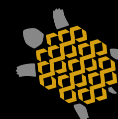
GLOBAL HIGH YIELD NEWSLETTER

Changing Markets - Strong Returns

Second Quarter 2019

SHENKMAN



Summary Returns

The global leveraged finance markets produced a solid quarterly return during the second quarter of 2019, but did so with more drama than the full quarterly numbers may reveal. The returns came with a high level of volatility, as the market experienced some downside too, and just as happened in early 2018, several subsets of the market are not following historical patterns.

The ICE BofAML Developed Markets High Yield Constrained Index (HYDC) produced a return of 2.58% for the quarter. This was achieved despite a negative return in May of (1.25%). During that month, all the same concerns that seemed to hit the capital markets from last October through December resurfaced. These included slowing global growth, trade wars and rising interest rates. However, this time the concerns dissipated more quickly than in 2018 and the market reactions, both down and up, were not as extreme. Even with the first negative return month of 2019, year-to-date returns of the HYDC Index have been outsized and returned 9.69% through June. As a reminder, this return started with an exceptionally strong January after a fourth quarter of 2018 that had a negative return of (4.44%).

The Constant Change in Leveraged Debt

One has to recognize that the global leveraged debt markets are in constant transition and cannot be expected to react the same in every cycle, especially if the components of the market and the drivers of performance have changed significantly from the past. Some of the patterns experienced in 2018 and year-to-date through June 2019 are very different than what has been seen in recent cycles. For example, thus far in 2019, returns have been substantially higher than average and also well above coupon only returns. This type of return resembles a "risk-on" environment usually characterized by riskier assets outperforming, such as CCC credits. However, during the first half of the year, CCCs underperformed and BBs outperformed. The inverse happened in the first quarter of 2018 when the market underperformed with the HYDC Index returning a negative (0.81%). In the past, this would be an environment in which returns would lead one to believe it was a "risk-off" environment, but in that period CCCs outperformed and BBs lagged.

There are several reasons that have likely caused the market to exhibit different performance from historical norms in these cycles. The CCC sector of the market has declined as a portion of the overall bond market, making it easier for a few large issues to have a more meaningful impact on the returns of the overall ratings tier. It appears that in the last year credit specific idiosyncratic events have had a more dramatic impact on the CCC-rated tier of the market. Another factor has probably been the shift in the Fed to a more activist mode. After such a long time with almost no Fed actions on rates (for example, in 2017 the Fed made eight major moves), this has increased the market's sensitivity to rising and falling rates. In 2018, the U.S. and major European government bond markets saw a rise in rates for most of the year and a decline this year. This sudden change in expectations may have caused performance by duration tier to be more meaningful than in the past. In 2018, the shortest segments of the market outperformed; while year-to-date through June 2019, the longer duration tiers of the market outperformed by far and BBs, on average, have longer duration than the market.

Another factor that we suspect has caused CCCs to underperform in 2019's bull market has been an increase in risk aversion. This has likely been driven by some combination of the following factors: i) the dramatic losses that occurred in CCCs in 4Q 2018; ii) the dramatic return that the non-CCC sectors of the market produced in the first quarter of 2019, coupled with a desire to "lock in" returns; and iii) a waning of risk appetite, as the cycle extends further and geopolitics gets more heated.

New issuance in leveraged finance has also gone through some meaningful transitions in the last 18 months. In the rising rate environment for much of 2018, flows were positive into leveraged loans and new issuance in 2018 for leveraged loans globally was $703.7 billion, while bond issuance was only $187.4 billion. With the shift in the direction of rates in 2019, leveraged loan new issuance and bond new issuance have been more in line with each other. However, differences in the markets have actually been increasing, as LBOs as a percentage of the loan market have increased. In fact, some estimates show that more than half of the leveraged loan market is related to LBOs, while in the bond market only slightly more than 10% of outstanding debt is estimated to be related to LBOs.

Returns by Currency

During the second quarter, Euro & U.S. dollar currency denominated high yield bonds performed in-line with each other, while Sterling based issues slightly outperformed. However, there were differences in performance in the two markets by industry. Although, the Cable Television sector was a strong performer in both markets, Telecommunications was a stand-out in the Euro market and the Gaming sector outperformed in U.S. dollars. There were also differences in the underperforming segments of the market, as Food and Drug Retailers underperformed in Euros, while Oil & Gas did so in U.S. dollars. These differences highlight that even in a period of similar returns in various markets, there can be meaningful differences by region.

Exhibit 1: HYDC Performance by Currency*

	1Q 2019	2Q 2019	YTD 2019
CAD	4.83%	2.41%	7.36%
EUR	5.37%	2.50%	8.00%
GBP	4.48%	2.92%	7.53%
USD	7.42%	2.58%	10.19%
TOTAL	6.94%	2.58%	9.69%

*As of June 30, 2019. In local currency.
Source: ICE Data Indices.

Exhibit 2: HYDC Performance by Rating*

	1Q 2019	2Q 2019	YTD 2019
BB	6.67%	3.09%	9.97%
B	7.08%	2.33%	9.58%
CCC	7.35%	0.65%	8.04%
CC	19.27%	3.94%	23.97%
C	4.88%	1.62%	6.57%
D	-13.24%	6.00%	-8.03%
Total	6.94%	2.58%	9.69%

*As of June 30, 2019. In local currency.
Source: ICE Data Indices.

Focusing on the exchange rate for the two currencies with the most debt outstanding, the EUR:USD rate started the quarter at 1.1213 in the spot market and ended at 1.1373, near the quarterly high. However, the 3-month forward points price declined during the quarter from about 86.52 to 81.56, slightly improving the relative attractiveness to buy USD.

Closing Comments

During the quarter, our global accounts kept a slight bias toward the U.S. dollar denominated debt relative to the HYDC Index. Similar to the broad market indices, our portfolio's overall duration declined due to the market rally. We did actively increase some of our weightings in our mid-duration buckets at the expense of some shorter duration buckets within the portfolio since the beginning of the year.

Global growth, geopolitical issues and potential pressure from a possibly weaker upcoming earnings season continue to be an overhang on the markets. However, the major developed economies do not appear to be facing recessionary risks. Additionally, capital for corporations seems broadly available from both traditional and non-traditional sources.

The global debt markets, and particularly the leveraged debt markets, are constantly changing. This decade, investors seeking income have faced more negative yielding debt than ever before, and in the last few quarters the amount has been on the rise. This appears to have lent technical support to the global leveraged credit markets and to have expanded the buyer base.

Non-stressed leveraged debt market spreads have moved tighter year-to-date, but generally not back to levels of September 2018. So while there is less margin for error than in January, virtually no tier is back to its recent historical tight spreads. Overall, these factors lead us to believe that tighter spreads and weak earnings may add to volatility and may create some interesting entry points, but global leveraged finance markets appear to be sound and present unique opportunities in various regions.

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