HIGH YIELD MARKET

INVESTMENT COMMENTARY & REVIEW

by Michael Yean

First Quarter 2018

A sharp rise in interest rates and stock market volatility, combined with concerns of a looming trade war contributed to the first quarterly loss in two years for the high yield market. In the first quarter of 2018, the Bloomberg Barclays U.S. High Yield Corporate Index (HY Index) generated a total return of -0.86%. Yet despite the high market sell-off, evidence of a risk-on environment persisted as the CCC-rated cohort delivered positive returns (+0.30%), and outpaced B-rated and BB-rated credits that produced negative returns of -0.55% and -1.60% respectively. Additionally, the 36 basis point rise in the 5-year Treasury yield helped exacerbate the negative returns in the BB-rated bucket, which tends to be more interest rates sensitive due to the lower coupons, longer durations and closer proximity to the investment grade bond market. As of the end of the first quarter the CCC-rated debt trades at an option-adjusted spread (OAS) of +644 bps with a yield-to-worst (YTW) of 9.24%. B-rated debt now trades at an OAS of +364 with a YTW of 6.14%, while BB-rated credits offer an OAS of +237 bps and a YTW of 5.09%. The High Yield Index OAS widened 11 bps to +354 bps, while the Index YTW climbed to 6.19% from 5.72%. Conversely the average dollar price for all bonds in the Index declined to $98.69 by quarter end.

In spite of negative first quarter returns, the high yield market has shown relative stability in the face of dramatic increases in volatility across most other risk asset classes, and high yield trading and selling has remained mostly orderly. The high yield market continues to be supported by healthy fundamentals including the trend of improving credit quality and interest coverage, reduction in leverage and increasing growth in revenues and EBITDA. Additionally, the High yield bond market continues to benefit from shrinking supply, as net new supply in the first quarter was negative $15.3bn, reducing the par value market capitalization down to $1.29trn. The trailing 12-month par-weighted high yield default rate as of the end of the first quarter increased from 1.27 at year-end to 2.21%, largely due to the iHeartCommunications default in Q1'2018. At the sector level, we saw a noticeable shift in defaults from Energy to Retail/Consumer, which now constitutes the bulk of defaults over the trailing twelve month period. Nonetheless, despite the 94 bps uptick the default rate remains materially below the long-term average of 3.5%.

After digesting a challenging first quarter, our 2018 high yield outlook remains constructive and we anticipate attractive total returns for the year. Positive market conditions are underpinned by the aforementioned healthy corporate fundamentals continued global economic expansion, benign default rates, and limited new net supply. We continue to focus on smaller companies and small bond issues as we believe these bonds continue to offer greater value in terms of yield per unit of default risk. By ratings, the portfolio continues to overweight B-rated credits, where our research indicated in similar spread environments historically, the B-rated cohort largely offsets the move in rates across the maturity spectrum (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, the portfolio has eschewed secularly and fundamentally challenged sectors such as Retail and Wirelines. We remain comfortable reaching for yield in industries with strong or stable fundamentals.

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