Global Asset Management

BlueBay Asset Management

Portfolio Manager Perspectives
BlueBay High Yield Update

December 2017 Leveraged Finance Review

Following a volatile prior month which culminated in a sharp rebound (although a still negative return) for Global High Yield (HY) markets, December was in comparison relatively muted with spreads and yields barely changed during the month. Almost offsetting November's mild losses, the ICE Bank of America Global High Yield Index returned +0.27% contributing to a muted fourth quarter return of +0.58% and full year (FY) 2017 return of +8.00%.

The prospect and ultimately successful passage of the US tax reform bill provided some wider market support although it wasn't enough to discourage the continuation of a period of fairly healthy outflows from the market which now total over US$8 billion over the past eight weeks. With regard to the tax bill, the effect on HY corporates is largely positive with an estimated 75% of HY issuers positively impacted by the bill. Naturally, limitations on interest deductibility become more credit negative at progressively lower credit ratings, so at the CCC level, it is estimated that the new tax bill will negatively impact 73% of issuers (for context CCC and below rated issuers make up around 14% of the US HY market).

Despite the longer term implications for lower rated issuers, CCC-rated securities notably outperformed during December returning +0.88% in comparison to BB-rated securities returning +0.07% as the mid-month back up in US Treasury yields weighed on more duration sensitive assets. Over the course of the year, US HY spreads contracted by 60bps while yields fell by 33bps to end the year at 5.84% (it is worth noting, however, that yields were almost 40bps wider during the final quarter of the year).

As was the case in November, European High Yield lagged US HY returns during December with the ICE Bank of America European Currency HY (ex-subordinated financials) index posting a small loss of -0.05% during the month contributing to a Q4 return of +0.57%. For FY 2017 European HY returned + 6.22%. A rise in idiosyncratic credit situations coupled with a widening in underlying government bond yields weighed during the period (as did the overhang from a busy period for new issuance over the preceding weeks). The cable and media sector which was the principal source of weakness during November did, however, rebound during the month and was a notable outperformer.

US Leveraged loans outperformed marginally during the month returning +0.41% (FY 2017 return of 4.25%) as issuance (which had previously weighed) eased and the likely path of rates again became topical.

Default rates closed out the year at a benign 1.3%, falling from 3.6% at the beginning of the year. Although declining significantly, the energy sector once again accounted for the largest portion of defaults.

Outlook

While the broader global economic outlook remains positive and credit fundamentals for the wider HY market both in the US and Europe continue to be robust, the recent rise in dispersion at a sector and individual security level witnessed over the past few months and the effect that these idiosyncratic events have had on the market during the fourth quarter provides a timely reminder that one cannot take the apparently supportive backdrop purely at face value.

Although we remain comfortable with the broader market environment and are encouraged that corporates are not yet engaging in exuberant or overly aggressive behaviour and do not believe current stresses in the likes of the retail and telecom sector will have a meaningful impact on default rates in the foreseeable future, simply 'owning the market' is not advisable at this stage of the credit cycle. Instead, it is crucial to focus on bottom-up credit selection as the cycle matures and seek potential alpha generating opportunities through disciplined fundamental analysis.

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