JULY 2019

CIO's Perspective: 2019 Half-Time Leveraged Credit Review and Outlook

- A shift in Fed policy and positive technicals led to the strongest first half performance for high yield bonds in ten years
- While I do not expect an inflection point to occur in 2019, tenuous economic growth, Fed policy risks and trade uncertainties will each contribute to continued market volatility

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1ST HALF 2019 REVIEW

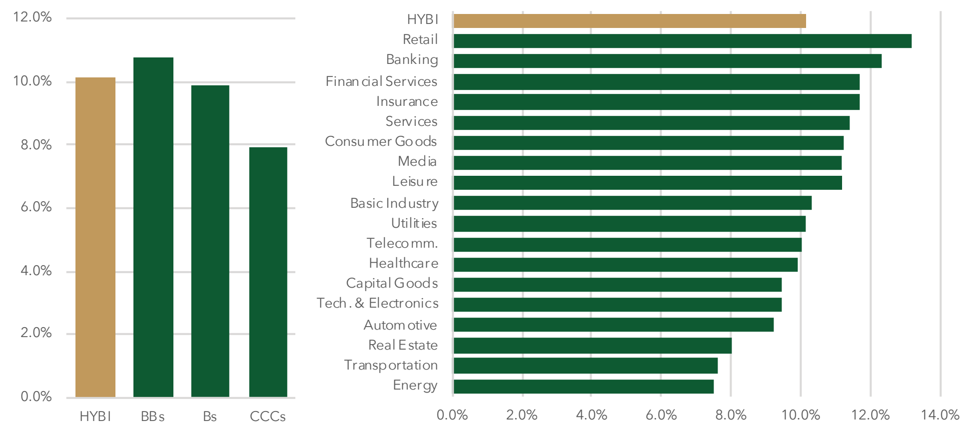
After experiencing the worst quarterly performance in over three years in the fourth quarter of 2018, the high yield market bounced back in 2019, particularly in the first quarter, generating the strongest first half performance since 2009. A major driver of this rebound in performance occurred at the beginning of the year when the U.S. Federal Reserve ("the Fed") signaled a more accommodative monetary policy stance going forward. The shift in monetary policy was solidified in March when the Fed, after increasing rates four times in 2018, cut its forecast for rate hikes in 2019 from two to zero. Interest rates declined across the board, broadly benefiting fixed income assets. This produced a positive swing in investor sentiment, which combined with a continued relatively strong U.S. economy, led to high yield bonds returning 10.16% during the period. [1]

Technicals also supported the high yield market in the first half of the year. Specifically, new issuance volume has been relatively anemic while inflows into high yield mutual funds were meaningfully positive after experiencing net outflows in both 2017 and 2018. The increase in buyers created favorable high yield bond supply/demand dynamics, supporting price appreciation in the secondary market.

Within the broader high yield market, BB-rated high yield bonds were the top performing quality bucket during the first half of 2019, while CCC-rated bonds underperformed though still managed to generate impressive returns on an absolute basis (Exhibit 1). The BB-rated segment typically has a longer duration than the B-rated and CCC-rated segments, and thus BB-rated bond performance benefited disproportionately from the decline in interest rates that occurred during the period. Performance by sector reveals that Retail (13.2%), Banking (12.4%), and Financial Services (11.7%) were the top performers in the first half of 2019. Conversely, Energy (7.5%), Transportation (7.6%), and Real Estate (8.0%) were the biggest laggards.

EXHIBIT 1
HYBI Rating and Sector Performance: 1/1/19 - 6/30/19

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



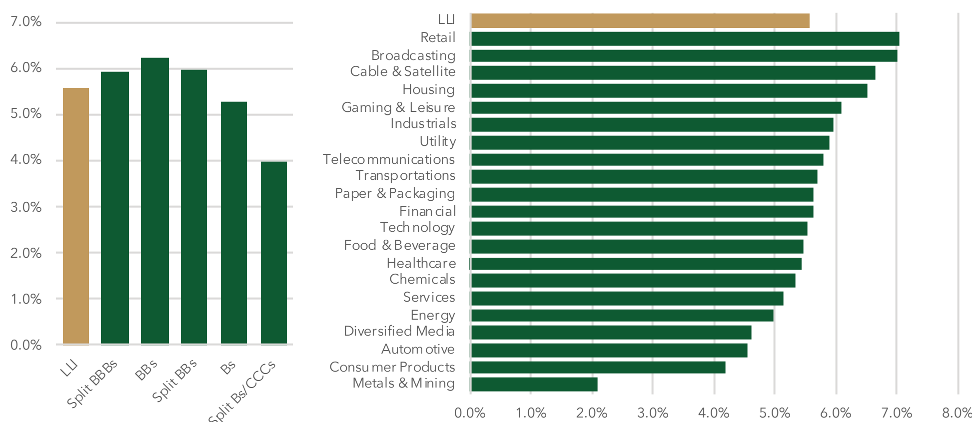
Leveraged loans also generated strong performance during the first half of 2019, though the asset class underperformed high yield bonds. Specifically, leveraged loans produced a gain of 5.58%.[2] The technical environment was not as favorable for leveraged loans as it was for high yield bonds, with loan mutual funds experiencing significant outflows during the period as declining interest rates and a more dovish Fed reduced the attractiveness of the floating rate coupon typical of most leveraged loans. Like high yield

[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*

bonds, lower-rated loans underperformed their higher-rated peers (Exhibit 2). From a sector perspective, the top-performing sectors were Retail (7.0%), Broadcasting (7.0%), and Cable & Satellite (6.6%), while the bottom-performing sectors were Metals & Mining (2.1%), Consumer Products (4.2%), and Automotive (4.5%).

EXHIBIT 2
LLI Rating and Sector Performance: 1/1/19-6/30/19

Source: JP Morgan; The JP Morgan Leveraged Loan Index ("LLI")



2ND HALF 2019 OUTLOOK

At the beginning of the year, I highlighted trade tensions and monetary policy mishaps as the greatest risks to the high yield market in 2019. When assessing risks for the balance of 2019, I believe that the risk associated with the Federal Reserve making a monetary policy mistake has diminished, but is not altogether eliminated, while trade tensions – primarily with China – remain at the forefront.

Seeing the forest through the tariffs

As I have noted previously, the importance of healthy trade relations between the world's two largest economies is vital for sustained global economic growth and positive market sentiment. Based on economics alone, China stands to lose more from a trade war than the U.S., given the relatively large amount of goods and services produced in China that are sold in the U.S. annually. This amount represents a disproportionately large portion of the Chinese economy, which should incentivize Chinese officials to reach an agreement on trade terms. Unfortunately, rational behavior and politics rarely mix – at least not in a timely fashion. While DDJ believes that the possibility of an all-out trade war with China is low, there has been an escalation in hostilities between the two parties more recently, resulting in increased volatility in the high yield market. Until a deal between the parties is reached, all markets, including the leveraged credit market, will be sensitive to news pertaining to such negotiations. DDJ continues to believe that trade negotiations between the U.S. and China will eventually end favorably, but it will take time, and brinkmanship on both sides will likely drag out the process. The longer it takes to resolve this situation, the greater the likely drag on global (including U.S.) growth.

Most of the media discussion around trade focuses on the tariffs imposed or threatened together with their associated impact on economic growth. To be sure, nationalism and protectionism are threats to global growth, and I view tariffs being imposed for any sustained period as a clear hindrance to long-term economic expansion. However, my belief is that the current administration has implemented tariffs as a negotiating tactic in an attempt to leverage the best possible new trade deals. I believe that such

deals ultimately will prove to be a net positive for the U.S. economy, but the magnitude is uncertain. Based on that view, it is very important to recognize that these trade agreements – whatever their final details may be – will result in significant structural changes to the global economy. In particular, many international companies will likely alter their supply chains as well as sourcing options because of such trade deals (and they almost certainly will make adjustments if no agreement is reached in the near-term). In the long-term, successful companies will adapt, but in the short-term, structural change creates potential risks and challenges that could negatively impact the fundamentals of issuers in the high yield market as well as create additional market instability.

Some companies are already taking steps in anticipation of such structural changes and the potential dislocation that may result. For example, a recent Reuters article stated that "Apple Inc. has asked its major supplier to assess the cost implications of moving 15% – 30% of their production capacity from China to Southeast Asia as it prepares for a restructuring of its supply chain."[3] I expect this type of behavior to become widespread whether or not trade deals – particularly with China – are finally reached. It is not difficult to imagine the disruption and uncertainty this could cause in the short-term. At DDJ, we do not think that we can add value by trying to forecast the macro implications of such changes. I believe we can, however, add value for our clients through our exhaustive, bottom-up fundamental research with respect to each individual investment opportunity. Part of the objective of such process is to fully understand a company's flow of goods and services from suppliers to end customers, including identifying any potential vulnerabilities in the issuers in which we invest as a result of trade deal uncertainty.

Private debt bubble?

Typically, inflection points in the high yield market result from external factors, such as excesses in the real estate market in 2007 or the dotcom bubble in 2000. When spreads are tight, as was the case before the global financial crisis in 2007, and to a lesser extent today, the high yield market is particularly vulnerable to negative external factors, given the lack of valuation support to weather such events. Currently, I am concerned about the significant growth of the private debt market in recent years. According to Preqin[4], as of June 2018, assets under management in the global private debt market was $769 billion, up from $465 billion as of June 2014.[5] And such amount most certainly has grown in the past year. In many cases, I believe that the investment managers for such assets have limited experience, with many having never navigated through a financial downturn. While the "private debt bubble" may not pose systematic risks, such as those posed by the failure of the big banks in 2007, I nonetheless believe that any material losses that occur in the private debt market could have negative spillover effects into the high yield market, especially given how tight spreads are currently. Such an outcome could accelerate the timing of an inflection point such that it arrives sooner than I am anticipating.

The Fed changes course

Investor concerns that the Fed was acting too aggressively in the face of slowing economic

[3] *https://www.reuters.com/article/us-apple-china-restructuring/apple-explores-moving-15-30-of-production-capacity-from-china-nikkei-idUSKCN1TK0XN*
[4] *Preqin is a leading provider of data for alternative asset classes including private debt.*
[5] *The 2019 Preqin Global Private Debt Report and the 2015 Preqin Global Private Debt Report*

data exacerbated the sell-off across risk markets that occurred in the fourth quarter of 2018. Given the volatility and negative sentiment that permeated throughout the markets at that time, I did not agree with the Fed's decision to raise rates in December 2018. In addition, in my view, the Fed's continued hawkish bias after the December rate hike, specifically forecasting two rate hikes in 2019, posed a real threat that could have derailed the historically long economic expansion. Fortunately, in the first week of January 2019, Fed Chairman Powell stated that the Fed would follow a more data-dependent approach to future monetary policy, abandoning the preset path of rate hikes that dictated monetary policy in 2018. The Fed further reversed course after its March policy meeting, announcing that due to slower economic growth projections, no rate hikes were expected in 2019, down from the two hikes that the Fed had forecast just three months prior. In addition, the Fed also stated it would scale back its balance sheet reduction program in the second quarter of 2019 and halt the program altogether in September. The Fed's balance sheet reduction program is another form of policy tightening. I am generally a proponent of a data-dependent approach to monetary policy as opposed to the implementation of a precise forecast of expected interest rate changes, as many factors that can impact economic growth, inflation, and employment levels are complex and can change rather quickly. The Fed can avoid credibility problems while also more effectively addressing any economic surprises that arise on a real-time basis by not boxing itself in with specific interest rate forecasts.

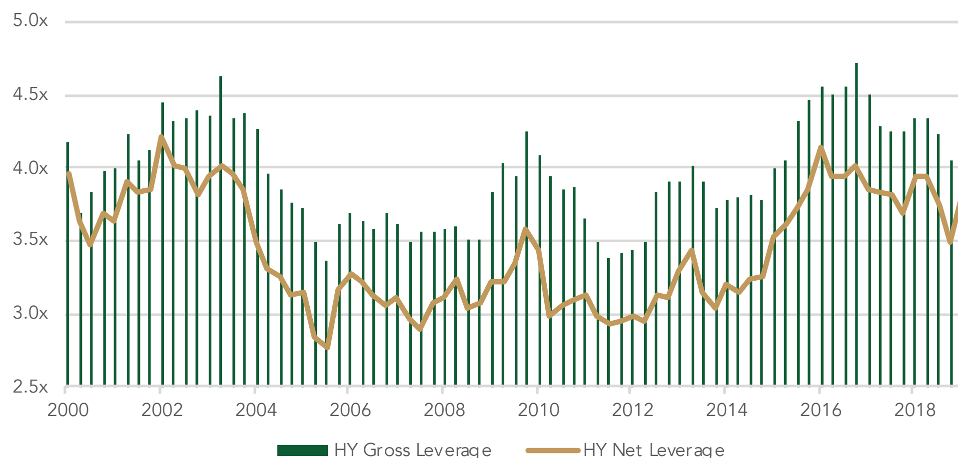
As of this writing, while the Fed has announced that it does not expect to change interest rates in 2019, the market does not appear to agree with this sentiment, as it is currently forecasting either one or two 25 basis point cuts this year – with the first occurring as early as July. Absent a significant negative economic event, I believe that it would be a mistake for the Fed to cut rates in the near term for a few reasons. The Fed's perceived independence from both political as well as market pressures is critical for it to maintain the credibility necessary to successfully manage monetary policy over the long-term. In addition, despite the recent hiking cycle, the Fed Funds rate is still currently at historically low levels, leaving the Fed with little ability to provide economic stimulus in the form of rate cuts should recessionary risks increase. I believe at this stage that the Fed should let the market sort itself out – the market can reset valuations if needed to reflect new economic expectations - and the Fed should resist any external pressure to act in response to market volatility. At the end of 2018, the risk posed by the Fed was from a too aggressive monetary policy; the opposite is now the case, and I am somewhat concerned that the Fed could make a mistake if it bows to market pressure and cuts rates in 2019.

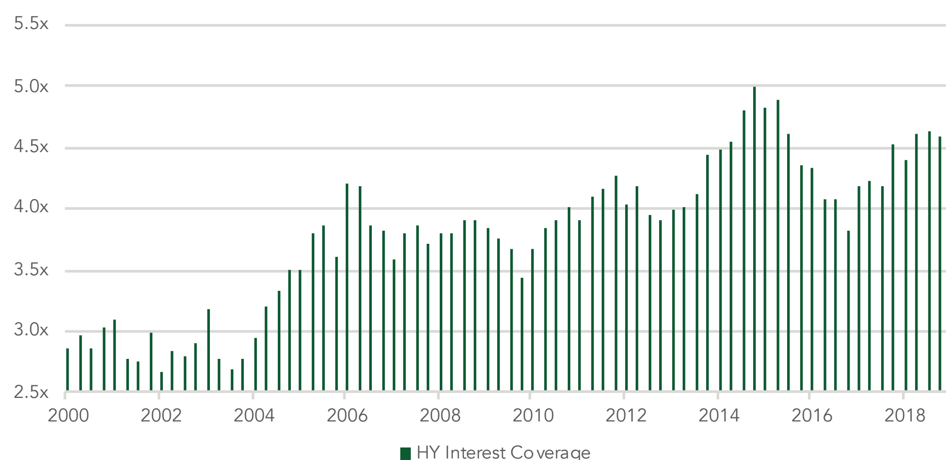
U.S. economy and high yield fundamentals in decent shape

Inflection points in the high yield market, as mentioned above, are generally driven by external factors that cause weakness in both the overall economy and individual high yield issuer fundamentals. I continue to expect positive – albeit moderating – economic growth in the U.S. into 2020. This is not an out-of-consensus view. The Fed, despite the significant change in monetary policy described above, currently expects U.S. GDP growth to be approximately 2.0% in 2019 and 2020. Slowing but positive economic growth should still benefit the fundamentals of many high yield issuers. In the aggregate, high yield issuer fundamentals remain relatively healthy, with leverage growth being contained by slower debt growth. In addition, interest coverage ratios generally remain elevated, providing high yield issuers a relatively healthy cushion with respect to their ability to make interest payments.

EXHIBIT 3
Fundamentals: High Yield Leverage *(top)* and Interest Coverage *(bottom)*

Source: Morgan Stanley Research, Bloomberg, Capital IQ, FTSE Fixed Income LLC





That being said, in 2018, the market appeared more focused on the fundamentals of individual issuers, as investors penalized issuers that underperformed and as a result the prices of their outstanding debt declined meaningfully. Although 2019 started off with a somewhat indiscriminate buying spree, I was pleased to see a focus on issuer fundamentals coming back into vogue in the second quarter, as the market once again punished poor performing companies, an outcome that I expect will continue moving forward. As a result, superior credit selection for asset managers will prove to be of paramount importance. In addition, while the equity market generally requires robust top and bottom-line growth to generate attractive returns, leveraged credit – primarily via the high coupon that the asset class offers – can generate attractive returns in an environment of stable to slightly improving fundamentals.

While on the subject of the economy, it is worthwhile to highlight another long-term positive macro factor I see unfolding, specifically, the pace of improving productivity in the U.S. Productivity has been improving since the invention of tools, but I expect the pace and direction to increase in magnitude as technology/artificial intelligence and other similar factors become larger inputs into overall economic output. For certain, in the shorter-term, such developments could also create uncertainty in the markets as well as disruptions for, or the outright elimination of, some companies; however, productivity advances will continue to benefit the broader economy in the long-term. One of the ways that the current trend of increased productivity favorably impacts the economy is through reducing inflation or inflationary pressures. With persistently low inflation a hallmark of this historically long economic expansion, could the increased pace of productivity similarly extend future economic expansions by containing inflationary pressures and the rising interest rates that typically accompany such pressures?

SUMMARY

The current economic recovery and credit cycle have been historically long; while I do not anticipate an inflection point occurring in 2019, we are certainly getting closer to its occurrence. I do, however, expect the market to experience bouts of volatility, as investors digest the latest data and accordingly reset expectations regarding global economic growth, the future path of Fed rate hikes, and developments on trade negotiations, amongst other factors. At this point in the cycle, with modest economic growth that is becoming more tenuous, it may not take much in the form of negative events to have an outsized detrimental impact on growth. Each of the primary risks that I am monitoring – the possibility of a trade war, monetary policy mistakes, and credit or liquidity issues in the private debt market – has the potential to end the current economic expansion if it unfolds in an undesirable and unexpected manner.

The same level of fragility applies to the leveraged credit market. Fundamentals in the aggregate remain relatively healthy, but vary significantly amongst issuers; moreover, given expectations for moderating growth, fundamentals will not benefit from continued robust economic growth like the U.S. economy has experienced in recent years, while tight valuations leave little room for disappointments. At the same time, the overall economy is changing. When trade deals are eventually reached between the U.S. and its significant trading partners, I believe that their impact will be far-reaching across the global economy for many years to come, presenting both new opportunities as well as new risks for discerning investors with a long-term investment horizon. At DDJ, we cannot control how these risks play out. However, we can be particularly vigilant in our issuer due diligence and remain intensely focused on monitoring the fundamental health of our existing portfolio holdings while likewise exploiting increased market volatility to opportunistically invest in solid credits with attractive risk-rewards 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.

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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Past performance is not guarantee of future returns.

Investing involves risk, including potential loss of principal.

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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