



HIGH YIELD MARKET

INVESTMENT COMMENTARY & REVIEW

by Bob Sydow, Kevin Buckle and Jim Lisko

First Quarter 2017

Last year in the early first quarter, the high yield market was reeling from a miserable Q4'15, led by the energy and commodity sectors and culminating in a risk-off approach to all credit assets. The high yield market was trading as if a recession could be in the offing with spreads widening to 706 basis points (bps) by the end of 2016, flirting dangerously close to the 800bps level that has historically portended even higher spreads and a potential recession. In fact, by January of 2016, CCC spreads were already pricing a typical recessionary scenario. However, March 2016 proved to be the big inflection point, and the high yield market has not looked back since. For a fleeting moment, March 2017 looked to be another inflection point but this time potentially reversing the impressive rally of the high yield market over the past 14 months. High yield market prices sold off close to \$2 through the beginning of March (fueled by the largest withdrawals since December 2015) but then quickly recouped two-thirds of that price drop by the end of the month. Still, March was the first negative return month (-0.22%) (Bloomberg Barclays High Yield Index) since January 2016.

Overall, the high yield market had another solid quarter with a 2.7% return, despite the modest setback in March. In what has been a familiar refrain of late, CCC quality credits were the biggest winners (+4.66%), followed by B rated credits at +2.53%, and then BBs, posting a +2.06% return. This cadence of returns by quality has largely reflected the risk-on theme employed since March of 2016. CCC spreads have now rallied to within 325bps of B-rated spreads. Historically, they have gotten as tight as 150bps in the rich days of early 2007. Although we are not advocating for 2007 level spreads, we do believe there is more room for CCC credits to outperform in the near-term with support from an economic backdrop of continuing low rates and pro-growth fiscal policies. High yield market spreads continued to grind tighter during the quarter, decreasing from 442bps to 412bps, once again pushing the average bond price above par

(\$100.9). In Q1 the CCC sector average price rose an impressive \$4 to \$95, versus a low of \$71.6 posted in January 2016. With both BB and B-rated credits now trading on average well above par, there are now few areas to gain additional price appreciation other than CCC's and distressed debt.

As the high yield market briefly broke through the 400bp spread level in February, issuers came out of the woodwork in March. Despite facing relatively sharp withdrawals, \$9.0 billion, during March from high yield retail funds, the high yield market absorbed one of the heaviest new issue months in recent memory, pricing \$42.6 billion in US\$ bonds (75% for refinancing purposes). In fact, the March US\$ refinancing activity modestly exceeded the prior record set in September 2012. Overall, high yield issuers were clearly taking advantage of strong investor appetite to lock-in attractive long term rates. Year to date (YTD) US\$ high yield new issuance now stands at approximately \$97 billion versus \$51 billion in 2016 (source: J.P. Morgan), although net new issuance year over year (YOY) (excluding redemptions) was relatively flat.

The economic backdrop continues to favor investment in high yield despite the elongated rally. Default rates (trailing 12 months) through March continue to be benign at 2.51%, down from the May 2016 peak of 4.89%, and a negligible .64% when excluding commodity credits. Most importantly, high yield issuer average revenue and EBITDA growth trends in Q4 of 2016 showed the highest positive YOY increases (+4.2% and +5.2%, respectively) over the last two years (source: JPMorgan Credit Strategy Weekly Update dated 3/31/2017). As a result, we would not be surprised at all to see the market test post-recession spread lows over coming quarters.

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Bloomberg 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.

Spread - the difference between the bid and the ask price of a security or asset.

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

Fiscal Policy - is the means by which a government adjusts its spending levels and tax rates to monitor and influence a nation's economy.

Par Value - is a static value, unlike market value, which can fluctuate on a daily basis. The par value is determined upon issuance of the security.

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.

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.

EBITDA stands for earnings before interest, taxes, depreciation and amortization. EBITDA is one indicator of a company's financial performance and is used as a proxy for the earning potential of a business.

The Bloomberg 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.

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