Allianz US High Yield

Fund manager commentary

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Summary

- US high-yield market resumed in September and closed higher.
- Allianz US High Yield gained in value (in USD terms) but lagged its market segment.
- 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. 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 High Yield Master II Index returned 0.90%. The BofA Merrill Lynch BB-B U.S. High-Yield Constrained Index lagged the Master II because the lowest-quality credits outperformed higher-quality credits. Credit-quality subsector returns for the month: BB rated bonds returned 0.77% as B rated bonds returned 0.80% and CCC rated bonds returned 1.61%. The credit spreads narrowed 29 basis points to 356.

After pausing in August, the rally in high-yield bonds resumed. Receding macro-related headwinds, a newly-released tax reform proposal, and fresh all-time highs in stocks were market supportive developments. The asset class's strength was notable given declines in investment grade corporates and Treasuries tied to reflationary concerns. The price of crude oil was higher and traded above $52/barrel on favorable global supply/demand dynamics. The commodity's strength lent support to energy-linked issuers.

The Fed kept interest rates on hold, but maintained its forecasts for one more increase in 2017, followed by three in 2018. The Fed also announced trimming of the balance sheet would start with a $10 billion reduction in October. Higher housing prices helped push household wealth to a record level. Consumer spending and business investment caused Q217 GDP growth to reaccelerate.

The stronger-performing industries were Energy, Theaters & Entertainment and Chemicals while the weaker-performing industries were Food & Drug Retailers, Aerospace/Defense and Telecommunications. Seventy-four new issues priced in the month, raising $43.3 billion in proceeds leading on a year-to-date basis to a surpass of last year's pace. Mutual-fund net flows were $1.7 billion. There was one default in the month. The trailing 12-month (TTM) default rate by issuer was 2.75%. By dollar volume, the default rate was 1.07%. The upgrade-to-downgrade ratio increased to 2.0 with 55 up to 27 down.

Performance analysis

The fund gained in USD terms but slightly lagged its market segment. An underweight in CCC-rated bonds was a headwind as the riskiest bonds continued to outperform.

Industry exposure that helped included Aerospace/Defense, Food & Drug Retailers and Theaters & Entertainment. In Aerospace/Defense, issue selection was positive and more than offset the adverse impact of an overweight. Outperformance was driven by a defense and security solutions company that has undergone and continues to focus on balance sheet improvements. An underweight in Food & Drug Retailers – the universe's worst-performing industry in the month – benefited relative performance. Also, holdings in grocery store operators held up better than the overall industry. In Theaters & Entertainment, a theater operator that saw a recent improvement in box office trends rebounded from prior period weakness.

In contrast, Telecommunications, Energy and Healthcare weighed on performance. In Telecommunications, issue selection and a relative overweight detracted. A voice and data network services provider that continues to make progress towards cutting costs and integrating recent acquisitions was lower due to slower top-line trends. A specialized REIT focused on diversifying its revenue stream was also under pressure. The Energy industry was the top-performing industry in the month. Although the portfolio return was in line with the industry, the underweight detracted. In Healthcare, a portfolio underweight aided relative performance, but issue selection was negative. Volume uncertainty and proposed payment structure changes resulted in declines in select healthcare service operators.

Portfolio strategy and activity

Buys/sells: New buys included primary and secondary market purchases. Additions included an engineered products manufacturer, a records management provider, an auto parts issuer, an oil and gas driller and a relative-value trade into another tranche of the same issuer. Sales included issues that were called or no longer offered attractive relative value.

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 356 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. Although some macroeconomic data may soften in the third quarter due to the hurricanes, the impact should be transitory and not alter the economy's growth trajectory.

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 2.3% 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; September 2017