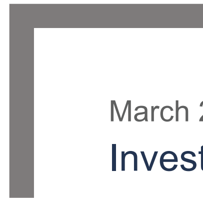

March 2013

Investment Publications Highlights

CAMBRIDGE ASSOCIATES LLC

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"Thank You for the Interest"

Hans Mikkelsen et al., Bank of America Merrill Lynch, March 8, 2013

Better economic data and rising interest rates have mixed implications for fixed income assets in the near term. Although rising rates may encourage investors to continue rotating out of high-grade bonds and into riskier assets, better economic data might allow credit spreads to contract further. Fund flow data indicate that many investors are already bracing for the prospect of higher interest rates.

Treasury yields have steadily risen in recent weeks due to a variety of factors including relief over events in Europe, an improving U.S. labor market, and ongoing recovery in the U.S. housing market. Perhaps the biggest upside risk to economic growth and thus rates is higher home prices, which we now believe may increase by around 8% in 2013. Rising rates may encourage investors to continue rotating out of high-grade bonds and into riskier assets, though better economic data might allow credit spreads to contract further, offsetting some of the pain.

Particular data points illustrate the risks to holders of investment-grade bonds. Recent Federal Reserve fund flow data show that mutual funds, exchange-traded funds, and closed-end funds had an 18% allocation in investment-grade and high-yield corporate bonds, totaling around $1.95 trillion at the end of 2012. Given such large holdings, there is reason to be concerned about the coming rotation—even if only a small share of these corporate bond holdings is sold. Regardless of the exact timing or magnitude of the rotation, investors that own illiquid corporate bonds should consider positioning for the eventual rise in interest rates.

Fund inflow data suggest investors are positioning for the risk of higher interest rates. Globally, high-yield funds have posted decent inflows (around $5 billion), though little has come from U.S. investors ($1 billion). In contrast, interest in loan funds has been well above historical averages, with the $10 billion of inflows year-to-date equaling around 14% of loan fund assets held at the start of the year. Emerging markets debt has also seen strong inflows (up around $16 billion), though it has tapered off in recent weeks. Investors should not expect these markets to post the same returns as prior months since yields are already near historic lows.

Shifting focus to U.S. financials and the implications of higher rates, several points are worth making. Recent Fed stress tests found that all but one of 18 tested banks had above the minimum required 5% Tier 1 common ratio. This implies that banks have significantly delevered since the financial crisis, and can now focus on creating value for their shareholders. With the Fed pinning interest rates at record-low levels, banks will be forced to loosen lending standards and to be more aggressive in areas with good fundamentals. These shifts have positive implications for the housing market, stocks in general, and the overall economy, but could pose risks to creditors of some high-quality industrial companies. Another trend worthy of notice is that while investment-grade trading volumes are actually up year-over-year, financial credit volumes have dipped. The most likely explanation is that investors started to position for an expected improvement in financials early in 2012, and this year has not seen a similar rush. Higher secondary volumes somewhat belie the concerns over reduced liquidity provided by Wall Street trading desks.

Finally, the economic recovery and thirst for yield have revived the merger & acquisition and leveraged buyout (LBO) markets. In 2013, the two largest announced LBO deals have been hybrid transactions involving a strategic investor in addition to private equity. This hybrid approach raises the maximum potential deal size to $30 billion or $40 billion, up from the $20 billion assumed if financial sponsors provided all of the equity. High-grade investors should take notice that a larger percentage of their universe is now susceptible to LBO risk—around 6% of the cash market and 28% of the credit default swap market. Investors should consider hedging some of this risk.

"Leveraged Financial Insights: Leveraging the Recovery"

Adam Richmond and Jason Ng, Morgan Stanley, March 11, 2013

An increase in debt issuance and slowing EBITDA growth has led to an increase in aggregate leverage in the U.S. high-yield market. Even with many measures of credit quality adequate and stable, the outlook for high-yield credit is less appealing than in previous years based on deteriorating fundamentals and low absolute yields.

For the first time in years, high-yield bonds look likely to meaningfully underperform the S&P 500 Index in 2013. If economic growth and earnings surprise to the upside, high dollar prices and yields near record lows will constrain high-yield returns. Conversely, if market volatility resumes, high-yield bonds present downside risks given fundamentals that continue to soften. Within the U.S. high-yield universe, leverage is rising as strong demand encourages companies to become more aggressive with their balance sheets. Adequate EBITDA growth and interest coverage ratios help cushion these risks, but the bottom line is that the outlook for high-yield credit is less appealing than in previous years.

Slowing EBITDA growth and rising new issuance have led to an increase in aggregate leverage in the U.S. high-yield bond market. Median gross leverage for high-yield companies now stands at 3.8 times last 12 months EBITDA as of fourth quarter 2012, up from 3.4 in fourth quarter 2011. While overall leverage has been increasing, the difference in the types of borrowers (by rating and sector) that have increased their debt loads and leverage ratios has been pronounced. For example, energy companies have largely not deleveraged, while two-thirds of media and health care firms have, boosted by strong earnings growth. Despite fairly loose credit markets, low-quality issuers or those with leverage ratios greater than 6.0 have had a harder time tapping the new issue markets and been forced to delever. The net result is that only 11% of new issuance in 2012 was from issuers rated CCC while in 2007 the corresponding figure was 24%. On the flipside, around two-thirds of companies with leverage ratios under 3.0 have increased leverage year-over-year. In aggregate, high-yield companies have increased their leverage 21% over the last three years. High-quality issuers rated BB have increased their leverage the most (32%), attracted to ultra-low new issue coupons.

Despite increasing debt issuance, interest-coverage ratios have only weakened slightly year-over-year from 4.1 to 3.9, as new debt issuance features lower coupons. In fact, interest coverage ratios remain just below cycle peaks and well above the financial crisis lows of 3.1. Cash as a percentage of total debt has also improved for high-yield issuers; median

cash/debt of 11.4% as of fourth quarter 2012 is above the lows seen in 2006–07 of 8% to 9%. During the crisis, high-yield borrowers shored up balance sheets by reducing capital expenditure; as a percentage of sales capital expenditure stands at 4.1% today, down from a pre-crisis median of 4.7%. Capital expenditure should continue to rise as confidence grows, but investors should watch this metric closely for signs that the economic recovery may be fading.

Overall, leverage has recently increased for high-yield bond issuers while fundamental metrics such as EBITDA and interest coverage have slightly weakened. Still, this deterioration was modest in 2012, and measures such as leverage and interest coverage are either in line with or slightly better than historical averages. These trends are likely to continue into 2013. However, the fact that much of the new issuance market remains bifurcated, with higher-quality issuers tapping the markets easily while lower-rated issuers struggle, makes it clear that a rising tide has not lifted all boats. Investors should remain selective—the current environment will not favor passive investing as diverging fundamentals will likely create many winners and losers within the high-yield credit universe. ■