HIGH YIELD MARKET

INVESTMENT COMMENTARY & REVIEW

by Michael Yean

Third Quarter 2017

As the U.S. progressed through its eighth consecutive year of economic expansion, this steadfast growth, combined with low market volatility continued to provide a constructive environment for risk assets. In addition, sustained low interest rates and accommodative monetary policies by the major central banks around the world also continued to foster favorable conditions for risk assets. Furthermore, the West Texas Intermediate (WTI) oil price move from a June low of $44.80/barrel to the quarter-end price of $51.67/barrel, along with the broad rally in commodities (S&P World Commodity Index up 13.20% for the third quarter), provided cyclical support for the high yield market. For the third quarter, the Bloomberg Barclays U.S. High Yield Corporate Index generated a total return of 1.98%, marking the seventh consecutive quarter of positive returns. The high yield market return for the first nine months of 2017 was 7.00%.

The prevailing "risk on" mentality throughout the first half of the year continued to be evident during the third quarter, with the CCC-rated credits returning 2.50%, outpacing BB-rated and B-rated credits which returned 2.01% and 1.75%, respectively. The B-rated category has been steadily underperforming the BB-rated category since mid-May, driven by fundamental challenges in several of the larger capital structures within the bucket. While CCC's have performed well year-to-date, we continue to believe there is opportunity for further modest spread tightening, as option-adjusted spreads (OAS) for CCC's closed the quarter at +647 basis points (bps) and offer a yield-to-worst (YTW) of 8.47%. This compares to an OAS of +206 bps and 4.03% YTW for BB's, and OAS of +340 bps and 5.33% YTW for B-rated credits. Overall, the high yield index spread tightened 17 bps in the third quarter to +347 bps from +364 bps, and index YTW declined to 5.45% from 5.62%. The average dollar price of the high yield index was $101.86 at quarter end. Although current high yield market valuations are elevated, the market is still wide of the recent cycle lows reached in June 2014 when the index offered an OAS of +337 bps and 4.83% YTW, and the average priced stood at $106.20.

The current valuations of the high yield market are supported by the strong aggregated fundamentals of the constituents of the high yield index, as bottom-up firm-level data through the end of the second quarter displayed continued sequential improvement in credit quality. The net leverage of the median non-financial company, measured by the ratio of net debt to EBITDA (earnings before interest, taxed, depreciation and amortization), declined to 3.62, while interest coverage improved by nearly half a turn. In addition, top-line revenue and annualized EBITDA both increased year-over-year for the third quarter of 2017, reflective of the solid macro backdrop both in the U.S. and globally (Goldman Sachs). Furthermore, the last-twelve-month par-weighted high yield default rate at the end of the third quarter decreased to 1.07%, down from 3.57% at the beginning of the year. On an issuer-weighted basis, the default rate has decreased to 2.75%, compared to 4.61% (JP Morgan).

Our outlook for the fourth quarter of 2017 remains constructive given the aforementioned supportive macro-economic backdrop. However, various government actions may pose risks in the fourth quarter and beyond. The recently disclosed framework for U.S. tax reform, specifically the prospective removal of the corporate interest tax deduction, may create a headwind for the high yield market. Although aggregate corporate leverage would likely decline over time, for nearly 10% of high yield companies, this current tax shield is the difference between operating profitably and losing money (Barclays). If interest deductibility were eliminated, a significant portion of high yield bonds may be pushed towards distressed situations which would eventually lead to a material rise in expected default rates in the high yield market. In other government proceedings, the Federal Reserve signaled a potential further increase of the fed funds rate in 2017 and announced its plan to begin reducing its balance sheet starting in October. While rising U.S. interest rates may act to limit price appreciation in high yield bonds, global rates and monetary policies remain accommodative by historical standards, and the strong overall fundamentals of high yield issuers – low default rates, and declining leverage coupled with revenue and earnings growth – argues for persistent tight spreads.

Michael Yean
High Yield Portfolio Manager