HIGH YIELD MARKET

INVESTMENT COMMENTARY & REVIEW

by Michael Yean

Fourth Quarter 2017

An eighth consecutive year of economic expansion, low rate and market volatility, commodity strength, and negative net high yield issuance all contributed to a constructive environment for risk assets and solid high yield market returns. For the full year 2017, the Bloomberg Barclays U.S. High Yield Corporate Index generated a total return of 7.50%. In the fourth quarter, the high yield market returned 0.47%, marking the eighth consecutive quarter of positive returns.

High yield spreads were nearly unchanged for the fourth quarter, but not without intra-quarter volatility that saw high yield spreads widen by nearly 50 basis points (bps) through mid-November only to recover the lost ground by the end of December. Generally, the prevailing "risk on" mentality witnessed through much of the year continued to be evident during the quarter, with the CCC-rated cohort returning 1.02%, outpacing BB-rated credits and B-rated credits, which returned 0.39% and 0.36%, respectively. B-rated credits have 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-rated credits have outperformed for the second year in a row, we continue to believe there are select opportunities, as option-adjusted spreads (OAS) for the bucket closed the quarter at +615 bps and offer a yield-to-worst (YTW) of 8.45%. This compares to an option-adjusted spread (OAS) of +211 bps and 4.37% YTW for BB-rated credits, and OAS of +343 bps and 5.70% YTW for B-rated credits. Overall, the high yield index spread tightened 4 bps in the fourth quarter to +343 bps, while the index YTW increased to 5.72% from 5.45%. The average dollar price of the high yield index was $100.91 at quarter end. Though current high yield market valuations remain elevated, the market is still wide of the recent cycle lows reached in June 2014 when the index offered an OAS of +337 bps, a 4.83% YTW, and the average price stood at $106.20.

The current valuations of the high yield market are supported by the healthy aggregated fundamentals, as bottom-up firm-level data through the end of the third quarter displayed sequential improvement in credit quality, with leverage largely stable and debt coverage edging higher. Additionally, revenue and annualized cash flow (EBITDA) both increased year-over-year through the third quarter of 2017, reflective of a solid macro backdrop both in the U.S. and internationally. Moreover, the trailing twelve-month (par-weighted) high yield default rate as of year-end was 1.27%, down from 3.57% at the beginning of 2017. In all, 37 companies defaulted in 2017, with debt totaling $34.1 billion, which registered the lowest annual total since 2013 (JP Morgan).

The shrinking high yield bond market, in terms of par value outstanding, has likewise provided broad technical benefit for the market. While gross bond issuance increased in 2017, net supply was negative for the third consecutive year as refinancing of existing bonds accounted for the biggest slice of the primary market's use of proceeds. For 2018, we expect net new supply to be relatively flat, with refinancing once again the largest use of proceeds. Aided by the impact of the Tax Cuts and Jobs Act, which reduces the attractiveness of debt relative to other forms of financing, the trend of lower overall market size for high yield bonds during the past three years should continue over the intermediate term.

Our high yield market outlook remains constructive, as we see much of the same favorable dynamics in place for 2018 – the aforementioned healthy aggregate corporate fundamentals, continued global economic expansion, benign default rates, and limited new net supply. We anticipate another year of positive total returns, albeit moderate and dampened by a low starting yield, tighter global monetary policy, and potential headwinds for the lowest rated credits from the corporate tax reform. The Tax Cuts and Jobs Act will have multi-faceted implications for the high yield market. The bill is generally supportive for issuers and the outlook for corporate earnings and cash flows is improved by the lower corporate tax rate, the tax relief on corporate cash held overseas, and the ability to fully deduct capital expenditures. Enhanced cash flows combined with limits on the deductibility of corporate interest expense also have the potential to materially reduce bond issuance over time. On the other hand, the limitations on interest deductibility and net operating loss utilization may push a significant portion of the lowest rated and stressed bonds towards distressed situations over time and eventually lead to a material rise in expected default rates. The differentiated impact from U.S. policy augments the rise in dispersion within the high yield market during 2017. Against a backdrop of persistently tight overall spreads and low volatility, bond-level dispersion moved higher and is elevated heading into 2018. The contrast can be seen in the bond-level spread differential between the 10th and 90th percentile spreads within the high yield index, which are near the highs of early 2016 and well above post-crisis averages. The wide range of valuations within the high yield market is also on display at an industry level, where approximately one-third of the largest 20 industries have an average spread ranking greater than its 50th percentile historically (Goldman Sachs). We anticipate high yield dispersion to remain a feature in 2018, cultivating an advantageous environment for credit selection.

We continue to focus on smaller companies and small bond issues as we believe small issues continue to offer greater value in terms of yield per unit of default risk. Our strategy is overweight B-rated credits and we're positioned to take advantage of their 2017 underperformance. Additionally, in a rising rate environment, research has shown that in similar spread environments historically, the B-rated cohort largely offsets the move in rates across the maturity spectrum while the BB-rated cohort does not (Barclays). The portfolio is also selectively constructive on CCC-rated credits, as this rating category trades wide relative to higher quality credits and enhances the portfolio's overall yield. Although overweight CCC-rated credits, our strategy continues to avoid secularly and fundamentally challenged sectors such as Retail, Wirelines, and Auto Rentals. We remain comfortable reaching for yield in industries with strong or stable fundamentals.

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