The US High Yield Market Paradox

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VIEWPOINT

By Bryan Petermann and Clint Comeaux

Question: Why are US high yield spreads tighter this year when the market has experienced net mutual fund outflows year-to-date?
Answer: Because the US high yield market is shrinking in size.

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The current US high yield market presents investors with an interesting paradox. Despite net year-to-date outflows of $6.8 billion from mutual fund investors through October 18, 2017 (source: Lipper), US high yield credit spreads have tightened (please refer to Figure 1 on next page). Why are US HY spreads tightening in the face of outflows? The answer is that outflows and spreads represent only part of the technical equation. The size of the market has been shrinking steadily for the last year. At its peak in 2016, the US high yield market had approximately $1.36 trillion of par outstanding. As of September 30, 2017, this amount had declined to approximately $1.25 trillion, an 8.1% decline in 15 months, while the default rate declined. We believe the shrinking market size represents a powerful technical tailwind for the asset class that easily overwhelms weekly technical mutual fund flows, especially when combined with the coupon generated by the asset class. This short note will explore the reasons for the decline in the size of the US high yield market and what it means for US high yield investors.

Why is the US High Yield Market Shrinking?

Figure 2 (next page) highlights the decline in the size of the US high yield market. It is worth noting that while the US high yield market has declined in size, the US loan market has increased in size.

Why has the US high yield market shrunk over the past 15 months?

1. Upgrades Exceed Downgrades. Given solid corporate credit fundamentals, high yield companies being upgraded to investment grade exceed the number of investment grade companies being downgraded to high yield. In short, more companies are exiting the US high yield universe via credit improvement than are entering it due to weakening fundamentals. This upgrade trend (see Figure 3 next page) started in mid-2016 and is prevalent across the entire high yield rating spectrum, indicating that the trend can continue into the foreseeable future.

2. Companies can Finance themselves Outside the US High Yield Market. We have observed that companies are increasingly raising capital by accessing markets outside of the US high yield market. For example, many US companies are choosing to finance themselves in Europe given low absolute rates. Domestic companies, particularly those with European operations, are choosing to take advantage of the rate differential and lock in lower European interest rates and currency advantages, thereby reducing their financing costs.

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High yield issuers are also increasingly choosing to finance themselves in the US loan market. This strategy might seem counter-intuitive as short-term rates have been and are likely to continue to move higher and loans are floating rate instruments. Short term rates are, however, still low from a historic perspective and issuers can choose to swap into fixed rates if desired. Moreover, we have found that many companies are choosing to finance themselves in the loan market given the favourable pre- payment terms of this asset class. Unlike the high yield bond market where issues are typically not callable for half of their life, loans can be prepaid at any time often with little or no prepayment penalty. Many US high yield companies are currently producing free cash-flow, some of which is being used to pay down debt. Given the lack of fiscal and tax policy clarity from the US government, company management teams have been reluctant to commit long- term capital to investing in costly capital expenditures or mergers and acquisitions (M&A). Companies are instead using their cash to pay down debt, and loans are attractive precisely because they do not penalize a borrower for repaying debt ahead of schedule.

3. Primary Use of New Issue Proceeds Remains Refinancing. Even though the high yield new issue market has been very active since the global financial crisis, the primary use of new issue proceeds remains the refinancing of existing debt. This means that very little new net supply has come to the market despite large gross numbers.

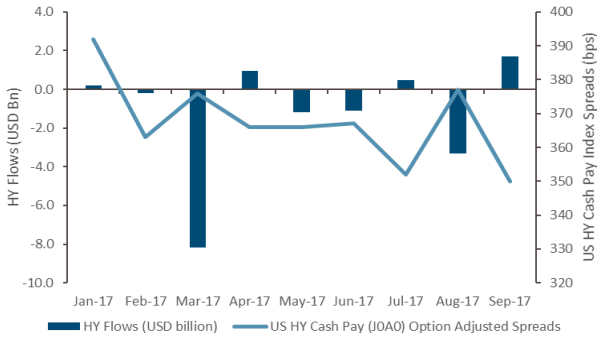
What Does This Mean For Credit Markets?

While US high yield valuations are approaching their cycle tights, we believe this is not only justified, but that spreads can continue to trade range-bound or tighten for the foreseeable future for the following reasons: corporate credit fundamentals remain strong, the default outlook is benign, very few bonds are maturing in the next two years, technicals are supportive, and investors need spread product (particularly if rates start to rise). In addition, the US high yield market also generates approximately $80 billion of annual coupon payments for investors, much of which is reinvested into the asset class. Against this backdrop, US high yield bonds can be viewed as a scarce resource as managers seek to put money to work in a shrinking market where scarcity generates value. It is difficult to predict if the market spread will approach the pre-recession low of 250bps experienced in June 2006, but it is equally difficult to predict that high yield spreads will widen materially in the near term due to internal factors.

There are still risks to consider. We view the primary risks to the high yield market to be rate risk and geopolitical/macro uncertainty. If rates increased suddenly, high yield investors will be better protected compared to their investment grade and Treasury counterparts but the asset class could experience stress similar to the 2013 taper tantrum. The excess spread offered by high yield, however, should provide a degree of cushion relative to higher quality fixed income areas. Geopolitical risks also abound and a correction due to an exogenous, macro shock to the asset class could likely lead to a re-pricing of risk assets across the globe. We believe that given solid fundamentals, this type of correction represents a buying opportunity and would be similarly short-lived as all the corrections experienced since the 2008 recession.

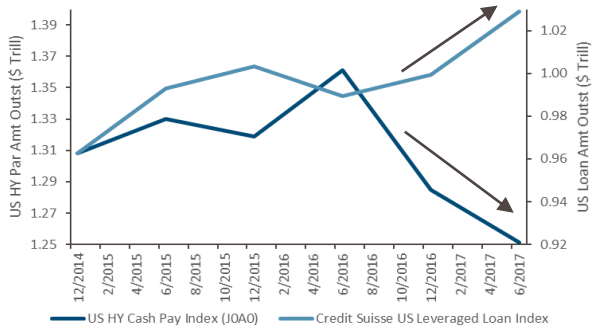
It is therefore important not to become complacent. We are seeing inflated asset prices globally and investors taking on increasingly greater risk for lower returns. We are carefully monitoring whether we see significant deterioration in credit underwriting standards and/or an increase in excessive leverage. So far, we have not observed this to be the case with the broad US high yield market. We believe, as a firm deeply rooted in fundamental credit research, that we are well suited to protect investors' capital should we witness such a weakening of underwriting standards. In the meantime, we believe US high yield represents an attractive spread product and portfolio diversifier for investors.

Fig. 1 – 2017 YTD Flows and Spreads



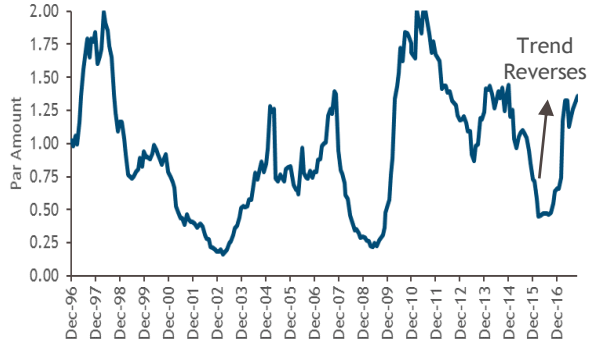
Source: JP Morgan HY Research for flow data; Spread data from Bloomberg. As of September 30, 2017.

Fig. 2 – Size of US HY vs. US Loan Market



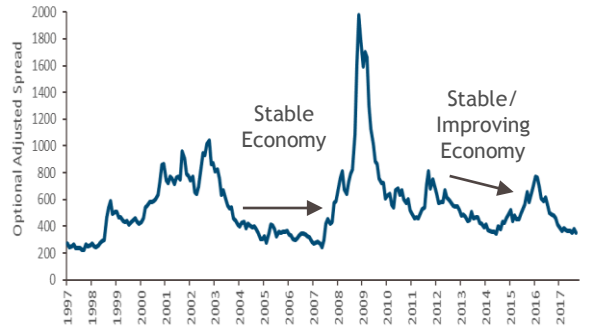
Source: BofA Merrill Lynch and Credit Suisse, as of August 31, 2017.

Fig. 3 – LTM Upgrade to Downgrade Ratio



Source: JP Morgan High Yield Monitor. As of September 30, 2017.

Fig. 4 – US HY (J0A0) Index Historical Spreads



Source: BofA Merrill Lynch US High Yield Cash Pay Index, as of September 30, 2017.

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About the Authors

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Bryan joined Muzinich in 2010. He is a portfolio manager, a member of the firm's Investment Committee and a PM for the Americayield, Developed Markets High Yield and US High Yield Corporate Bond Funds. Prior to joining Muzinich, Bryan was with PineBridge Investments (formerly AIG Investments) where he served as Managing Director, Head of high yield for the last five years of his tenure. Bryan started his career in the banking sector, working in the media and cable groups at the Union Bank of California and Banque Paribas. He also participated in the start of Société Générale's cable and media group. Bryan earned a B.A. from the University of California, Los Angeles, where he was a Phi Beta Kappa scholar, and an M.B.A. from the University of California, Berkeley.

Clint Comeaux

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Clint joined Muzinich in 2006. He is a portfolio manager focusing on US high yield and the lead PM for the Americayield and US High Yield Corporate Bond Funds. Prior to joining Muzinich, Clint was a research analyst for the high yield and private equity funds at WR Huff Asset Management. Previously, Clint was a Manager at Enron responsible for physical trading in the commodities group. Clint is a Chemical Engineer, formerly with PPG Industries. He earned a B.S. in Chemical Engineering, Summa Cum Laude, from Tulane University and an M.B.A. from New York University's Leonard N. Stern School of Business.

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