Allianz US High Yield

Fund manager commentary

May 2017

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Summary

- The US high-yield market increased for the month of May.
- The fund posted a positive return (in USD terms) in-line with its market segment.
- Among fixed-income alternatives, high-yield bonds should contribute from both a diversification and a relative-performance perspective.

Market environment

The US high-yield market increased for the month of May. Market strength centered on solid first-quarter corporate earnings and sustained improvement in credit fundamentals. Investor sentiment was steadfast in the face of macro headlines and crude oil volatility. High-yield bond prices were resilient given mutual fund outflows. Regarding the US economy, reports were generally positive. The stronger-performing industries were Healthcare, Banking and Telecom-Wireless. The weaker-performing industries were Media Content and Personal & Household Products – the only two to decline. Energy was modestly positive, but underperformed. Fifty-four new issues priced in the month, raising $30.8 billion in proceeds. Two issuers defaulted in the month. The trailing 12-month (TTM) default rate by issuer was 3.23%. By dollar volume, the default rate was 1.31%. The upgrade-to-downgrade decreased to 1.1 with 34 up to 30 down.

Performance analysis

The fund posted a positive return in-line with its market segment. Nearly all issues traded higher during the period, and all but two industries ended negative. An underweight to CCC rated bonds, which outperformed the overall universe, held back relative performance. Industry exposure that helped included Printing & Publishing, Financial Services and Retail. In Printing & Publishing, issue selection drove relative performance and an overweight was additive. In Financial Services, returns outpaced the market average. Gains were broad-based, but a consumer-finance company was a top contributor and aided issue selection. In Retail, portfolio holdings outperformed the peer group and an underweight contributed positively. Industry exposure that lagged included Healthcare, Technology & Electronics and Telecommunications. In Healthcare, the return matched the index, but an underweight detracted. In Technology & Electronics, performance was higher, but slightly lagged the industry's return. There were no downside outliers to report. In Telecommunications, an overweight and to a lesser degree, modest underperformance, were headwinds.

Portfolio strategy and activity

New buys included primary and secondary market purchases within the industrials, utilities and consumer sectors. Sells included called issues and a car rental company that is exhibiting weaker fundamentals.

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Outlook

From a fundamental standpoint, as well as the observed condition of the economy, defaults should maintain near their long-term historical average in 2017. At month-end, the current spread of 374 basis points reflects a market that is still pricing in a higher-than-likely realized default rate. Stress in select industries of the market has waned, and overall, balance sheets, leverage ratios and interest-coverage ratios continue to support an investment in the asset class. Furthermore, less than 13% of the market matures before 2020. This amount is well below the average annual new issuance over the past five years.

The US economy is expected to expand at a moderate pace in 2017, and the equity-market performance and the Treasury yield curve helps confirm this notion. Moreover, the President's agenda should result in even stronger economic growth. Positive tax reform could boost corporate profitability, ignite consumer and business spending, spur mergers and acquisition activity and even lead to debt-reduction efforts. Decreased regulation should have a positive impact on many industries, including, but not limited to, banks, energy companies, drug manufacturers and automobile manufacturers. The effects should be wide-ranging, including stimulating companies to hire and invest, driving lending activity and improving trading liquidity. Increased fiscal spending should accelerate economic growth. Along those lines, cyclicals could benefit from infrastructure spending and military-exposed companies may be impacted by higher defense spending. However, optimism around a Trump presidency and US economic prospects could falter if protectionist and anti-trade policies are greater than expected.

After bottoming in the second quarter of 2016, corporate profits have accelerated through the first quarter of 2017. Based on bottom-up estimates, they are poised to trend higher throughout year. Additionally, the administration's policies could create the most favorable backdrop for corporate earnings in years.

US monetary policy continues to be modestly accommodative with the Fed expected to take a gradual approach toward policy adjustments. Additional interest rate hikes in 2017 would signal confidence in the US economy's ability to grow. The purpose of these adjustments would be to achieve a normalized rate environment after an extended period of extreme accommodation. Until the Fed either moves aggressively or is well into the tightening cycle, monetary policy should not be expected to drive an extended sell-off and spread-widening in high yield. Notably, in the past 30 years, the US has not fallen into recession, nor have high-yield spreads moved substantially higher, without being preceded by an inverted yield curve. The difference between the three-month Treasury bill and the 10-year Treasury note remains accommodative for growth. Outside of the US, global monetary policy continues to be overwhelmingly accommodative, with policymakers maintaining aggressive stimulus measures. Relative value within the rating categories can be viewed as the composite of all of the factors expected to affect the market. B-rated issuers offer the most attractive balance between return and risk without sacrificing the benefits of interest-rate diversification. It is worth noting that higher interest rates are likely to have the greatest impact on the more narrow-spread and generally higher-rated issues in the high-yield market. CCC-rated bonds are the least compelling of the three credit-quality buckets due to their elevated exposure to default risk and significant price recovery. It is prudent to be highly selective when choosing to invest within this subcategory.

From an asset-class perspective, the relative value proposition of US high-yield bonds is clear. With US Treasuries and US investment-grade corporates yielding 2.2% and 3.2%, respectively at month-end, and trillions worth of debt globally yielding even less, the 6.0% yield of the US high-yield market is a compelling opportunity for both international and domestic investors alike. Among fixed-income alternatives, high-yield bonds should contribute from both a diversification and a relative-performance perspective. In 2017, a coupon-like return can be achieved. Interest rates should not have a significant impact on the high-yield market given the relative average spread and dollar market price today. The Fed path, earnings trends, commodity prices and global growth will all influence the outlook.

Opportunities

+ Particular yield potential of high-yielding corporate bonds
+ Capital gains opportunities on declining market yields
+ Currency gains against investor currency possible in unhedged unit classes
+ Broad diversification across individual securities
+ Possible extra returns through single security analysis and active management

Risks

- Bonds suffer price declines on rising interest rates
- High-yielding corporate bonds entail above-average risk of volatility, illiquid markets and capital loss. The fund unit price may be subject to sharply increased volatility.
- Currency losses against investor currency possible in unhedged unit classes
- Limited participation in the potential of individual securities
- No guarantee that single security analysis and active management will be successful

Source: Allianz Global Investors; May 2017