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Global High Yield

Global High Yield Update

Since the February lows, Global High Yield (HY) has rebounded by 16%. A rally in energy and commodity prices has supported the US HY market which has been the main catalyst for this substantial tightening of spreads. Peter Khan, manager of Fidelity's Global High Yield strategies, provides an overview of his outlook for the asset class and an update on fund positioning below.

Outlook: well balanced in the medium term

The hunger for yield remains in place supporting flows into the asset class. To date, Asia and Europe have led the way and in the months ahead, accommodative monetary policy should continue to benefit both risk and income producing assets. Against this backdrop, supply has been subdued, at levels well below the last 2 years and at only 50%[1] of the 2015 run rate. As a result form a technical standpoint the market remains well balanced and underpinned in the medium term.

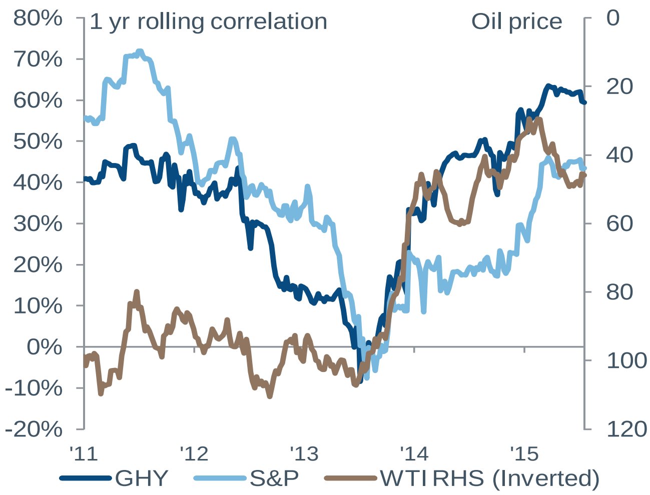
Over the next 3-6 months we find it hard to envisage a scenario where these returns will be replicated. It would require bullish assumptions about economic growth, fiscal policies transitioning to support growth, a material fall in forecasted defaults or a continued rebound in commodity prices. On the latter, over the past few weeks we've seen a breakdown in the correlation of commodity prices and risk assets (Chart 1). The ability of broader risk markets to remain immune to weaker commodity prices going forward will determine whether we'll comfortably clip our coupon or need to fasten our seatbelts.

[1]Source: Deutsche Bank. Data as of 30 June 2016, based on Global HY USD denominated issuance.

Defaults: little margin for error

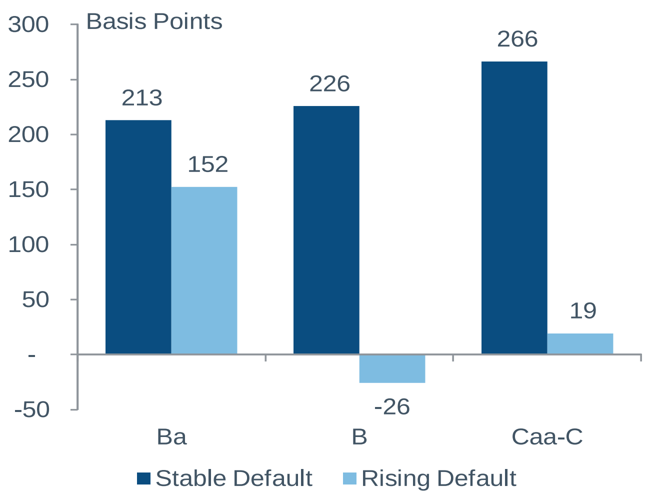
At the lows in February, the market implied global HY defaults would rise to around 9% over the next 12 months and indicated an 80% probability of a US recession. Currently, the market is pricing in a default rate of 3.8% slightly lower than the Moody's forecast of 4.2%[2] over the 12 months. Defaults are already into

Chart 1: The relationship between commodity prices and risk assets has diverged recently



Source: Fidelity International, Bloomberg, BofA Merrill Lynch Indices, 29 July 2016.

Chart 2: Slimmer margin of error for lower rated; BBs still offer default adequate compensation



Source: Fidelity International, Moody's Research, BofA Merrill Lynch Indices, Bloomberg, data as at 21 July 2016. Spread Premium Conditional to Default Regime from 1970.

double digits in the energy sector but have been relatively contained. In US HY more broadly, there are some signs of balance sheet repair with leverage coming down, but this comes from a high base as issuers levered up massively post the financial crisis.

Our spread premium model gives an indication of the amount of spread we need to compensate for defaults in each rating bucket based on default cycles back to 1970. In a rising default environment, we are adequately compensated in the BB bucket and we have been rotating up in quality in the portfolio to reflect this (Chart 2). Lower down the ratings spectrum, there is now a much slimmer margin for error and we have been consolidating positions here into high conviction names.

[2]Source: Moody's Research, June 2016.

Risks: impact as yet indeterminate

There are numerous risks facing high beta assets into year end. At a fundamental level, shrivelling earnings growth and margins reaching a plateau leave valuations, particularly in the equities market, vulnerable. This combined with the lower level of absolute yields and spreads leaves little margin for error. In addition, normalisation of US monetary policy alongside the US elections is unlikely to be a smooth ride. China is also a concern. Its debt dependence is a longer term issue but a slowdown in growth or disappointing data will require closer examination. Finally, the technicals – flows, consensus positioning and liquidity – are a risk to any market. Contrary to popular belief, liquidity has not completely evaporated in high yield, however liquidity is now concentrated in the hands of end investors which means it is more momentum driven (Charts 3 and 4).

Chart 3: Average daily trading volume of HY has remained stable

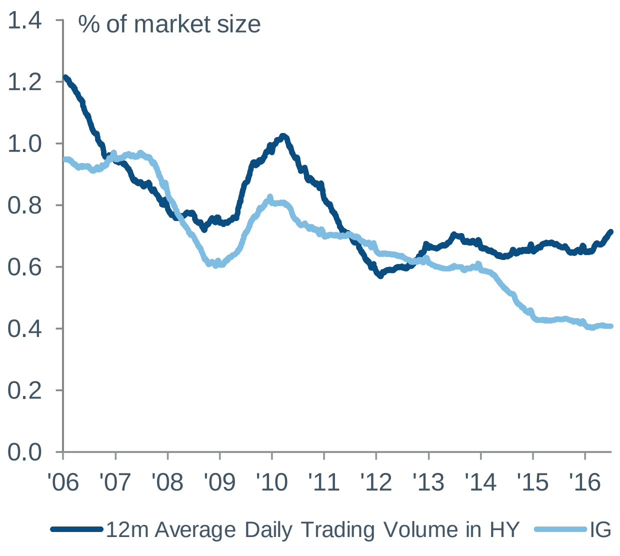
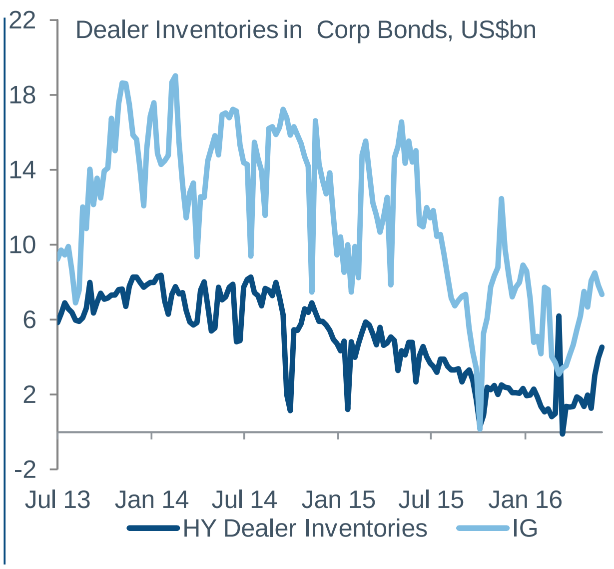


Chart 4: Dealer inventories have been steadily declining, but some respite in periods of volatility



Source: Fidelity International, Deutsche Bank. Data as of 30 June 2016

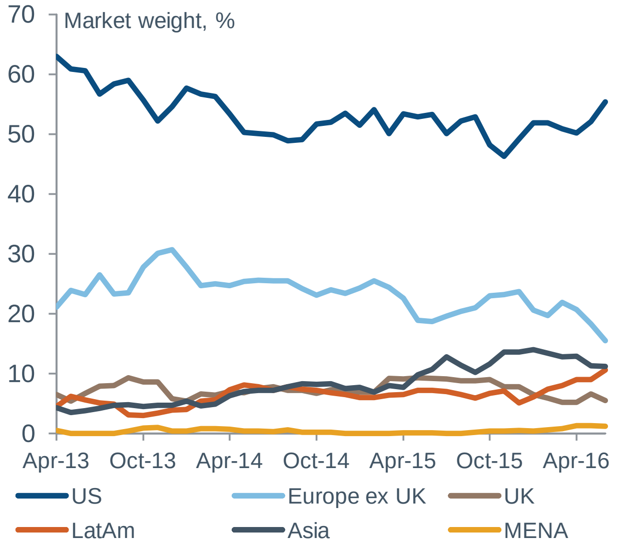
Positioning: defensive, preferring US and Latin America

Through the summer, we plan to further reduce risk in the fund by rotating into higher quality names and raising our cash cushion to the top of our typical 5-10% range. We entered the year with a credit beta of 115% versus the benchmark (measured on a DTS basis) and lowered this to 103%. If spreads continue to grind tighter over the traditionally slower summer months, we will use it as an opportunity to get more defensive, taking credit beta down further, towards 90%. Our cash buffer will be used to raise DTS through the primary market, where new issue premiums are still on offer, and the secondary market where volatility could give way to attractive entry points.

In terms of regional positioning, we have rotated positions out of Asia HY where we find valuations too stretched given the deterioration in balance sheets and less compelling technicals (Chart 5). Carrying on from the end of last year, we continued to lower our allocation to the UK on the anticipation that the Brexit vote could increase volatility and also took some profit in our European holdings recognising the rise of political risks. Cash has been rotated into US HY to capture some of the stabilisation in commodity prices and Latin America. The latter represents our largest regional change to date, due to its risk / reward outlook and high conviction from our sovereign and credit analysts. Here we have added in capital goods, through names such as Cemex and Eldorado, and consumer non-cyclical names via JBS, the Brazilian protein producer.

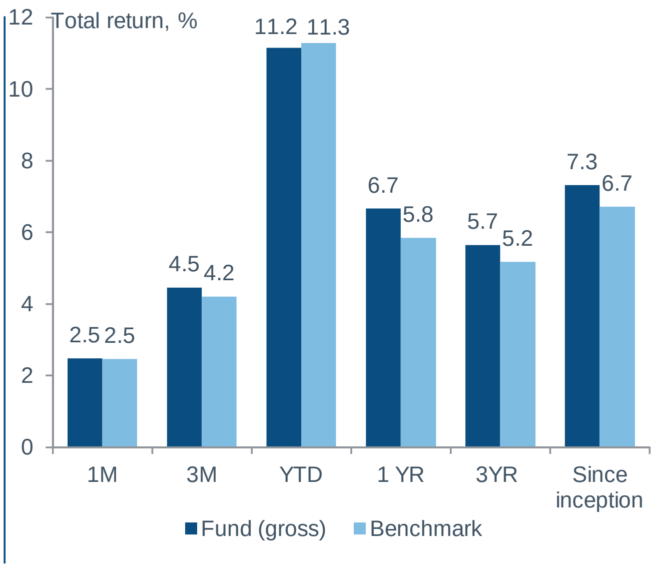
The Fidelity Global High Yield fund has delivered a double digit return this year, in line with its benchmark (Chart 6). Given its ability to tactically allocate across the regions, we are able to take advantage of different business and economic cycles. As a result, we expect a coupon clipping return for the remainder of the year as, with yields above 6%, the asset class should remain underpinned.

Chart 5: Increasing allocation to US and Latin America at the expense of Asia and Europe



Source: Fidelity International, 30 June 2016. Regional allocation based on FF Global High Yield.

Chart 6: FF Global High Yield has delivered consistent returns since inception in 2012



Source: Fidelity International, 29 July 2016. BofA ML Global High Yield Index (HW0C). Performance based on gross paying A ACC Shares for FF Global High Yield (SICAV). Basis Nav-Nav with gross income reinvested. Annualised returns. Past performance is not a reliable indicator of future results.