2018 HIGH YIELD OUTLOOK

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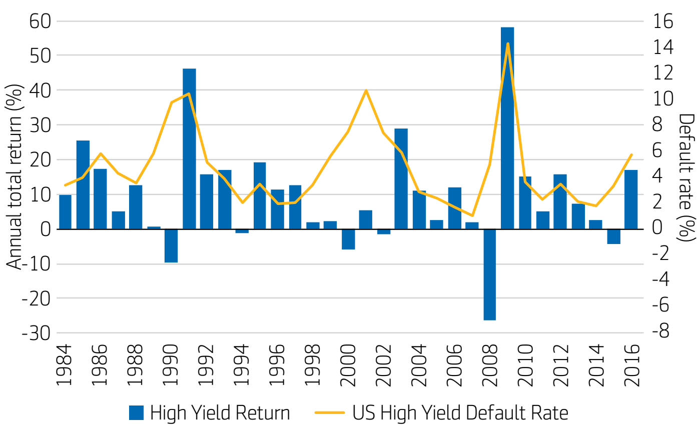
Market Outlook

The US high yield market finished 2017 on a slightly softer note than it began, with second half returns lower than the first half. Still, the asset class's performance was solid, overall, as the Bloomberg Barclays US Corporate High Yield Bond Index returned over 7% in 2018. The market benefitted from a complementary macro backdrop—improving global growth, low unemployment and low, stable inflation. In the major tax policy overhaul, markets found reason for optimism. More specific to the high yield market, the backdrop of low defaults, solid earnings growth and stable interest rates have led to spread compression across ratings categories.

As we look out to 2018, we anticipate many of the same factors that benefitted the market in 2017 to remain supportive. We anticipate continued solid global GDP growth across regions, with a relatively high probability of the US getting an additional bump from corporate tax cuts. We envision unemployment can likely remain at very low levels and believe secular trends in most developed economies will keep inflation contained. All of this leads to a healthy macro backdrop for the US high yield market, which combined with modest earnings growth, should lead to another year of low default rates.

Given our constructive view of the asset class fundamentals, we are forecasting high yield's 2018 returns in the 4-6% range. The biggest constraining factor will likely come from tighter monetary policy. A series of Federal Reserve rate hikes could pressure interest rates higher across the curve. And while rising rates can negatively affect total returns, default rates are, historically, more important. As Exhibit 1 shows high yield total returns have only been negative in years of spiking defaults (i.e., recessions or industry corrections). The one exception was 1994, when the Fed surprised the market with 250 basis points of rate hikes.

Exhibit 1: Bloomberg Barclays US Corporate High Yield Index Annual Total Return



Source: Barclays Live, Moody's, as of 2016

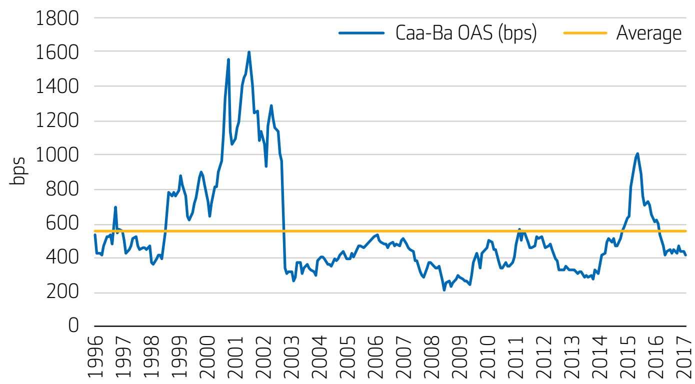
Positioning

To the extent interest rates move materially higher in 2018, we believe the higher-quality segments, most notably Ba bonds, which have the lowest spreads and longest durations, will be most negatively affected. Hence, we prefer B and select Caa credits to Ba-rated paper.

Similar to 2017, we anticipate returns to be driven by idiosyncratic credit risks. While spreads tightened meaningfully in all ratings categories last year, we believe lower quality spreads are ripe for security selection, as Caa paper offers reasonable relative value to Ba bonds in a low default environment.

Exhibit 2 illustrates the differential between Caa and Ba spreads, which is currently near its long-term average.

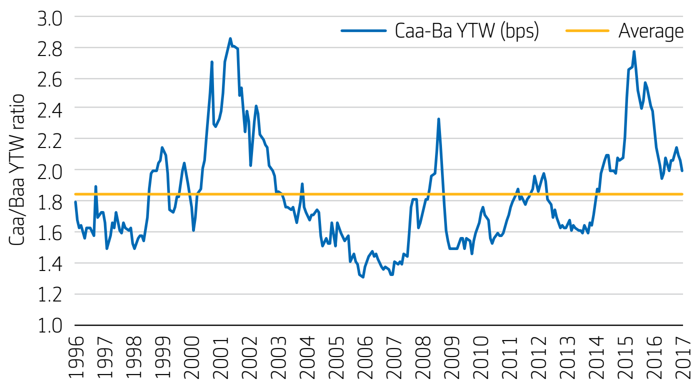
Exhibit 2: Caa-Ba OAS Differential



Source: Barclays Live, as of November 2017

In a low yield environment, the additional yield pick-up for Caa bonds over Ba bonds is even more notable, as Exhibit 3 shows.

Exhibit 3: Caa/Ba YTW Ratio



Source: Barclays Live, as of November 2017

While many of these opportunities are limited to a few specific industries, we believe valuations within these sectors are more attractive than they have been in recent years. Hence, while we are not outright bullish across entire sectors, we do believe there are specific names and securities that are attractive, notably in telecom, retail, healthcare/pharma, and energy.

Overall, we remain constructive on the fundamentals of the high yield market and believe this will lead to historically low, but positive returns (4-6%) in a rising rate environment. We continue to look for idiosyncratic opportunities where we believe the market has pushed bond prices down to attractive levels. We believe some of these oversold situations can have a meaningfully positive impact to total returns in 2018 and offset some of the negative influence from rising rates.