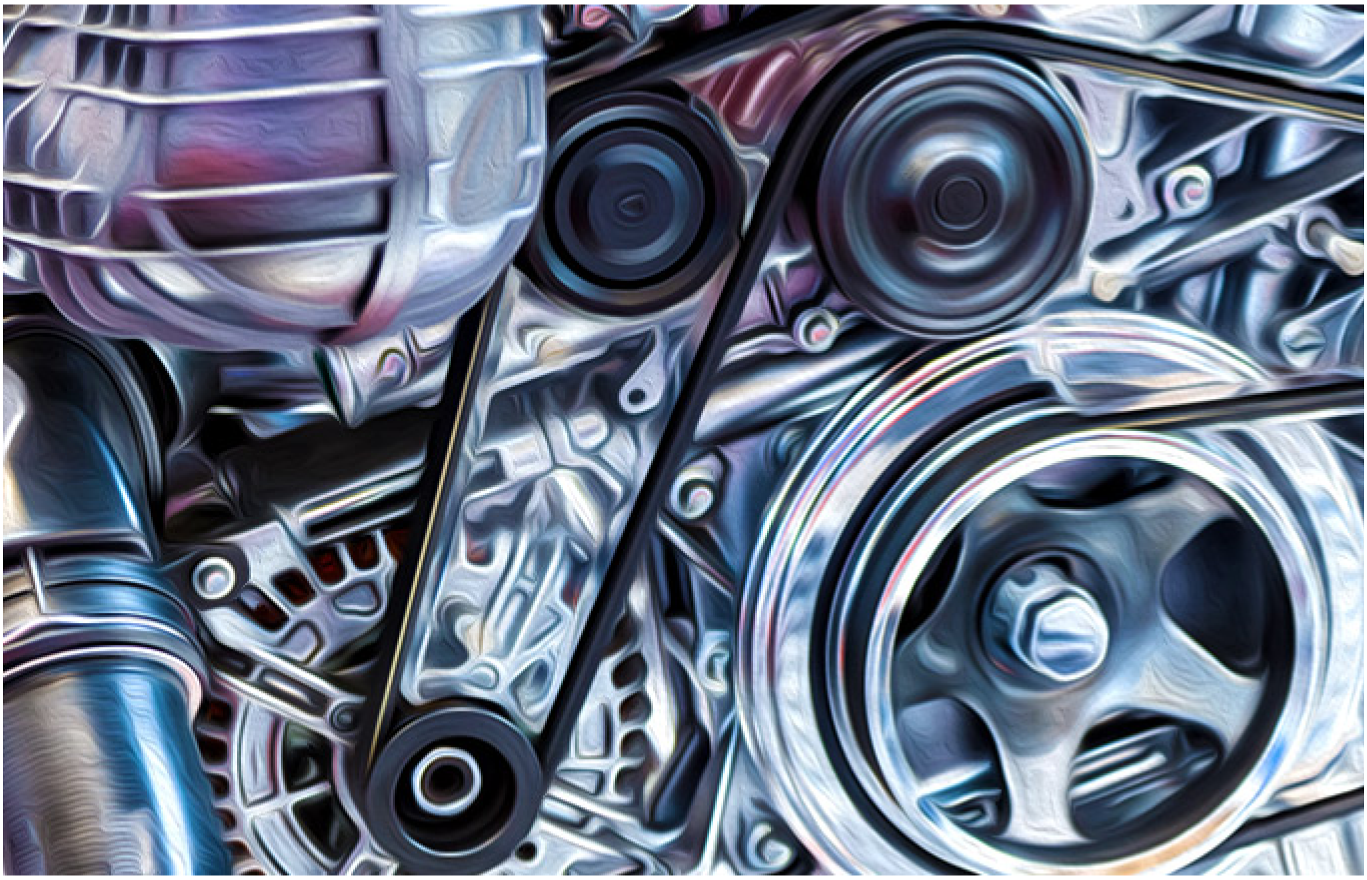

HY markets – a closer look under the hood

Market Insight

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Despite a recent wobble, global leveraged credit markets, at first glance, appear to be in a relatively sound place. But on closer inspection, the entire high yield (HY) market is not faring quite as well as headline statistics would suggest.

On the surface

Let us take a look at the facts. US HY default rates have declined progressively throughout the year and currently sit at a rather muted 1.2%[1], while the US and European HY markets have returned close to +7.0%[2] year-to-date (YTD). Equities paint an even more bullish picture (the NASDAQ has returned over +27%[3] YTD), and global growth has touched +3.7% in the middle quarters of this year, providing what appears to be a supportive backdrop. One would certainly be forgiven for assuming that all was well in the world of levered credit.

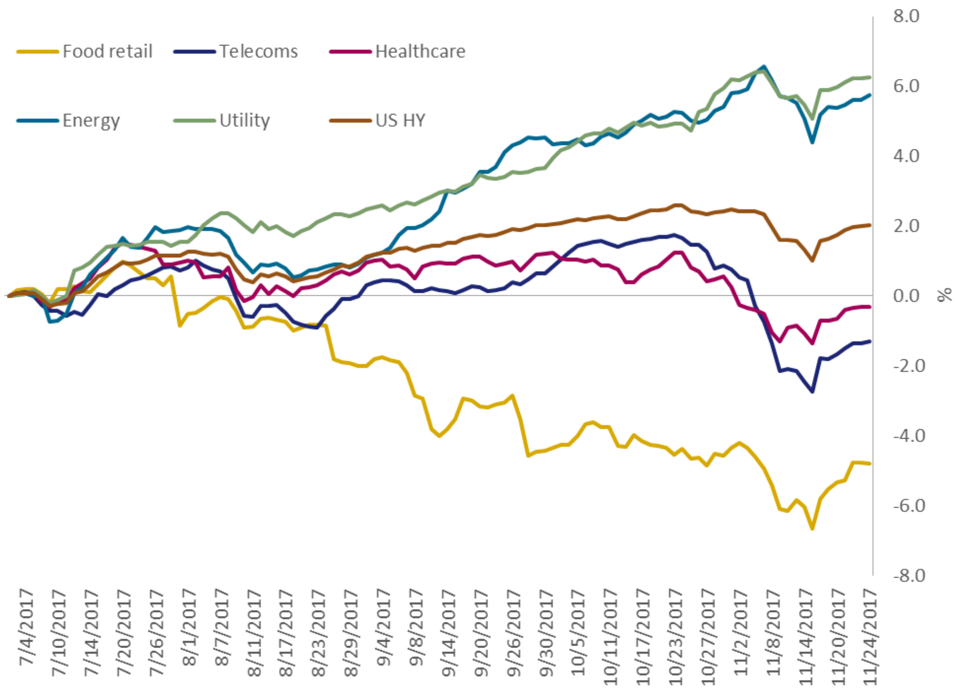
1 JPMorgan par weighted US HY LTM default rate as at 31 October 2017
2 BAML US High Yield Index, BAML European Currency HY Constrained Index
3 Nasdaq YTD return as at 20 November 2017

On the surface, we would agree. Economic growth is driving improvements in revenue and earnings which in turn is helping HY corporates to de-lever. Inflation is relatively muted, companies are acting rationally and terming out debt, and there are limited signs of the more aggressive borrowing activity that would typically worry us. With easy lending conditions still apparent on both sides of the Atlantic, there is nothing to suggest that the generic default rate is going to rise anytime soon too.

Under the hood

Recent volatility within the market has, however, served as a very timely reminder that on closer inspection not all of the HY market is faring quite as well as headline statistics would suggest. While the broader market has performed well YTD, the variation of returns across sectors within the US HY market is striking – with the recent underperformance of the retail and telecom sector particularly noteworthy.

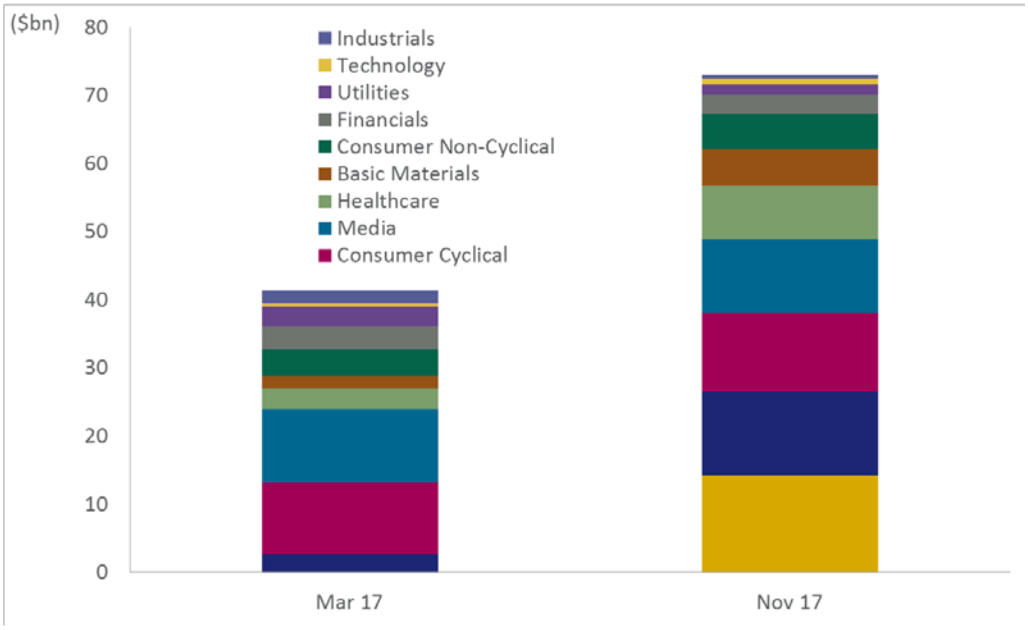
US HY sector return since 30 June 2017



Source: BAML 27 November 2017

Interestingly, this underperformance is not just confined to these two sectors. The chart below shows the quantum of US HY names trading wide of 1000bps (on a spread basis – a measure often used to define a 'distressed' security) has almost doubled over the past eight months. This despite market spreads actually tightening during this period.

HY market trading above 1,000bps or 'distressed'

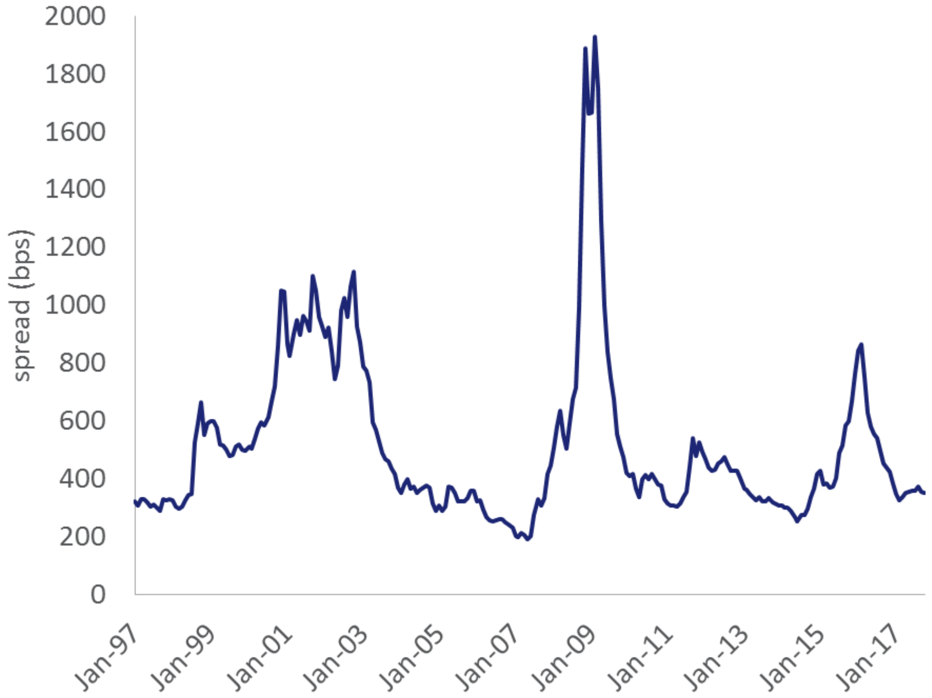


Source: Morgan Stanley 17 Nov 2017

In addition to the outright rise in the magnitude of debt trading at elevated spread levels, of interest is the wide distribution of sectors represented in the chart. In contrast to 2016, when distress in the market was largely reflected in the commodities sector, this time around it is far more diverse and reflects fundamental challenges across a wide range of industries (media, healthcare, energy in addition to the more high profile problems in the telecom and retail sector) to which the HY market is exposed to (much more so than the investment grade market).

While not significant in terms of outright size affected just yet (US$80 billion is not a large number in the context of the size of the US HY market), the trend we believe is an important one and can perhaps be viewed as an early warning sign that the credit cycle is nearing maturity – something not reflected in generic market spreads at this point.

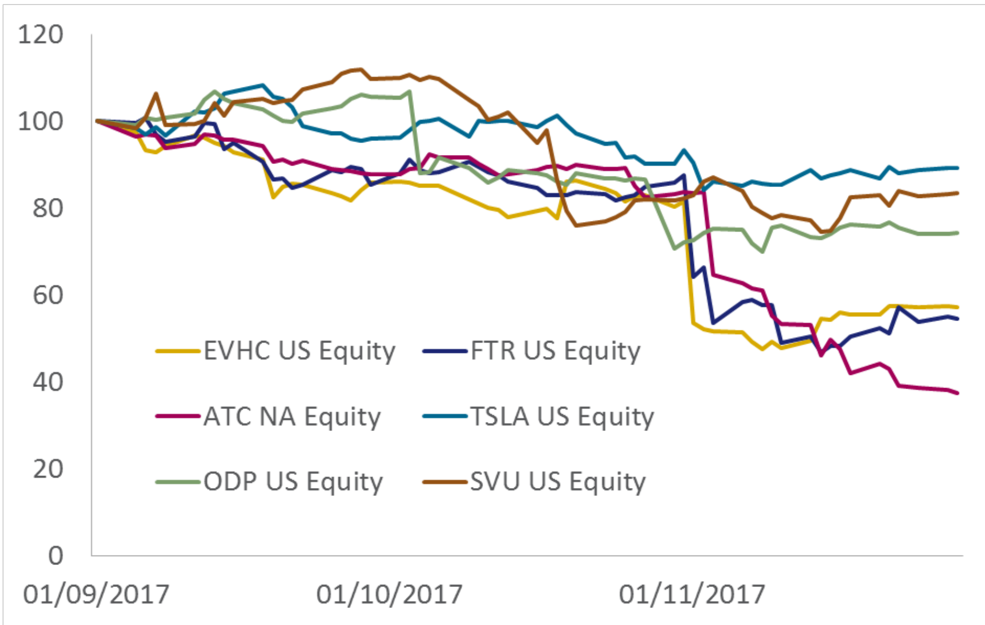
US HY dispersion - spread difference (bps) between widest 50% and tightest 50% of the market



Source: BAML 16 November 2017

The pressures emerging within the HY universe are naturally well illustrated on a single name basis too. A brief look at the recent equity performance of a number of high profile US HY issuers illustrates the pockets of weakness (not evident at a headline level as equity indices waiver around all time highs) and that not everything is on a stable or upward trend.

US HY issuer equity market performance since Sep 1 2017 (rebased to 100)



Source: Bloomberg 27 November 2017 (Envision Healthcare, Frontier, Altice, Tesla, Office Depot, Sapervalu)

Coupled with the sector dispersion highlighted above, these sharp corrections are good examples in our opinion of what is going on 'under the hood' at the moment – namely, a significant divergence in performance across sectors and a meaningful variation of returns at a single name level as the cycle matures and industry-specific issues develop.

In mid-cycle corrections adopting a 'mean reversion' approach to this type of movement is often a successful strategy – in the latter stages of a cycle, this is rarely wise.

As dispersion rises and the market becomes increasingly discerning, we believe 'owning the market' is not a sensible option and eventually, idiosyncratic risks will no longer seem quite so idiosyncratic. While dislocation in the wider market is not our core view for now (as highlighted broader market conditions are still quite supportive) what is quite clear is that sector and bottom-up name selection is absolutely crucial to optimising returns, preserving capital and making the most of the sparse spreads that are on offer.

Active management has once again moved to the fore.

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