HIGH YIELD: WHAT LIES AHEAD?

Last year was a rocky one for high-yield investors. Liquidity dried up, volatility increased and concerns about oil prices hit the energy sector. The result? The first negative annual return for high yield since 2008. This year, markets are likely to stay volatile, and defaults are sure to pick up. But the outlook for returns? Surprisingly rosy.

+ Historically, speedy recoveries have followed high-yield drawdowns. The bigger risk today may not be further volatility, but rather pulling out of the high-yield market prematurely, or even missing the opportunity to buy into high yield before it rebounds.

+ What makes high yield a “comeback kid?” While it may initially seem counterintuitive, the market’s quick rebound rate after downturns actually makes sense. Its consistent high income makes it among the most resilient asset classes.

+ The high yield market has climbed as high as 10% in the first quarter—more than 4% higher than it was in 2014. History has shown that starting yield is usually a reliable indicator of what you can expect to earn over the next five years.

+ What’s one of the best way to both reduce risk and increase return potential in almost any market environment? Diversification. Diversifying across geographies and high-income sectors helps to manage today’s two biggest challenges: liquidity risk and default risk. Plus, diversification increases access to a much broader opportunity set. It is important to remember that diversification does not guarantee a profit or eliminate risk.

**HOW WELL DO YOU KNOW HIGH YIELD?**

**US HIGH YIELD BY THE NUMBERS**

- **NUMBER OF YEARS** since 1984 that annual return has been negative, with no consecutive years of negative returns: **9**
- **NUMBER OF TIMES** since 1998 that there has been a peak-to-trough loss of more than 5%: **5**
- **NUMBER OF TIMES** since January 1991 that the high-yield market has taken more than one year to reclaim its prior high after hitting bottom: **0**
- **LONGEST RECOVERY TIME** in months, that it has taken in the past 17 years to recover to the prior peak level after a loss exceeding 5%: **8**
- **AVERAGE NUMBER OF MONTHS** it has taken since 1998 to recover from peak-to-trough loss greater than 5%: **4**
- **SHORTEST RECOVERY TIME** in months, that it has taken over the past 17 years to recover after a loss greater than 5%: **2**

Past performance is not a guarantee of future results.

As of December 31, 2015

US high yield is represented by the Barclays US High-Yield Index.

An investor cannot invest directly in an index, and its performance does not reflect the performance of any AB portfolio. The unmanaged index does not reflect the fees and expenses associated with the active management of a portfolio.

Source: Barclays and AB
HOW WE LOOK TO ADD VALUE

- Be selective
- Tread cautiously with energy-related bonds

IT’S NOT 2008 ALL OVER AGAIN

A TALE OF TWO MARKETS
The 2008 crisis grew out of massive leverage throughout the financial system—notably at financial firms and federally insured banks. There was a real risk that the entire global banking system would grind to a halt. Repercussions were felt across markets and the world.

The recent sell-off looks a lot more like what the market endured in 2002. Back then, the bursting of the dot-com bubble exposed excessive borrowing at many telecom companies, which had made up a large share of the overall market. That led to higher defaults in that sector and slightly negative returns in the high-yield market.

This time, the trouble is mostly in a few commodity-dependent sectors, such as oil & gas, and metals & mining. Companies borrowed aggressively when commodity prices were high, only to find their margins squeezed and projects unprofitable when prices plunged.

So what should investors expect? Defaults will probably rise—especially among commodity-dependent companies. But issuers in other sectors will likely benefit from lower oil prices. That suggests plenty of upside in the years ahead. Remember, investors who bought non-telecom sectors of the market in the years following the 2002 sell-off did quite well.

THE MARKET IS PREPARED FOR MORE DEFAULTS
Defaults among commodity companies could add up quickly over the next couple of years. But for non-energy companies—the majority of the index—lower commodity costs will help the bottom line. The US economy is in better shape than any other major economy. That should lend further support to US companies that have their finances in order.

After several years of historically low default rates, a move back to the long-run average or slightly higher over the next couple of years seems likely for the US, with the bulk of defaults coming from issuers in the energy sector.

Defaults in Europe are likely to lag, given the tempered leverage levels there—especially since senior secured bonds make up a relatively large proportion of Europe’s high-yield universe. Those bonds rank right at the top of the payout list should an issuer default.

Defaults hurt most when they come as a surprise, as they did in 2008. Most energy-sector bonds are already priced like they may default. If they do, we think the spillover effect on bonds from non-energy-sector companies with better finances will be limited.

And many non-energy-sector bonds are now attractively priced and offer higher yields than they have in years. That favorable risk/reward trade-off isn’t going to change if default rates creep higher. In 2009, high-yield defaults hit a record high (10.3%)—but so did high-yield returns (58.2%).

MANY HIGH-YIELD BONDS ARE ATTRACTIVELY PRICED
Global investors over the past several months have punished high yield indiscriminately, and that presents an opportunity for the value-minded. The yield to worst—a metric used to evaluate the lowest possible yield an investor might receive on a bond, provided the issuer doesn’t default—of the Barclays US High-Yield Index sat above 9% at the end of February. Yields are even higher now on some individual non-energy bonds.

Starting yield is a reliable indicator of what you can expect to earn over the next five years. Why? Because most issuers that don’t default typically call their bonds before they mature—and pay a premium to bondholders for the privilege. That offsets losses on the bonds that do default, leaving investors to earn something close to their starting yield.

YIELD TO WORST GENERALLY PREDICTS MARKET RETURNS OVER THE NEXT FIVE YEARS

Historical analysis does not guarantee future results.

Through December 31, 2015

High yield is represented by Barclays Global High-Yield Index. An investor cannot invest directly in an index, and its performance does not reflect the performance of any AB portfolio. The unmanaged index does not reflect the fees and expenses associated with the active management of a portfolio.

Source: Barclays, Bloomberg, Credit Suisse and AB
THE EVOLVING HIGH-YIELD MARKET

KEEPING AN EYE ON THE CREDIT CYCLE
Market volatility—sell-offs especially—can be unsettling for investors. But to keep a perspective, it’s important to focus on where we are in the credit cycle.

Credit cycles have distinct stages. During an expansionary period, easy access to credit boosts earnings and encourages companies to take on debt. As those debt levels rise, so does credit risk. Asset values start to decline, causing lenders to become stingier. A rise in interest rates then leads to a period of contraction and balance-sheet repair, and eventually a recovery phase. How does this apply to what’s going on today?

Let’s look at the US high-yield market. We expect defaults to rise this year, but not as much as they did during the global financial crisis. We don’t see another systemic crisis or evidence of a bursting bubble. Rising defaults happen when the credit cycle moves from expansion into contraction. Think of it as cleansing the problem credits.

High-yield energy and mining companies are already in the contraction phase. They borrowed aggressively when commodity prices were high, only to find their margins squeezed when prices plunged. For some, bankruptcy is likely. In recent months, they’ve led the downturn in the broader US high-yield market.

Investors still need to be selective, even among non-energy-sector bonds. High yield includes many sectors and regions, all at different stages in the cycle.

Asian corporates are in contraction, but Latin American companies are in recovery mode and are repairing their balance sheets. US and European financials are in the recovery phase: leverage is decreasing, debt growth is stable and earnings before interest, taxes, depreciation and amortization (EBITDA) is on the rise.

With different markets and sectors at different stages, one of the most important things investors can do is diversify. Exposure to various regions and sectors expands the opportunity set and varies credit risk.

LIQUIDITY MATTERS
Liquidity is episodic and can affect different sectors in different ways. Consequently, segregating one’s allocations into single-sector funds—US high yield, emerging markets, and so on—can be excessively risky; if liquidity dries up in one sector or region, investors can find themselves trapped. In our view, a holistic and dynamic multi-sector approach that lets investors tap into a broad universe of high-income assets offers better protection should liquidity in a specific sector dry up.

Low interest rates around the world have forced investors to hunt for yield in the same places at the same time. We think it’s better to avoid the crowd and make decisions based on value, not popularity. The ability to take the other side of popular trades can be a crucial advantage. Should something happen that makes others want to sell, investors who didn’t follow the crowd may be in a position to buy attractive bonds at a reduced price.

A BROAD MULTI-SECTOR APPROACH CAN ENHANCE LIQUIDITY
Market Size of Various Credit Sectors (USD Billions)

Historical analysis does not guarantee future results.
As of December 31, 2015
US high yield is represented by Barclays US Corporate High-Yield; pan-European high yield by Barclays Pan-European High-Yield (EUR); Asia credit by J.P. Morgan Asia Credit; bank loans by Credit Suisse Leveraged Loan; emerging-market high yield by J.P. Morgan EMBI Global Non-Investment Grade; emerging-market corporates by J.P. Morgan CEMBI Broad Diversified; and emerging-market local by J.P. Morgan GBI-EM (since 2002) and J.P. Morgan ELMI+ (prior to 2002). An investor cannot invest directly in an index, and its performance does not reflect the performance of any AB portfolio. The unmanaged index does not reflect the fees and expenses associated with the active management of a portfolio.
Source: Barclays, Credit Suisse, J.P. Morgan and AB

HOW WE LOOK TO ADD VALUE
+ Diversify by sector and region
+ Avoid crowded trades
IT ALL COMES DOWN TO VALUATIONS

SITTING TIGHT IF THE FED TIGHTENS
The Federal Reserve has hit the pause button on interest-rate hikes, adopting a wait-and-see attitude with respect to global growth and capital markets. But the reality is that financial conditions have already tightened as the Fed has stopped growing its balance sheet.

As the Fed began to taper its bond purchases back in early 2014, its reduced liquidity provision coincided with drawdowns in numerous markets, including US high yield. Further tightening of liquidity could continue to weigh on global markets.

But for bond investors, there’s now a notable difference: they’re being compensated for risk-taking with much more attractive valuations than in the past several years. A sizable spread cushion makes a huge difference in the market’s resilience.

As for interest-rate hikes, high yield has historically performed well during periods when the fed funds rate has risen. We expect that relationship to continue to hold true, since high yield, unlike other bond markets, is not particularly sensitive to interest rates.

MORE CUSHION FOR INVESTORS
Things could get a bit trickier if slow global growth pushes the US economy into recession. Still, investors may find that their high-yield allocation holds up better than other parts of their portfolio. Yield spreads have already widened considerably, providing more cushion for investors.

In other words, the high-yield market is already starting to price in a possible US recession. If one occurs, most of the spread widening and price declines will have already happened.

How likely do we think recession is for the US economy? Not very likely, at this point. Continued market disorder would pose a risk to the expansion at some point, but key indicators today—among them the Institute for Supply Management’s New Orders Index, building permits and jobless claims—suggest the growth cycle is still on track.

Some investors worry that the current equity market sell-off could pose a risk to the economy. We think the setback is a long overdue correction—a necessary readjustment from the Fed’s highly accommodative monetary policy, which helped equity prices race far ahead of the economic cycle.

History shows that substantial and sustained declines have often been a precursor to recession; but they’ve also been false signals. That imperfect reliability probably has to do with household equity market ownership. It’s mostly concentrated in the top 10% of income groups. In contrast, ownership of residential real estate is much broader.

HOW TO REACT TO SELL-OFFS
Given the reduced liquidity in the market, investors should expect to see amplified sell-offs more frequently. But keep in mind that, because of its consistent high income, high yield recovers rapidly from these sell-offs.

Furthermore, we aim to use liquidity-driven dislocations to our advantage. Take last December’s short-lived correction to the gating of a 40 Act mutual fund as an example. Investors panicked about the liquidity risks of a single highly concentrated fund that had invested primarily in illiquid, distressed debt. But the rest of the US high-yield, mutual fund universe doesn’t look like that. The volatility created from the resulting outflows spelled opportunity, and the market didn’t take long to recover.

EUROPE’S BANK BARGAINS
And here’s another example: the financials sector in Europe has sold off very sharply as investors have grown increasingly anxious about monetary policy (specifically, negative interest rates), tighter regulation and potential losses on loans to commodity-related businesses. All three could hurt banks’ profitability.

But the financials sector is huge and diverse, and includes many banks that have made massive strides in improving their solidity and stability since the global financial crisis. Creditor anxiety about the health of a few bad apples shouldn’t spoil the whole barrel. We see the sell-off in bank bonds as overly indiscriminate, with about 70% of European bank bonds trading at levels unjustified by their fundamentals.

HOW WE LOOK TO ADD VALUE
+ Actively manage liquidity risk
+ Take advantage of dislocations as they arise
HOW WE LOOK TO ADD VALUE

+ Don’t stretch for yield
+ Take advantage of dislocations as they arise
+ Be selective by issuer and sector

THE IMPORTANCE OF BEING SELECTIVE
For a host of reasons—declining liquidity, the stage of the credit cycle, falling oil prices and individual fundamentals—issuers in the high-yield market don’t behave like a homogenous group. So even though our overall outlook calls for a market rebound, making thoughtful credit selections matters.

Blindly buying the index with, for example, a passive exchange-traded fund (ETF) is highly risky. That’s because it exposes investors to CCC-rated junk bonds from highly levered companies that are the most likely to default—many in embattled commodity-sensitive sectors. Investors who loaded up on CCCs hoping to boost returns are nursing sizable losses today. CCCs were down more than 12% in 2015, compared to 1% for BB-rated bonds and 4.7% for B-rated ones. We think CCCs may fall more in the months ahead.

It’s important to be selective among higher-quality securities, too—especially in the US high-yield market, which is in the later stages of its credit cycle—but also among European financials. This is why an active global and multi-sector approach is critical.

BUY HIGH YIELD TO DE-RISK YOUR PORTFOLIO
Looking for a tactical way to de-risk your overall portfolio? You might consider rotating a portion of your equity allocation into high-yield bonds. That may take a minute to process, since buying high yield is usually thought of as a way to add risk. But adding high yield to your overall portfolio can provide equity-like returns with less risk.

The key to understanding this boils down to how one thinks about high yield. Most investors consider it part of their fixed-income allocation. But in reality, high yield acts a lot more like equities than it does other bonds—with one important difference: it’s less volatile. When times are good, high yield doesn’t go up as much as stocks. However, it declines less in down markets, and recovers more quickly. As a result, tactically rotating some equity exposure into high yield can provide valuable downside protection while maintaining equity-like returns.

HIGH-YIELD BONDS AND EQUITIES: EFFECTIVE COMPLEMENTS
A Combination of High Yield and Equities Has Historically Provided Better Risk-Adjusted Returns

Diversification does not eliminate the risk of loss. Past performance is not a guarantee of future results.
Data are from July 1996 through December 2015.
US High Yield is represented by Barclays US Corporate High-Yield. Equities are represented by S&P 500.
An investor cannot invest directly in an index, and its performance does not reflect the performance of any AB portfolio. The unmanaged index does not reflect the fees and expenses associated with the active management of a portfolio.
Credit ratings measure of the quality and safety of a bond or portfolio, based on the issuer’s financial condition and not of the fund itself. AAA is highest (best) and D is lowest (worst). Investment-grade securities are those rated BBB and above. Ratings are subject to change.
Source: Barclays, Bloomberg, S&P and AB
INDEX DEFINITIONS

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