

Good Yield Hunting: Is Carry Still King?

22 February 2021



Pilar Gomez-Bravo, CFA
Director of Fixed Income -
Europe



David P. Cole, CFA
Fixed Income Portfolio
Manager



Linda Nockler
Investment Solutions Group

Investment outlook – early recovery signs favour flexible allocations

Growth: Feels like in early recovery cycle with economic backdrop supporting risk-on activity, especially given strong monetary and fiscal stimulus. Optimism is evident as vaccines roll out; however, output gaps remain large and still concerns regarding long-term economic scarring and virus variants. Key question is whether we will move straight into mid or late-cycle dynamics. If so, there is potential for inflationary risks to appear sooner than expected.

Rates: Inflation is increasingly becoming a consensus view although, in the near term, rising inflation driven by base effects. Break-evens are leading yields higher and curves steeper in a synchronized fashion. Divergent recovery and fiscal paths will lead to differing monetary outcomes and rate dispersion. Carefully watching the US to see if huge stimulus leads to a faster recovery compared to rest of the world, prompting questions around the timing and size of withdrawing monetary stimulus.

Credit: Strong risk appetite has led to full valuations and limited opportunity for spread compression opportunity. We are focusing on idiosyncratic opportunities and diversified carry.

Investment grade: Unattractive break evens particularly in the US where there is rates sensitivity and spread duration caution. Ongoing central bank largesse will support current carry but dispersion is low and compression opportunities limited. Reduced overweight; focus on higher-conviction idiosyncratic ideas. We favour Europe over US for IG credit.

High yield: Lowest yields on record as investors seek income. Cyclical recovery supportive of asset class but sector/credit differentiation remains key. Low loss-adjusted spreads leave no room for complacency in CCCs. Focus on higher-quality BB/B issuers while mindful of convexity. Some compression potential left.

Structured credit: Also rallied significantly rally but remains an area of interest. Little value in MBS, mortgage pass-throughs or agency CMBS. See some value in CRE CLOs but structure selection is key and driven by new issues. Mindful of liquidity in structured credit; tends to be high rated but does not mean more liquid.

Emerging market debt: EMD has also recovered and seen a huge issuance in the past few months. Spreads have retraced but remain elevated compared to other asset classes. Still see opportunities in hard currency but diversified approach is more interesting with risk added in local rates and EM FX.

In this environment, we believe it pays to be active. We favor flexible allocations within a broad opportunity set, given difficulties around valuations and low yields. We think security selection will really be key regardless of the environment and will be the highest alpha generator within total return.

The hunt for good yield – a more nuanced approach

Greater opportunity for active managers to add value when there is higher volatility and more dispersion in asset classes. With low returns from carry and reduced dispersion, spread compression offers fewer opportunities for investors.

Simple approach looks at spreads (Option Adjusted Spread) versus risk (Duration Times Risk). Higher risk asset classes like emerging markets and high yield are providing higher spreads so, for a given risk tolerance, investors will seek out asset classes which provide the highest spread available.

We prefer a more nuanced approach that focuses on breakeven spreads and their percentile history covering the past 5 years versus risk (DTS again). This analysis helps to identify how much spreads have to move by before you start losing money, provides an idea of whether spreads are thin compared to duration risk taken and also whether there is further room for spreads to compress.

Results show that:

1. US IG, which has been the most popular asset class for investors due to the Fed's put, really has very little potential for further spread compression.
2. The European Corporate Index, which investors often feel presents a lower opportunity set, provides a slightly better potential for spread compression than US Corporates.
3. Some higher spread asset classes, like emerging markets, offer fewer opportunities for spread compression than spread alone would suggest while others, like US HY, still appear attractive.
4. Some higher quality asset classes, like US CLOs, offer more potential value than their spreads suggest.

This advocates for having a diversified approach to composing credit risk, selecting some asset classes for carry while selecting others for spread compression.

High Yield – using secular trends and sector valuations to find opportunities

We believe high yield offers reasonable relative value compared to other fixed income asset classes. HY should be supported by the economic recovery and pent-up demand; however, market is already pricing in much of this good news.

We have built a framework to assess opportunities using views on secular trends and COVID-19 impact. Using this framework, we are focused on sectors offering good long-term characteristics but facing headwinds from the pandemic. These sectors include gaming, aircraft leasing, aerospace and defense and certain parts of the leisure industry.

We are spending less time looking at yield and spread opportunities from more secularly challenged sectors like energy, retail and autos. While they may offer reasonable spreads at today's levels, we think they also come with higher credit risk, higher default risk and higher volatility.

We are also looking at valuations to identify where COVID-related disruptions have created opportunities. For this, we evaluate sector spreads relative to their 5-year average alongside COVID-19 impact and our view on secular trends. From this analysis, sectors like gaming, aerospace and defense and aircraft leasing offer attractive opportunities with spreads 50 bps to 150 bps higher than their 5-year average.

Risk management – diversification and research are crucial in the hunt for yield

Given the largesse of central banks and fiscal authorities, there is certainly a hunt for yield but investors still need to be aware of sharp drawdowns. Risk-on asset correlations can potentially exacerbate the pain so diversification is crucial.

In our view, the best risk management starts with research. Investing in riskier parts of the credit market requires a strong research team with a dual role: aiming to add alpha and to alleviate drawdowns through bottom-up security selection.

Discussions around hedging become more important when adding risk to portfolios. Items we discuss include:

- What are we trying to hedge? Rates risk, spread risk or both (taper tantrum)?
- Are we looking to mitigate volatility of returns in a range-bound but volatile period, or are we looking for tail-risk hedges?

22 February 2021

- With the efficacy of hedges not as strong as before, being mindful of asset correlations and how much upside the hedge has relative to history.
- Searching for simple solutions rather than very complex ones as easier to monitor impact and track valuations.
- Portfolio approach to hedging as it helps with diversification and cost management; hedges are a cost drag to portfolio returns so we are mindful of when to use them and how to size them.

For more information about MFS' fixed income views or strategies, please contact your MFS representative.

MFS International Australia Pty Ltd (“MFS Australia”) (ABN 68 607 579 537). MFS Australia holds an Australian financial services license number 485343 and is regulated by the Australian Securities and Investments Commission.

The authors' comments, opinions and analysis are for general informational purposes only and should not be considered investment advice or a recommendation to invest in any security or to adopt any investment strategy. This material has been prepared without taking into account any personal objectives, financial situation or needs of any specific person. Comments, opinions and analysis are rendered as of the date given and may change without notice due to market conditions and other factors. This material is not intended as a complete analysis of every material fact regarding any market, industry, investment or strategy.

Unless otherwise indicated, logos, product and services names are trademarks of MFS and its affiliates and may be registered in certain countries.