HIGH YIELD MARKET

INVESTMENT COMMENTARY & REVIEW

by Michael Yean

Second Quarter 2019

The high yield bond market continued to post gains during the second quarter driven by expectations of Fed easing, declining interest rates, a supportive technical backdrop and continued steady aggregate corporate fundamentals. The Bloomberg Barclays U.S. High Yield Corporate Index returned 2.50%.

Extending the trend that began in the first quarter, higher quality bonds continued to outperform, with BB-rated and B-rated cohorts returning 3.08% and 2.66% respectively, while CCC-rated credits gained a paltry 0.29%. The Index option-adjusted spread (OAS) tightened 18 bps in the second quarter to +377 bps from +395 bps, while the yield-to-worst (YTW) declined to 5.87% from 6.43%. By ratings, BB-rated credits now trade at an OAS of +227 bps and offer a YTW of 4.36%, B-rated credits at an OAS of +385 bps and 5.99% YTW, and CCC-rated credits and below at an OAS of +874 bps and 10.75% YTW. The average dollar price of the Index rose to $99.46 by quarter end.

Default rates remain benign, as the second quarter par-weighted high yield default rate climbed to 1.46% from 0.94% as of first quarter-end, but declined from 1.98% year-over-year. Distressed bond ratios also remain low, indicating the implied forward market default expectations remain well below the 3.5% long-term average.

The decline in yields has continued to translate into greater primary market activity, as $69.7bn new bonds were priced, adding net new supply of $23.1bn during the quarter. However, the technical backdrop remains supportive thus far, as net supply has been offset by coupons and high yield inflows.

The high yield market gained nearly 10% in the first half of 2019, and thus we see limited total return opportunity for the market in the remainder of 2019. Fed fund rate cuts appear priced in, global trade tensions continue to persist, there is still an uncertain global economic outlook, and yields are back at 12-month lows that will likely cap any further significant rally.

However, while the overall high yield market should likely see constrained returns, we believe there is significant relative value in the B-rated, and in particular CCC-rated cohorts given the price action over the first half of the year and the spread dislocations versus history across the ratings spectrum. The BB/BBB spread ratio remains historically tight, while the B/BB and CCC/BB ratios remain near historic highs (source: Deutsche Bank). A substantial portion of the BB-rated universe literally cannot rally more than fractions of a point before trading at negative yield-to-worsts. We find inadequate value in these historically tight BB-rated credits and continue to significantly underweight this quality bucket. Following our top-down and granular bottom up research process, we continue to find value in lower rated credits, and seek opportunities to invest in bonds where we believe the yield offered overcompensates for the risk.

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