

Welcoming Heights



In a low-yield world, investors in high-yield bonds have enjoyed the view

Amid arguably the most challenging economic recovery since the 1930s, financial market conditions might be described as ... unusual.

In September, for instance, yields on some Treasury bills turned negative.¹ In other words, investors paid for the privilege of lending their money to Uncle Sam.

No such oddity has yet been witnessed in the high-yield bond market. In fact, average yields on noninvestment-grade U.S. corporate debt still stood at 5.73% around the time that those short-term Treasury yields dropped below zero.²

"A buy-and-hold allocation to high yield since the 2008 financial crisis has been a very good place to be for

investors," said Colin Robertson, managing director of Fixed Income for Northern Trust Asset Management. "The doomsday scenario that so many pundits were predicting during the Great Recession never happened."

Reasonable value

Though yields in the noninvestment-grade sector are low by historical standards, they nonetheless offer investors positive nominal and inflation-adjusted returns, excluding any changes to underlying bond prices, of course.

And while the yield differential between government bonds and their sub-investment grade cousins is smaller

than average, Robertson does not believe credit spreads are unreasonably tight under the circumstances.

Robertson recounted the spread between the BoA Merrill Lynch U.S. High Yield Master II Index (a popular benchmark of U.S. high-yield bonds) over Treasury securities was 3.84 percentage points in late August, up from 3.53 percentage points about two months earlier. Credit spreads peaked at a whopping 21 percentage points over Treasuries during the financial crisis in 2009.³

According to Robertson, yield differentials compared to Treasury securities actually are tighter in the investment-grade sector of the domestic

fixed-income market than in high-yield securities, relative to past credit cycles.

“I don’t see excess in high yield from issuers or investors,” Robertson said. “It has been a strong market for years, but it’s been strong for very good reasons.”

Friendly Fed

Underpinning the strength of the high-yield market has been the extended periods of ultra-low official interest rates, which have hovered near zero since December 2008. Those low rates have allowed companies to extend maturities and refinance debt on highly favorable terms. That’s helped push the default rate among high-yield issuers down to about 2%, Robertson said, well below the historical average of roughly 4%.

Investors have also been encouraged by the generally prudent use of borrowings by high-yield issuers. Ironically, the stop-and-start nature of the economic recovery may have bolstered corporate fundamentals by discouraging leveraged buyouts, a tactic that came back to haunt the sector in some previous business cycles.

According to Robertson, between half and two-thirds of new issue proceeds this year have gone toward refinancing outstanding loans. Lower borrowing costs reduce interest burdens and increase debt coverage ratios.

More broadly, the U.S. corporate sector is doing well, too. In the second quarter of 2014, after-tax corporate profits grew at the fastest pace in two years.⁴

Staying realistic

Robertson emphasized, however, that high-yield bond prices are not traveling merrily down a one-way street. Inevitably, there will be potholes and periods of negative returns.

“It’s natural to want to own an asset that never has a down year, but that’s not how it works in the real world,” Robertson said. He noted that cash, with its virtually zero percent nominal return, is losing close to 2% a year to inflation. Losses,

it seems, can come in many forms.

Yet volatility in high-yield bonds has picked up, as it has in other global markets.

This summer, high-yield bonds sustained a mild sell-off as geopolitical tensions escalated between Russia and Ukraine. The sudden emergence of the terrorist group ISIS in the Middle East and pro-democracy demonstrations that threatened to turn violent in Hong Kong destabilized so-called risk markets as well.

Finally, ongoing speculation that the Federal Reserve would raise interest rates sooner and more aggressively than expected also caused investors to pull back.

The selling caused the average yield on noninvestment-grade U.S. corporate bonds to jump back to almost 6% from the all-time low of 4.8% in June.⁵

But last summer’s correction may have been the pause that refreshes, rather than the start of a lasting decline.

“High-yield bonds had come a long way and market participants decided to take some risk out of their portfolios,” Robertson said. “That’s understandable.

And because many investors were overweight high yield, that was the asset class they used to lighten up.”

Buying the dips

Despite renewed volatility, Robertson is encouraged by the continued strong demand for high-yield securities, both from individual and institutional investors. Though issuance is near record levels as well, the ample supply is being easily absorbed, at least so far.

And on those few occasions when high-yield bonds have come under selling pressure, issuers simply backed off and waited for conditions to stabilize.

Core holding

Because of the sector’s solid long-term record, Robertson recommends that high-yield bonds be viewed as a core holding within the fixed-income portion of most investors’ portfolios. Robertson said that high-yield bonds can be less interest-rate sensitive than investment-grade or government debt, and the sector might

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be viewed as a potentially less volatile surrogate for equities as well.

Robertson cautions, however, that investors should avoid putting money into high-yield bonds that might be needed in the near future. Sub-investment grade debt prices can fluctuate more than higher-quality bonds, especially during short periods.

In addition, liquidity in the secondary market is less than what it used to be in the wake of new regulations affecting broker-dealers.

“You never want to find yourself in the position of having to be a forced seller,” Robertson said. “A better approach is to allocate the proper amount to high yield based on your individual circumstances, and then to stay the course regardless of what the market might be doing.”

Lower for longer

Like all fixed-income assets, high-yield bond prices move inversely to interest rates. That’s made some investors fearful that the sector could be hit hard if the Fed tightens monetary policy too soon or too quickly.

While no one can say with certainty what the Fed will do or when it will do it, Robertson is confident that the interest rate jitters are misplaced and premature.

“The Fed has told us for years that it will err on the side of caution,” Robertson said. “Based on key economic metrics, we expect interest rates to stay lower for longer than the market expects.”

Lack of price pressure

Robertson cited benign inflation, which remains well below the Fed’s 2% target, as

ample justification for keeping monetary policy accommodative. He noted that the Fed hasn’t taken extraordinary steps to foster a recovery from the Great Recession, only to undue its efforts with possible victory so close at hand.

Though economic growth has exceeded 3.5% in three of the last four quarters⁶ — a highly favorable backdrop for the high-yield market — consumer prices hikes remain remarkably tame.

The personal consumption expenditures index, the Fed’s preferred gauge of inflation, rose just 1.6% during the year through August. Excluding the volatile food and energy sectors, the rise was only 1.5%. Inflation has now undershot the Fed’s 2% target for 28 consecutive months and is lower than at an equivalent period of the previous four economic recoveries.⁷

“At this point, the Fed has no reason to worry about inflation, which means that rate hikes probably will come later rather than sooner,” Robertson said. And once policy rates do begin moving up, Robertson thinks the pace of increases will be gradual and over an extended period.

Labor market slack

Several factors are keeping inflation under control despite the recent acceleration in economic growth.

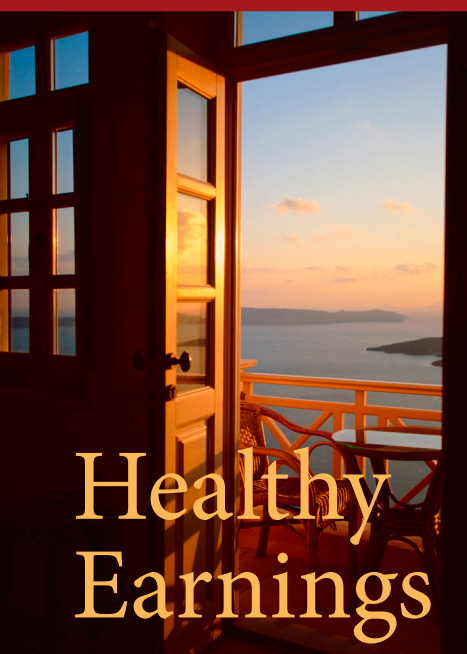
With unemployment still elevated, workers have little or no leverage in requesting generous increases in their compensation. Unit labor costs, a key category that includes wages, salaries and benefits, declined in the second quarter, and rose by only 1.7% during the previous 12 months.⁸

Meanwhile, continued economic malaise in Europe and indications of a sustained slowdown in the pace of Chinese growth also has put downward pressure on U.S. inflation by slowing American exports to those markets and boosting the value of the U.S. dollar. The greenback recently rose for nine consecutive weeks against a basket of foreign currencies, including the yen and euro, which was its longest such winning streak in 17 years.⁹

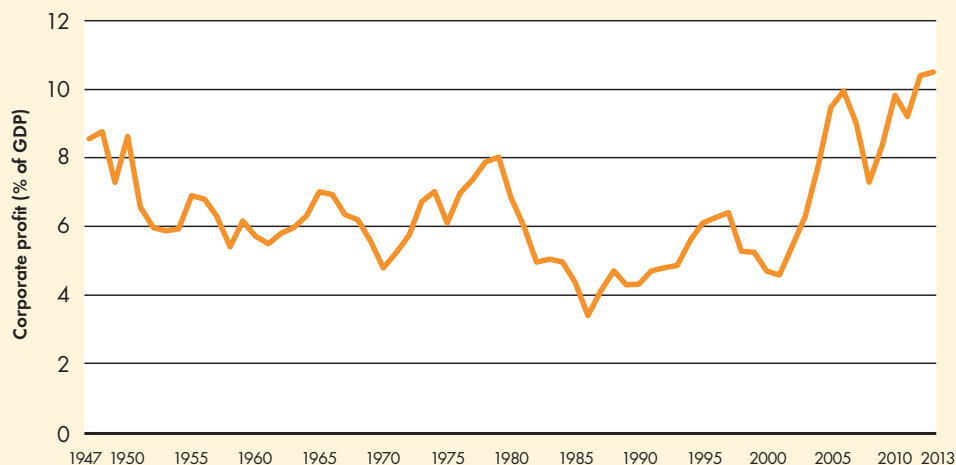


High-Yield Choices

Northern Funds offers three compelling options for investors seeking more current income than that usually available from Treasury debt or investment-grade corporate bonds. The **Northern High Yield Municipal Fund** focuses on securities issued by state and local governments that are rated near the top credit rung of the noninvestment-grade category and the bottom rung of the investment-grade category. Income from the High Yield Municipal Fund is generally exempt from federal tax. Meanwhile, the **Northern High Yield Fixed Income Fund** invests in a broad array of noninvestment-grade corporate bonds. The **Northern Multi-Manager High Yield Opportunity Fund** also invests in noninvestment-grade corporate debt, but employs three outside advisers carefully vetted on the basis of performance and complementary styles. Talk to your Northern Funds relationship manager about which of the high-yield bond offerings might best fit your needs.



Despite a sluggish recovery from the 2008 financial crisis and Great Recession, corporate profits as a percentage of U.S. gross domestic product are at the highest level since at least World War II.



Source: Federal Reserve Bank of St. Louis

Healthy Earnings

By one measure, the dollar is up 17% since bottoming in 2011.¹⁰

A strong dollar is potentially bullish for high-yield bonds in two ways. First, it acts to restrain inflationary pressures by making U.S. imports cheaper. It also tends to make American assets more attractive to foreign investors, who stand to gain when they repatriate holdings into their local currencies.

Unstressed

While Robertson called the prolonged period of tranquility that prevailed in most markets during the last year an aberration that is not likely to continue, heightened volatility in recent weeks and months need not be cause for undue alarm, either.

According to an 18-factor index compiled by the Federal Reserve Bank of St. Louis, the level of stress in U.S. financial markets recently touched one of the lowest levels since the index was created in December 1993.¹¹

For Robertson, who oversees the management of \$375 billion in fixed-income assets, the bottom line is clear: “The United States is in a moderate growth environment where economic activity is fast enough to maintain solid corporate fundamentals but not fast enough to stoke inflation. And we expect that investor-friendly backdrop

to continue into next year and possibly beyond.”

Good enough reasons, he believes, for investors to keep holding the high ground. ■

Past performance is no guarantee of future results.

Bond Risk: Bond funds will tend to experience smaller fluctuations in value than stock funds. However, investors in any bond fund should anticipate fluctuations in price, especially for longer-term issues and in environments of rising interest rates.

High-Yield Risk: Although a high-yield fund’s yield may be higher than that of fixed income funds that purchase higher-rated securities, the potentially higher yield is a function of the greater risk that a high-yield fund’s share price will decline.

Tax-Free/AMT Risk: Tax-exempt funds’ income may be subject to certain state and local taxes and, depending on your tax status, the federal alternative minimum tax.

Basis Points (bps) is a unit of measure in quoting yields, changes in yields or differences between yields; 100 basis points is equal to 1%.

Personal Consumption Expenditures Index (PCE) is a measure of price changes in consumer goods and services; it includes data pertaining to durables, non-durables and services.

BofA Merrill Lynch U.S. High Yield Master II Constrained Index contains

all securities in the BofA Merrill Lynch U.S. High Yield Master II Index, but caps issuer based on their current amount outstanding, provided the total allocation to an individual issuer does not exceed 2%. The Index tracks the performance of US dollar denominated below investment grade corporate debt publicly issued in the US domestic market.

It is not possible to invest directly in an index.

¹ “Treasury-Bill Yield Tips Into Negative Territory.” Min Zeng and Katy Burne. *The Wall Street Journal*. Sept. 23, 2014.

² “Junk bond issuers lock in low costs.” Vivianne Rodrigues. *Financial Times*. Sept. 18, 2014.

³ “The Signals From the High-Yield Bond Market.” Conrad De Aenlle. *The New York Times*. Aug. 14, 2014.

⁴ “U.S. Economy Grew at 4.6% Rate in Second Quarter.” Josh Mitchell. *The Wall Street Journal*. Sept. 26, 2014.

⁵ “No need to panic about high-yield bonds.” David Riley. *Financial Times*. Aug. 26, 2014.

⁶ “U.S. Economy Grew at 4.6% Rate in Second Quarter.” Josh Mitchell. *The Wall Street Journal*. Sept. 26, 2014.

⁷ “U.S. Consumer Spending Rises 0.5% in August.” Ben Leubsdorf. *The Wall Street Journal*. Sept. 29, 2014.

⁸ Bureau of Labor Statistics. Sept. 4, 2014.

⁹ “Resurgent Dollar Fuels Rally.” Ira Iosebashvili, Dan Strumpf and Min Zeng. *The Wall Street Journal*. Sept. 13, 2014.

¹⁰ “Resurgent Dollar Fuels Rally.” Ira Iosebashvili, Dan Strumpf and Min Zeng. *The Wall Street Journal*. Sept. 13, 2014.

¹¹ Federal Reserve Bank of St. Louis

Please carefully read the prospectus and summary prospectus and consider the investment objectives, risks, charges and expenses of Northern Funds before investing.

Call 800-595-9111 to obtain a prospectus and summary prospectus, which contain this and other information about the funds.

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