Asset Management

2019 HIGH YIELD MARKET OUTLOOK

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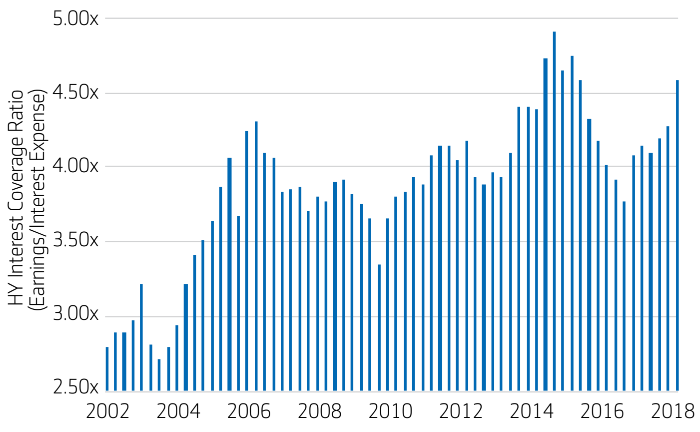
Market outlook

The US high yield market spent much of 2018 trading lower as it dealt with the macro headwinds of higher rates, volatile equity and currencies markets, and uncertainties around late-cycle credit market conditions. This was despite strong US GDP growth and solid high yield issuer fundamentals (low defaults, strong earnings, etc.) See Exhibit 1. Through the first three quarters, the high yield market absorbed some of the move in underlying interest rates as spreads tightened by 25 basis points. However, as future global growth expectations were lowered in the fourth quarter, weakness in commodities and broader credit markets overwhelmed the supportive high yield technical conditions, and spreads pushed wider by over 100 basis points. This caused the market to give up the positive coupon income earned, resulting in full-year (through November) total returns of basically zero (0.06%). While disappointing, relative to other fixed income assets (Treasuries, investment grade, and emerging markets bonds), high yield still managed to be a modest outperformer.

Looking ahead to 2019

We anticipate the high yield market will continue to grapple with many of the same concerns that have plagued the market in 2018. Headwinds to markets in 2019 may include further trade escalation, further quantitative tightening by central banks, uncertainties around Brexit and Italian politics, slowing Chinese growth, weak energy prices, tight labor markets in developed economies, etc.

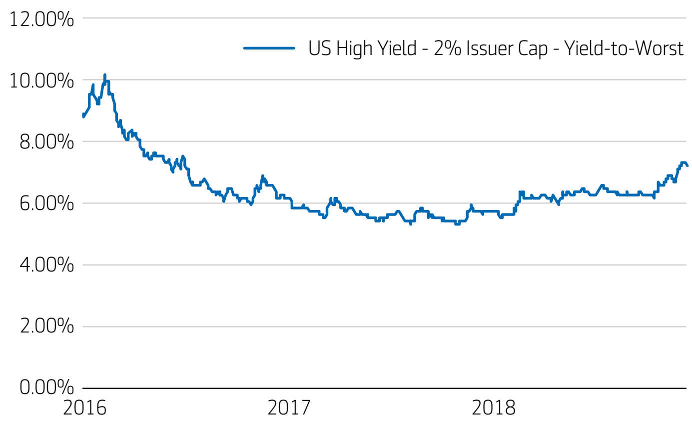
Exhibit 1: High Yield Interest Coverage



Source: Morgan Stanley, Bloomberg, Capital IQ, Citigroup Index LLC. Data as of June 30, 2018.

However, offsetting these risks, the high yield market appears to be starting from a relatively strong position. Fundamentals remain healthy as most issuers' earnings have been strong and most high yield companies have not aggressively added leverage to their balance sheets. Interest coverage ratios are solid with balance sheets termed out in relatively low coupon debt. This combination should result in another year of below-average defaults. Additionally, the technical environment remains solid as there has been a very limited supply of new issue. Despite the elevated leverage of many BBB issuers, we believe fallen angel risk from investment grade remains contained in 2019.

Exhibit 2: Historical YTW Ratio



Source: Barclays Live. Data as of November 28, 2018.

Our base case

Finally, valuations are at reasonable levels given the current interest rate and default environment, with yields higher than they have been since mid-2016 and spreads outside of 400 basis points (Exhibit 2). Given our view that the high yield market is starting from a reasonable level, we believe the market is better positioned to deal with the negative headwinds than it was in 2018. Therefore, we expect returns will be modestly better, with our base case pointing to 4-6% returns in 2019. That being said, given the magnitude of macro uncertainties, we can envision scenarios where returns deviate materially and anticipate volatility to remain high.

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