Allianz US High Yield

Fund manager commentary

October 2017

Doug Forsyth
Fund manager

Summary

- US high-yield market closed higher in October.
- Allianz US High Yield gained in value (in USD terms) but lagged its market segment slightly.
- The US economy is expected to expand at a moderate pace in 2017 with the stock market's strength and the Treasury's yield curve confirming this notion. Positive tax reform, decreased regulation, increased fiscal spending and a healthier economic environment internationally could result in even stronger US growth.
- US monetary policy continues to be modestly accommodative with the Fed expected to take a gradual approach toward policy adjustments

Market environment

The high-yield market was positive for the month. The BofA Merrill Lynch US High Yield Master II Index returned 0.39%. The BofA Merrill Lynch BB-B US High-Yield Constrained Index outperformed the Master II because the lowest-quality credits trailed higher-quality credits. Credit-quality subsector returns for the month were as follows: BB rated bonds returned 0.34% while B rated bonds returned 0.55% and CCC rated bonds returned 0.10%. The credit spreads narrowed 5 basis points to 351.

High-yield bonds extended their rally alongside major US equity indices which recorded fresh all-time highs. The asset class's strength was notable given a second consecutive month of declines for Treasuries. There were numerous market-supportive developments including a solid start to the third-quarter earnings season, continued optimism around the prospects for tax reform, robust economic data and reduced but extended accommodation by the ECB. Specific to high yield, credit trends continued to improve. Commodity (industrial metal and energy) price strength, M&A headlines and competitive concerns led divergent returns among select industries. Economically, jobless claims dropped to the lowest level since 1973 and housing prices continued to rise. Manufacturing and non-manufacturing indexes ticked higher and third-quarter GDP growth was faster than projected.

The stronger-performing industries were Utilities, Trucking & Delivery and Aerospace/Defense while the weaker-performing industries were Telecom-Wireless, Healthcare and Personal & Household Products. Forty-two new issues priced in the month raising $23.9 billion in proceeds. The year-to-date level through October is just shy of last year's new issuance for the full year. Mutual-fund net flows were $1.0 billion. There were two defaults in the month. The trailing 12-month (TTM) default rate by issuer was 2.85%. By dollar volume, the default rate was 1.18%. The upgrade-to-downgrade ratio decreased to 1.3 with 39 up to 29 down.

Performance analysis

The fund gained in USD terms (net of fees) but slightly lagged its market segment. An underweight in CCC-rated bonds helped relative performance as the lowest-quality bonds were notable laggards.

Allianz Global Investors

Additionally, an overweight in B rated bonds, which outperformed the broader market, was a benefit. Industry exposure that helped included Telecommunications, Retail and Healthcare. In Telecommunications, issue selection was positive and a portfolio overweight was beneficial. A specialized REIT that continues to work toward diversifying its revenue stream rebounded from oversold conditions. In Retail, the portfolio's return was positive compared to a negative return for the industry. Additionally, a relative underweight was additive. A top contributor included an apparel company that continues to focus on operating performance as sales trends stabilize. In addition to Retail, the broader market was also adversely impacted by weakness in Healthcare. A portfolio underweight and credit selection were sources of strength in this industry. An acute care facilities operator previously under pressure due to proposed payment structure changes rebounded.

On the other hand, industry exposure that lagged contained Energy, Printing & Publishing and Media. In Energy, the portfolio return was positive, but lagged the industry due to underperformance in select oil and gas issuers. In Printing & Publishing, a relative overweight detracted and the portfolio underperformed due to weakness in a commercial printer. This issuer remains focused on controlling costs and stabilizing operating performance. Credit selection was the source of weakness in Media. A global loyalty program company that was lower on technical-related factors continues to execute on plans to drive core business growth.

Portfolio strategy and activity

Buys/sells: New buys included primary and secondary market purchases. Additions included an oil and gas services provider and a relative-value trade into another tranche of the same wireless telecom issuer. Sales included called issues and a healthcare equipment supplier on an operational performance basis.

Outlook

From a fundamental standpoint, as well as the observed condition of the economy, defaults in 2017 and 2018 are expected to remain below their long-term historical average. Spreads ended the month at approximately 351 basis points over comparable Treasuries - narrowing in the month, but not materially. This stage of the market cycle can be compared to the mid-1990s and mid-2000s - market environments that exhibited economic stability, low defaults and healthy balance sheets.

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 with the stock market's strength and the Treasury's yield curve confirming this notion. Positive tax reform, decreased regulation, increased fiscal spending and a healthier economic environment internationally could result in even stronger US growth. After bottoming in the second quarter of 2016, corporate profits have accelerated through the second quarter of 2017. Based on bottom-up estimates, they are poised to trend higher quarter-over-quarter for the remainder of the year and throughout 2018.

US monetary policy continues to be modestly accommodative with the Fed expected to take a gradual approach toward policy adjustments. Additional interest rate hikes and balance sheet reduction efforts would signal confidence in the US economy's ability to grow. The purpose of these adjustments would be to achieve a normalized 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. Overseas, monetary policies continue to be constructive.

The following factors should be considered when investing in high yield's credit quality subcategories. While BB rated bonds have the lowest perceived credit risk among the three rating buckets, rising interest rates – should they materialize – would have the greatest impact on these more narrow-spread issues. B rated bonds offer an attractive balance between return and credit risk without sacrificing the benefits of interest-rate diversification. CCC rated bonds are the least compelling of the three credit-quality buckets due to their elevated level of credit risk in conjunction with a tighter-than-average spread. 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 2.4% 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. Thus far this year a coupon-like return has been achieved. Interest rates should not have a significant impact on the high-yield market given its relative average spread. 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; October 2017