GLOBAL HIGH YIELD NEWSLETTER

2019 Year of the Rally; 2020 Expectations

SHENKMAN

Fourth Quarter 2019

Summary

The global leveraged debt markets had a healthy return for the quarter, with particular strength in December during which riskier assets in the U.S. dollar denominated market outperformed for the first time since January 2019. Full year 2019 results were some of the best in history with more highly rated securities and longer duration issues outperforming. Virtually all capital market asset classes produced extremely strong 2019 returns, in part due to a rebound from the dismal returns in the fourth quarter of 2018.

Given an improved framework for global trade and the potential for increased fiscal spending, we expect a modest acceleration of global growth rates in developed countries. While we believe the major central banks will continue to maintain an accommodative stance, there will likely still be a degree of upward pressure on rates by year end if our growth outlook is correct.

While this macro scenario is one that is fairly positive for credit, spreads are generally tighter than recent averages, just as valuations in investment grade and equities are high. However, below investment grade credit spreads are still above their recent tights and several sectors are meaningfully cheaper. Given this backdrop, credit missteps are likely to be severely punished by the market and brief periods of volatility, such as those that may be triggered by U.S. political events, may present interesting entry points and opportunities in portfolio realignments.

Quarterly Results

For much of the year, the U.S. dollar denominated issues drove the performance for the global high yield bond market (see Exhibit 1). In the U.S. dollar market BB rated issues outperformed and CCCs dramatically lagged, while in European bond markets, the much smaller CCC portion of the market generally outperformed throughout the year. The fourth quarter saw a reversal of this trend when U.S. dollar market CCC rated issues outperformed the broader market in the U.S. Interestingly, this past quarter was the first of 2019 in which performance characteristics of the U.S. and European denominated bond markets were aligned.

EXHIBIT 1

ICE BofA Developed Markets High Yield Constrained Index (HYDC)

Performance by Currency	Q1 19	Q2 19	Q3 19	Q4 19	FY 19
Canadian Dollar	4.83%	2.41%	1.74%	1.07%	10.39%
Euro	5.37%	2.50%	1.45%	1.78%	11.51%
British Pound	4.48%	2.92%	1.61%	3.23%	12.79%
U.S. Dollar	7.42%	2.58%	1.22%	2.61%	14.45%
Total	6.94%	2.58%	1.28%	2.46%	13.83%

As of December 31, 2019. Source: ICE Data Indices.

Within the U.S. dollar market, CCC bond performance was boosted by oil & gas issues, which rose in connection with increased oil prices, and by healthcare credits, which rebounded in part due to the likelihood of less disruptive regulation than expected, and some apparent progress on the issue of opioid settlements. In European currency denominated issues, CCCs produced healthy performance, helped by the debt of telecommunications and shipping industry issuers.

Longer duration tiers of the developed market bond markets outperformed the shorter duration segments in the quarter and throughout the year. This was primarily driven by U.S. credits as rates declined through the year and the U.S. central bank cut rates, and the ECB had a change of leadership but remained dovish and fairly benign.

Despite limited action from the ECB and BOJ, the year saw a decline in the quantity of outstanding negative interest rate bonds. Rates moved less negative in both Japan and Europe during the fourth quarter.

Leveraged loans had a strong quarter yet lagged the bond markets. Convertible bonds and emerging market corporate indexes also had a strong quarter and outperformed the developed country bond debt for the last quarter of the year (See Exhibit 2).

EXHIBIT 2

2019 Index Performance	Q4 19	2019
ICE BofA Developed Markets High Yield Constrained Index (HYDC)	2.46%	13.83%
ICE BofA US High Yield Index (H0A0)	2.61%	14.41%
ICE BofA European Currency High Yield Index (HP00)	2.12%	11.53%
S&P/LSTA B- & Above Leveraged Loan Index	1.82%	9.11%
Thomson Reuters US All-Cap Focus Index (Convertibles)	6.74%	19.30%
ICE BofA High Yield Emerging Markets Corporate Plus Index (EMHB)	4.15%	13.49%

As of December 31, 2019. Source: ICE Data Indices.

The strong returns in the fourth quarter led to a healthy amount of new issuance coming to the market. The global high yield bond market was particularly strong with $78.4 billion priced in the quarter (source: JP Morgan Research, Bloomberg, Lipper FMI). New issuance in the bond market has been of a high credit quality, with the majority of new issues in 2019 carrying a BB rating from at least one rating agency.

Economic View

Economic growth has been firm in the U.S. for the last year. Europe has also produced solid results, but lower levels of trade have weighed more heavily on European economic growth than in the U.S.; this was particularly notable in Germany.

We do not expect trade issues to vanish from the global economic landscape simply because the phase one trade deal between the U.S. and China is now in place. However, we see this as a positive framework for China and the U.S. to engage in discussions, which may result in a further improvement in the trade environment and limit future tariff wars. In addition, the completion of other transactions such as the USMCA trade deal should help to reduce a degree of U.S. corporate uncertainty and in turn may lead to an increase in business investment, which was a notably lackluster area in the U.S. in 2019.

Along with the hope of increased business investment there is also some expectation that we may see an increase in fiscal policy spending. New leadership at the ECB is heavily favoring fiscal stimulus in speeches and policy statements. Japan approved a major stimulus package in December and we assume that if successful, it will beget imitators. In the U.S. there has been increased defense budgeting and it would not be unexpected to see an increase in local and state fiscal spending in an election year.

Weighing the potential for increased business and fiscal spending, we believe that 2020 could see a slightly faster rate of economic growth in developed countries than in 2019, even as China and India continue to see deceleration. Accommodative interest rate environments will also likely help.

View on Rates & Currencies

Central banks in developed markets, as well as in China, have continued to take an accommodative stance to help support economic growth. We do not foresee this changing in 2020. However, if our outlook for a higher pace of growth occurs and the recent spike in commodity prices holds, we would expect increased market speculation about re-inflation.

We believe this could lead to a bias toward higher rates by year end as private market participants push the curves steeper, in anticipation of some re-emergence of inflation in due course. Thus, while we think it likely to see rates have an upside bias, any movement is likely to be limited given the apparent reluctance of central banks to move rates upward for now.

We are also starting to see increasing talk about the ineffectiveness of negative interest rates, as is evidenced by the recent push in Sweden to unwind them. Globally, during the fourth quarter, the debt markets have experienced a meaningful decline in the amount of debt in the market that is offering negative rates. This push against negative rates may reduce interest rate differentials in some major currencies; which could make U.S. dollar assets more attractive on a hedged basis for some non-U.S. investors. We began to see a decline in interest rate differentials during 2019 (see Exhibit 3). Although policy makers may become unwilling to tolerate negative interest rates, we do not expect a jolt upwards; we are still likely to see a continuation of this period of ultra-low rates in developed economies.

EXHIBIT 3

	Yield Differential (bps)			
	3 Month		10 Year	
	US-Germany	US-Japan	US-Germany	US-Japan
January 15, 2019	304	260	251	271
January 15, 2020	216	168	199	178
Change	**-88**	**-92**	**-52**	**-93**

As of January 15, 2020. Source: Bloomberg.

Positioning

Our Global High Yield portfolios have been slightly overweight dollar assets for most of 2019, relative to broad global indexes, such as the ICE BofA High Yield Developed Market Index (HYDC). While our portfolios have less duration than most global indexes, we had a bias toward longer duration in Europe than in the U.S. during most of 2019. In the fourth quarter of 2019 and early 2020 we have looked to decrease some of this duration in Europe. We have also looked to increase our relative weighting in single B rated issues, especially in Europe where relative value appears more attractive for this tier of the market.

We have maintained an overweight in healthcare and cable television and underweights in finance and energy. We also may look to selectively add cyclical issues given our overall outlook.

During the quarter, we increased our position in out-of-benchmark positions by holding a higher portion of BBB credits and adding to our bank loan holdings which also increased. Our BBB position increased as a consequence of rating agency upgrades of some of our holdings from sub-investment grade to investment grade. Bank loans have been added based on relative value as many issues lagged the bond market performance. This disconnect created attractive relative value opportunities.

Conclusion

2019 produced admirable returns for the global leveraged finance markets, and while such returns are unlikely to be repeated in 2020, the conditions are in place to be supportive of credit markets. The "risk-on" rally in December 2019 appeared to pull some of the potential 2020 return into 2019, but selected CCCs should still tighten. We also expect a modest increase in "fallen angels" from investment grade after a very low year of downgrades in 2019.

In 2020 the markets are likely to have some bouts of volatility. We believe a modest rise in default rates would not be surprising, which could cause some market weakness temporarily. We also expect to see volatility around the key U.S. election dates, which could create opportunities for interesting entry points.

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