HIGH YIELD MARKET

INVESTMENT COMMENTARY & REVIEW

by Bob Sydow, Kevin Buckle and Jim Lisko

Third Quarter 2016

In the early days of the quarter investors were seeking a "safe haven" on the heels of the vote by the United Kingdom to exit the European Union. Money flowed into the U.S. Treasury market driving the yield on the 10-year Treasury to record low levels only six days into the quarter. The markets seemed to digest the Brexit decision fairly quickly. Shortly thereafter, positive economic data in the US (June labor report, retail sales, and business inventories) combined with the perceived stability in the Eurozone and China led investors back to the search for yield. Major central banks around the globe continued accommodative monetary policy throughout the quarter, while the Fed kept rates unchanged at its late September meeting. The unprecedented accommodative monetary policies in many developed economies have resulted in roughly $10 trillion in government bonds (predominantly Euro and Yen denominated) trading with negative yields, producing a favorable environment for the high yield market.

Economic data in the US was mixed throughout the quarter, with above consensus employment numbers for June and July, followed by a below consensus report for August. Consumer spending was generally strong throughout, while construction spending was mixed. Second quarter GDP came in well below expectations at 1.4% (revised upward from 1.2%), with the biggest drag coming from the draw down in inventories, which prompted concerns that the US may be headed for a recession. However, the market concerns seemed to evaporate with the beginning of an inventory rebuild in the third quarter.

The high yield market performed well in the third quarter returning 5.55% (Barclays high yield index) with all three months recording positive returns. The index yield-to-worst at the end of the period was 6.17%, a decline of 110 bps from the beginning of the period as well as a sixteen month low. The index average spread contracted 120 bps to 507 bps by quarter end. Investors continued to seek yield in a low rate environment, leading to a "risk on" mentality that prevailed during the period and resulted in the lower rating tier outperforming. The Caa index returned 8.20% for the period while the Ba and B indexes returned 4.36% and 5.70%, respectively. The high yield market had a nice tailwind during the period with stable, albeit tepid, economic growth, the continuation of a low interest rate environment, and a moderating default rate. The market received additional support during the period from a modest level of new issue activity as well as $5.4 billion inflows into retail funds. U.S. dollar denominated new issuance year-to-date is $168 billion (down 22% year-over-year), and combined with expected fourth quarter new issuance will likely result in 2016 producing the lowest level of new issuance since 2011. Net new issuance is a negative $27 billion year-to-date; resulting from the amount of redemptions, tenders, and maturing bonds exceeding the $168 billion new issuance. Since 1997, there have been only two other years where the market experienced negative net new issuance, 2008 ($7bil) and 2015 ($5bil). Refinancing activity represents 64% of new issuance year-to-date, while M&A/LBO new issuance accounted for 20%. The majority of new issues pricing this year, have been Ba or B rated (85%), with Caa and non-rated issuance comprising the remaining 15%. Petroleum prices were essentially unchanged during the quarter with prices hovering around $48/barrel. The commodity sectors (metals & mining and energy) constituted 85% of the default volume year-to-date. Including distressed exchanges, the trailing twelve month default rate was 4.85% at quarter end. Excluding the commodity sectors, the default rate was a mere 0.50%. Despite the elevated defaults in the commodity sectors, metals & mining had the highest year to date return at 41%, and it was one of the best performers in the quarter returning 8.90%. The second best performing sector year-to-date was the energy sector with a 30% return.

Credit metrics for the high yield market, aside from

the commodity sectors, remained healthy despite a modest uptick in leverage and a slight erosion in interest coverage. Dividend deals represented less than 1% of new issuance year-to-date. We expect credit fundamentals to remain relatively healthy for the remainder of the year unless there is a meaningful increase in dividend deals and M&A/LBO deals.

We expect the economy will continue to grind along for the remainder of the year, which portends a favorable environment for high yield. However, we do expect volatility will increase in the fourth quarter following the presidential election in early November. Despite the Fed deciding at its late September meeting to maintain accommodative monetary measures, they did signal that prospects are improving for a rate increase later this year. Market participants seem to be evenly split regarding a rate increase by the Fed at the December meeting. If the Fed does decide to act in December, we would expect a short term increase in volatility.

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