HIGH YIELD MARKET

INVESTMENT COMMENTARY & REVIEW

by Michael Yean

Fourth Quarter 2019

Spurred by the announcement of a Phase-I trade agreement between the U.S. and China, the Bloomberg Barclays U.S. High Yield Corporate Index (Index) generated a return of 2.61% during the fourth quarter. For the year, the Index produced a total return of 14.32%, propelled by the Fed pivot in early 2019.

During the fourth quarter, the BB-rated and B-rated cohorts posted gains of 2.45% and 2.61%, respectively, while CCC-rated credits produced a gain of 3.73%. For the year, however, the BB-rated and B-rated cohorts returned 15.51% and 14.80%, respectively, substantially outperforming CCC-rated credits, that gained 9.51%.

The Index option-adjusted spread (OAS) tightened 37 bps in the quarter to +336 bps, while the yield-to-worst (YTW) declined to 5.19% from 5.65%. By ratings, BB-rated credits now trade at an OAS of +182 bps and offer a YTW of 3.63%, B-rated credits at an OAS of +324 bps and 5.12% YTW, and CCC-rated credits and below at an OAS of +920 bps and 10.94% YTW. The average dollar price of the Index rose to $101.23 at quarter end.

2019 was a strong year for the high yield credit market, rebounding from recessionary fears and a disappointing 2018 with double-digit gains. Historically, this type of bounce-back performance has been fairly typical following down years in high yield. What was extremely unusual, however, was the dramatic outperformance of higher quality credits. In the prior three decades, there has never been a year when the Index returned over 5% and CCC credits did not outperform BB credits on an absolute basis. On a risk-adjusted basis, the 2019 relative performance of CCC bonds versus their BB peers was the worst on record (Goldman Sachs). Market appetite for smaller or less liquid issuers was virtually non-existent for much of the year, and valuation alone did not resonate with the market. On the other hand, perceived quality, lower rates and an overall "search-for-yield" environment provided ongoing demand for higher quality credits at ever tighter levels.

This up-in-quality trade has left the high yield market with a challenging setup for 2020. Although the overall balance of market risks remain to the downside, our base case calls for continued accommodative Fed policy and extended slow economic growth in the U.S. and globally, that in combination with supportive technicals and only a slight uptick in default rates, should result in a fairly constructive backdrop for credit. However, with most of the largest ratings cohort (BB) call-constrained and mathematically challenged to repeat last year's performance, we anticipate the overall high yield market to generate positive but sub-coupon returns in 2020.

While the overall high yield market should see modest returns, we continue to favor single-B's and also find significant opportunity and value in the CCC ratings cohort, given the price action witnessed the previous year and the historic spread dislocations across the ratings spectrum. Our focus in the CCC-rated category is to invest in bonds we believe would perform through a down-cycle and currently offer yields that overcompensate for the assumed risk. We believe our attention to these types of credits, along with a continued emphasis on small issues (which was also out of favor in 2019), will result in attractive, better-than-market returns. Outperformance in 2020 will likely be delivered by investing in true high yield.

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