High Yield Strategies

Executive Summary

The high yield ("HY") market posted its third weakest quarter since 2008 led by fears of an economic slowdown, or worse, thanks in part to China, the Federal Reserve, ("Fed") and oil prices.

Winter is coming... or is it already done?

Concerns regarding the Fed, tariffs, and the economy finally boiled over into the credit markets during 4Q 2018 ("4Q"). After spreads touched post-Lehman lows in 3Q 2018, they nearly doubled from their low 300 basis points position. Energy credits and CCC-rated bonds led the downdraft as oil prices fell 40%. BB-rated credits were negative in 4Q but outperform the broad HY market as risk was off and US Treasuries were well bid. During 4Q, losses were broad-based, however, the Energy exploration & production segment and the Services sector significantly underperformed with double-digits negative returns whereas Utilities and Packaging sectors outperformed.

However, according to J.P. Morgan, despite higher leverage levels through their loan layer, publicly traded HY companies have reached post-Lehman highs in EBITDA margin and interest coverage are nearing post-Lehman lows for total leverage. Therefore, we believe declaring an end to the credit cycle is premature. In our opinion, 4Q returns might recoup in 2019 assuming the Fed maintains patience, a China trade deal is reached, and oil prices rebound within range-bound levels.

Capital Market Indicators

Leveraged finance markets buckled under significant withdrawals from both HY bond and loan funds as well as ETFs in 4Q. Almost half of the 2018 HY mutual fund bond outflows ($46b) occurred during 4Q, whereas $18b of quarterly outflows from loan mutual funds erased all of last year's inflows for the asset class. Despite these outflows, negative net supply for the combined bond and loan markets contributed to an overall balanced technical picture for 2018. New bond issuance in 4Q took a pause, which resulted in negative net issuance for both the quarter and the year; that is, the value of all calls, tenders, and maturities exceeded the amount of new bonds issued. For loans, significant paydowns and repricings resulted in a modest $29b of net new issuance for 4Q, whereas 2018's total of $201b of net new issuance was the highest annual total since before 2012. Whereas the overall quality of issuance in 2018 remained high, we have noted an increased percentage of proceeds being used for acquisitions. While not at a concerning level, this bears watching in our opinion.

Concurrently, the equity market continues to be an important source of capital. Although 4Q was relatively quiet for equity issuance, companies still priced $18b of primary and secondary stock. According to Bloomberg, primary and secondary equity issuance for the year totaled $140 billion which topped 2016 levels but fell short of 2017's mark. We believe capital markets remain open to higher quality sub-investment grade companies to grow their businesses responsibly, even if doing so by acquiring other companies with modest additional leverage.

Defensive

Our Defensive HY strategy underperformed its benchmark in 4Q, the ICE BofA Merrill Lynch BB-B Rated Non-Distressed Index, but did outperform the broad HY market as measured by the ICE BofA Merrill Lynch US HY Constrained Index. The strategy was negatively impacted by an overweight to single-B rated credits, which underperformed the typically less-riskier BB-rated bonds. Security selection within commodity-oriented industries such as, Energy, Metals/Mining, and Chemicals, was a detractor after being a contributor for the strategy in the first three quarters of 2018. Our underweight positioning, coupled with security selection, within Packaging and Technology sectors was a detractor in 4Q as well. However, this more than offset positive security selection within Healthcare, Transports, Food, and Food & Drug Retail sectors in the quarter. For accounts with a loan allocation, senior floating rate loans outperformed the bond sell-off given their potential for added security.

Opportunistic

During 4Q, our Opportunistic HY strategy performed in-line with the ICE BofA Merrill Lynch US HY Constrained Index as strong security selection within CCC-rated bonds offset the strategy's underweight position to BB-rated bonds. Our underweight positioning, coupled with security selection, within Packaging and Technology sectors was a detractor in 4Q as well. However, this more than offset positive security selection within Healthcare, Transports, Food, and Food & Drug Retail sectors in the quarter. For the quarter, poor security selection within the Metals & Mining sector was more than offset by solid security selection within the Energy sector. For accounts with a loan allocation, senior floating rate loans outperformed the bond sell-off given their potential for added security.

Ultra Short Duration

Our Ultra Short Duration Corporate Income strategy, which owns only paper maturing in three years or less, underperformed the ICE BofA Merrill Lynch 1-3 Year US Corp/Government Index in 4Q. However, the strategy did outperform both the BB-rated and BB/B-rated versions of the ICE BofA Merrill Lynch 1-3 Year US Cash Pay HY Index. Our strategy of mainly BB-rated sub-investment grade holdings, which include corporate bonds and loans, underperformed short-term US Treasuries amid a strong risk-off sentiment in 4Q. The strategy benefitted from its exposure within Industrials, Packaging, and Automotive, whereas Technology and Chemicals were weaker. Single-B rated bonds underperformed both BB and BBB-rated bonds within the strategy. For accounts with a loan allocation, short-maturity floating rate loans underperformed short duration bonds given interest rate fears and large asset class outflows.

Defensive Short Duration

In 4Q, our Defensive Short Duration High Income strategy, which maintains an average maturity of three years or less, underperformed both the BB-rated and BB/B-rated versions of the ICE BofA Merrill Lynch 1-3 Year US Cash Pay High Yield Index. Security selection within Metals & Mining and Aerospace/Defense was a detractor, as was an underweight position to Packaging and Building/Building Materials sectors. Strong security selection was a contributor within Healthcare, Food, Transports, and Technology. Single-B rated bonds underperformed both BB and BBB-rated bonds within the strategy. For accounts with a loan allocation, short-maturity floating rate loans underperformed short duration bonds given interest rate fears and large asset class outflows.

Defensive Floating Rate Income

The Defensive Floating Rate Income strategy outperformed its broader loan index in 4Q, the Credit Suisse Institutional Leveraged Loan Index, as well as the S&P/LSTA BB-Rated Loan Index. The strategy benefitted from an underweight position in large liquid loans while our HY bond allocation performed in-line. Our best performing position was a European cable operator that successfully turned around its operations and sold assets to reduce debt. The largest detractor was an investment in an oilfield service company that declined with oil prices. Despite a quality balance sheet and management team, we exited the position given the near-term outlook for continued oil price volatility and the accompanied uncertainty weighing on the business.

Despite a poor quarter (December 2018 marked the second worst monthly return in 10 years ending 12/31/18 for the S&P/LSTA Leveraged Loan Index), loans were one of the few asset classes globally to generate a positive return for the full 2018 calendar year. The combination of Chinese trade tensions, hawkish Fed messaging, and a sharp decline in oil prices caused a record wave of fund redemptions and a sharp price correction. Thin year end liquidity exacerbated the selloff, causing the average loan dollar price to drop by 5 points during 4Q.

Overall, we remain constructive on the loan market in 2019. Notwithstanding valid red flags like slowing global GDP and uncertain China talks, we believe a patient Fed will restore US "goldilocks" financial conditions. Companies face minimal debt maturities, borrower interest coverage remains near peak levels, and 2019 defaults are expected to remain below 2%. Higher borrowing costs and tighter terms are keeping new issue supply in check. Healthy collateralized loan obligations (CLO) formation and post selloff inflows both provide a bid for risk. This backdrop enables investors to clip an attractive yield while the 4Q smoke clears while benefitting from any future pull to par.

Market Outlook

Despite the 4Q sell-off, we remain relatively optimistic on the US economy and corporate creditworthiness. The US high yield and loan last-twelve-month bond default rate is currently below 2% at quarter-end as we continue to forecast a relatively low default rate for 2019. Generally, we expect fundamentals for HY companies, most of which are US-centric non-global-traders, to remain relatively healthy, and we expect commodity-industry defaults to remain below historical HY averages. If anything, Q4 could help usher in the return of a "goldilocks" economy, with modest growth and inflation which would be a positive attribute for the credit environment.

Although 2018 ended in the red for the broad HY market, this marked only the 7th negative return occurrence for HY bonds on a calendar year basis in its history. In fact, the HY bond market has never posted two consecutive negative calendar year returns. History suggests 2019 may be a positive year for the asset class based on how certain geopolitical concerns are addressed, the direction of the Fed, and whether oil prices have bottomed. We continue to favor the loan asset class as a bond complement, particularly after the 4Q sell-off. Although the outlook for short-term interest rate hikes is somewhat diminished, higher quality loans trading just below par are attractive for secured debt, in our opinion.

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The ICE BofA Merrill Lynch 1-3 Year US Corporate & Government Index is a subset of the ICE BofA Merrill Lynch US Corporate Master Index tracking the performance of US dollar denominated investment grade rated corporate debt publicly issued in the US domestic market. This subset includes all securities with a remaining term to final maturity of less than three years. An investor cannot directly invest in an index. The ICE BofA ML US HY Cash Pay BB-B Rated 1-3 Year Index is a subset of The ICE Bank of America Merrill Lynch US Cash Pay High Yield Index, which tracks the performance of non-investment-grade corporate bonds with a remaining term to final maturity less than three years and rated BB-B. An investor cannot directly invest in an index. The ICE BofA Merrill Lynch US High Yield Constrained Index contains all securities in The ICE BofA Merrill Lynch US High Yield Index but caps issuer exposure at 2%. An investor cannot directly invest in an index. The ICE BofA Merrill Lynch BB-B Rated Non-Distressed Index is a subset of The ICE BofA Merrill Lynch US High Yield Index including all securities rated BB1 through B3, inclusive, with an option-adjusted spread less than 1,000 basis points. The Credit Suisse Institutional Leveraged Loan Index is a sub-index of the Credit Suisse Leveraged Loan Index. The Credit Suisse Leveraged Loan Index is designed to mirror the investable universe of the $US-denominated leveraged loan market. The Credit Suisse Institutional Leveraged Loan Index is designed to more closely reflect the investment criteria of institutional investors by sampling a lower volatility component of the market. An investor cannot directly invest in an index.

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