HIGH YIELD MARKET

INVESTMENT COMMENTARY & REVIEW

by Michael Yean

Fourth Quarter 2018

High yield bonds successfully navigated the pervasive "risk-off" market environment throughout the first three quarters of 2018; however, the Bloomberg Barclays U.S. High Yield Corporate Index (Index) turned decidedly negative in the fourth quarter. The Index generated a -4.53% total return in the fourth quarter, bringing the full year 2018 return down to -2.08%. Macro concerns abound – decelerating growth, trade tensions with China, slowing U.S. housing market, heightened risk of policy mistakes, significant decline in industrial commodity prices, slowing global growth, and flattening of the yield curve have all led to increasing consensus expectations for recession sometime by 2020.

Lower rated credits underperformed during the selloff, with the CCC-rated credits generating a loss of -9.10%, while BB-rated and B-rated cohorts returned -2.85% and -4.41%, respectively. The Index option-adjusted spread (OAS) widened 210 bps during the quarter to +526 bps, while the yield-to-worst (YTW) rose to 7.95% from 6.24%. By ratings, BB-rated credits now trade at an OAS of +354 bps and offer a YTW of 6.24%, B-rated credits at an OAS of +531 bps and 8.00% YTW, and CCC-rated credits at an OAS of +989 bps and 12.55% YTW. The average dollar price of the Index declined to $92.56 by quarter end.

Although investors have grown increasingly concerned with the aggregate credit quality of the high yield market, continued growth in the U.S. economy has supported solid corporate earnings. The constituents of the Index continue to exhibit healthy fundamentals, with slight improvements in leverage and interest coverage, and revenue and annualized EBITDA growth persisting during the past quarter.

In 2018, the par-weighted high yield default rate was 1.81%, a decline from the 2.02% in the previous quarter and an increase from 1.28% at the end of 2017. Despite the uptick year-over-year, the default rate remains well below the long-term average of 3.5%. Overall, 29 companies defaulted in 2018, with debt totaling $40.9bn.

Both the fourth quarter and 2018 marked a shrinking high yield bond market and a lackluster primary activity. Highlighted by no new issues coming to market in December, the first such month since November 2008, net new supply declined $24.9bn during the quarter, bringing the size of the market, as measured by the par value outstanding of the Index down to $1.17trn.

While the market consensus has moved towards a recession occurring in 2020, we believe with solid fiscal and monetary policy making the U.S. may merely experience an industrial production slump – a slowdown of growth rather than a full recession. While we remain cautious regarding U.S. policy making; we're constructive about the sound aggregated credit quality, benign default rates, a supportive technical backdrop, and starting yields near 8.0% - all of which offer potential for greater-than-coupon total returns for the full year 2019.

Historically a 7.95% year-end Index yield represents a healthy starting point. Throughout various conditions over the past 20-plus years, for those periods where the average starting yield was greater than 7% the Index has return 8.82%, 7.85%, 7.49%, and 7.41% on a 1-year, 2-year, 3-year, and 5-year annualized basis, respectively. Furthermore, totals returns are even more robust when the starting yield is greater than 7% during periods of rising interest rates; with 1-year and 5-year annualized returns of 11.13% and 8.44%, respectively (Wells Fargo Securities).

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