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CIO's Perspective: 2018 High Yield Market Review & 2019 Outlook

- Volatility returned in 2018; leveraged loans outperformed high yield bonds for only the second time in the past ten years.
- I am cautiously optimistic about 2019 and believe that the high yield market will rebound in the year ahead.

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2018 HIGH YIELD MARKET REVIEW

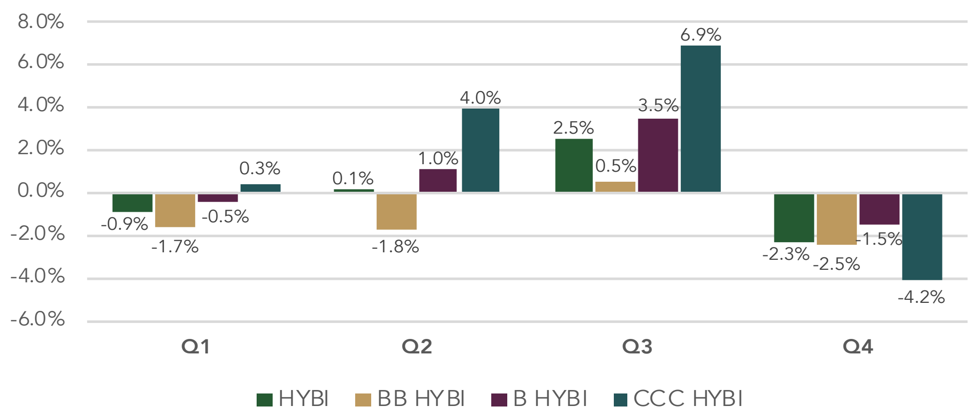
Following two years of steadily declining spreads and strong returns, high yield bond performance turned negative in 2018. U.S. tax reform, healthy economic growth and tightening monetary policy helped to push Treasury yields higher for most of the year. The rise in yields led to weak performance for all fixed income products, including high yield bonds, which produced a loss of -2.27% following a volatile fourth quarter.[1]

During the first half of the year, the increase in interest rates led investors to redeem from high yield bond mutual funds, which exacerbated price pressure especially amongst higher quality, longer duration bonds. Returns rebounded during the summer months, as outflows slowed and primary market activity for high yield bonds declined, resulting in secondary market price increases. At the end of the summer, CCC-rated bond performance was well ahead of its higher-quality peers. However, in the fourth quarter, the high yield market experienced a spike in volatility brought on by several factors, including heightening trade tensions between the U.S. and China and its potential impact on the global economy. This renewed volatility led to a significant sell-off in high yield bonds and erased all of the gains produced during the first three quarters of 2018 (Exhibit 1).

Performance by sector reveals that Healthcare (1.6%), Telecommunications (1.1%) and Utility (1.0%) were the top performers in 2018. Conversely, Automotive (-8.3%), Energy (-6.4%) and Banking (-4.7%) were the biggest laggards. The spike in volatility in the fourth quarter, especially in December, was particularly hard on Energy sector bonds, which were the third best performers year-to-date as of September 30, 2018. However, a 39% decline in the price of oil during the fourth quarter completely reversed the sector's fortunes. In addition, the poor performance of Energy sector bonds was a significant reason for the weakness among CCC-rated bonds in the fourth quarter.

EXHIBIT 1
High Yield Bonds: 2018 Year-to-Date Returns at Each Quarter-End

Source: ICE BofA Merrill Lynch U.S. High Yield Index ("HYBI")



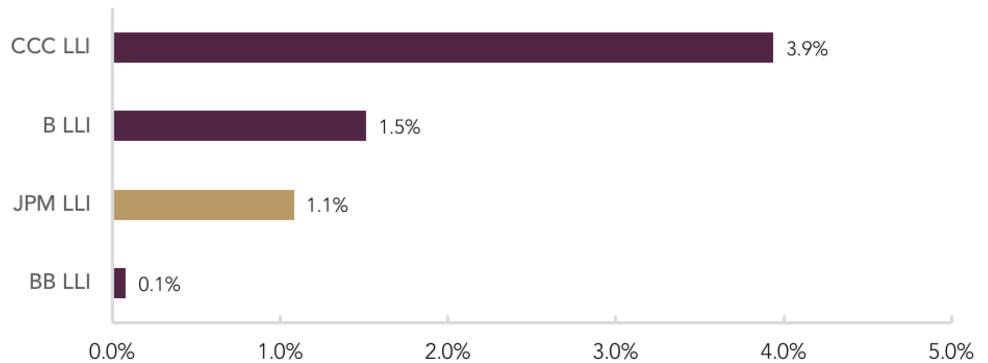
Though also harmed by the rout in the fourth quarter, leveraged loans nonetheless fared better than high yield bonds in 2018. Specifically, leveraged loans produced a gain of 1.08%, outperforming high yield bonds for only the second time in the past 10 years.[2] While accelerating outflows from loan mutual funds pressured loan prices into year-end, leveraged loans, for most of the year, benefited from strong demand from collateralized loan obligations ("CLOs") and loan mutual funds. Leveraged loans were the financing source of choice for issuers in 2018, and according to S&P Leveraged Commentary & Data statistics, while issuance of high yield bonds was down 39% in 2018, leveraged loan issuance fell by only 13%. This trend in financing is likely to continue, which should support leveraged loan performance in 2019.

[1] *As measured by the ICE BofA Merrill Lynch U.S. High Yield Index*
[2] *As measured by the J.P. Morgan Leveraged Loan Index and compared to the ICE BofA Merrill Lynch U.S. High Yield Index.*

During 2018, lower-rated leveraged loans outperformed their higher-rated peers. Specifically, CCC-rated loans performed the best, driven by higher income returns as a result of this group's greater exposure to second lien loans, which offer higher coupons than their first lien peers. Meanwhile, the top-performing sectors were Metals & Mining (4.3%), Retail (3.9%) and Transportation (3.5%), while the-bottom performing sectors were Diversified Media (-1.7%), Housing (-0.2%) and Paper & Packaging (-0.1%).

EXHIBIT 2
Leveraged Loans:
2018 Performance by Rating

Source: J.P. Morgan, J.P. Morgan Leveraged Loan Index ("LLI")



2019 OUTLOOK

In my view, escalating trade tensions and monetary policy mishaps present the greatest risks to the high yield market in 2019. How these risks play out over the next 6-12 months will drive the fortunes of all markets, including high yield. Tension between the U.S. and its primary trading partners was one of the biggest macroeconomic risks in 2018 and the same will be true in 2019. The recently signed trade agreement between the U.S., Mexico and Canada, which awaits ratification, eased concerns on at least one front. However, with "New-NAFTA" largely in the rear-view mirror, all eyes may now focus on the simmering trading relationship between the U.S. and China. The return of the two sides to the bargaining table in early January is positive for markets, which have thawed to start the year.

While the preservation of a free trade zone amongst the North American countries will benefit the U.S. and global economy, a healthy trade relationship between the world's two largest economies carries far greater importance, especially as it relates to other potential geopolitical implications and market sentiment. And while the possibility of an all-out trade war with China remains remote, such an event would have a materially negative effect on all markets, in my opinion. In addition, the new Congress, now with a Democratic-controlled House of Representatives, may affect the Trump Administration's ability to focus on its agenda, including trade negotiations, making a resolution more difficult. I continue to believe that trade negotiations between the U.S. and China will end favorably, but until such time, markets will be sensitive to news regarding any progress or lack thereof.

The Fed and fundamentals…

Given the volatility and negative sentiment that permeated through the markets in December 2018, I did not agree with the Fed's decision to raise interest rates at such time. Admittedly, a rate hike into market weakness seemed inevitable given President Trump's very public statements against such action, coupled with the Fed's desire to affirm its independence and not appear to bow to political pressure. Based on comments by the Fed chairman in early January, the Fed now intends to maintain flexibility with respect to any rate hikes in 2019.

Given that bond prices and interest rates generally move in opposite directions, this last development is a positive for high yield markets, as fewer hikes should slow the rise in yields and ease the pain felt by holders of fixed coupon high yield bonds. In addition, measured rate hikes are also supportive of leveraged loans as investors continue to seek shelter from a rising rate environment. One of the hallmarks of this cycle has been the unprecedented levels of liquidity in the market provided by very accommodative monetary policy. As I have pointed out previously, exogenous events during this cycle (e.g., European debt crisis, collapse of oil prices, Brexit, etc.) that likely would have led to an inflection point in prior cycles have instead merely given the market pause while at the same time instilling an additional measure of credit discipline. While global monetary policy is still relatively accommodative, it is now contracting, and markets are grappling with how best to incorporate this new paradigm. From my perspective, the tightening of monetary policy on a global basis will undoubtedly result in increased volatility, and unlike previous points in this cycle, monetary policies will likely push the market to an inflection point rather than pull it back from one.

While inflection points generally coincide with weakness in issuer fundamentals, I am not yet observing such weakness in the market. In the aggregate, fundamentals have been decent, and leverage has been stable to slightly declining because of slower debt growth and solid earnings. Furthermore, relative to historical standards, interest coverage ratios are at a high level. In that same vein, 2019 could prove to be a challenging year for a number of issuers, as 2018 top- and bottom-line growth, boosted by the stimulating effects of the 2017 changes to the U.S. tax code, may prove to be a difficult comparable for earnings in the upcoming year. For most of 2018, when issuers underperformed the prices of their outstanding debt decline meaningfully. Conversely, for those issuers that performed well, already elevated prices translated into very little upside. I would suspect that 2019 would bring more of the same, and prudent credit selection will prove to be paramount.

Over the past two years, improving fundamentals have led to a relatively benign default environment, which I expect to continue in 2019. However, there are still some bonds and loans that trade at stressed or distressed levels, and if the recent decline in oil prices persists, that number could rise. Furthermore, the average credit spread on the ICE BofA Merrill Lynch CCC-rated Index exceeded 1000bps in December for the first time in two years, which indicates to me that stress is building in the lowest rated segment of the high yield market.

However, the most levered corner of the high yield market is not the only one feeling stressed. Idiosyncratic risk in larger, well-established companies has the potential to pressure the entire high yield market. Case in point, General Electric ("GE") was in the news for most of the second half of 2018 as an example of a large BBB-rated issuer facing challenges, from a significant debt load and declining profitability that is at risk of a potential downgrade. Should such a downgrade occur, it could be part of a large wave of fallen angels to hit the high yield market (a topic that I cover in more detail in the section below).

According to BofA Merrill Lynch, GE has approximately $48bn of high yield index eligible debt, which would make it the largest issuer in the high yield market and comprise nearly 4% of the index. To put that number in perspective, the two largest issuers in the index at the end of 2018 were HCA and Sprint, which, when combined, would still have less debt in the index than GE. However, a fallen angel wave is not about any single issuer.

Undoubtedly, GE, and other BBB-rated issuers, will take further actions in an effort to maintain their investment grade rating, but GE's situation illustrates the technical risk facing the high yield market should a wave of downgrades occur.

BBBs and the High Yield Market

There has been much reporting on the health and size of the BBB-rated corporate bond market ("BBB market") in the second half of 2018. The BBB market as of December 31, 2018 was greater than 2.5x the size of the entire $1.2 trillion high yield bond market, up from 1.2x ten years ago.[3] Because of the sheer magnitude of the BBB market relative to the overall high yield market, investors want to understand the impact that a wave of downgrades might have on the high yield bond market.

From the table below (Exhibit 3), one can see that the investment grade corporate bond market, fueled by cheap debt in the ultra-low interest rate environment following the 2008 global financial crisis, has grown considerably during the current cycle. It is also evident from the table that the BBB market has accounted for a disproportionate share of this growth in the investment grade corporate bond market. Specifically, the BBB market accounted for 50.1% of the ICE BofA Merrill Lynch U.S. Corporate Master Index as of the end of 2018 compared to only 35.9% in December 2008. Furthermore, this growth has led BBBs to become 5.6x the size of the BB segment of the high yield market, significantly up from 3.4x ten years ago.

EXHIBIT 3
Change in the Composition of the U.S. Corporate Market: Par Value in Billions

Source: ICE BofA Merrill Lynch, ICE BofA Merrill Lynch U.S. Corporate Master Index

	Dec 2018	Dec 2008	% of U.S. Corp IG in 2018	% of U.S. Corp IG in 2008	Times Larger than 2008
AAA Rated	105.5	99.5	1.6	4.0	unch
AA Rated	600.2	354.0	9.4	14.2	1.7x
A Rated	2,487.9	1,147.5	38.9	46.0	2.2x
BBB Rated	3,210.2	895.9	50.1	35.9	3.5x
Total IG	6,403.9	2,496.9	-	-	2.5x

With the above statistics in mind, I pose the question of what peak fallen angel activity has looked like based on history. There are several episodes of peak fallen angel volume over the last 20 years; however, only two such episodes have coincided with recessions (occurring in 2002 and 2009). I believe that it is best to assess such activity during recessionary environments because those, in my view, offer the best gauge for what worst-case scenarios could look like. Other non-recessionary fallen angel peaks, such as 2005 (GM and Ford downgrades) and 2016 (Energy and Metals & Mining downgrades), while insightful, are less useful in understanding potential worst-case environments.

For example, 2002 and 2009 fallen angel volume as a percentage of the BBB market were 23% and 17%, respectively. Using this history as a guide, and based on the size of the BBB market today, peak year fallen angel volume could range between $480 billion and $675 billion face value, or between 42% and 60% of the size of the current high yield market. To put those numbers into some context, the peak volumes of 2002 and 2009 accounted for 43% and 23% of the high yield market, respectively. In general, fallen angel activity acts on the high yield market as additional supply and places downward pressure on secondary bond prices. As a result, a peak wave of fallen angels such as the one outlined above could pressure the high yield market considerably.

[3] *Based on face value outstanding using ICE BofA Merrill Lynch U.S. Corporate Master Index data as of 12/31/2018.*

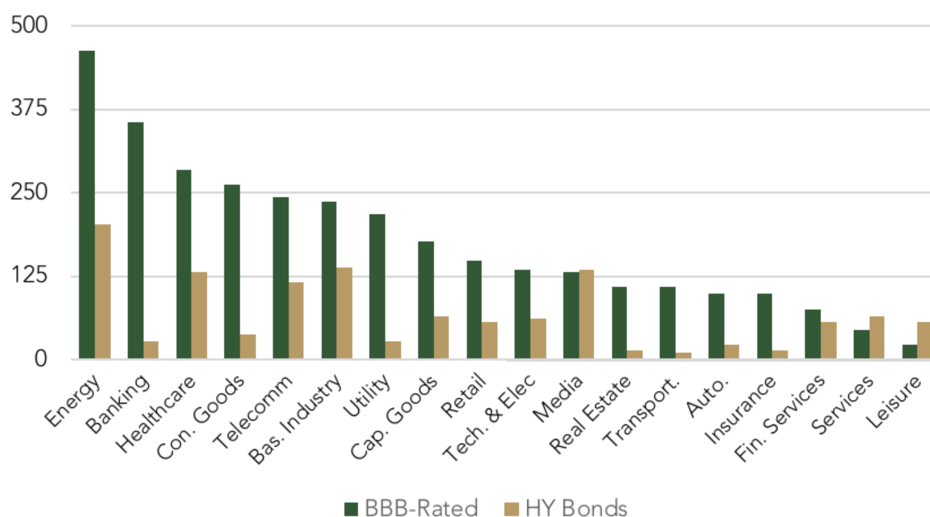
Fallen angel waves generally occur in connection with a recession, whether it be economy wide or within specific sectors. As such, it is unlikely that we will see peak fallen angel activity without some corresponding weakness in issuer fundamentals. Broadly speaking, fundamentals for investment grade credits have deteriorated since the financial crisis, dragged down by the growth of the BBB market. That said, in the aggregate, leverage levels of approximately 2.2x and interest coverage ratios close to 10x are far from high yield metrics. In addition, debt growth has slowed more recently as certain changes in the tax code have made the incurrence of additional leverage somewhat less appealing for investment grade companies.

Be that as it may, there are several companies in the BBB market that have leverage levels that are comparable to BB-rated credits.[4] However, as a bottom-up, fundamental credit selector, I do not judge credit worthiness of an issuer based on a single statistic. Nevertheless, because of the elevated leverage, together with heightened awareness of the burgeoning problems now affecting the BBB market, there are BBB-rated bonds trading at spread levels greater than the average spread of the BB-rated segment of the high yield market. As of December 31, 2018, there was approximately $121 billion principal amount of BBB-rated bonds that traded at spreads wide of their BB-rated peers, 46% of which are Energy sector bonds. Before the December 2018 sell-off in high yield bonds, this number was more like $360 billion.

In the chart below (Exhibit 4), I detail the sector distribution of principal amount outstanding in both the BBB market and the high yield bond market. It is clear to me from the chart that there are several cyclical sectors that comprise a meaningful portion of the BBB market; therefore, a significant wave of fallen angels would likely dwarf existing high yield credits in those sectors (e.g., Energy and Banking). The same is true for certain non-cyclical sectors like Healthcare and Consumer Goods that, in a deep enough recession, may also find their way into the high yield market.

EXHIBIT 4
Sector Distribution by Principal Amount Outstanding ($ bn): BBB-Rated Bonds Relative to High Yield Bonds as of December 31, 2018

Source: ICE BofA Merrill Lynch



In all likelihood, the next peak in fallen angel activity will likely coincide with a recession and such fallen angel activity will have the potential to be larger than previous episodes. Such an event will likely inject a considerable amount of volatility into the high yield market. However, the effects from fallen angel activity are not all doom and gloom. For

[4] *"A $1 Trillion Powder Keg Threatens the Corporate Bond Market" Smith and Cannon October 11, 2018, Bloomberg*

example, history shows that fallen angels have generally outperformed BB-rated credits following a downgrade. In addition, fallen angels typically improve the overall credit quality of the high yield market. Conversely, an influx of "higher-quality" companies will, in my opinion, potentially crowd out "lower-quality" credits and place short-term pricing pressure on such bonds in the secondary market, as well as the opportunity for active managers to identify good values caused as a result. Only time will provide an answer to the magnitude and duration of the next downgrade wave. However, using history as a guide, investors should prepare for a fallen angel wave that has the potential to exceed all others, especially in light of the current size of the BBB market.

SUMMARY

Now that the Fed and other foreign central banks have begun to tighten monetary policy, liquidity may not be the savior that markets have recently relied upon, and as such, perhaps the next exogenous shock will truly mark the end of the credit cycle. Heading into 2019, high yield markets are facing several headwinds, such as elevated trade tensions, the tightening of monetary policy, and difficult hurdles to overcome for issuers to achieve revenue and earnings growth. However, the sell-off to end 2018, which coincided with outflows from high yield mutual funds and ETFs, could provide an attractive entry point for investors with a longer-term view as fundamentals remain stable while wider spreads at the start of the year better compensate investors for the risks outlined above. In addition, the present environment, where economic activity is plateauing, favors active managers that are focused on bottom-up, fundamental research as all credits are not created equal. As I gaze into my opaque crystal ball, I am cautiously optimistic about the year ahead. The high yield market has never produced negative total returns in back-to-back years. With that statistic in mind, I believe that the high yield market will rebound in 2019 and produce a positive return, though its magnitude remains uncertain. As these broader themes play out, positive developments in the areas of risk that I outlined above have the potential to make 2019 a solid year for returns in several markets, including high yield. At DDJ, we will do as we always do, and remain intensely focused on monitoring our existing holdings while exploiting increased market volatility to opportunistically invest in solid credits with attractive risk-reward profiles.

APPENDIX

BPS: Stands for basis points. A basis point is one one-hundredth of one percent (0.0001).

Coupon: The stated interest rate paid on a bond. Coupon payments for high yield bonds are typically made semi-annually.

Duration: Duration is a measure of the sensitivity of the price - the value of principal - of a fixed income investment to a change in interest rates. Duration is expressed as a number of years. Effective duration is such calculation for bonds with embedded options.

Fallen Angel: A fallen angel is a bond that was given an investment-grade rating but has since been reduced to junk bond status due to the weakening financial condition of the issuer.

High Yield Bond: A high yield bond is a debt security issued by a corporate entity where the debt has lower than investment grade ratings. It is a major component – along with leveraged loans – of the leveraged credit market.

Investment Grade: Investment grade are those securities rated Baa3/BBB-/BBB- or above by Moody's, S&P, and/or Fitch, respectively.

Spread: The yield of a bond minus the yield of the government bond that matches the maturity (or appropriate call date) of the bond.

10 yr. Treasury: Treasury yield is the return on investment, expressed as a percentage, on the U.S. government's debt obligations. Looked at another way, the Treasury yield is the interest rate that the U.S. government pays to borrow money for different lengths of time, in this case, 10 years.

Yield: The yield is the income return on an investment, such as the interest or dividends received from holding a particular security.

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The ICE BofA Merrill Lynch U.S. High Yield Index tracks the performance of US dollar denominated below investment grade corporate debt publicly issued in the US domestic market. Please note that one cannot invest in the index.

The J.P. Morgan Leveraged Loan Index is designed to mirror the investable universe of USD institutional leveraged loans, including U.S. and international borrowers. Please note that one cannot invest in the index.

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