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 basis points (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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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).

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.

Leverage results from using borrowed capital as a funding source when investing to expand the firm's asset base and generate returns on risk capital.

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.

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.

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.

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.

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

The Fund held 0% in I Heart Communications.

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Past performance does not guarantee future results.

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