HIGH YIELD MARKET

INVESTMENT COMMENTARY & REVIEW

by Michael Yean

First Quarter 2019

The high yield bond market posted its second best first quarter total return on record, with the Bloomberg Barclays U.S. High Yield Corporate Index (HY Index) gaining a robust 7.26%. Healthy valuations, a dovish Fed pivot, reported progress on trade tensions, a supportive technical backdrop, and continued steady aggregate corporate fundamentals, combined to drive the sharp recovery from the previous quarter's sell-off.

Unlike most risk-on periods higher quality bonds outperformed, with the BB-rated and B-rated cohorts both returning 7.21%, while CCC-rated credits gained 7.15%. The HY Index option-adjusted spread (OAS) tightened 135 bps in the quarter to +395 bps from +526 bps, while the yield-to-worst (YTW) declined to 6.43% from 7.95%. By ratings, BB-rated credits now trade at an OAS of +235 bps and offer a YTW of 4.85%, B-rated credits at an OAS of +387 bps and 6.42% YTW, and CCC-rated credits and below at an OAS of +902 bps and 11.50% YTW. The average dollar price of the HY Index rose to $97.90 at quarter end.

Although U.S. and global growth has moderated, the current macro-economic environment continues to support corporate earnings and margins, resulting in steady levels of leverage and interest coverage and solid overall fundamentals for the constituents of the HY Index in aggregate.

Default rates continue to be benign. The par-weighted high yield default rate was 0.94%, a decline from 1.81% at the previous quarter-end and 2.21% in the year-over-year quarter, largely due to the iHeart Communication default exiting the last-twelve-month calculation. Furthermore, based on current distressed bond ratios, the market implied forward default expectations remain well below the long-term average of 3.5%.

The improved market sentiment also translated to greater primary market activity, as $59.9bn new bonds were priced, adding net new supply of $23.9bn during the quarter. However, the 2019 primary market still trails the past two years and the technical backdrop remains supportive, as net supply has been offset by coupons and the significant inflows into the asset class experienced during the quarter.

Our initial outlook for 2019 anticipated greater-than-coupon total returns underpinned by sound aggregated credit quality, low default rates and a positive technical setup, and driven primarily by starting yields near 8.0% and a low probability for a 2019 recession. While our fundamental and economic outlook remains mostly unchanged, high yield market valuations have reset and we now see limited High Yield total return opportunity for the remainder of 2019.

However, while the overall high yield market should see constrained returns, we still believe the first quarter price action has created significant relative value in the B and CCC ratings cohorts. The near-uniform absolute total return performance across ratings buckets during the first quarter has resulted in the lowest BB/BBB spread ratio in the past 17 years, and the highest B/BB ratio in 18 years. The CCC/B ratio approximates the average for the post-crisis period (Deutsche Bank). We find inadequate value in these historically tight BB-rated credits and continue to significantly underweight this quality bucket. We continue to focus on B-rated and CCC-rated credits, and we seek opportunities to invest in bonds where we believe the yield offered overcompensates for the risk assumed.

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