High Yield Strategy

Supply/Demand Outlook for 2019

Bank of America Merrill Lynch

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Add risk here to reduce earlier underweight; skip CCCs

Another week of outsized moves across the risk spectrum has left the DM USD HY index 23bps wider at a 3-mo peak of 368bps. This move in HY spreads was 0.9x stdev event compared to a 1.5x move in equities. In rates, the 10yr Trsy yields declined by 8bps over the past week, touching on 3.10% earlier on Thrs and effectively reversing all of their MTD increase to 3.25%. This combination of spread and yield moves has translated into a total return of -0.55% and an excess return of -0.84%. In qualities, BBs outperformed CCCs by 25bps and 20bps in total and excess returns.

All sectors widened this week, with largest spread increases in energy (WFT, EPENEG, CHK), materials (FCX, ARGID) and healthcare (HCA, VRXCN). On the other end, food producers (PF), gaming (JACFIN), and transportation (TK) widened less than others.

For the month of October the HY index netted a 1.3% negative returns on both total and excess scales, leaving its YTD numbers at +1.2% and +2.1% respectively. EM HY outperformed DM USD HY by 40bps in ERs this week; we view EM BBs as fair value from this point on, while maintaining a modest overweight in EM single-Bs.

Earnings season progressed with about a third of all issuers reporting to this point. Results are generally coming in modestly ahead of expectations (0.8% beat in sales, 4.8% beat in EPS) and reaffirming strong growth rates (8.1% in sales, 23% in EPS). Apparently this was not good enough for the market, and we think the key to recent repricing in risk was rooted in caution voiced by management teams in describing earnings outlooks and the negative impact from trade tensions.

This was the first full quarter when global economy operated under the weight of new trade barriers and so companies had their first chance to describe their impact publicly. A subdued outlook from Caterpillar, for example, provided a good case in point as the company voiced concerns around rising input costs. Largest multinational corporations are sending a message to the US administration trade is becoming a meaningful headwind. On Weds, the S&P500 has closed 100pts away from wiping out *all of the benefits* from tax reform. This brings us close to the end of opportunistic trade policies.

In technicals, the past week has been light in coupons ($100mn), while next week brings a heavy intake ($3.4bn). Calls and maturities came in at $1.7bn this week, and we are expecting this pace to pick up through the next few weeks. In issuance, we had $2.7bn priced this week, bringing MTD volume to $8.4bn. This leaves October to become one of the slowest months over the past year, contrary to what historically has been a seasonally active primary period. Looking out to November, we estimate $20bn in potential issuance for month bringing us a step closer to our full-year estimate of $205bn. If achieved, 2018 will register a 25% drop in issuance relative to 2017 and a 20% drop relative to the 10-year average volume.

Refreshing our thoughts on the market here, the HY index is now 18bps wide to our target of 350bps, the first time we are seeing it at these levels since early July and prior to that since late May. We recommended raising cash in early October, and view this pullback as a good opportunity to step in and add risk here. This is not a call to go overweight risk yet, but to reduce an earlier underweight. We continue to recommend moderately underweighting CCCs in favor of equal reallocation of risk to BBs and Bs.

Refer to important disclosures on page 7 to 8.

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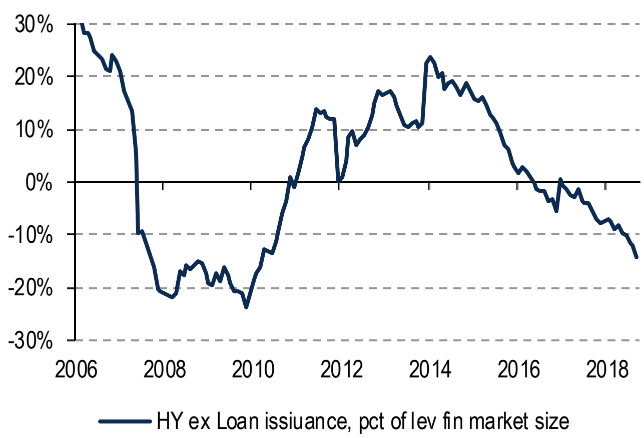
The slowdown in HY issuance is one of the key surprises of this year. The perfect hindsight makes it look like inevitability – with factors like rising rates, trade wars, and tax reform all contributing to this outcome. However this outcome was way out of consensus going into the year, and it caught us by surprise too.

So what can we learn from this experience going forward? Most importantly, we think the market remains generally open, i.e. most issuers who want to borrow can borrow on reasonable terms; there is just lack of appetite on both sides. This is not yet the case of demand drying up to an extent where financial conditions would become restrictive, although lack of appetite on the part of investors naturally leads to some degree of capital rationing, however modest at this stage.

What causes the lack of appetite on both sides? Investors appear to be most concerned about rising rates, and capital has flown towards floating rate instruments, including syndicated loans and private debt. Figure 1 shows how issuance has shifted away from bonds and towards loans, a process that was underway for a number of years, but the balance turned meaningfully negative only over the past twelve months. We accounted for at least $22bn in new money loan issuance in 2018 where borrowers are part of the HY index, a potential 10% to HY volume that never materialized.

On the issuer side, rising rates had a side effect in the form of absence of refinanceable paper, as shown in Figure 2. Here we plot the proportion of the HY index with coupons below current yields by 2% or greater. This is an arbitrary threshold that just happened to have a stronger statistical relationship to subsequent issuance. The actual choice of a threshold is not critical, as any of them – 1%, 1.5%, 2.5%, etc – are all going to produce highly correlated series, even if absolute levels would differ.

Figure 1: HY ex loan issuance, trailing 12mo pct of combined market



Source: BofA Merrill Lynch Global Research

Figure 2: Proportion of HY index with coupons < current yield by 2%+

Source: BofA Merrill Lynch Global Research

Away from rates, issuers are also facing uncertainty around potential paths to resolution of trade wars and tax reform. The former is more likely a temporary factor and yet it is significant enough at the moment to warrant caution. Anyone making projections for capex or an acquisition has all reasons to wait a few months to figure out the new rules of the game for years to come. The longer this uncertainty lasts the more projects will be put on hold, undermining the prospects of economic growth in coming quarters. We think we are getting closer to the end of this tunnel; however it will take some time for the uncertainty to clear away.

The normalization of global interest rates that has transpired over the past two years is another key element of this transformation, in our opinion. Figure 3 shows the income generated by Global Agg index has reached its extreme 30-year lows in 2016, when measured as a percent of global GDP. It has since recovered to a significant extent, and while still low by pre-2012 standards, it has just returned back to its range established since early 1990ies for the first time in six years. This is an important development as it demonstrates that the extreme yield deprivation is now behind us.

Figure 4 goes on to show how within the context of Global Agg, the global HY market has become an extreme outlier contributor of income around the same time in mid-2016. Since then, the picture has normalized mostly through normalization of yields elsewhere, complemented by spreads tightening in HY. At this juncture, the HY contribution to Global Agg has returned to historically established range, although it still has some room for normalization. The key takeaway here is that the extreme pressure to reach for yield in the HY space is now behind us; investors have returned, to a significant degree, back to their normal higher-quality habitats for income generation.

Figure 3: Global Agg income as a pct of global GDP

Source: BofA Merrill Lynch Global Research

Figure 4: Global HY income as a pct of Global Agg income

Source: BofA Merrill Lynch Global Research

To summarize, we see four factors driving HY issuance lower, including the tax reform and global yield normalization, both of which are here to stay, the trade war uncertainty (more likely to be a temporary dynamic), and the rising rate risk (probably peaking right around here, although the market will need some time to get comfortable with this view). Between these four, we think HY issuance will remain subdued for a number of months, although there is a decent chance that it could pick up steam later in 2019 as the latter pair eventually fades in memory.

Our model for HY issuance has been signaling slowdown in expected volumes since Q2 of this year, and it continues to do so going into 2019. As a reminder, the model uses the following factors to estimate next-12mo issuance: (1) normalized trailing-10-years average issuance volume pct of market; (2) distress ratio as a pct of par; (3) HY liquidity premium from the previous exercise; (4) proportion of HY ex loan issuance (Figure 1); and (5) proportion of refinanceable bonds (Figure 2). The model explains 85% of historical variation[1] in HY issuance over the past 14 years (Figure 5).

At this point in time, the model bottoms out at around $200bn annualized issuance pace over the next 12 months, although it shows a potential for a subsequent uptick later next year. Given that realized issuance has come in slightly below our model estimates over the past six months, we are making a qualitative adjustment and pencil down our formal forecast at $185bn to account for potential factors outside of our model scope.

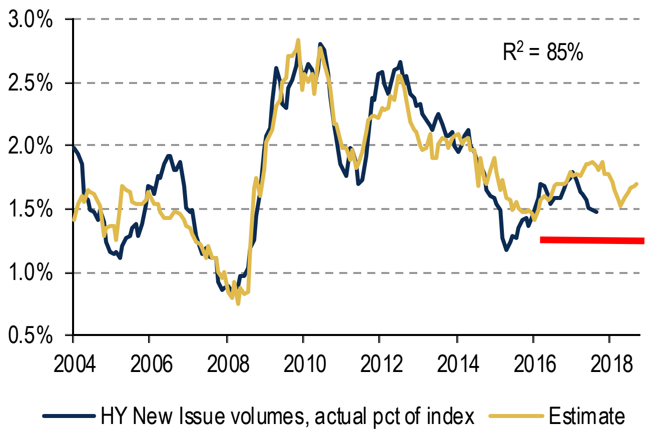
Year 2018 is currently on pace towards $205bn full year issuance total (-25% vs FY 2017, if materialized), so our 2019 forecast could be another 10% off of this year's pace. At $185bn, the HY issuance would be the slowest since 2009, and 20% below its average over the past 10 years.

[1] Actual values for pct issuance pace stop in Sept 2017 to allow for next-12-momths calculation.

Figure 6 goes on to show monthly estimates based on the $185bn annual run rate and applying standard seasonal weights as averaged over the past 15 years. November brings the last seasonally-heavy month of the year, and we look for $20bn priced during this period. Things should naturally slow down into the holidays, and are expected to stay slow in Jan-Feb, before seasonal tailwind should return in March-May.

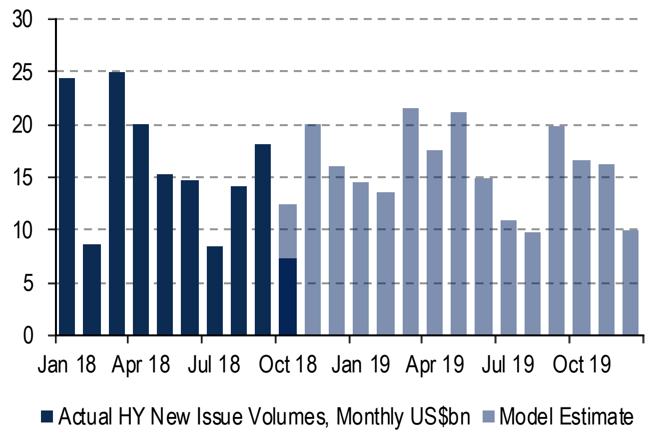
Next, we turn to the demand side of the equation, where calls, tenders, and maturities, i.e. all forms of redemptions, were fully offsetting gross issuance over the past six months. Year-to-date, gross issuance of $157bn is running roughly $20bn ahead of redemptions, mostly as a function relatively strong calendar in Jan-Apr, so well behind us at this point.

Figure 5: HY issuance, actual vs estimated as a pct of index, next-12mo



Source: BofA Merrill Lynch Global Research

Figure 6: HY issuance, actual and estimated US$bn, monthly



Source: BofA Merrill Lynch Global Research

Note that we only include redemptions in calculating net issuance, and exclude coupons and fund flows by design. Coupons are excluded due to temporary nature of cash availability (accumulated income is paid out to fund end-holders periodically; reinvested coupons are then captured as new inflows).

To understand the rationale behind this point one can look at longer-term market flows: over the past 10 years, HY gross issuance totaled $2,438bn, while HY calls, tenders, maturities and both retail institutional flows have totaled $2,427bn, resulting in a near-perfect balance. In the meantime, coupons would have added another $1,032bn to the demand side, throwing the whole picture out of balance. Instead, the proper way to think about them is as a source of temporary cash, which gets repaid to ultimate investors, and then gets partially reinvested back into HY and recaptured as an inflow.

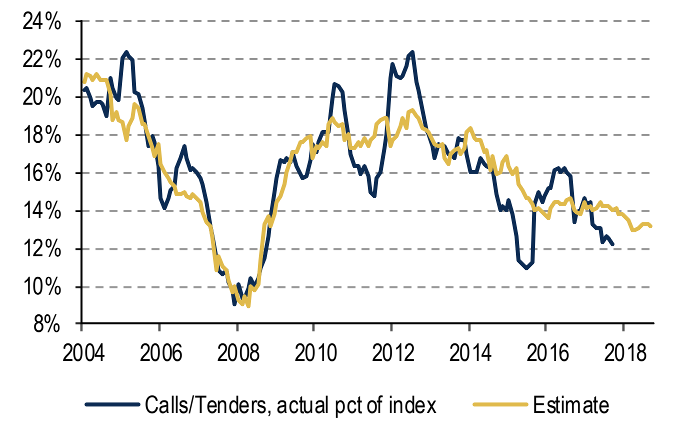
When thinking about the next-12months supply/demand picture we also exclude fund flows due to their dependency on prevailing market conditions: inflows will likely follow strong returns, while poor performance will probably trigger continued outflows. Because of this element of uncertainty, we do not find inclusion of flows in net issuance estimates useful.

Calls/tenders, on the other hand, are subject to the same factors that impact expected issuance, and stronger issuance leads to stronger optional redemptions. So our issuance model has a module to apply a similar set of factors to expected calls/tenders, producing an estimate of $165bn for the next year as show in Figure 7.

Maturities do not require forecasting as they are known in advance; 2019 brings $35bn of such mandatory redemptions. Combined, calls, tenders and maturities stand to create $200bn in demand for the developed market USD HY product next year, exceeding our gross issuance forecast by 8.1%.

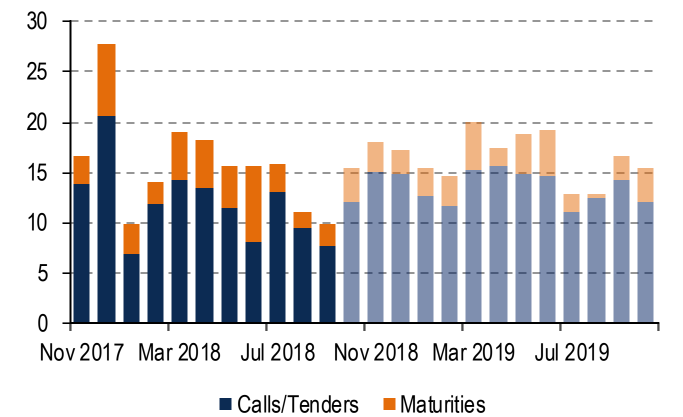
November is expected to bring close to $18.1bn in all forms of redemptions, historically one of the strongest seasonal periods of the year (Figure 8).

Figure 7: Calls/tenders, actual vs estimated as a pct of index, next-12mo



Source: BofA Merrill Lynch Global Research

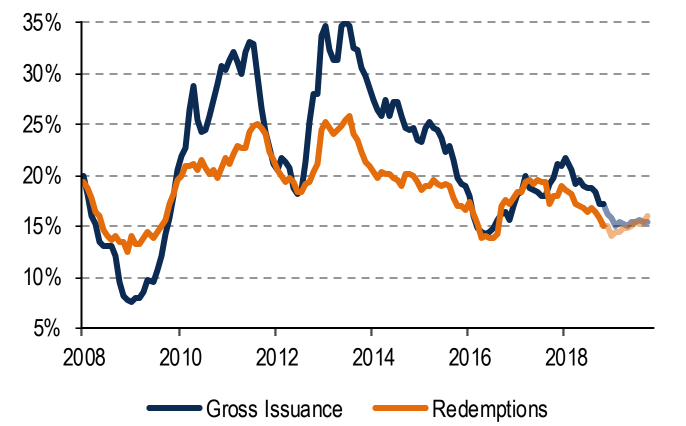
Figure 8: Calls/tenders/maturities, actual vs estimated, US$bn monthly



Source: BofA Merrill Lynch Global Research

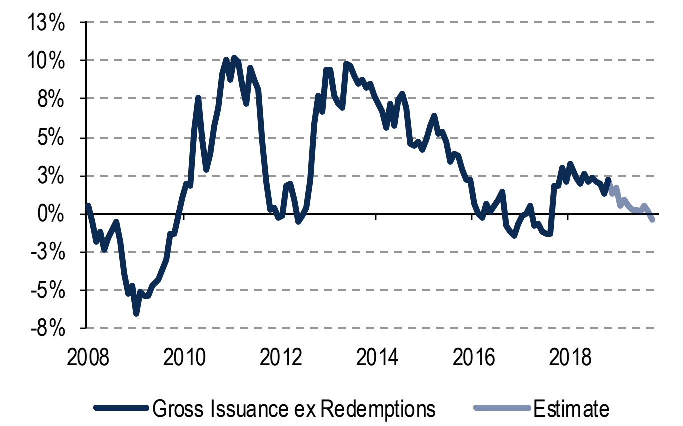
Figure 9 brings both components of supply and demand together by showing gross issuance and all forms of redemptions (calls, tenders, maturities) on one chart. Importantly, while issuance exceeded redemptions in late 2017 and 2018, this will no longer be the case in 2019.

Figure 9: Supply and demand, actual vs estimated pct of index, L12mo



Source: BofA Merrill Lynch Global Research

Figure 10: Net supply, actual vs estimated as a pct of index, L12mo



Source: BofA Merrill Lynch Global Research

The last time redemptions exceeded issuance, briefly, was in early 2017. Prior to that, one will have to go back to 2012 and 2009 to find such instances. In other words, such a positive technical backdrop does not happen very often in our market, and we need to take this datapoint into account while sketching out our thoughts on valuations and performance next year. Technicals are likely to remain a supportive factor in the next few months; potentially even more so than what was the case since the early summer this year.

Figure 10 brings the whole picture together, by showing the net supply graph, expressed as 12-month total divided by market size.

While we think the factors driving HY issuance lower in recent months could persist for some time, we also believe that our $185bn forecast is unlikely to be broken on the downside, as it already represents an 8% discount to an estimate produced by our issuance model. In addition, certain factors that are driving the model estimate lower – such as availability of refinanceable bonds and loans-for-bonds refies have already reached their practical floors in case of the former (Figure 2), or approaching such levels in the latter instance (Figure 1). Finally, we note that our 2019 model issuance estimate bottoms out at its lowest levels since 2016 and prior to that since 2009 (Figure 3). The red horizontal line on that chart represents our qualitative adjustment in issuance estimate from $200bn to $185bn.

We note that a lower bottom on this scale would require more than just a softer demand driven issuance slowdown. A scenario where the developed market HY issuance comes in materially below $185bn next year would require a more negative set of circumstances to drive a significant deterioration in financial conditions than our base-case scenario envisions. We would be less surprised to see some upside risks to the gross issuance forecast once trade war risks are removed from the picture, and issuers return to the market with a greater degree of confidence behind their capex, expansion, and investment plans.

Separately, we are forecasting a $410bn volume in broadly syndicated leveraged loan issuance next year, which would represent a similar 10% drop from this year's annualized pace of$450bn.

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