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 (earnings before interest, taxed, depreciation and amortization) 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 (year over year) 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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High Yield Portfolio Manager

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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.

Issuance - A reference to a security that has been registered, issued and is being sold on a market to the public for the first time.

The Barclays' Quality sectors discussed above use the following rating methodology. Securities that are rated by three rating agencies, 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.

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.

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.

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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