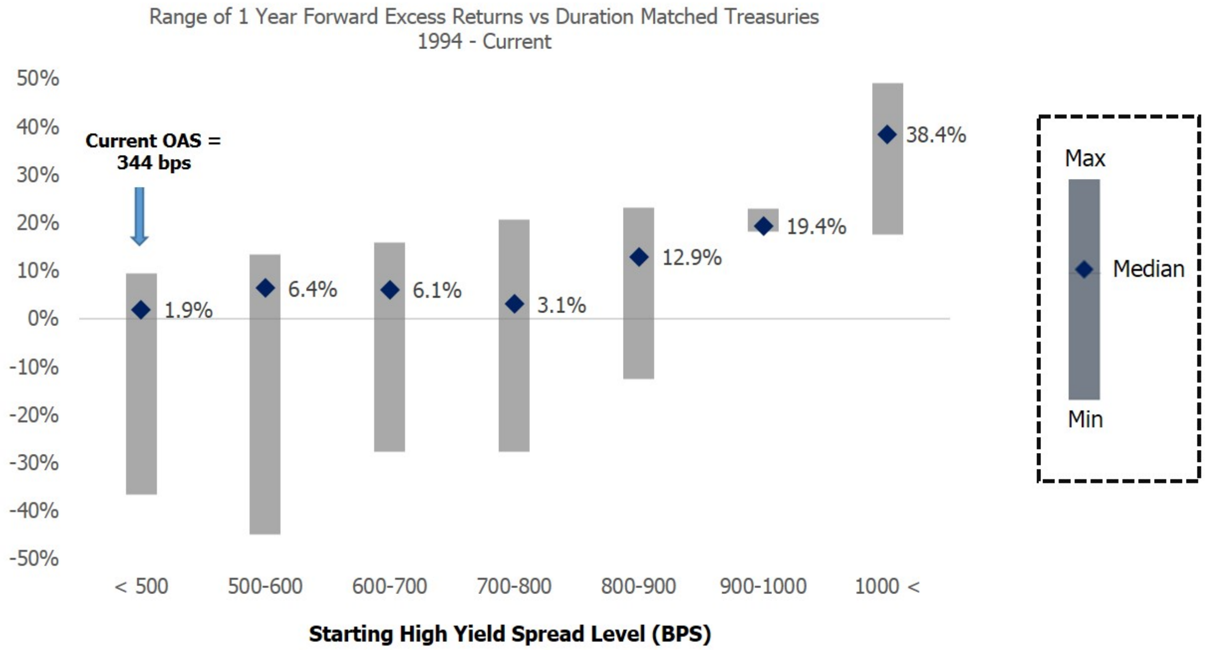
Bond iQ
Intra Quarter Update

Will Plus Become A Minus?

Sometimes, less is more. That may be true today for fixed income investors who have added high yield to traditional bond allocations. Since early 2016 high yield spreads have tightened by nearly 500 basis points, and currently are well below their historical average of 515 basis points**. The exhibit below demonstrates that as high yield spreads tighten, their ability to provide excess returns becomes increasingly limited . . . with dramatically elevated downside risks.**



Once high yield spreads fall below 500 basis points their median excess return over the next 12 months is just 1.87%, with a simple average of only 0.2% return for all such periods. At the same time the downside risk for high yield excess returns far exceeds the limited upside potential. It's not until spreads trade substantially higher that the average excess returns start to become compelling and the upside/downside outcomes become more balanced. At today's level of 344 basis points investors are far from this safe zone, with history suggesting that the risk-return relationship for high yield is now skewed toward risk.

That's not to say that high yield can't continue to generate modestly higher returns than traditional fixed income, so long as the economy doesn't falter. Historical trends have shown that spreads can linger around relatively tight levels for some time. In fact, high yield spreads traded in a range between 235 and 384 basis points for over four years during the mid 1990's. While spreads may not widen in the short term, the return outlook for high yield has dimmed. **Now may be the right time for Core Plus investors who wish to protect their portfolios against spread widening to consider shifting to a more defensive position and reducing exposure to high yield.**

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