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 Federal Reserve (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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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.

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.

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

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

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