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High Yield's 18-month "Value Restoration Project"

A special report by the Portfolio Advisory Group – Fixed Income Strategies

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RBC Wealth Management
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High Yield's 18-month "Value Restoration Project"

It is often said that financial markets swing on a pendulum between fear and greed. These swings tend to be more extreme in markets that are illiquid—and high yield bonds are one of the least liquid markets. In just two short years, the valuation of this asset class has flipped from historically unattractive to attractive as large price declines in resource debt ushered in a tone of risk aversion.

We believe risk-tolerant investors should be adding high yield bond exposure as a result of our more upbeat view on valuation. Investors have already started to discount a number of headwinds facing the space and we believe inexpensive valuations should leave the asset class less vulnerable to bad news.

This view stands in stark contrast to the opinion we expressed in March 2014 that noted that expensive valuations left high yield bonds susceptible to a number of possible negative catalysts. Valuation is rarely a catalyst that leads to significant price movement in the short term. But it is one of the most important drivers of long-term returns for credit investors. We believe a 5%–7% annual return is a reasonable expectation from current levels, even if the default rate is above historical averages for a prolonged period of time.

An Illiquid Market Swings From Unappealing to Attractive

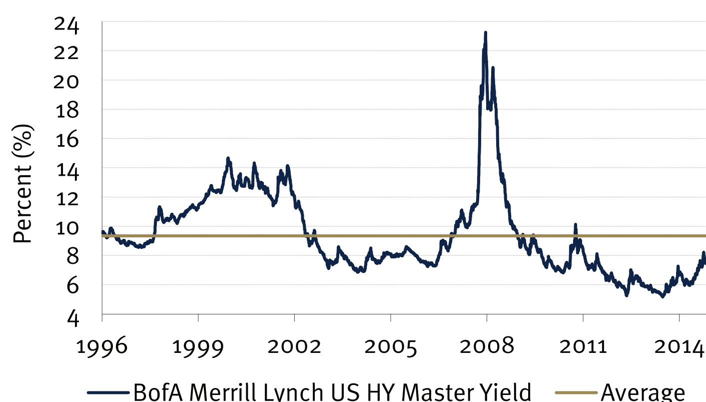
It is often said that financial markets swing on a pendulum between fear and greed. These swings tend to be more extreme in markets that are illiquid—and high yield bonds are one of the least liquid markets. In just two short years, the valuation of this asset class has flipped from historically unattractive to attractive as large price declines in resource debt ushered in a tone of risk aversion. The impact of this shift in sentiment was magnified as previously yield-seeking investors attempted to sell positions to trading desks with a reduced capacity to buy the bonds as a result of regulatory changes enacted in the wake of the financial crisis.

Below are five reasons why we believe it makes sense for risk-tolerant investors to add to high yield bond exposure.

(1) High Yield Bonds Actually Carry High Yields Again
The valuations of high yield bonds appear to be at the most compelling levels since 2009 on an absolute yield basis. Depending on which index one uses, the high yield

High Yield Bond Index Yield Has Doubled From Near All-Time Lows in 18 Months

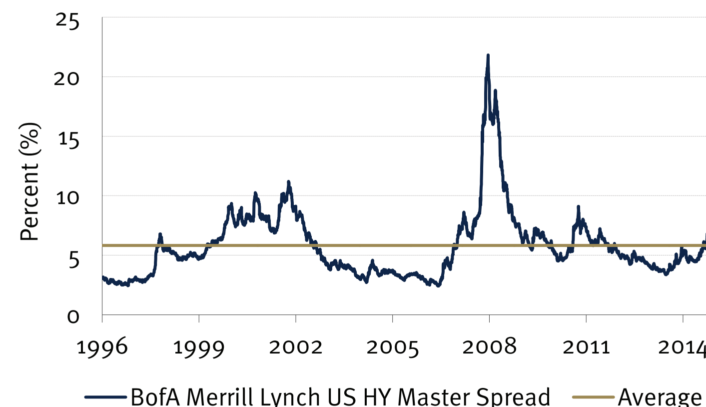
HY Yield vs. Historical Average



Source - St. Louis Federal Reserve, BofA Merrill Lynch

Credit Spread on BofA Merrill Lynch US High Yield Master II Index Has More Than Doubled

HY Spread vs. Historical Average



Source - St. Louis Federal Reserve, BofA Merrill Lynch

market carries a yield-to-worst of around 10%. This is almost double the yield the index carried in March 2014.

(2) Wide Credit Spreads Suggest the Market Is Pricing in a Lot of Bad News

In our view, valuations are the most compelling they have been since 2009 on a relative value basis. Since March 2014, the excess yield (also known as the spread) on the BofA Merrill Lynch US High Yield Master II Index versus government bonds has jumped from 375 basis points (bps) to nearly 900bps today.

Notwithstanding 2008–09, spreads on the overall high yield market are within approximately 200bps of the widest levels ever recorded. This suggests the market is pricing in a significant uptick in defaults. Typically, the high yield default rate spikes to around 10% for a short period during a recession. An index yield of approximately 10% reflects the extent to which the index has already begun pricing in this scenario. RBC Capital Markets continues to believe that U.S. recession risks remain low as most indicators including job creation, wage growth, capacity utilization, and housing starts continue to point toward modest growth.

(3) Yield Pick-Up vs. Investment Grade Bonds Also Reflects Healthy Compensation for Bearing Risk

More evidence that suggests bond investors are receiving greater compensation for taking credit risk can be found in individual quality spreads that currently sit above average levels. The chart illustrates that the yield differential between high yield bonds and investment grade bonds is well above average.

(4) Upside Potential Exists With Average High Yield Bond Price in the $80s

After spending most of the last six years above $100, the average dollar price of the high yield bond market is now in the $80s. An average price below $90 means the high yield market once again offers investors some upside potential.

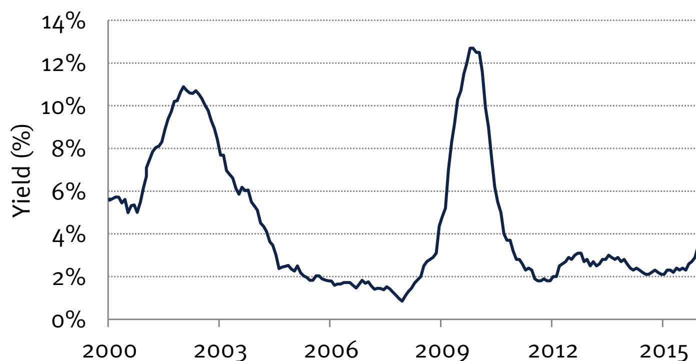
(5) Scenario Analysis Underscores the Amount of Pessimism Imbedded in Current Valuations

With an index yield in the 10% area, we believe a significant buffer against defaults and price declines has been built into high yield bond prices. The forward return outlook for high yield bonds appears more promising from the current valuation level following a two-year period in which high yield bonds delivered a cumulative total return of -10%.

Even if the default rate were to climb to 5% (currently between 2%–3% depending on the measure) and the

Market Is Pricing in a Substantial Jump in the Default Rate

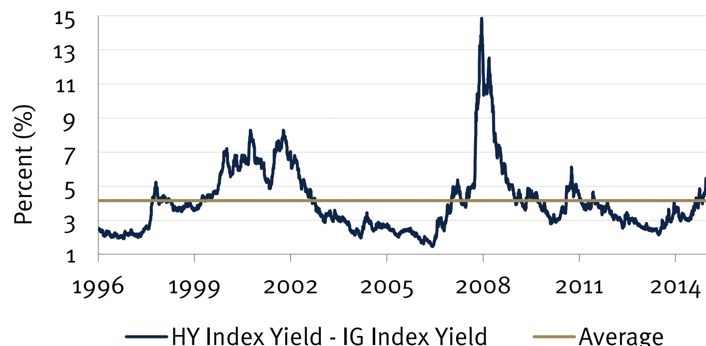
Moody's Historical HY Default Rate



Source - KDP Investment Advisors Inc., Moody's Investor Service

Excess Yield on High Yield vs. Investment Grade Bonds Above Historical Averages

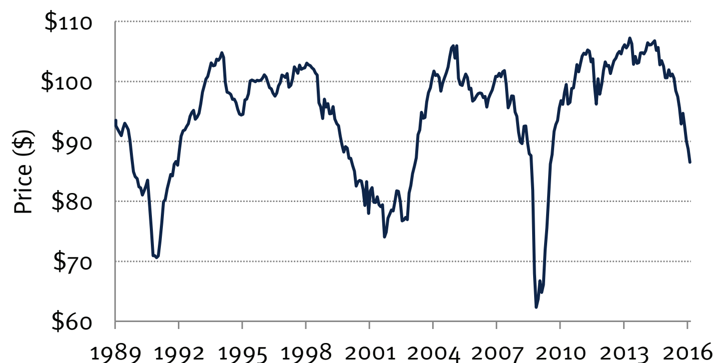
Spread Between Investment Grade and High Yield



Source - St. Louis Federal Reserve, BofA Merrill Lynch

Average Price Below $90 Means Upside Potential Exists

KDP Universe HY Bond Price



Source - KDP Investment Advisors Inc.

average recovery were to be 20% (28% in 2015, 41% is the historical average), the high yield market would deliver an annual return in the 5%–7% area. In a lower default scenario in which the default rate were to settle closer to 3% and spreads were to return to the historical average, double-digit annual returns would be possible, in our view.

Reasons to Scale in, Rather Than Jump in

We believe it is prudent for investors to scale into this market slowly as a number of themes that have dragged the market down could linger. While we believe high yield bonds already represent a compelling long-term opportunity, it could still take time for this market to find a bottom. We see five headwinds that could result in a better entry point presenting itself in the future:

- **Spike in the default rate**: The high yield default rate peaked around 10% in each of the last two cycles. With about 30% of the high yield market trading at distressed prices and 18% and 7% respective default rates in metals and mining and energy high yield bonds in 2015, the market is bracing for a surge in defaults.
- **Weaker covenants lead to lower recovery rates**: Defaults are more impactful to high yield bond investors when recovery values are low. The average recovery in 2015 was only 28%, well below the 41.5% 25-year average. Record volumes of covenant-lite issuance that occurred from 2012–14 will likely erode bondholder recoveries as companies facing a cash crunch can issue secured bonds that rank ahead of existing bonds. Recovery values have been especially poor in the resource sector recently as low commodity prices are depressing the valuations on distressed asset sales.
- **Commodity exposure**: Lower energy prices have been a problem for the high yield market. The energy sector has been one of the biggest sectors of growth in the high yield market as a flurry of high yield bond issuance has financed a boom in shale oil exploration. At the high in 2014, energy companies constituted 16% of the high yield market, up from 4% in 2005 and 8% in 2010. As oil prices remained low in 2015 and into 2016, there have been a number of defaults and recovery values have been very poor.
- **Liquidity**: As high yield bonds are one of the least liquid markets, price movements often overshoot fundamental developments in both directions. New regulations that inhibit the ability of trading desks to hold high yield bonds have exacerbated this challenge.
- **Investor positioning**: The impact of the four preceding factors could be magnified if previously yield-seeking investors attempt to sell positions to trading desks with a reduced capacity to buy the bonds. Inflows into high yield bonds were relentless for the better part of 2009–2014, and many investors are now underwater and heading for the exits. A disorderly wave of outflows could result in outsized price declines.

Return Profile of the High Yield Market

HY Index Yield	Assumed Default Rate	Assumed Recovery Rate on Defaults	Loss from Defaults	Average Annual Return
10.00%	5%	20%	5% x 80% = **4%**	10% - 4% = **6%**

Note: Return profile shows the course of a cycle from the current valuation
Source - RBC Dominion Securities, Bloomberg

AUTHORS

Mikhial Pasic – Toronto, Canada
mikhial.pasic@rbc.com; RBC Dominion Securities Inc.

Alana Awad – Toronto, Canada
alana.awad@rbc.com; RBC Dominion Securities Inc.

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