Viewpoint

High Yield – Timing your Entry Point

January 2019

Underlying fundamentals remain solid despite recent price weakness

The high yield market had a difficult end to a volatile 2018 which saw the asset class fall -2.26% in the US and -3.62% in Europe.[1]

For European high yield, 2018 was the worst year in a decade and yields doubled. For the US high yield market, the last three months of the year were particularly notable - the market moved from its cycle tight spread-to-worst (STW) of 324bps to a STW level last seen following the energy crisis in 2015/2016 - a level well wide of the long-term average.[2]

Multiple headlines drove events - oil price weakness, trade wars, US Federal Reserve monetary policy, the US government shutdown, Italy's budgetary situation, Brexit, signs of weakening economic data etc. Yet few had any immediate and direct impact on the high yield market. These headwinds combined to unnerve investors across all risk assets and resulted in a broad-based move into government bonds and cash.

Although some of the economic numbers highlighted a slowdown, none indicate an imminent recession in either the US or European economies.

In addition, we believe none of these events are likely to cause the high yield default rate to increase materially in 2019, and we expect the rate to stay well below the historical average over the next 12 months.

Both European and US high yield markets have dynamics that we believe underpin each market and help paint a positive picture from an investment perspective.

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Bryan joined Muzinich in 2010 from PineBridge Investments (formerly AIG Investments) where he served as Managing Director, Head of high yield for the last five years of his tenure. Bryan has also held roles at Union Bank of California, Banque Paribas and Société Générale.

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Hugo joined Muzinich in 2013. Prior to joining Muzinich, Hugo worked in the markets division at Société Générale on the credit trading desk. Hugo studied English and American literature at the University of Warwick and holds the Chartered Financial Analyst designation.

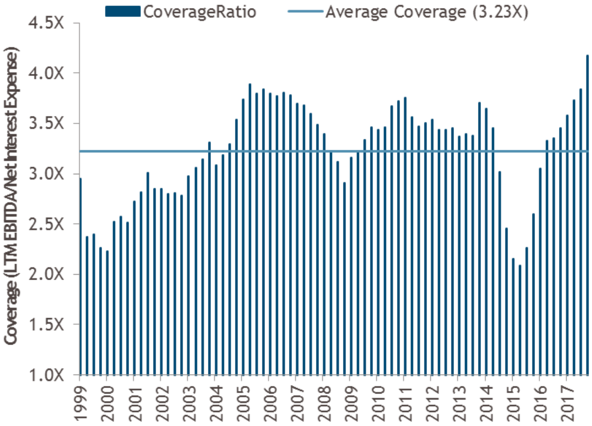
1. ICE BofA ML US Cash Pay High Yield Index (J0A0), ICE BofA Merrill Lynch European Currency High Yield Constrained Index (HE00), as of 31st December 2018
2. ICE BofA ML US Cash Pay High Yield Index (J0A0)

US High Yield

Within the US, we believe the asset class is being supported by a number of attributes:

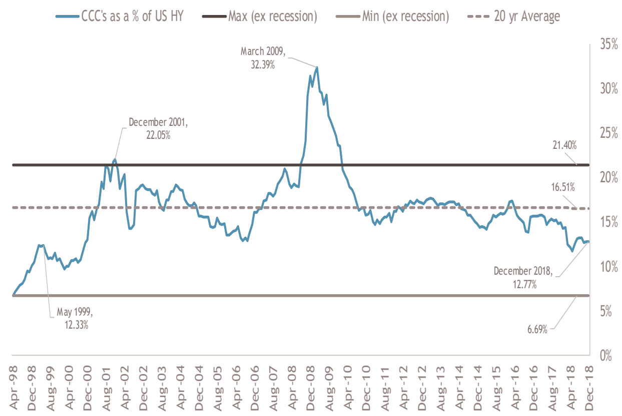
- Corporate issuers have deleveraged their balance sheets since 2015;
- Coverage ratios are high, driven by low interest rates and borrowing costs (Fig.1);
- The upgrade/downgrade ratio is positive;
- The maturity wall is manageable;
- CCC rated credits are at a decade low (Fig. 2); and
- The market has been shrinking since September 2016.

Fig. 1 – Interest Coverage Ratio has Improved Since 2015 Commodity Cycle



Source: BofA ML Global Research HY Market Statistics. As of 30 September, 2018. Data ex-LBO. BofA ML updates this data approximately quarterly with a 1 quarter lag because of staggered company reporting schedules. Accordingly, this data is updated quarterly with a 1 quarter lag.

Fig. 2 – CCCs as Percentage of US High Yield Market at Decade Lows

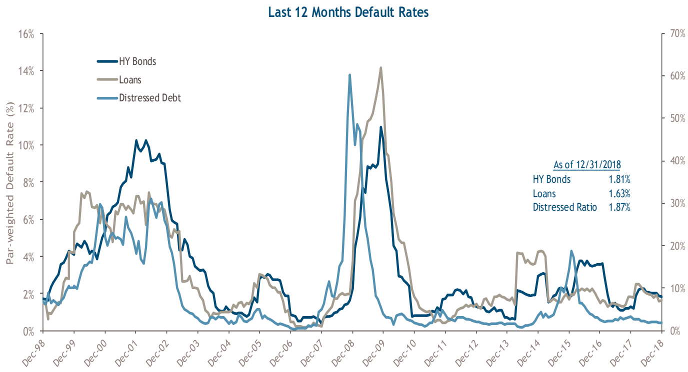


Data as of 31st December, 2018. Source: Bloomberg. Indices used are the ICE BofA ML US Cash Pay High Yield Index (J0A0) and the ICE BofA ML CCC and Lower US Cash Pay High Yield Index (J0A3). Chart shows the face value of the J0A3 as a % of the face value of the J0A0, going back monthly for the past 20 years. Shaded areas represent recession periods.

These characteristics highlight that corporate fundamentals do not justify spreads wide of the long-term average, when defaults will be well inside of the long-term average. Indeed, default rates have been trending lower for some time (Fig. 3).

While we have downgraded our economic assessment of the US to neutral in the last month, we believe the economic assessment is still fine for high yield.

Fig. 3 – Default Rates and Distressed Debt Ratios Trending Lower



Source: JP Morgan High Yield Bond and Leveraged Loan Market Monitor. Data as of 31st December, 2018. For illustrative purposes only.

Price action was particularly negative in December, although we believe much of it was technical in nature due to it being year-end.[3] This tilted the playing field in favour of the downside, a situation that allowed longer-term investors with longer-term liabilities (such as insurers and pension funds, etc.) to step in and buy at lower levels.

We should also recognize that in most years the high yield coupon offsets volatility around interest rates and credit concerns (Fig. 4). This is why high yield generally produces positive returns for investors.

Fig. 4 – Performance and Volatility

Performance	1Yr	3Yr	5 Yr
ICE BofA Merrill Lynch BB/B Non-Financial Index (JC4N)	-1.96%	6.53%	3.76%

Volatility	1Yr	3Yr	5 Yr
ICE BofA Merrill Lynch BB/B Non-Financial Index (JC4N)	3.27%	4.16%	4.78%

Data as of 31st December, 2018. ICE BofA Merrill Lynch BB/B Non-Financial Index (JC4N)

Since 1994, when the market was less than US$150 billion in size, the asset class has only had four negative return years before 2018.[4]

There are two things that bind these four negative return years together. They all occurred around significant default waves (bursting of TMT bubble in 2000, WorldCom/Enron collapse in 2002, Great Recession 2008 and oil/commodities crisis in 2015), and that the subsequent year saw a strong recovery that ranged from 6% - 56%.[5]

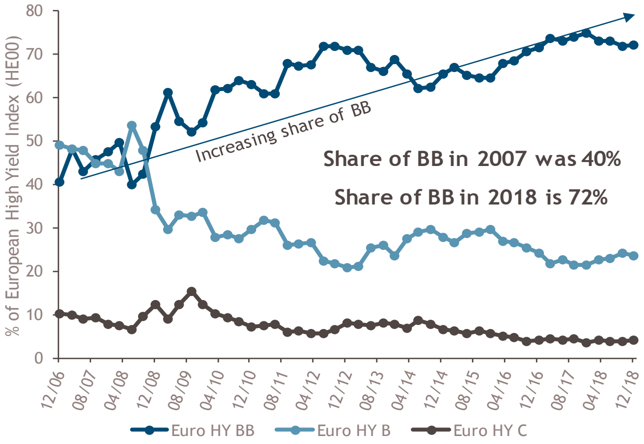
Thus, yield and spread increases improve break-evens and minimize the potential for additional downside.

European High Yield

Within European high yield, we believe there is a similar dynamic – namely that the underlying fundamentals are solid and do not indicate that a sudden increase in the default rate is likely.

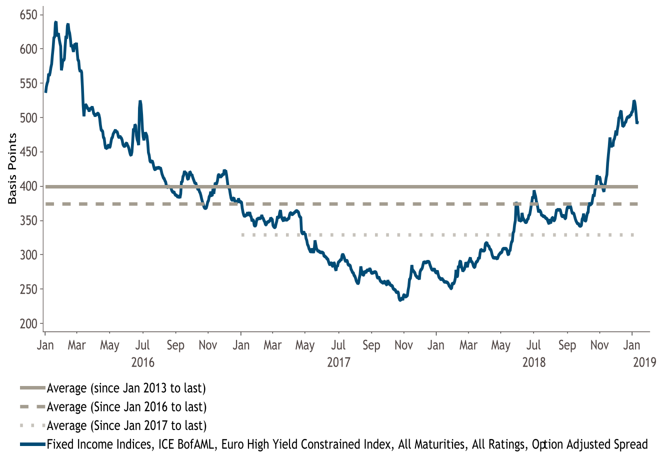
3. ICE BofA ML US Cash Pay High Yield Index (J0A0) -2.19%
4. ICE BofA ML US Cash Pay High Yield Index (J0A0)
5. Ibid.

Fig. 5 - Credit Ratings in European High Yield



Source: Bloomberg, ICE BofA Merrill Lynch European Currency High Yield Constrained Index (HE00), as of 31st December 2018.

Fig. 6 - European High Yield Option Adjusted Spread Since Jan 2016



Source: Macrobond, ICE BAML Indices (ER40 Index, Euro Area Corporate BBB rated, HEC0 Index, European High Yield constrained), January 10, 2018.

The default rate in recent years has been low, oscillating between 1% and 3%.[6] There are good reasons for this – higher-quality BB rated issuers now make up 70% of the European high yield market, whereas a decade ago it was closer to 40% with the rest of the market comprised of riskier B or CCC rated debt (Fig. 5).

This current high-quality ratings bias makes a large difference for expected credit losses with long-term average annual credit losses from B rated credits 2.4% compared with 0.6% for BB rated credits.[7] On this basis alone default rates seem poised to remain low.

Other metrics also highlight the good financial health of European issuers. Issuers have taken advantage of low interest rates and spreads to term out debt with the average tenor of the market now over 5 years which compares to just over 4 years in 2013.[8]

A combination of high interest coverage ratios, low overall leverage and no near-term maturity wall makes the asset class well placed to weather economic turbulence.

Whilst fundamentals are comforting, the technical picture has clearly worsened over the last year.

With the European Central Bank corporate sector purchase programme now at an end, spreads widening and volatility on the rise we are no longer seeing as much of the ‘crowding out’ effect that saw yield-hungry investors chase high yield bonds in 2017.

However, European deposit rates remain negative and we believe will stay that way for some time to come, and this is likely to keep yields somewhat anchored (assuming a non-recessionary environment) as depositors and holders of risk free assets at some point are unable to ignore the opportunity cost of not being invested in the high yield market.[9]

Looking now at the long-term valuations of European high yield (Fig. 6) current spread levels are wider than the 5-year average and yields have risen to 4.6%.[10]

These valuations seem attractive, particularly when compared with other fixed income asset classes.

6. Moody’s Europe Trailing 12-Month Issuer-Weighted Spec-Grade Default Rate Forecasts. Data as of December 31st, 2018
7. Moody’s, Annual Default Study: Corporate Default and Recovery Rates 1920-2017, data as of December 31st, 2017 from the 15 February 2018 report.
8. ICE BofA Merrill Lynch European Currency High Yield Constrained Index (HE00), as of 31st December 2018.
9.https://www.ecb.europa.eu/stats/policy_and_exchange_rates/key_ecb_interest_rates/html/index.en.html

The average cash price of bonds in the market is also interesting to observe as it is now more than 10 points lower than its November 2017 peak and is at a discount to par for the first time since the first quarter of 2016.[11] Assuming default rates stay subdued, this means that future return potential is building up in the market.

The current yield-to-worst level means that 12-month breakevens are now at compelling levels; simple bond maths will dictate that, with a starting yield of 4.6%, and a spread duration for the asset class of 4, we would need to see a significant further bout of spread widening to generate a negative total return in 2019.[12]

Time to Reallocate?

It is impossible to predict that the market has reached a bottom, since volatility is coming from factors primarily outside of the economic data and credit fundamentals. However, we believe some of the headwinds can be resolved favourably and, when that happens, risk premiums should contract.

From an historical perspective, negative return years in high yield have been followed by positive years, although in those years, spreads were wider than current spread levels.

If spreads do tighten, the move is likely to be faster than many investors anticipate due to low inventories. Investors who look beyond the daily mark-to-market volatility and act as a liquidity provider to wary investors/traders will likely be rewarded at current levels.

However, risks remain. Within Europe, the technical picture deteriorated somewhat in 2018 and there are clearly some clouds on the horizon in the shape of less accommodative monetary policy and signs that the global economic cycle is aging.

Nevertheless, we feel that, given the strong fundamentals and the more attractive valuations, investors with a medium-term horizon are now being properly compensated for adding exposure to high yield and 2019 is shaping up to be a year with attractive return potential.

10. ICE BofA Merrill Lynch, BB-B European High Yield Constrained Index (HP4N), as of 31 December 2018
11. ICE BofA Merrill Lynch European Currency High Yield Constrained Index (HE00), as of 31st December 2018.
12. ICE BofA Merrill Lynch, BB-B European High Yield Constrained Index (HP4N), as of 31 December 2018

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Index Descriptions

J0A0 - The ICE BofA ML US Cash Pay High Yield Index tracks the performance of US dollar denominated below investment grade corporate debt, currently in a coupon paying period that is publicly issued in the US domestic market. Qualifying securities must have a below investment grade rating (based on an average of Moody's, S&P and Fitch), at least 18 months to final maturity at the time of issuance, at least one year remaining term to final maturity as of the rebalancing date, a fixed coupon schedule and a minimum amount outstanding of $250 million.

J0A3 - The ICE BofA ML CCC & Lower US Cash Pay High Yield Index is a subset of the ICE BofA ML US Cash Pay High Yield Index (J0A0) including all securities rated CCC1 or lower.

JC4N - The ICE BofA ML BB-B US Non-Financial Cash Pay High Yield Constrained Index contains all securities in the ICE BofA ML US Cash Pay High Yield Index (J0A0) that are rated BB1 through B3, inclusive, except those of financial issuers, but caps issuer exposure at 2%.

HE00 - The ICE BofA ML Euro High Yield Index tracks the performance of EUR dominated below investment grade corporate debt publicly issued in the euro domestic or eurobond markets. Qualifying securities must have a below investment grade rating (based on an average of Moody's, S&P and Fitch), at least 18 months to final maturity at the time of issuance, at least one year remaining term to final maturity, a fixed coupon schedule and a minimum amount outstanding of EUR 250 million.

HP4N - The ICE BofA ML BB-B European Currency Non-Financial High Yield Constrained Index contains all non-financial securities in The ICE BofA ML European Currency High Yield Index rated BB1 through B3, based on an average of Moody's, S&P and Fitch, but caps issuer exposure at 3%.