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 (bp) 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 (earnings before interest, taxes depreciation and amortization). 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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Bloomberg Barclays U.S. Corporate 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. You cannot invest directly in an index.

The 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. Bond ratings start at Aaa (denoting the highest investment quality) and usually end at D (meaning payment is in default). In limited situations when the rating agency has not issued a formal rating, the rating agency will classify the security as non-rated (NR).

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

Yield - the income return on an investment, such as the interest or dividends received from holding a particular security.

Duration - A commonly used measure of the potential volatility of the price of a debt security, or the aggregate market value of a portfolio of debt securities, prior to maturity. Securities with a longer duration generally have more volatile prices than securities of comparable quality with a shorter duration.

Option-adjusted spread (OAS) is the measurement of the spread of a fixed-income security rate and the risk-free rate of return, which is adjusted to take into account an embedded option. Typically, an analyst uses the Treasury securities yield for the risk-free rate.

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

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.

Leverage - Companies rely on a mixture of owners' equity and debt to finance their operations. A leverage ratio is any one of several financial measurements that look at how much capital comes in the form of debt (loans), or assesses the ability of a company to meet financial obligations.

Par- Short for 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.

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.

Default - The failure to promptly pay interest or principal when due.

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