



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 (bp) 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 ratings' 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.

Michael Yean
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.

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).

Spread - The difference in yields between two fixed-income securities with the same maturity, but originating from different investment sectors.

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.

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.

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.

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.

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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