GLOBAL HIGH YIELD NEWSLETTER

SHENKMAN

Credit Markets Power through a Number of Third Quarter Events

Third Quarter 2019

Summary Returns

In the midst of a string of significant events during the third quarter, the global leveraged finance markets posted a positive return. The ICE BofAML Developed Markets High Yield Constrained Index (HYDC) produced a return of 1.28% for the quarter. While positive, this return is below the average quarterly coupon rate. The year-to-date return of the HYDC Index was 11.09% and it was heavily driven by strong first quarter returns.

Many of the performance characteristics that have been in place for much of the year remained in place during the third quarter. Double B-rated bonds outperformed the market and CCCs materially underperformed. Longer duration bonds continued to outperform short duration, as they have done for most of the year. While performance during the quarter was reasonably healthy, there were significant events during the most recent quarter that may begin to shift market performance more dramatically.

Perhaps, Changes are Afoot

Through shifts in interest rates and global trade negotiations, the equity and credit markets in most developed countries have posted strong returns throughout the year. This rally has not dragged along risk assets. Generally, CCC-rated securities have significantly underperformed this year and the ICE BofAML U.S. Distressed High Yield Index (H0DI) had a -5.7% return year-to-date and was -11.25% in the quarter, as volatility appeared to increase (which can be seen in higher levels of the VIX Index), and riskier assets were out of favor.

The list of significant events that occurred around the globe in the last quarter is somewhat astounding. These events may increase investor uncertainty, as we head into the final quarter of the decade. The list of the last quarter's events include:

- The first and second interest rate cut in years by the U.S. Federal Reserve;
- A new head of the ECB was selected, with Christine Lagarde taking over in January;
- A new British Prime Minister was elected with a strong Brexit agenda;
- A collapse of the Italian government;
- Impeachment inquiry for the President of the U.S. began;
- One of the most significant drone attacks ever disrupted Saudi Arabian oil production;
- Continued weakness in the U.S. and German manufacturing and export data;
- A decline in U.S. corporate business investment according to GDP, but a continued healthy consumer spending trend; and
- The first quarter this year in which value stocks outperformed growth stocks in the Russell 2000 and S&P 500.

Coupling the list of these recent developments with three quarters of strong general returns and weak performance in stressed credits, it could lead some investors to become even more risk-averse at year-end. It could also lead to even greater dispersion in performance between credits viewed as higher quality and those considered higher risk.

Some heightened risk aversion can be seen in the high yield bond and loan new issue markets. While third quarter volume was generally up from a year ago, higher-rated issues were generally well-received by the market, while numerous lower-rated and potentially riskier issues struggled as they came to the market toward the end of the quarter. In some cases, despite changes to terms, some deals were still pulled from the market.

Returns by Currency

The quarterly returns were fairly similar in both the U.S. dollar and European denominated currencies. There were, however, some significantly different trends in the two markets. Notably, in August while the U.S. dollar denominated market (H0A0) posted a slightly positive return, the ICE BofAML European Currency High Yield Index (HP00) was slightly negative as bad economic news, particularly out of Germany, weighed on cyclicals.

Exhibit 1 illustrates the differences in both markets and performance by ratings and duration. While CCCs materially lagged in the U.S., with their second worst quarterly performance since the end of 2015, they outperformed in the European Currency High Yield Index (HP00). This was heavily driven by the performance of Altice in the European CCC Index. The CCC segment of the market in Europe is significantly smaller at only about 5.5% of the market than in the U.S., which is about 11% CCCs. Therefore, a single name in the European CCCs can have bigger impact on the sector. European CCCs were also helped by having much smaller exposure to Oil and Gas credits than the U.S. market. On the flip side, with two rate cuts in the U.S., the longer duration segment of the market dramatically outperformed in the U.S. dollar market, while duration impacts were not nearly as strong in the HP00 Index.

Exhibit 1

ICE BofAML Developed Markets High Yield Constrained Index (HYDC)

Performance by Currency (LOC)	Q1 2019	Q2 2019	Q3 2019
Canadian Dollar	4.83%	2.41%	1.74%
Euro	5.37%	2.50%	1.45%
British Pound	4.48%	2.92%	1.61%
U.S. Dollar	7.42%	2.58%	1.22%
Total	6.94%	2.58%	1.28%

As of September 30, 2019.
Source: ICE Data Indices.

Q3 2019 Performance by Rating (LOC)	ICE BofAML U.S. High Yield Index (H0A0)	ICE BofAML European Currency High Yield Index (HP00)
BB	2.06%	1.54%
B	1.22%	0.62%
CCC & Below	-2.27%	2.30%
Total	1.22%	1.36%

As of September 30, 2019.
Source: ICE Data Indices.

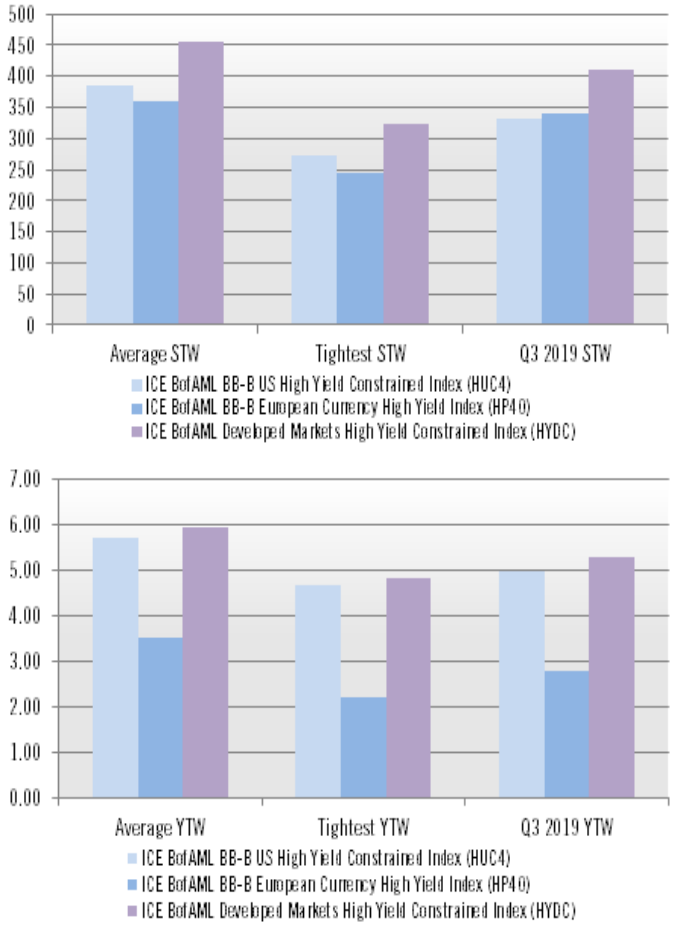
Relative Value

Despite the rally year-to-date in the global credit markets, the markets still appear to represent relatively fair value when compared to the recent five year market averages and considering how much negative yielding paper exists in the world.

As one can see in the graphs in Exhibit 2, which utilize the BB-B Index, we believed it was worth taking out the most extreme parts of the market when looking at relative values, in order not to overstate yields and spreads. On a spread basis, the European market looks to represent particularly reasonable value versus historical averages. When looking at the relative value of the HP00 Index, one should also consider that it is higher quality based on ratings and has lower Energy exposure than the global market, and it has experienced improved industry diversification over the last decade.

Exhibit 2 shows the five year average versus the quarter end yield and spread-to-worst, as well as the recent richest extremes during the period.

Exhibit 2



October 1, 2014 through September 30, 2019.
Source: ICE Data Indices.

Closing Comments

During the quarter, we increased exposure to Euro denominated debt relative to the HYDC Index in our global accounts. Just like all the broad market indices, the portfolio's overall duration declined due to the market rally. However, we did actively increase some of our weightings in mid and long duration buckets at the expense of some shorter duration buckets relative to the Index and also increased our BB positions.

Unfolding events during the fourth quarter may increase investor uncertainty and risk aversion. Additionally, after strong returns year-to-date, investors may be even more driven toward holding higher quality investments to protect against losses. The better quality tiers of the leveraged debt markets should benefit in this environment, especially in a world of ultra-low interest rates.

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