HIGH YIELD MARKET

INVESTMENT COMMENTARY & REVIEW

by Michael Yean

Third 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. Corporate High Yield 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 (Earnings before Interest, Taxes, Depreciation and Amortization) 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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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).

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.

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 to worst - the lowest potential yield that can be received on a bond without the issuer actually defaulting.

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

Yield - the income return on an investment, such as the interest or dividends received from holding a particular security.

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.

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.

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

Monetary - consists of the actions of a central bank, currency board or other regulatory committee that determine the size and rate of growth of the money supply, which in turn affects interest rates.

Fiscal policy is the means by which a government adjusts its spending levels and tax rates to monitor and influence a nation's economy.

Coupon - A coupon rate is the yield paid by a fixed-income security.

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