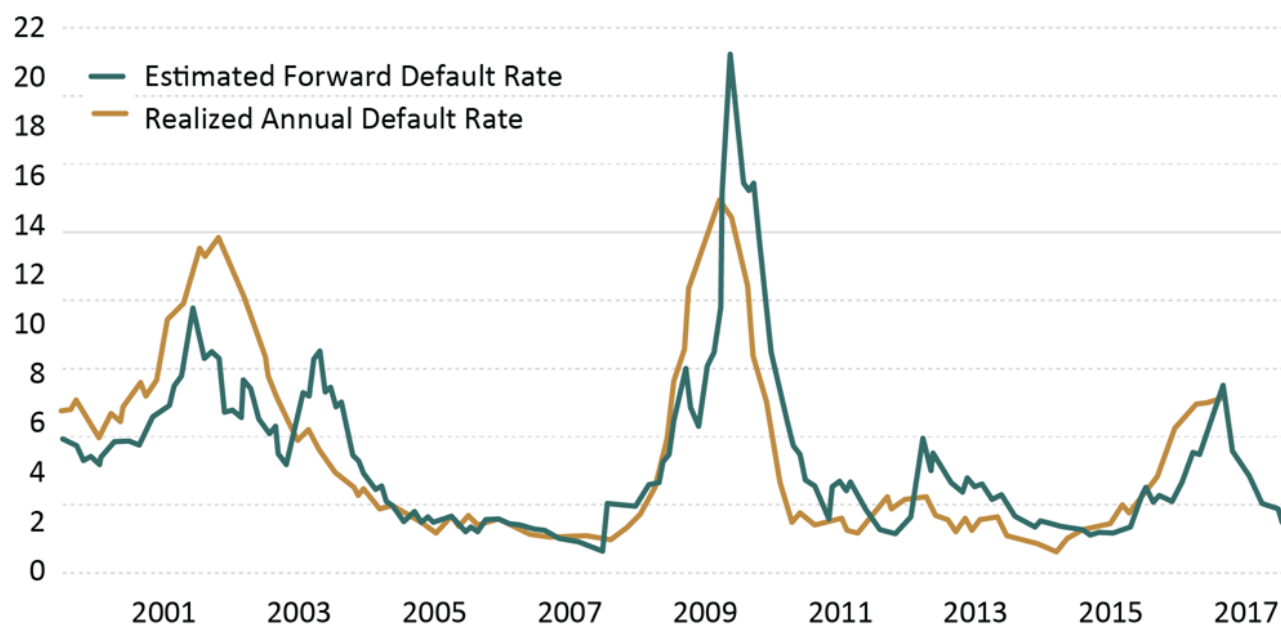
Small Business Optimism

We think small business optimism is one of the most important leading indicators for credit market performance—and generally for the U.S. economy. We recently shared a [Chart of the Moment](#) highlighting small business optimism and continue to believe that several modest interest rate increases should not derail improving economic prospects.

Default Rates

Defaults within the U.S. high yield universe are expected to stay in the in the 3-4% range in 2017; however our default expectation falls lower, at around 2%, as shown by our proprietary research in [Chart 2](#).

Chart 2: Historical Default Rates vs. Proprietary Internal Estimates %, As of 1/31/2017



Source: Brandywine Global

We will continue to be selective about the sectors and credit quality we invest in. The retail sector has been ailing for a long time as traditional brick-and-mortar operations failed to evolve and keep up with online retailers. Although energy prices have recovered and spreads have compressed, many weak balance sheet companies built their assumptions on much higher crude prices. We think these two sectors will make up the bulk of the declining defaults in 2017.

The credit market could experience a few bumps along the way. We believe the risk premia embedded in credit spreads should provide enough of a cushion for investors. Economic optimism bodes particularly well for credit markets, which exhibit lower interest rate sensitivity and currently provide excessive compensation for default risk. Such a benign environment for defaults supported by stronger economic growth supports allocations to lower quality credit. We believe single-B and BB credits offer significant relative value opportunities in global fixed income.

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