HIGH YIELD MARKET

INVESTMENT COMMENTARY & REVIEW

by Michael Yean

Second Quarter 2018

The high yield bond market produced solid returns in the second quarter, as the early year volatility subsided and the capital markets were receptive to debt and equity issuance. The Bloomberg Barclays U.S. High Yield Corporate Index generated a second quarter total return of 1.03%. The two largest sectors, Communications and Energy, outpaced the Index as credit-friendly bond redemptions, refinancings, equity and convertible issuance improved capital structures within several sizable Communications companies, while elevated oil prices boosted the performance of the Energy sector.

Lower rated credits continued to outperform, with the CCC-rated and B-rated cohorts returning 2.87% and 1.42% respectively; far outpacing the -0.17% return for BB-rated credits. The rally in CCC-rated credits offset the 18 bps increase in the 5-year Treasury yield, as CCC's tightened to an option-adjusted spread (OAS) of +598 bps and a yield-to-worst (YTW) of 8.84%. Conversely, BB-rated credits widened to an OAS of +253 bps and 5.40% YTW, and B-rated credits widened to an OAS of +372 bps and 6.59% YTW. The High Yield Index OAS widened 9 bps in the second quarter to +363 bps, while the Index YTW increased to 6.50% from 6.19%. The Index average dollar price declined to $98.01 by quarter end.

Higher input and material costs compressed margins and, given the looming global trade war, we intend to continually re-appraise our forward fundamental outlook. However, at present, the high yield market is supported by healthy aggregated fundamentals including improving credit quality, stable leverage and interest coverage, increasing revenue and annualized EBITDA growth. Additionally, the market continues to benefit from shrinking supply as measured by the outstanding par value. Net new supply was a negative $32.2 billion in the second quarter, reducing the high yield market capitalization to $1.28 trillion.

At quarter-end the trailing twelve-month par-weighted high yield default rate was 1.98% (1.26% excluding iHeartCommunications) compared to 2.21% in the previous quarter and 1.50% a year earlier. Despite the 48 bps YOY uptick, the high yield default rate remains well below the long-term average of 3.5%. Furthermore, the volume of stressed and distressed debt, typical indicators of future defaults, progressively declined during the second quarter.

Second quarter gains brought high yield market returns into positive territory year-to-date; however, the first half of 2018 remains the worst start to a year since 2008. We anticipate modest positive total returns for the high yield market in the second half of 2018. While strong domestic fundamentals, benign default rates, and the technical tailwind of limited new supply remain firmly in place, market concerns for rising interest rates, inflationary pressures, and heightened political tensions will likely continue to pressure credit markets. We continue to focus on smaller companies and bond issues, as we believe these bonds offer greater total return per unit of default risk. By ratings, the portfolio is overweight B-rated credits, where historical research has shown that in similar spread environments the B-rated cohort largely performs well in similar market environments. 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 risk-return profile. Although overweight CCC-rated credits, we continue to avoid secularly and fundamentally challenged sectors such as Retail and Wirelines. We remain comfortable with higher-yielding credits in industries with strong or stable fundamentals.

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