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# CIO's Perspective: 2019 High Yield Market Review

- In a year in which the high yield bond market produced double-digit performance, uncharacteristically lower-rated bonds lagged their higher-rated peers.
- I do not expect a recession in the coming year and generally view 2020 as having the potential to produce another year of price appreciation for the high yield market.

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## 2019 HIGH YIELD MARKET REVIEW

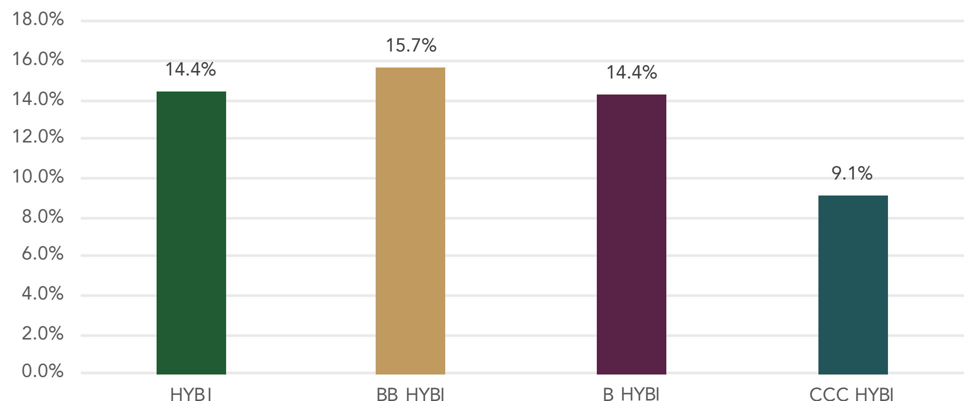
In 2018, the high yield market ended the year on a low note. A negative return in December capped off one of the weakest quarters of high yield bond performance in history. Of course, this negative performance was not isolated to the high yield market. Rather, concerns surrounding trade tensions, economic growth and the trajectory of monetary policy weighed heavily on markets ranging from corporate bonds to equities. Many market observers were curious whether 2019 would bring more of the same or if markets would reverse course.

By way of background, I am by nature an optimistic person. This may seem counterintuitive given my chosen profession; after all, when it comes to investments in the high yield market, one must always be focused on what can go wrong. Having said that, I cannot help but view things through the prism of positivity. So, even in the face of dreadful performance to end 2018, I was cautiously optimistic about the prospects for the high yield market in 2019.

History shows that it is not uncommon for the high yield market to generate an above-coupon return following a year of negative performance, and as it turned out, 2019 was no exception. Consequently, while the strong performance of this past year is not a shock, what has been surprising is the way in which the double-digit gains in the high yield market were generated. From the chart below, one can observe that 2019 performance was led by BB-rated bonds, rather than CCC-rated bonds, which customarily have been the best performer within the high yield asset class in a year of double-digit gains.

**EXHIBIT 1**
High Yield Bonds: 2019 Full Year Returns by Rating

*Source: ICE BofA U.S. High Yield Index ("HYBI"). One cannot invest directly in the index.* ***Past performance is no guarantee of future results.***




Notwithstanding the outcome at year-end, an interesting but rarely highlighted point is that through April, CCC-rated bonds were outperforming their BB-rated and B-rated counterparts by 181bps and 146bps, respectively. During the first four months of 2019, declining U.S. Treasury yields, minimal supply of new bonds and an accommodative Federal Reserve led investors to view yields in the high yield market as relatively more attractive when compared to alternatives. These factors led investors to pile into high yield mutual funds, thereby bidding up high yield bond prices.

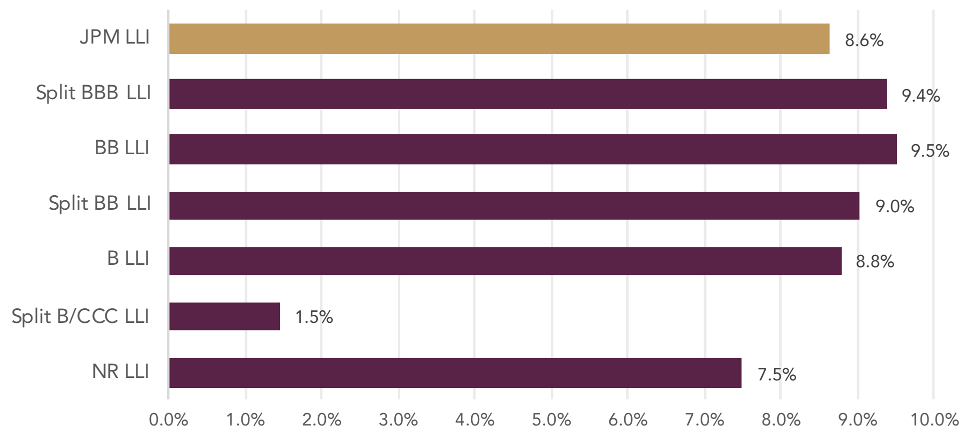
However, as summer approached, the weather heated up and so did trade tensions between the U.S. and China, resulting in a risk-off mentality that led to a divergence in the performance of CCC-rated bonds and their higher-rated peers. As a result, higher-rated bond issues (which are also typically longer duration and larger sized than most CCC-rated issues) significantly outperformed during the year.

Furthermore, concerns about economic growth prospects driven by the escalating trade war weighed heavily on oil prices during the second half of 2019. This decline came after oil prices had rebounded during the first half of the year. As a result, the Energy sector, which returned 5.6% in 2019, was the worst performer in the high yield market for the year with Energy sector bonds in the BB, B and CCC-rated segments of the market generating returns of 13.7%, 6.2% and -23.6%, respectively. Conversely, every other sector of the high yield market generated double-digit gains for the year, with the Insurance sector performing the best in 2019.

Additionally, bank loans experienced a bifurcation in performance similar to that of the high yield bond market. As one can see from Exhibit 2 below, Split B/CCC rated loans underperformed the aggregate loan market by more than 700 basis points. Overall, leveraged loans faced several headwinds during the year, with falling U.S. Treasury yields being chief among them. The decline in Treasury yields prompted investors to rethink their exposure to variable rate fixed income products, such as leveraged loans. As a result, leveraged loan mutual funds experienced outflows throughout 2019, applying downward pressure on pricing. Furthermore, Collateralized loan obligation ("CLO") origination declined year-over-year, reducing one of the loan market's strongest tailwinds of the last several years. Regardless, a solid rebound to start the year following the sell-off at the end of 2018 coupled with a limited supply of new issues helped leveraged loans in the aggregate produce respectable gains in 2019.

**EXHIBIT 2**
Leveraged Loans: 2019 Full Year Returns by Rating

*J.P. Morgan, J.P. Morgan Leveraged Loan Index ("LLI"). One cannot invest directly in the index.* ***Past performance is no guarantee of future results.***




Most sectors of the loan market produced high single-digit total returns for the year. Housing was the top performing sector and was one of four sectors in the loan market that produced double-digit gains in 2019. Conversely, the Metals & Mining sector was the biggest laggard and produced a negative return during the year.

As we say goodbye to 2019 and turn the page on the "20-teens", we find ourselves closer to the end of the economic cycle. We escaped the last ten years without a recession after living through two in the previous decade, including one of the worst recessions in history. Will 2020 be the year that the current expansion comes to an end? Or will it be another year where the "can" will be kicked further down the proverbial road? Only time will tell.

## 2020 OUTLOOK

Of course, predictions are difficult, especially ones that involve the U.S. economy, credit cycles, or even the performance of the high yield market itself. Be that as it may, I do not

expect a recession in the coming year and generally view 2020 as having the potential to produce another year of price appreciation for the high yield market. However, unlike 2019, any such appreciation in price will likely be driven by performance in the lower-tier of the high yield market given where spreads reside today.

**EXHIBIT 3**
Historic HYBI Option-Adjusted Spread ("OAS") in Basis Points 12/31/97 - 12/31/19

*ICE BofA U.S. High Yield Index ("HYBI"); based on daily option-adjusted spread. One cannot invest directly in the index.* ***Past performance is no guarantee of future results.***

| | HYBI | HYBI - BBs | HYBI - Bs | HYBI - CCCs |
|---|---|---|---|---|
| December 31, 2019 | 360 | 202 | 356 | 1,008 |
| *Percentile Ranks* | *17th* | *7th* | *17th* | *51st* |
| Low OAS for Full Period | 241 | 165 | 236 | 414 |
| Difference between December 2019 OAS and "Low" OAS | 119 | 37 | 120 | 594 |

From the table above, one can see that in the aggregate, the option-adjusted spread ("OAS") for the high yield bond market is tight by historical standards. This tightness is being driven by BB-rated bonds, which are very close to their low for the entire period. Consequently, spreads for BB-rated bonds appear to have tightened to the point that they now provide very little upside given the risk incurred. On the other hand, as of the turn of the year, CCC-rated bonds are offering an option-adjusted spread of approximately 1,000 basis points. Therefore, given the current spread on CCC-rated bonds, even a stabilization in the prices of those bonds should help drive a healthy gain for the overall market in 2020. In any case, these two segments of the market are clearly pricing risks differently. BB-rated bonds are making it seem as though risks are at or near all-time lows while the spread of CCCs would lead one to believe that risks are much higher. So, which is it?

The truth is probably somewhere in the middle. If one digs a little deeper into the lower-tier of the market, one would see that most sectors in this segment produced double-digit returns last year. However, in 2019, the trade war weighed heavily on commodity prices, resulting in price weakness in the bonds issued by commodity-related businesses. Furthermore, the trade war placed pressure on supply chains, and caused some U.S. companies to relocate at least a portion of their supply chain away from China, causing disruption and uncertainty.

Meanwhile, credits in other sectors of the market were hurt by more idiosyncratic risks. For example, in June 2019, the unsecured bonds issued by Frontier Communications, one of the largest issuers in the high yield market, were downgraded from B-rated to CCC-rated. Frontier highlights some of the divergence in the high yield market as its B-rated secured bonds produced gains of over 20% while its downgraded CCC-rated unsecured credits generated a loss of around 3%. While Frontier's unsecured bonds staged a recovery in the fourth quarter of 2019, it appears that the company may still be headed for some type of balance sheet restructuring.

Regardless, in some cases, it seemed as though the market's punishment for underperforming credits was at times extreme. In my opinion, the risk-off mentality towards CCC-rated credits that began in May led to greater than expected price declines. This mentality was a leading contributor to the divergence in performance among higher-rated and lower-rated bonds in 2019.

However, over time, I anticipate that the relationship between the different ratings segments of the high yield market will normalize. Therefore, I expect that there will be some compression between BB/B-rated bonds and their CCC-rated counterparts, especially in the first half of 2020 as investors may selectively hunt for bargains in the lower-tier. To that point, we have already seen some recovery in the lower-tier, which returned over 5% in December 2019 and significantly outperformed its higher-rated peers during this time period.

## RISKS TO THE OUTLOOK

Broad risks affecting the market have not changed much over the past couple of years. The trade war with China remains top of mind for investors as a key risk to the global economy and market sentiment. Constant talk of a deal followed by no-deal injected volatility into the market, and, as we saw in 2019, can help fuel divergence among higher and lower-rated issuers within the leveraged credit market.

Having said that, with the announcement of a Phase 1 trade deal in mid-December, trade tensions between the U.S. and China seem to have simmered at least for the time being. As I have stated many times, I believe that it is in the best interest of both economies to come to an agreement, but until that agreement is reached, the news flow surrounding the ongoing unsettled situation will result in continued volatility. This volatility occurred in both 2018 and 2019, and will likely influence performance in 2020. Nonetheless, this most recent announcement is a positive development and should remove some degree of uncertainty from businesses and markets.

In addition, the likelihood of a monetary policy mishap is another ever-present risk, particularly this late in the cycle. Volatility injected into markets by the accelerating trade war resulted in the Fed taking a more accommodative stance throughout 2019. However, with the trade talks finally headed in the right direction, the Fed should proceed with caution as it attempts to balance promoting economic growth without overheating the economy. As we have seen before, monetary policy actions are a bit of a double-edged sword. Tighter monetary policy can bring economic expansion to a halt while more accommodative monetary policy can lead to market bubbles.

Furthermore, on top of these macro-economic risks, the extreme partisanship in Washington, DC has created greater political risks domestically. In 2019, political uncertainty in the U.S. peaked after rising steadily over the past several years. First, it was the findings of the Mueller report, which provided some resolution with respect to the Russian meddling in the 2016 U.S. presidential election. However, the report also set forth certain potential allegations of obstruction of justice against President Trump.

Subsequently, however, those allegations were largely forgotten because after claiming "complete and total exoneration" and "no collusion", President Trump jumped out of the Russian frying pan and right into the Ukrainian fire. As a result, calls for his impeachment increased and ultimately culminated in December with the U.S. House of Representatives voting to impeach a sitting president for just the third time in our nation's history.

I mention developments around impeachment because in my opinion these proceedings went hand-in-hand with the escalation in the trade war in 2019. As of this writing, the removal of President Trump from office via the impeachment process seems unlikely given the Republican-controlled Senate. Nevertheless, in my opinion, China took a harder line

for most of 2019 when negotiating trade terms under the belief that Trump's potential replacement may pursue a different agenda with respect to trade. Therefore, negotiating a deal with the present administration may have proven to be a waste of time.

However, the lack of bipartisan support for the President's removal likely played some role in the Chinese government's more recent willingness to negotiate the parameters of a deal. And in any event, with the upcoming presidential election on the horizon, China will assuredly assess who it believes will be sitting across the bargaining table going forward. China's recent willingness to negotiate with the present administration may indicate that what they thought would be a domestic political quagmire stalling trade discussions is rather simply a short-term distraction, or perhaps they are positioning themselves to deal with President Trump for another four-year term.

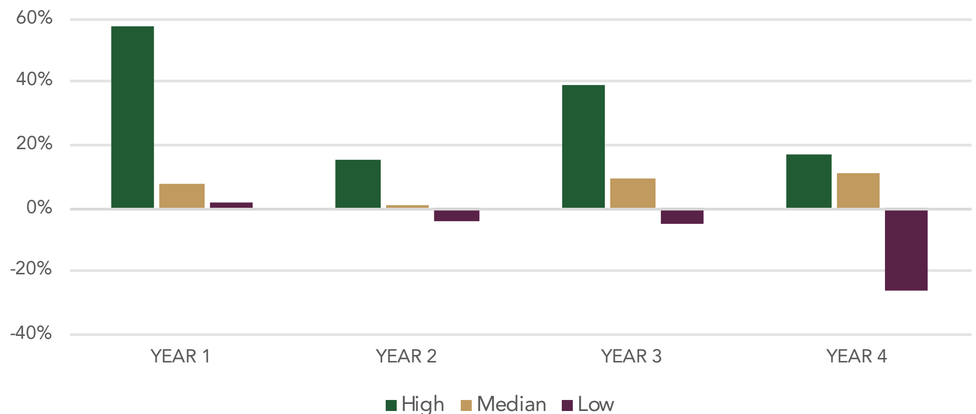
Whatever the case may be, if President Trump is reelected, the present administration will likely focus even more effort on trade. Winning a second term would provide the Trump administration with a more solid footing from which to negotiate trade agreements not only with China, but with other trading partners as well. Therefore, in my opinion, China will seek to conclude a trade deal sooner rather than later, particularly if they come to believe that President Trump is increasingly likely to be reelected.

## U.S. PRESIDENTIAL ELECTION YEARS AND HIGH YIELD MARKET PERFORMANCE

Given that 2020 is a presidential election year in the U.S., I thought that it would be worth reviewing the historic performance of the high yield market during those periods. Going back to 1987, the first full calendar year of returns for the ICE BofA U.S. High Yield Index, there have been eight such elections with each party winning four. Other than the 1992 election, when George H.W. Bush was defeated by Bill Clinton, the incumbent has won reelection each time.

**EXHIBIT 4**
High Yield Market (HYBI) Performance by Year of President's Term 1987-2019

*ICE BofA U.S. High Yield Index ("HYBI"). One cannot invest directly in the index.* ***Past performance is no guarantee of future results.***




During the covered period, Exhibit 4 above shows the high, median and low return for the high yield market as measured by the HYBI for each year of a president's term. Although not reflected in the chart, Years 1 and 3 of a president's term have provided the highest average returns. However, Years 1 and 3 also include the two best calendar years of performance in the high yield market's history. As a result, average returns for Years 1 and 3 are skewed positively. Conversely, the average return for Year 4 is skewed negatively by the performance of 2008.

With that skewness in mind, if we turn our attention to the median statistics presented in the chart, we can see that Year 4 of a president's term has historically offered the highest median return. This last point is interesting given that, unlike Years 1 and 3, Year 4 does not include a significant positive outlier, suggesting that Year 4 has been a more consistently positive year for performance.

While there are of course other factors, besides the timing of the U.S. presidential cycle, that affect high yield market performance in a given year, presidential elections typically create market uncertainty. As the year progresses, we will get more clarity as to who President Trump's opponent will be. As such, as it becomes more obvious what, if any, potential policy shifts may be in store over the next four years, market participants may begin to factor that expectation into their investment approach. In any event, I believe that the election cycle will contribute to market volatility in the coming year.

## SUMMARY

The high yield market's performance in 2019 will be a tough act to follow. Given the history of the high yield market, while another year of above-coupon performance is not out of the question, in all likelihood, gains will need to be driven by the lower-tier of the market. After all, option-adjusted spreads in the highest rated segment of the high yield market are close to the tightest that they have been all-time. Accordingly, the risk/reward associated with an investment in the highest rated segment of the market is unlikely to sufficiently compensate a discerning investor in today's environment. In particular, significant macroeconomic and domestic political risks persist. Furthermore, the burgeoning hostilities between the U.S. and Iran present an example of how quickly geopolitical risks can unexpectedly arise. These risks have the potential to create greater angst among investors, which could lead to a risk-off mentality and hamper high yield market performance. However, such an outcome is far from certain.

Nonetheless, even with these circumstances in mind, investors should be prompted to search for attractive risk/reward opportunities in higher yielding credits, especially in the context of the low yield environment globally. As a result, the lower-rated segment of the high yield market, which appears attractive on a relative basis to its higher-rated peers, has the potential to lead high yield market performance in 2020. However, heightened volatility in a presidential election year may result in potentially weaker performance, particularly during the second half of the year. The unexpected has already presented itself in 2020 and while geopolitical shocks can lead to a tipping point, especially late in the cycle, I still maintain confidence that a recession in the U.S. is unlikely to occur this year. Ultimately, I believe that the high yield market could produce another year of modest price appreciation.

## APPENDIX

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

***Collateralized Loan Obligation:*** A collateralized loan obligation (CLO) is a single security backed by a pool of debt.

***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.

***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.

***Leveraged Loan:*** A leveraged loan is a senior secured debt obligation rated below investment grade.

***Option-Adjusted Spread:*** The 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.

***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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