HIGH YIELD MARKET

INVESTMENT COMMENTARY & REVIEW

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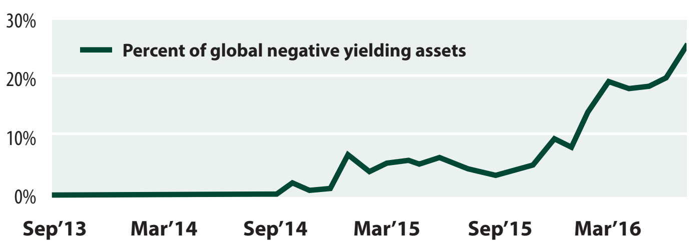
We find it difficult to rationalize the contradictory signs given off by both risky and ostensibly risk-free assets in recent times. In this quarter, Treasuries have rallied to record lows (but still looking very cheap to the rest of the developed world), equities have leapt to new all-time highs (despite continued central bank easing), while the economies of the developed world barely manage to stay in positive territory. Something seems counterintuitive in all of this, but what is it? From a fixed income standpoint (and apparently equities as well), there is one graph (below) that really puts things into perspective. There are simply few places to go for returns.



Source: BofA Merrill Lynch Global Research
Based on BofA Merill Lynch Global Fixed Income Markets Index, GFIM

It seems that just when the pundits believe the Fed is finally going to follow through on rate increases, something conveniently comes up to render the Fed's innuendos un-actionable. It was a slowing China late last year, and now it's Brexit. The fall-out from Brexit will likely take years, so now the Fed has a long-term excuse to keep rates low, along with the rest of the world's central banks. As such, worldwide monetary policies continue to "push on a string". This scenario has given high yield investors a reason to no longer fear rates, and that in turn has made high yield an oasis in the desert.

Q2 2016 was a banner quarter for high yield, returning +5.52%, surpassing even the strong high yield start in Q1 (+3.35%). As we shall detail below, much of this return was driven by a small segment of the high yield universe. Q2's solid high yield returns were nonetheless somewhat confounding on the back of one of the more significant (and surprising) geopolitical events occurring during the quarter - the British vote to leave the European Community. The investment community was certainly not prepared for the "leave" vote winning. However, following an immediate $2-3 average decline in high yield bond prices, it took only a matter of days for the market to fully recover. That was it, a fleeting "whoa!" moment. To be sure, there are no immediate consequences of the U.K. exit on the financial markets (at least that we know of yet.) The vote does, however, reflect the popular uneasiness not only in Britain, but across the world, and this is not something to ignore.

At the end of 2013 when high yield was trading at a dollar price of $103.5 (spread of 428bps) and the Fed was signaling an imminent easing of monetary accommodation, we believed double digit returns in high yield market were behind us, at least until we saw the next recession. Well, 2016 may prove us wrong on this thesis, as YTD returns are already approaching double digits (+9.06%), and this despite Brexit shocking most of the world in June. Sure we were bouncing off negative high yield returns in 2015, but this was principally due to severe depression conditions in the commodity sectors. Risk aversion did eventually spread to anything with a Caa handle later in that year, and this risk class (despite a strong YTD rally) continues to trade relatively wide here even in Q2 2016.

In Q2 2016, the high yield markets rallied through Brexit on the back of both decidedly increased optimism in the energy and commodity sectors, and a continuing rebound in the otherwise "left for dead" Caa credit universe. Overall, high yield spreads compressed 71bps (from 699bps to 628bps) and the yield to worst declined sharply from 8.2% to 7.3%. The +5.52% return for high yield handily surpassed all other fixed income class returns in the quarter. The 5-yr and 10-yr Treasuries also provided a strong tailwind for high yield, with yields declining 21 and 30 bps, respectively (almost all of which occurred post-Brexit in June). As mentioned above, the big industry performance outliers (comprising19.5% of the index combined) in the quarter were energy (+18.34%) and metals/mining (+15.22%) bonds. These two high yield sectors alone accounted for nearly 60% of the high yield market return and almost all of the spread tightening in the quarter. High yield energy credit prices, which bottomed around 60c on the dollar at the end of January 2016, have now rallied back to 87c (not adjusting for the index exit of bankrupt energy names and entrance of fallen angels over the period). Interestingly, excluding the outsized returns of these two sectors, the balance of the market just performed roughly in line with U.S. Treasuries during the quarter. As noted above, the other big contributor in the quarter was the performance of Caa credits (acknowledging this includes some energy and commodity issuers). Caa-rated bonds returned +11.83% in the quarter, as spreads compressed by 213bps (from 1,398bps to 1,185bps). This class of credits now trade approximately 581bps wide of single B's. To put this in perspective, at the end of February 2016, Caa-rated bonds were approaching near recessionary spread differentials versus B's, at approximately 866bps, while peaking (at its tightest) around 225bps in December 2013. It is therefore not surprising to have seen a rebound in this risk class, which we expect may continue albeit at a more modest clip in coming months.

Default activity (including distressed exchanges) continues to be dominated by the energy and mining sectors. In fact, almost 85% of defaults YTD are from these industries. The reported 12-month trailing U.S. high yield default rate (including distressed exchanges) fell to 4.68% (source: J.P. Morgan) in the quarter. Notably, excluding energy and commodities, the high yield default rate is a miniscule .53%. Although energy and commodity names will still continue to dominate near term defaults, we expect to see an uptick in other industries (especially if Caa access to the markets remains limited as it is currently). Virtually absent Caa issuance in the quarter (and YTD,) U.S. new issuance was still fairly solid in Q2 with approximately $82bil pricing. This is still down about 20% quarter over quarter and YTD, new issuance trails the previous year by 35%.

Technicals continue to be the dominant theme in all markets, and high yield is no exception here. We expect the backdrop of continuing absolute low rates, limited high yield new issuance, and the modestly growing U.S. economy to continue to support U.S. high yield markets. We acknowledge the unsustainable pace of the high yield rally YTD but believe there is still selective value to be found in the lower quality tier asset class. So until the next significant geopolitical event (and maybe not even then), we maintain a relatively sanguine outlook for our market in the near term.

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