



HIGH YIELD MARKET

INVESTMENT COMMENTARY & REVIEW

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Fourth Quarter 2016

The high yield market as measured by the Bloomberg Barclays High Yield Index closed out a robust 2016 with a fourth quarter return of 1.75%, thanks to a solid December return of 1.85%. The 2016 total return was 17.13%; ex- energy the index returned 14.08%. Notably, this is the highest annual return since the post-recession all-time high returns of 2009. All other credit sensitive bonds and leveraged loans, as well as every high yield industry except pharmaceuticals, produced positive returns in 2016. In the fourth quarter, oil field services (11.08%) and exploration and production companies (5.82%) led the way, as they had throughout the entire year. The average spread for the index ended the year at 442bp, within 65bps of its tightest level since the great recession and 264bps tighter for the year. The average bond price has climbed back close to par (\$99.8) for the first time since May of 2015. Mutual Fund flows into the high yield sector for 2016 were about \$15 billion, the best since 2009, and U.S. high yield issuance fell about 13% versus 2015 as issuers overwhelmingly favored the loan market. The combined effect of lower issuance and higher redemptions actually shrank the size of the high yield market by 5% (measured by par value), adding a strong technical boost to returns, which were already fueled by expectations of a strong recovery in the energy and commodity sectors.

The high yield story in the 4th quarter and throughout all of 2016 was the resurgence of the CCC quality sector after two years of underperforming their higher quality brethren. The other story was of course the expected strong recovery surrounding the energy and metal/mining sectors which propelled returns of 37.44% and 45.49% for the year, respectively. From a ratings perspective, CCC's returned 4.70% in the 4th quarter versus 2.01% for B rated debt and .43% for BB's. For the year, CCC enjoyed a robust return of 31.46%, again significantly outpacing both B and BB rated debt at 15.80% and 12.78%, respectively. CCC bond prices began the year at an average dollar price near a cycle low of \$71.6 and finished at approximately \$91. The performance of CCC was not that surprising to us given

the sector was well oversold in the 4th quarter of 2015, seemingly in sympathy with the growth slowdown in China and resultant sharp credit sell-off in the energy and commodity sectors. In late 2015 and early 2016, CCC average spreads had reached spread differentials versus B rated debt that had not been seen since the great recession. Although we think there may still be some additional upside from investors seeking returns in riskier credits, driven in part by expectations for pro-growth economic policies from the new administration, we believe overall market performance will be capped by limited price appreciation remaining in the higher quality ratings spectrum.

The most notable development affecting the market in late 2016 was a return to meaningfully positive EBITDA growth among high yield issuers. Year-over-year EBITDA growth (ex the stricken energy and commodity sectors) had declined more or less continuously since mid-2014 from 14% to -2% by mid-2016. In late 2016, this key metric rebounded strongly to 5.7%. Interest coverage had remained at historically high levels throughout the decline in cash flow, due to very low absolute rate levels, but as interest rates rise cash flow momentum will be necessary to extend the seven year period of low default rates. Revenues and gross margins also posted their best performance in several quarters, in concert with improved GDP numbers, and capital expenditures continued at low levels. The LTM default rate itself declined to 3.98% in December (pre-recovery values, including distressed exchange offers, as measured by JPMorgan). Notably, the LTM default rate excluding metals and energy is just .68%. Most default prediction models continue to forecast historically low default rates over the next two years, and the percentage of bonds trading at distress levels (defined as option-adjusted spreads exceeding 1,000bp) declined to 6.4%, the lowest level in two years.

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