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 (Brexit). 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 Federal Reserve (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 Gross Domestic Product (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 basis points (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 sector 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 Merger and Acquisitions/ Leveraged Buyouts (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 41.12%, and it was one of the best performers in the quarter returning 8.80%. The second best performing sector year-to-date was the energy sector with a 29.81% 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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High Yield Portfolio Managers at Pacific Income Advisers

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Barclays High Yield Index - covers the universe of fixed rate, non-investment grade debt. Eurobonds and debt issues from countries designated as emerging markets (e.g., Argentina, Brazil, Venezuela, etc.) are excluded, but Canadian and global bonds (SEC registered) of issuers in non-EMG countries are included. Original issue zeroes, step-up coupon structures, 144-As and pay-in-kind bonds (PIKs, as of October 1, 2009) are also included. The index includes both corporate and non-corporate sectors. The corporate sectors are Industrial, Utility, and Finance, which include both U.S. and non-U.S. corporations. The Yankee sector has been discontinued as of 7/1/00. The bonds in the former Yankee sector have not been removed from the index, but have been reclassified into other sectors.

Yield - the income return on an investment, such as the interest or dividends received from holding a particular security.

Brexit - an abbreviation of "British exit", which refers to the June 23, 2016 referendum by British voters to exit the European Union.

Eurozone - a geographic and economic region that consists of all the European Union countries that have fully incorporated the euro as their national currency.

Federal Reserve Bank - The central bank of the United States and the most powerful financial institution in the world. It was founded by the U.S. Congress in 1913 to provide the nation with a safe, flexible and stable monetary and financial system.

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

European Union (EU) is a group of 28 countries that operates as a cohesive economic and political block.

Basis point (bp)- A unit that is equal to 1/100th of 1%, and is used to denote the change in a financial instrument.

Yield to worst - the lowest potential yield that can be received on a bond without the issuer actually defaulting.

New Issue (issuance)- A reference to a security that has been registered, issued and is being sold on a market to the public for the first time.

Merger and Acquisitions (M&A) - type of restructuring in that they result in some entity reorganization with the aim to provide growth or positive value.

Leveraged Buyout - (LBO) The acquisition of another company using a significant amount of borrowed money (bonds or loans) to meet the cost of acquisition.

The Barclays' Quality sectors discussed above use the following rating methodology. Securities that are rated by three rating agencies, (Moody's, S&P and Fitch) will receive the middle of the three ratings. Securities that are rated by only two agencies will receive the lower of the two ratings. Securities rated by only one agency will receive that rating while securities not covered by any of the three agencies will receive a non-rated (NR) rating. Long-term credit ratings are denoted with a letter: a triple A (AAA) is the highest credit quality, and C or D (depending on the agency issuing the rating) is the lowest or junk quality.

Default Rate - The rate of borrowers who fail to remain current on their loans. It is a critical piece of information used by lenders to determine their risk exposure and economists to evaluate the health of the overall economy.

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