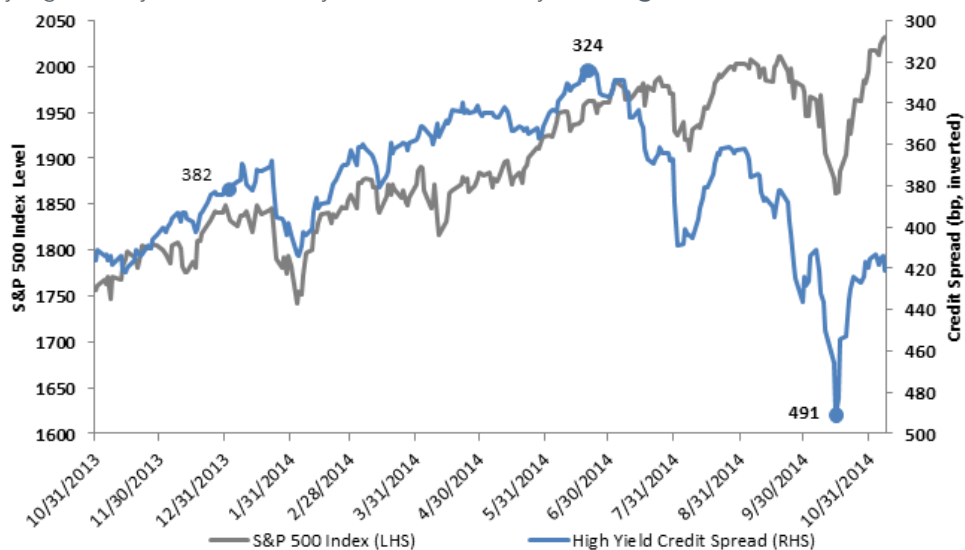


EXAMINING THE DIVERGENCE BETWEEN EQUITIES AND CREDIT

Bradley Krom — U.S. Head of Research

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Until the last few months, U.S. high-yield bonds had been one of the best-performing asset classes in the global fixed income markets. Since 2009, investors have generally been rewarded for assuming ever-greater amounts of credit and [interest rate risk](#).¹ However, there has recently been a marked divergence between U.S. equity and high-yield bonds. Given the historically strong [correlation](#) between these two markets, we believe that [high-yield credit](#) may represent an attractive opportunity for investors seeking to benefit from stronger U.S. growth. Over the last year, U.S. equities rallied, and credit [spread](#) generally [tightened](#). However, in recent months, this winning formula has started to diverge. Concerns about global growth, potential changes in [monetary policy](#) and uncertainty from geopolitical risk weighed on investor sentiment. In response, equities fell, and [credit spreads widened](#). As we show in the chart below, even though stocks have since rebounded, creating fresh all-time highs, U.S. high-yield credit spreads have failed to recover. In fact, credit spreads are actually significantly wider than they were to start the year. **High-Yield Credit vs. S&P 500 Index, 10/31/13–**



Sources: Barclays, Bloomberg, as of 11/07/14. High-yield credit proxied by the Barclays U.S. High Yield Index. Credit spread axis (on the right-hand side) is inverted. Lower numerical values imply the market is demanding less compensation for assuming credit risk. Past performance is not indicative of future results.

11/07/14

For definitions of

terms and indexes in the chart, please visit our [glossary](#).

Default Rates vs. Flows

To understand which market is potentially under- or overvalued, it's important to understand what might be driving this divergence. Historically, credit spreads and equities have generally exhibited a fairly consistent correlation, given that both benefit from positive economic momentum. With increasing corporate earnings, stock prices have risen. In an improving economy, risky borrowers generally pose a lower risk of [risk of default](#) due to strengthening [fundamentals](#).² Examining default risk more closely, over the last 12 months, [Moody's](#) reported that the average issuer default rate decreased to 1.7%. This compares to the 2.8% rate they reported at this time last year.³ With the economy continuing to perform, corporate fundamentals seem to be broadly supportive of strengthening credit conditions. However, the price of credit is still ultimately dictated by supply and demand. While U.S. equities have seen strong inflows so far in 2014, high-yield bond strategies have seen

net outflows of nearly \$14 billion.⁴ Even though investors remain [bullish](#) on the U.S. economy, they are choosing to express this view via equities as opposed to fixed income. As a consequence, equity markets are outpacing the recovery in high-yield debt, resulting in a divergence. **Expressing a Bullish View of Credit** While we continue to believe that high yield can continue to perform well from a credit perspective, concerns about [rising interest rates](#) may be dampening investor enthusiasm and flows. In our view, an interesting alternative would be to own high-yield bonds but then [hedge](#) the interest rate risk of the portfolio. In this approach, investors are able to isolate their exposure to [credit risk](#) while reducing their exposure to movements in interest rates.

¹Sources: WisdomTree, Bloomberg, as of 5/31/14.

²Figlewski, Stephen, Halina Frydman, Weijian Liang (2010), "Modeling the Effect of Macroeconomic Factors on Corporate Default and Credit Rating Transitions," Credit Suisse. ³Source: Moody's Investor Service, as of 10/31/14.

⁴Source: EPFR Global, as of 11/7/14.

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DEFINITIONS

Interest rate risk : The risk that an investment's value will decline due to an increase in interest rates.

Correlation : Statistical measure of how two sets of returns move in relation to each other. Correlation coefficients range from -1 to 1. A correlation of 1 means the two subjects of analysis move in lockstep with each other. A correlation of -1 means the two subjects of analysis have moved in exactly the opposite direction.

High Yield : Sometimes referred to as "junk bonds," these securities have a higher risk of default than investment-grade securities.

Credit : A contractual agreement in which a borrower receives something of value now and agrees to repay the lender at some date in the future.

Spread : Typically refers to a difference between a measure of yield for one asset class and a measure of yield for either a different subset of that asset class or a different asset class entirely.

Tighten : a decline in the amount of compensation bond holders require to lend to risky borrowers. When spreads tighten, the market is implying that borrowers pose less risk to lenders.

Monetary policy : Actions of a central bank or other regulatory committee that determine the size and rate of growth of the money supply, which in turn affects interest rates.

Credit spread : The portion of a bond's yield that compensates investors for taking credit risk.

Default : A failure to meet the legal obligations (or conditions) of a loan.

Fundamentals : Attributes related to a company's actual operations and production as opposed to changes in share price.

Credit ratings : An assessment of the creditworthiness of a borrower in general terms or with respect to a particular debt or financial obligation. Credit assessment and evaluation for companies and governments is generally done by a credit rating agency such as Standard & Poor's, Moody's or Fitch.

Bullish : a position that benefits when asset prices rise.

Hedge : Making an investment to reduce the risk of adverse price movements in an asset. Normally, a hedge consists of taking an offsetting position in a related security, such as a futures contract.

Credit risk : The risk that a borrower will not meet their contractual obligations in conjunction with an investment.