GLOBAL HIGH YIELD NEWSLETTER

Volatility with a Vengeance

Fourth Quarter 2018

SHENKMAN

Fourth Quarter Review

The key phrase to describe the fourth quarter in the capital markets was "downside volatility." Negative price movements were experienced globally and across multiple assets from equities to U.S. Treasuries to commodities. While valuations were down broadly, there were definite differences in performance by geography and currency during this volatile period.

The sell-off appeared to be triggered by a strongly–worded, hawkish statement from U.S. Federal Reserve Chairman Powell that was made on October 3 and caused the 10-year U.S. Treasury to move 12bps in one day, trading through the one year forward contract at the time. The implication of higher funding costs and a uni-directional Fed, coupled with concerns about slower global growth in 2019 and geopolitical issues, led to significant revaluations of equity and debt instruments.

Within the leveraged bond markets, the revaluation at the beginning of the quarter appeared driven by interest rate concerns as longer-duration bonds weakened more than shorter-dated issues. However, by mid-quarter the concerns seemed to be dominated by credit differentiation, as CCC-rated issues began to significantly underperform and BB issues outperformed. The downward pressure on leveraged loans during the fourth quarter seemed a bit more technical in nature as retail outflows were high and CLO formation was minimal. Unlike the bond market, the weakness in loans was fairly even across rating categories, a typical sign of a more technical market decline.

With interest rate concerns much less of an issue in Europe and the U.K. than in the U.S., the European currency high yield bond markets outperformed during the quarter. The European market also benefitted from having much less exposure to the energy sector, which suffered as oil prices declined dramatically during the quarter (the peak to trough move in WTI crude prices during the quarter was ~$33, or 44%).

Early 2019 and Beyond

Despite declines in many soft economic data points, constant Brexit drama, a lack of resolution in situations like trade, the U.S. government shutdown and the Italian budget, the markets rebounded dramatically in early 2019 with oil prices, bonds, loans and stocks all rallying. Hopes of a U.S. China trade deal, or at least a detente, as well as very reassuring minutes from the last Federal Reserve FOMC meeting were among the factors that seemed to give the markets confidence. We believe the Fed minutes in particular reassured markets of a pragmatic and more restrained approach to interest rate hikes in the U.S. and lowered the risks of interest rate moves crushing economic growth.

Our expectation in 2019 is for continued economic and corporate earnings growth in the developed countries, albeit at a slower pace than in 2018. Even if a trade deal materializes, it appears that China's growth will be materially slower in 2019, which should impact specific companies and industries more than others. Interest rate moves should be much more modest in 2019; however, geopolitical uncertainty is unlikely to be diminished as European leadership prepares to go through a change and U.S. 2020 elections will loom over the market. More specifically for the sub-investment grade markets, volatility may be heightened periodically by the potential for supply shocks to come in the form of investment grade debt downgrades, although with the sub-investment grade market having declined in size and no abatement in the demand for income from investors, there may well be demand to easily absorb new "fallen angels" in the high yield bond and loan markets.

In our view, all these factors should combine to result in a fairly positive year for leveraged debt asset classes, although performance is likely to be spiked with bouts of volatility especially around geopolitical issues and with a greater dispersion in the performance by industry and credit quality tiers in the market.

Positioning and Performance

Our global composite entered the fourth quarter with an overweight to Euro-denominated debt and underweights in U.S. dollar and Sterling issues. We maintained these biases throughout the period, in part due to our view on interest rates. We were overweighed single B-rated issues, but increased our double B rating exposure during the quarter by about 200bps. The currency positioning aided our relative performance as Euro currency issues had less downside volatility during the quarter.

The weighting references are relative to the ICE BofAML Developed Markets High Yield Constrained Index (HYDC).

While our underweighting in double B-rated issues led to relative underperformance, the increase in this category during the quarter helped relative performance, as did our underweight in triple C-rated issues. By industry the worst performing industry was oil and gas, which we were materially underweighted. Utilities and banks outperformed, although we were underweighted both of those industries relative to typical benchmarks. We also had about a 4% weighting in loans that outperformed the leveraged bond market despite the technical pressures on that asset class.

Exhibit 1: Global Asset Class Performance

Q4 2018

Developed Markets High Yield (HYDC)*	-4.27%
U.S. High Yield (H0A0)	-4.67%
European Currency High Yield (HP00)	-3.55%

*USD Hedged.
Source: ICE Data Indices.

Conclusion

With greater dispersion and heightened market reactions to geopolitical issues in 2019, we believe that having more flexibility in fixed income mandates can be very additive to performance. It is likely that performance in different geographies will see greater dispersion in 2019, and being able to rotate geographically and by currency should allow for a greater opportunity set for upside and an ability to minimize the impact of periods of drawdowns.

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