

Global High Yield Bond Market Outlook: The “Return” of Beta Valuations, Improving Fundamentals Support Moderate Overweight Allocation

August 21, 2009



Beta:

a measure of the sensitivity of an asset's returns to the market's returns; also known as non-diversifiable risk, systematic risk or market risk.

Return:

the ratio of money gained or lost (realized or unrealized) on an investment relative to the amount of money invested.

There was a systemic meltdown in the global credit markets in the fourth quarter of 2008, but beta has returned with a vengeance in 2009. Year-to-date returns in global credit have been led by high yield bonds and loans, and more specifically by the lowest quality tiers. While performance has more than fully recovered from the pummeling in 2008, we believe there are compelling reasons to continue having exposure to high yield bonds. We continue to support a moderate overweight allocation to high yield bonds, based on historically compelling valuations and an improving fundamental landscape. Looking forward, we expect a shift in returns to be generated more from idiosyncratic, or security-specific, risk rather than market risk, or beta.

In this report, we touch on year-to-date returns, current valuations, default rates, new issuance, bank loan refinancing, the relationship with US Gross Domestic Product and fallen angels.

High Yield Delivers Strong Performance After 2008 Meltdown

This year has been widely characterized as the return of systematic – or market – risk. The higher the market risk, the higher the return has been. There was a systemic meltdown in the global credit markets in the fourth quarter of 2008, but beta has returned with a vengeance in 2009. Year-to-date returns in global credit have been led by high yield bonds and loans, and more specifically by the lowest quality tiers. Through July 31, the Global High Yield Bond Index has returned 41.0%, led by the CC and CCC quality tiers, which have returned 90.9% and 64.6%, respectively (Illustration 1). Performance was enhanced by a strong bounce in the Financials industry, with many credits new to the high yield market after fresh downgrades. Banking has returned 78.8% and Financial Institutions have returned 71.2% year-to-date.

While performance has more than fully recovered from the pummeling in 2008, we believe there are compelling reasons to continue having exposure to high yield bonds. This is especially the case when high yield is compared with investment alternatives such as 10 year U.S. Treasury Notes, yielding less than 4%, and investment grade corporate bonds, yielding roughly 5%.

Illustration 1: Total Rates of Return

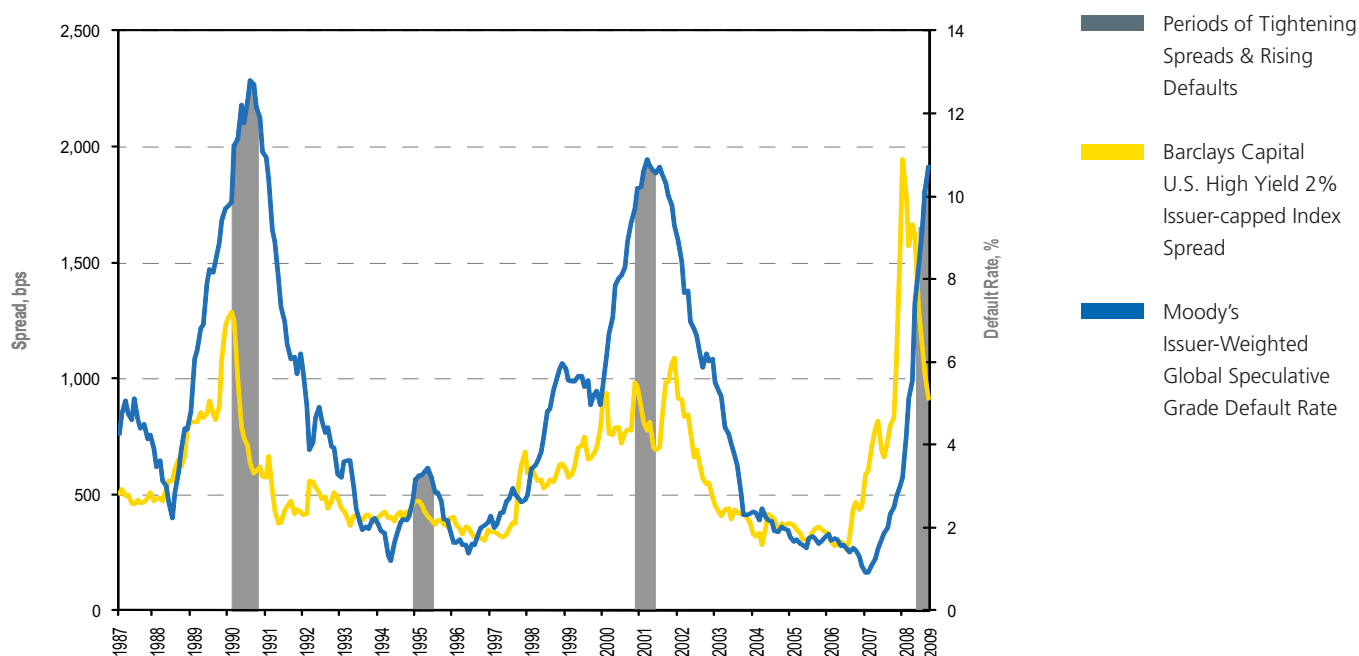
INDEX	2008	YTD
Global High Yield	-26.5%	41.0%
U.S. High Yield	-25.9%	38.8%
Euro High Yield	-32.6%	49.4%
Global High Yield - BB	-17.7%	34.1%
Global High Yield - B	-27.8%	34.4%
Global High Yield - CCC	-44.6%	64.6%
Global High Yield - CC	-47.7%	90.9%
Global Investment Grade Corp.	-5.1%	11.0%
Bank Loans	-29.5%	41.0%
U.S. Treasury Bonds	13.7%	-3.9%
S&P 500	-37.0%	11.0%
EAFE	-43.1%	18.0%

Multi-currency and Euro indices are 100% hedged to USD YTD as of July 31, 2009
Source: Bloomberg, Barclays Capital

In our report dated January 12, 2009, “Global High Yield Bond Market Outlook: The Power of the Coupon,” we upgraded our high yield bond view to a moderate overweight allocation for long-term investors. We also noted that high yield spreads typically lead default rates, and this relationship has continued. As spreads widened, default rates followed higher; now as spreads have narrowed, default rates have started to decline (Illustration 2). While the Moody’s trailing 12-month default rate reached 10.7% in July, the month-over-month default rate is on the decline. The trailing 12-month rate is expected to decline to 4.4% in July 2010, below the long-term average. As of July 31, the spread on the Global High Yield Bond Index was 956 basis points over Treasuries, still high on an historical basis.

We continue to support a moderate overweight allocation to high yield bonds, based on historically compelling valuations and an improving fundamental landscape.

Illustration 2: High Yield Spreads and Default Rates



As of July 31, 2009

Source: Bloomberg, Barclays Capital

Default Rate Forecast To Decline Significantly

The Moody’s global speculative-grade default rate increased to 10.7% on a trailing 12-month basis as of July 31. This compares with a 2.3% default rate one year ago. Moody’s also lowered its default forecast, predicting that the default rate would peak at 12.2% in the fourth quarter and then decline to 4.4% in July 2010. The estimated peak was lowered from 14.8%, the forecast of only three months ago. According to Moody’s, “As 2009 progressed, Moody’s model forecasts for the peak default rate in this cycle have fallen significantly as high yield bond spreads have narrowed. This narrowing of spreads and the recent re-opening of the high yield bond market is allowing many issuers to refinance their debt who might otherwise have defaulted.”¹ The year-to-date default count is 183 issuers.

While the forecast trend is clearly a positive, the forecast decline to 4.4% represents a significant improvement in default rates that may be on the optimistic side. High yield issuers now have access to the capital markets, which is allowing them to extend upcoming maturities. However, the ability to service debt through increased cash flow generation and reduced interest expense is expected to remain relatively challenging.

Open Capital Markets Have Positive Fundamental Impact

The 2009 new issue market has seen \$82.1 billion in new high yield bonds through the end of July, compared with \$55.7 billion for the full year of 2008. Opening the capital markets for new high yield bond issuance has had a significant positive impact on forecast default rates. Companies have been extending maturities, providing an improvement in their balance sheet liquidity.

There have been three pronounced characteristics to this new issuance: high ratings quality, secured or senior priority, and U.S. Dollar-denominated issuance. Specifically, 57% of new high yield issues have been BB rated, 93% have been either secured or senior in priority and 86% have been U.S. Dollar denominated (Illustration 3).

Illustration 3: Global High Yield Bond New Issue Volumes

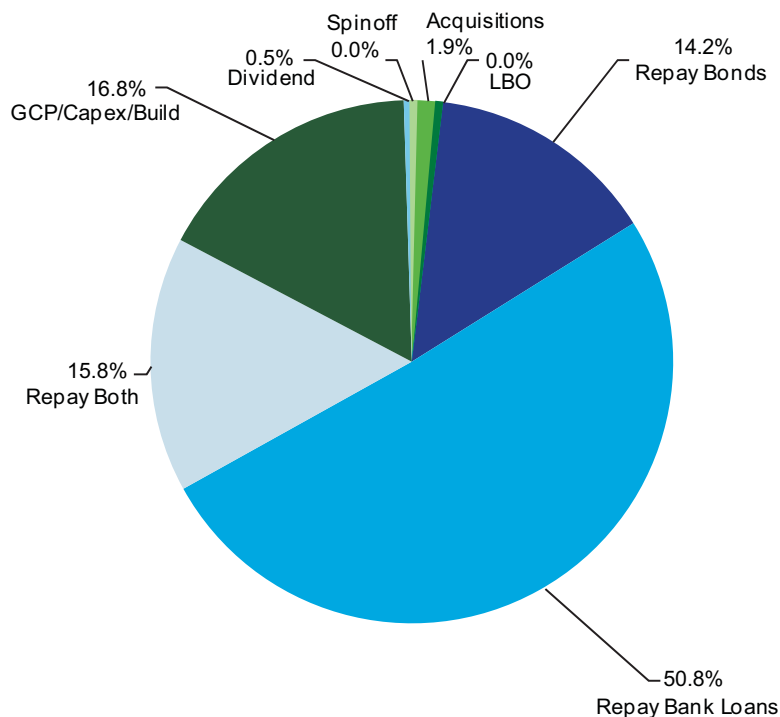
Annual	Total	Ratings				Currency				Seniority		
		BB	B	CCC	NR	USD	EUR	GBP	CAD	Secured	Senior	Sub
FY 2009	82,104.9	46,931.8	31,093.1	3,680.0	400.0	70,635.1	11,244.4	0.0	225.4	26,403.0	49,981.4	2,643.5

Source: Banc of America Securities - Merrill Lynch; July 31, 2009

Face Values (US\$m equivalent)

The majority of new issuance in high yield bonds this year has been for purposes of refinancing bank loan debt (Illustration 4). The bank loan refinance issue will be an interesting dynamic during the next few years.

Illustration 4: Proceeds of High Yield Bond Issuance



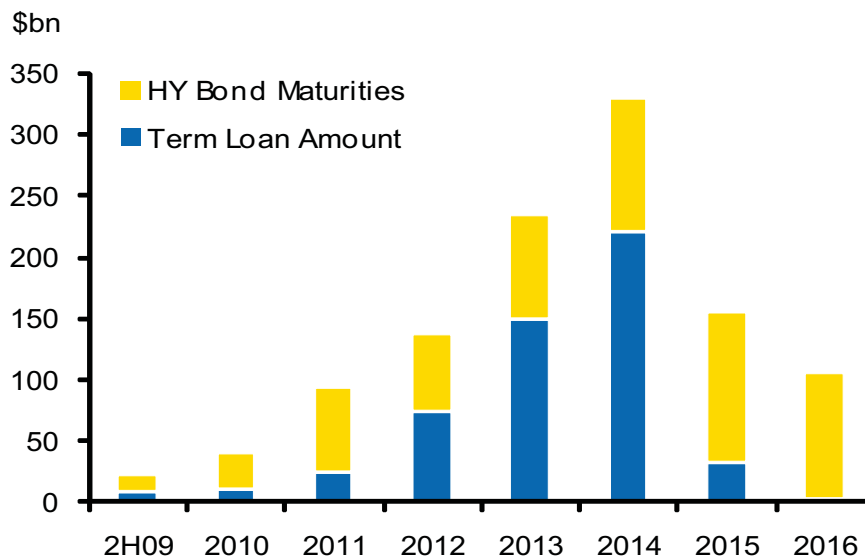
As of June 19, 2009

Source: Barclays Capital

Fears Overblown About Upcoming Wave Of Bank Loan Maturities²

High yield bank loans also are referred to as levered loans, floating rate loans or par loans. There was an extraordinary amount of bank loan issuance during the leveraged buyout boom from 2005 to 2007. The issuance increased the total size of the loan market to approximately \$575 billion, according to Barclays Capital, approaching the roughly \$900-billion size of the high yield bond market. The buyer base of bank loans for these issues was concentrated in leveraged structured vehicles called collateralized loan obligations (CLOs). With the bid for bank loans by CLOs nearly nonexistent today after the devastation in structured products, the wave of bank loan maturities coming in 2012–2014 leaves a possible refinancing dilemma. That’s because there is a concentration of maturities totaling \$440 billion from years 2012 through 2014, compared with an evenly distributed maturity schedule in the high yield bond market (Illustration 5).

Illustration 5: High Yield Loan & Bond Maturity Schedule



As of June 19, 2009

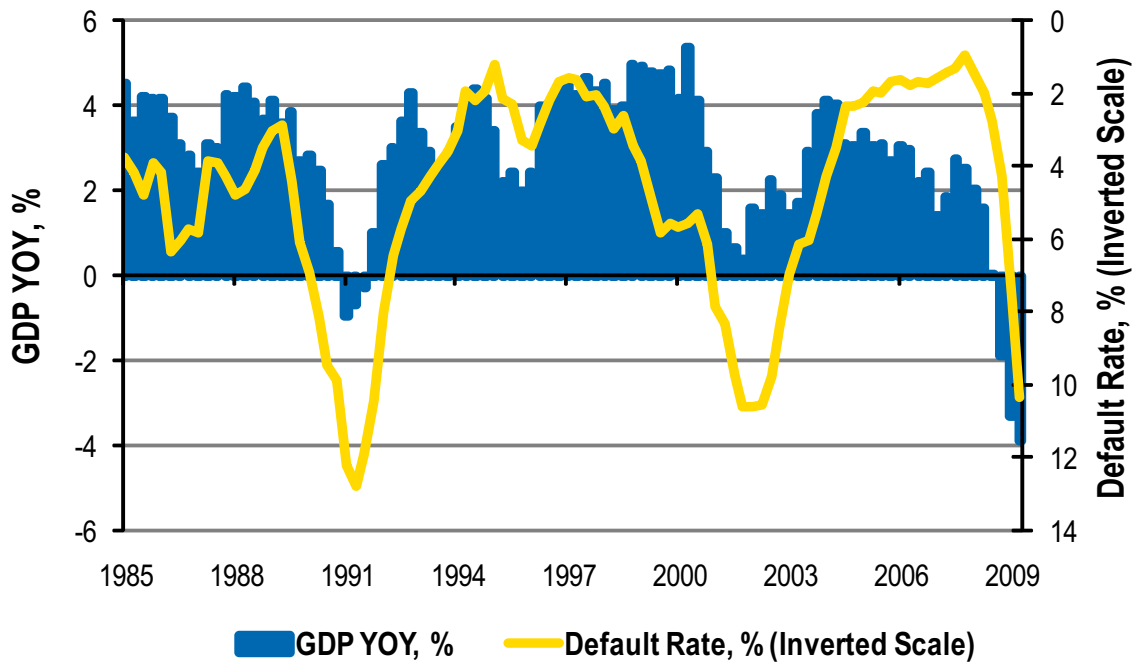
Source: Barclays Capital

This wave of bank loan refinance risk can seem intimidating, but there are several factors that are expected to reduce the amounts over the next few years. For example, loan defaults and restructurings are expected to reduce the peak of \$230 billion in 2014 down to \$150 billion, according to S&P’s Leveraged Commentary & Data and The Loan Syndications and Trading Associations. The high yield bond market also is expected to remain an avenue for funding bank loan maturities. We expect to see more loans converted to equity, existing maturity schedules amended and extended and cash flow sweeps (a protective covenant that requires free cash flow to be used to reduce loan debt) to reduce the upcoming wave of loan maturities. While the upcoming wave in loan maturities is large, there are many factors that are likely to absorb it.

Relationship Remains Among U.S. GDP, Default Rates And High Yield Spreads

The negative correlation between high yield default rates and U.S. Gross Domestic Product (GDP) reflects the fact that as economic growth declines, default rates increase and vice versa. Illustration 6 shows this historical relationship since 1985. The year-over-year GDP growth rate as of the second quarter was -3.9%, preceded by -3.3% in the first quarter and -1.9% in the fourth quarter of 2008. We forecast GDP growth at -2.6% in 2009 and +1.5% in 2010, below the consensus forecast of 2.2% in 2010.³ The forecast improvement in GDP shows a similar trend to the forecast for improvement in default rates. In fact, when regressing Moody’s forecast of a 4.4% default rate for July 2010 against historical GDP data, a 4.4% default rate typically has been realized during periods of 2.8% GDP growth.

Illustration 6: U.S. GDP and Default Rate

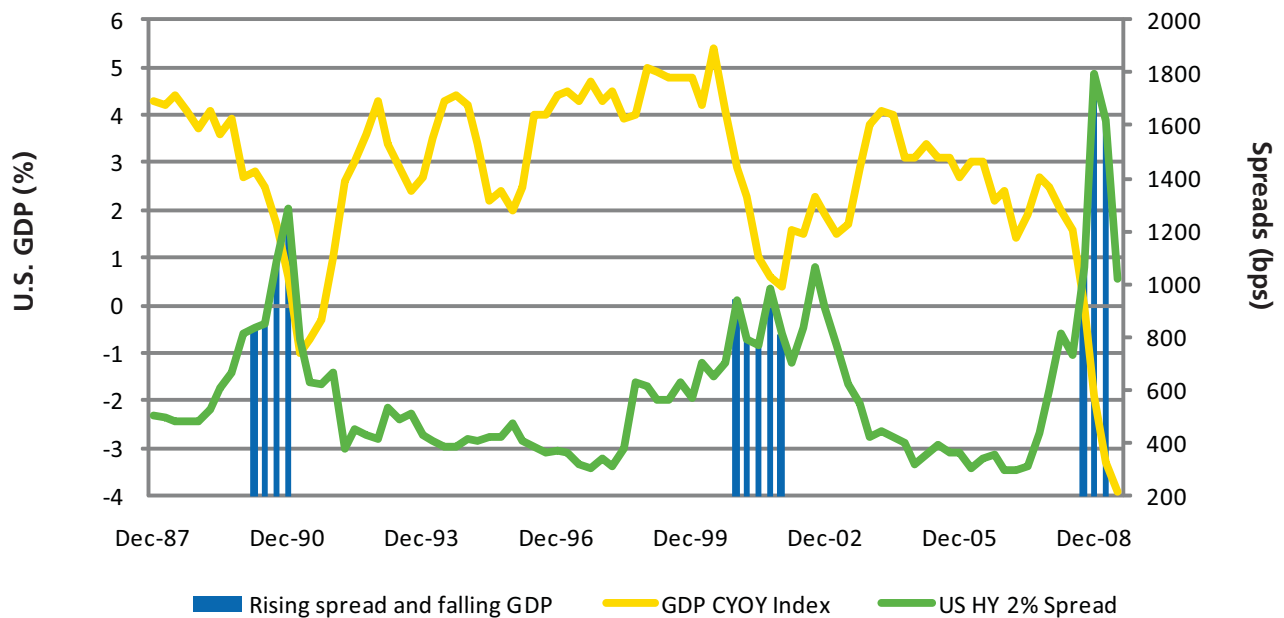


As of June 30, 2009

Sources: Banc of America Securities - Merrill Lynch, Moody's Investors Service, U.S. Department of Commerce Bureau of Economic Analysis

We also can regress a possible GDP range for 2010 of 1.5% from Aviva Investors, 2.2% from the consensus estimate and 2.8% derived from the Moody's default forecast against the historical data set of high yield spreads to find where spreads could be at these different GDP growth rates. Illustration 7 shows the historical relationship between U.S. GDP and high yield spreads. The result shows spreads at 719 basis points (bps) at a 1.5% GDP, 647 bps at a 2.2% GDP and 585 bps at a 2.8% GDP. All of these spread levels are tighter than the spread on the Global High Yield Index at the end of July of 956 bps, supporting the argument that high yield bonds have further to run.

Illustration 7: U.S. GDP and High Yield Spreads



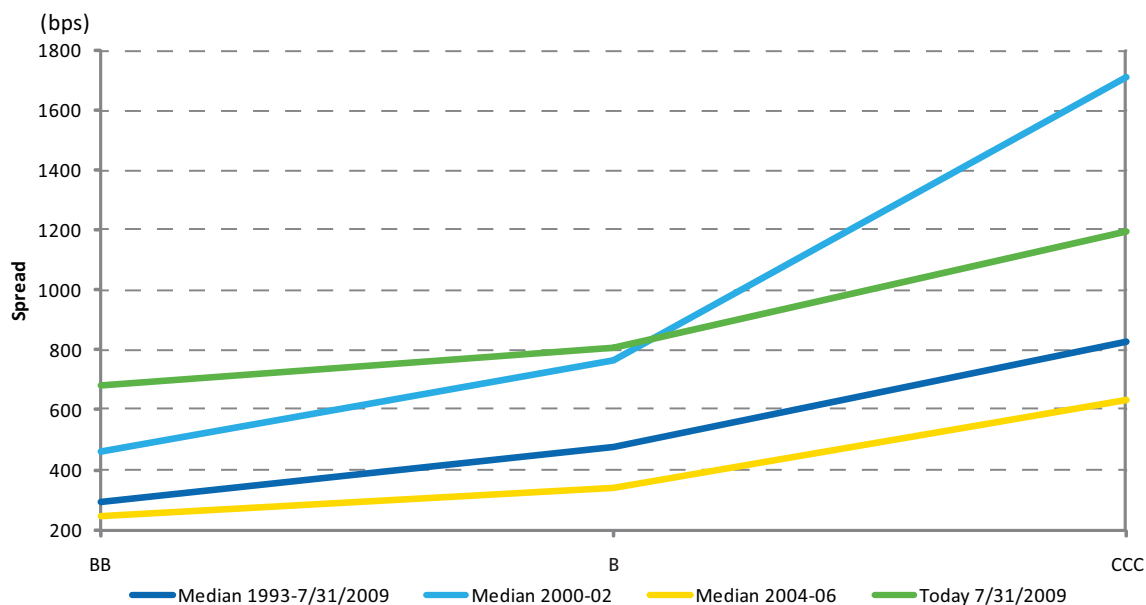
As of June 30, 2009

Source: Bloomberg, Barclays Capital

BBs Provide Value After CCC Rally

The more exposure to market risk this year, the higher the return achieved. While the CCC and below quality tiers historically have underperformed BB and B over a long time horizon, there are shorter time periods in which the lower quality tiers have performed exceptionally well. The CCC and below tiers have performed extremely well year-to-date, making the spread differential between CCCs and BBs relatively slim on an historical comparison. At the end of July, the difference in spread between CCCs (at an average of 1,196 bps) and BBs (at an average of 682 bps) was 514 bps, as shown in Illustration 8. This compares with a much steeper credit curve in 2000–2002, when default rates were at similar levels to today. When looking at a longer term average dating to 1993, today's curve still is slightly flatter, presenting a more compelling case for BBs.

Illustration 8: Credit Rating Curve for BB, B, & CCC



January 31, 1993-July 31, 2009

Source: Barclays Capital U.S. High Yield 2% Issuer Cap Index

Illustration 9: Average Annual Default Rate

Aaa	0.00%
Aa	0.04%
A	0.03%
Baa	0.20%
Ba	1.19%
B	5.49%
Caa - C	23.55%

Annual Issuer-Weighted Global Default Rates by Letter Rating 1983 – 2008

Source: Moody's Investors Service

While default rates are expected to decline considerably over the next 12 months, we believe corporate fundamentals are not strong enough to take on large exposure in the much more default prone CCC quality tier. It may come as a surprise, but CCCs have a significantly higher default rate than the higher quality tiers on a long-term, annual coverage (Illustration 9). It's the main reason the CCC quality tier historically has underperformed the BB and B tiers. CCCs and below are approximately 24.6% of the Global High Yield Index, a relatively high amount compared with history. The attraction of the CCC quality tier is materially less today and investors will need to be extra selective when creating exposure in this quality tier.

Fallen Angels Providing Majority Of 2009 Supply

While the new issuance amounts are respectable this year, the majority of supply has come from fallen angels. Fallen angel bonds are defined as those that originally held investment-grade agency ratings (Moody's, S&P, and Fitch), but because of financial deterioration have been downgraded to noninvestment grade, or high yield. There have been \$187 billion in fallen angels in 2009.⁴

Of this amount, \$139 billion – or roughly 75% – was from the Financials sector with CIT being the largest contributor. The amount of fallen angel candidates (Baa3-rated credits on negative watchlist) as of July 31 also was \$187 billion.

The Banc of America Securities - Merrill Lynch U.S. Fallen Angel High Yield Index has returned 39.8% year-to-date through July 31. The average market-value weighted quality of this index is BB-. When comparing this performance to the BB and B quality tiers at 34.1% and 34.4%, respectively, fallen angels are more like guardian angels.

A study by Moody's Investors Service in 2003 looked back at more than 20 years of data and concluded that fallen angels have a higher default probability than original issue high yield bonds immediately after they are downgraded to noninvestment grade.⁵ This is because of the loss of access to short-term credit and potential restructuring during difficult market conditions. Because noninvestment grade companies are not as dependent on short-term financing, fallen angels often are forced to restructure their debt to avoid refinance risk.

The Moody's study also found that fallen angels that avoided default after two years were more likely to be upgraded to investment grade than original issue high yield bonds. This is primarily because fallen angels that survive the distress and liquidity risk associated with altering their business models after being downgraded typically have unencumbered assets, helping to provide the firm with access to the capital markets by secured financing. Many fallen angels also have "franchise strength and business incentives" that enable them to repair their balance sheets by issuing equity and eventually gaining lines of credit.

A more recent report by Banc of America Securities - Merrill Lynch⁶ noted that fallen angels have a lower average default rate than the broad high yield market, especially during periods of above-average default rates. The fallen angel default rate is roughly 70% that of the overall market. Fallen angels also historically have provided a higher recovery rate on average than the high yield market in the event of default.

About 25% of today's high yield market is composed of bonds that originally were rated investment grade. While investment grade corporate bond investors fear the next fallen angel candidate, high yield investors approach these angels opportunistically as they have proven to offer good potential for value.

Conclusion

While total return expectations certainly are less than what was realized over the past seven months, we believe today's valuations in the high yield bond market still provide a compelling case for exposure, especially against an economic backdrop that is showing signs of stability. The fact that capital markets are active again is a large factor when estimating defaults, which are starting to show improving trends. While the more default prone, CCC and below rated bonds may have largely run their course, there are ample opportunities in the BB and B rated quality tiers. We believe that several dynamics will make the high yield bond universe continue to present new opportunities, such as fallen angels and secured high yield bond issuance used to refinance bank debt. Looking forward, we expect a shift in returns to be generated more from idiosyncratic – or security-specific – risk rather than market risk, or beta. The market may see some temporary profit-taking going into year-end, but valuations support a moderate overweight allocation for investors over the long-term.

Rating Key:

For example, a client may have an allocation range to high yield bonds of 5% - 15% as a percentage of assets. The following provides a possible % allocation in parentheses and a definition of the rating.

Overweight (15%):

Maximum exposure to high yield bonds. Recommendation reflects a high level of conviction for returns higher than the historical average.

Moderate Overweight (12.5%):

Exposure to high yield bonds is recommended at the higher end of the allocation range. Return expectations are higher than the historical average.

Marketweight (10%):

Exposure to high yield bonds is recommended to be in the middle of the allocation range. Return expectations are roughly in line with the historical average.

Moderate Underweight (7.5%):

Exposure to high yield bonds is recommended at the lower end of the allocation range. Return expectations are lower than the historical average.

Underweight (5%):

Minimum exposure to high yield bonds. Recommendation reflects a high level of conviction for returns lower than the historical average.



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Todd Youngberg joined Aviva Investors North America, Inc. in 2008. He is responsible for overseeing all high yield strategies and managing the high yield business.

He has more than 19 years of investment management industry experience. Prior to joining the firm, Todd was senior managing director and global head of high yield for ABN AMRO Asset Management, Inc.

Todd earned his bachelor's degree in business management from Central College and his master of business administration degree from Drake University. He holds the chartered financial analyst designation and is a member of the CFA Institute and the CFA Society of Chicago.

NOTES:

- 1 – Source: Global Speculative-Grade Corporate Default Rate Surpasses 2002's Peak, Moody's Investors Service, August 6, 2009.
- 2 – Sources: U.S. Credit Alpha – "Regulators, Let's Ride!", U.S. Credit Strategy, Barclays Capital, June 19, 2009; "Heading Towards the Refi Cliff", Richard Kellerhals, Investment Dealer's Digest, June 19, 2009
- 3 – Source: Bloomberg
- 4 – Banc of America Securities - Merrill Lynch, July 31, 2009
- 5 – Source: What Happens to Fallen Angels? A Statistical Review 1982 – 2003, Moody's Investors Service, July 2003
- 6 – Source: Fallen Angels: Gems or Empty Shells? Banc of America Securities - Merrill Lynch; March 18, 2009

Key to Index Names:

- Barclays Capital Global High Yield xCMBS xEMG 2% Cap Index
- Barclays Capital U.S. High Yield 2% Issuer Cap Index
- Barclays Capital Euro High Yield 2% Issuer Cap Index
- Barclays Capital Global High Yield 2% Issuer Cap Ba Component Index
- Barclays Capital Global High Yield 2% Issuer Cap B Component Index
- Barclays Capital Global High Yield 2% Issuer Cap Caa Component Index
- Barclays Capital Global High Yield 2% Issuer Cap Ca Component Index
- Global Aggregate – Corporates
- Barclays Capital U.S. High Yield Loans Index
- Barclays Capital U.S. Treasury Index
- S&P 500 Index
- EAFE Index

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