# HIGH YIELD MARKET

## INVESTMENT COMMENTARY & REVIEW

by Michael Yean

Third Quarter 2018

The Bloomberg Barclays U.S. High Yield Corporate Index generated a total return of 2.40% in the third quarter. The Communications and Energy sectors continued to lead the market, with Healthcare and Pharmaceuticals also posting robust total returns.

Lower rated credits continued to outperform, with CCC rated and B rated cohorts returning 1.20% and 0.61% respectively, outpacing BB rated credits (0.26%). High yield credit spread compression offset the 21 basis point rise in the 5-year Treasury yield, as the High Yield Index option-adjusted spread (OAS) tightened 47 bps to +316 bps, while the yield-to-worst (YTW) declined to 6.24% from 6.50%. All rating's spreads compressed: BB rated credits closed the quarter trading at an OAS of +206 bps and a YTW of 5.14%, B rated credits at an OAS of +312 bps and 6.23% YTW, and CCC rated credits at an OAS of +584 bps and 8.87% YTW. The average dollar price for the High Yield Index increased to $98.77 at quarter end.

We continue to re-evaluate the increasing input, freight, and labor costs that are pressuring corporate margins, as well as the escalating global trade tensions, all of which threaten our forward fundamental outlook. However, the strength of the U.S. economy continues to support the high yield market, and its' constituents continue to exhibit healthy aggregated fundamentals with stable leverage and interest coverage, revenue and annualized EBITDA growth.

Additionally, the market continues to benefit from the shrinking supply of high yield debt as measured by the par value outstanding. The amount of bonds that have rolled down to less-than-one-year maturities and thus index-ineligible, more than offset the $13.9 billion of net new third quarter supply, reducing total high yield market capitalization to down to $1.27 trillion.

The trailing-twelve-month par-weighted high yield default rate through quarter-end was 2.02% (1.29% excluding iHeartCommunications); approximately flat to the 1.98% second quarter rate and up 95 bps year-over-year. Despite the annual uptick, the default rate remains well below the 3.5% long-term average. Furthermore, the high yield distressed ratio (percentage of bonds under $80) remains low at 3.4%. This ratio serves as a strong lead indicator of defaults and is currently consistent with a forward default rate of between 2.0% to 2.5% (Credit Suisse).

Given the strong domestic fundamentals, benign default rates, and the technical tailwind of limited new supply, current conditions are unlikely to materially improve going forward. Combined with spreads once again near post-crisis lows, we see limited prospects for further spread compression over the broader high yield market. Our outlook still calls for only modest positive total returns for the full year 2018. However, within the high yield market, we continue to see value in B rated and CCC rated credit relative to BB rated credits. When comparing spread ratios across the ratings buckets, the spread ratio of BB credits to BBB credits is currently only 11% above the lows for the past 18 years whereas the ratio of B credits to BB credits is a much more attractive 32% and the ratio of CCC credits to B credits sits at 37% (Barclays). Furthermore, the lower rated credits provide superior insulation from interest rate risk, where research has shown that in similar spread environments historically, B rated and CCC rated spread compression largely offset the impact of rising interest rates across the maturity spectrum. Our portfolio is overweight B rated credits, where we remain comfortable reaching for yield in industries with strong or stable fundamentals. The portfolio is also overweight and selectively constructive on CCC rated credits, while we continue to avoid secularly and fundamentally challenged sectors such as Retail and Wirelines. Lastly, 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.

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