HIGH YIELD MARKET

INVESTMENT COMMENTARY & REVIEW

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The high yield bond market had a shaky start to the new year following weak economic data out of China and projected sequential rate hikes by the Fed. However, high yield bonds rebounded strongly in the back half of 1Q'2016, with the Barclays High Yield Index climbing 4.44% in March and none of the return coming from a change in interest rates. This was the strongest month since October 2011, and brought the first quarter return to 3.35%. As usual, there were additional perceived global macro factors at work – more expansionary policy from the ECB than expected, some calming of the concerns about Chinese growth, and rhetoric from major oil suppliers about restraining production. But as high yield returns are overwhelmingly driven by expectations of near-term default rates, the biggest factors were decreased fears of a US recession and a $12 rise in WTI oil prices since the low point in February. Sometimes the market unaccountably and unpredictably decides it was wrong about a recession even where there is no clear trend or reversal in domestic macro variables.

As is usually the case in strongly rising markets, risky assets dominated. BB, B, and CCC-rated bonds rose 3.45%, 3.60%, and 9.27% respectively, while the distressed sector rose a stunning 29%. The top performing industries were the "dogs" of 2015: independent oil producers, oil field services, metals and mining, and midstream energy; with the first three of these sectors all trading at distressed levels (many bonds in these industries are equity-in-waiting). Bond prices are exquisitely sensitive to rises in their underlying commodity prices and can even rise when commodity prices are mixed (coal prices fell during March and commodity metals prices rose only 6.5% from very depressed levels). All industries had positive returns. Money flowed into high yield funds – there was net inflow of $7.1 billion in March, the sixth largest month on record, and the first week of March saw the largest inflow in history. Fund managers put this to work in liquid issues, driving returns on larger issues above those on smaller deals, where they are not able to assemble positions to their liking.

Issuance rose in each month in 1Q and is now at a ten month high. Quarterly volume was down 46% versus 2015 and ran at 60% of the long term average, but it rose 21% over the fourth quarter of 2015. Issuance was concentrated in higher quality names, and only 10% was rated CCC or split-rated B/CCC. Issuance for the riskiest purpose (LBO financing) was also down versus 2015, another indication of the market reacting to very high credit spreads.

Defaults continued to rise. Twelve billion dollars of bonds defaulted in the month of March, the largest monthly total since the great recession (excluding the months of the mega-defaults of TXU and Caesar's Entertainment). The trailing twelve month default rate (including, as it should, distressed exchanges) rose to 4.45% from 3.62% in February. However, 90% of these defaults have been in the energy and metals/mining sectors. Outside of those industries, the trailing twelve month default rate has been a minuscule .41%, extending a string of six very low-default years. The recent increase in oil prices will not be enough to prevent additional massive defaults in the energy sector. JPMorgan is forecasting a market wide 6% default rate for each of 2016 and 2017, but embedded within that prediction are annual default rates within the energy sector of 20%.

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