HIGH YIELD MARKET

INVESTMENT COMMENTARY & REVIEW

by Michael Yean

Third Quarter 2019

The Fed and central banks globally provided an accommodative tailwind to the market, helping the Bloomberg Barclays U.S. High Yield Corporate Index post a 1.33% third quarter return.

The divergence between lower and higher rated credits continued during the third quarter with the BB-rated and B-rated cohorts posting gains of 2.03% and 1.65% respectively, while CCC-rated credits produced a loss of -1.76%. The High Yield Index option-adjusted spread (OAS) tightened 4 bps during the quarter to +373 bps, while the yield-to-worst (YTW) declined to 5.65% from 5.87%. By ratings, BB-rated credits now trade at an OAS of +215 bps and offer a YTW of 4.05%, B-rated credits at an OAS of +370 bps and 5.66% YTW, and CCC-rated credits and below at an OAS of +947 bps and 11.29% YTW. The average dollar price of the Index rose to $99.79 by quarter end.

The par-weighted high yield bond default rate was 2.52%, up from 1.46% over the quarter and up from 2.02% year-over-year. The higher default activity is due largely to the Energy sector, which represented five of the six bond defaults during the quarter. Excluding Energy, the default rate is a much more modest 1.11%, and overall high yield default rates remain comfortably below historical averages.

As yields continued to decline, the primary market remained active during the third quarter, printing $64.9 billion (bn) of new bond issuance. However, the technical backdrop remains constructive, as the primary use of proceeds has been debt refinancing, resulting in net supply of a manageable $10.2bn.

Given robust year-to-date returns and low overall yields, we continue to see limited near-term total return opportunity for the high yield market heading into the fourth quarter. Although accommodative central banks will continue to provide support, global trade tensions, political uncertainty, and deteriorating economic data set the stage for a challenging market environment.

However, while the overall high yield market should see constrained returns, we continue to see attractive relative value in the B-rated and CCC-rated cohorts, given the price action over the first three quarters of the year and the spread dislocations across the ratings spectrum. The BB to BBB spread ratio remains historically tight, while the B to BB and CCC to BB ratios remain near historic highs. We find inadequate value in the historically tight BB-rated credits and continue to significantly underweight this quality bucket. We continue to focus on lower rated credits, and seek opportunities to invest in bonds where we believe the yields overcompensate 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.

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.

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

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