HIGH YIELD MARKET

INVESTMENT COMMENTARY & REVIEW

by Bob Sydow, Kevin Buckle and Jim Lisko

Second Quarter 2017

Second quarter market conditions favored the high yield market. Persistent low volatility coupled with stable, albeit modest economic growth continued to provide a favorable backdrop for risk assets, as the U.S. enters its eighth consecutive year of economic expansion and low unemployment. Low interest rates and accommodative monetary policies by the major central banks around the world continue to create a favorable environment for risk assets, while the market seemed to digest the Fed Funds increase in June with ease. However, the depressed oil market started to catch the investor's attention near the end of the quarter. The price of oil reached a year-to-date low on June 21st, before recovering near the end of the quarter. The West Texas Intermediate (WTI) oil price was last above $50/barrel on May 24th and the renewed weakness in oil prices weighed on the energy sector's performance in June. The energy sector yield-to-worst increased by 72 basis points (bps) in June, yet the weakness in oil prices did not spill over into the broader market performance. Despite the late quarter renewed weakness in the energy sector, the market had a good quarter overall with the index (Bloomberg Barclays High Yield Corporate Index) returning 2.17% for the second quarter, marking the sixth consecutive positive return quarter. The high yield market return for the first sixth months of this year was 4.93%.

U.S. dollar denominated new issuance was $62.4 billion in the second quarter, which is roughly $8 billion less than the average 2Q new issuance over the past nine years. However, "net" new issuance was negligible as the preponderance of new issue activity was for refinancing. We expect refinancing activity to continue to constitute a significant share of new issuance moving forward given the large universe of bonds that are callable within the next 12 months. Merger and acquisitions (M&A) and leveraged buyout (LBO) new issuance has declined to 20% year-to-date, and below the 23% historical average. Despite the low interest environment and receptive market conditions, very few new companies have tapped the high yield market.

The prevailing "risk on" mentality, that has been in place since March 2016 continued for the first half of the year; where Caa(s) returned 6.59%, while Ba(s) and B(s) returned 4.79% and 4.28%, respectively. However, between mid-March and mid-June the 10-year U.S. Treasury rallied 50 bps, resulting in a break in the second quarter trend. Ba(s) returned 2.68% for the second quarter outpacing its lower rated cohorts. B(s) returned 1.71% and Caa(s) returned 1.85%. Ba(s) spreads declined 29 bps in the second quarter bringing the Ba spread down to a cycle low 246 bps at quarter end (compared to 256 bps in late June 2014). The Caa-B spread differential remained virtually unchanged compared to the first quarter and was 327 bps at quarter end. We continue to believe there is an opportunity for modest spread tightening for Caa(s), as spreads closed the quarter at 714 bps. Notably, more than 62% (par value) of Caa(s) trade at a spread less than 600 bps, while 14% (par value) trade at a spread in excess of 1,000 bps. The index yield-to-worst declined to 5.62% and the average spread tightened 23 bps in the second quarter down to 390 bps from 412 bps at the beginning of the quarter. The average price was 101.5 at quarter end. Current market valuations may appear elevated but they are still below the recent cycle highs. In late June 2014 the index average spread was 362 bps, while the index yield-to-worst was 4.83% and the index average price stood at 106.2.

The elevated valuations in the high yield market are supported by strong fundamentals as public index constituents posted strong financial results with the last quarter annualized EBITDA (earnings before interest, taxes, depreciation and amortization) increasing 15.5% year-over-year for the first quarter of 2017 (JPM Morgan). Credit metrics remain reasonable with market leverage at 4.43X. The par weighted default rate at the end of quarter was 1.50%, down from 3.57% at the beginning of the year. (JP Morgan)

Moving into the second half of the year we remain constructive given the backdrop of a stable economy and a low default rate. With that said, we do not expect second half returns to be of the magnitude of those realized in the first half of the year as there is less room for spread tightening and price appreciation especially for Ba(s). Major central banks have indicated that they will be scaling back their accommodative monetary policy moving forward. While we do not expect significant widening in response to central bank policies, it does pose a risk in the second half of the year. Any further prolonged weakness in oil prices also presents a risk as we move into the second half of the year.

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High Yield Portfolio Managers at Pacific Income Advisers

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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.

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.

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

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.

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

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.

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

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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