Global Asset Management

BlueBay Asset Management

Portfolio Manager Perspectives
BlueBay Global High Yield Update

May 2017 Leveraged Finance Review

Global high yield (HY) consolidated upon April's strength and posted another robust performance during May with the Bank of America Global High Yield Bond Index returning + 0.80% during the month.

While markets dipped briefly on headlines surrounding Brazilian President Temer and President Trump's high profile communique surrounding the head of the FBI, this ultimately proved to be a buying opportunity for most. A light new issue calendar, strong corporate earnings and tightening US Treasury rates all provided support during the month and outweighed resurfacing oil price volatility. Yields on the BAML Global High Yield Index fell to 5.12%, tightening a further 17bps during the month. Year to date global HY bonds have returned +4.92%.

Regionally there was little difference in return performance between the US and Europe during the month with US HY (BAML US HY Index) returning +0.93% and Europe +0.85% (BAML European Currency High Yield Ex Subordinated Financials Index). In the US, healthcare was the strongest sector (returning +2.85%) due to stronger than expected earnings from several of the larger capital structures in the sector. At the other end of the spectrum energy recorded only very slightly positive returns (+0.15%) weighed on by questions over the efficacy of the extended oil production cuts. Once again CCCs were the best performing rating class returning +1.3% supported by strong fundamentals as results from the wider HY universe indicated another quarter of strong revenue and earnings growth.

As noted, Europe enjoyed a similarly strong return although arguably a more noteworthy performance as yields declined 26bps to 2.81%. Year to date the BAML European Currency High Yield Ex Subordinated Financials Index has returned +3.64%. With the French election conforming to expectations, many of the anticipated hurdles facing the market during the early part of the year have now been digested (although we note the risk of an early Italian election has risen and isolated issues in the Spanish banking sector are focussing the attention once again). For now the market is being driven by strong economic and corporate fundamentals and in addition, pent up demand for credit. On this latter point, although issuance picked up in May it is still more than manageable and offset laterally by modest renewed inflows into the asset class and an ongoing search for yield.

Interestingly European loans significantly outpaced their US counterparts during the period returning +0.69 (Credit Suisse Western European Leveraged Loan Index) and +0.36% (JPMorgan Leveraged Loan Index) respectively. European loans benefitted from resilient demand and further price appreciation toward par while the US retail demand waned somewhat as rate concerns continued to ease.

Commensurate with the improving corporate fundamental backdrop, default rates continue to decline with the US HY par-weighted default rate at 1.31% (down from 3.57%) at the start of the year. Notably, recovery rates have improved significantly this year increasing by 750bps at the bond level to stand at 38.6% while at the leveraged loan level they improved by 1560bps YTD to 78.3% - well above their long term average of 67%.

Outlook

As reinforced by first quarter 2018 reporting, corporate fundamentals continue to improve with positive revenue and earnings growth and falling leverage levels evident both in the US and in Europe. Combined with falling default rates, the near term outlook for fundamentals underpinning leveraged corporate credit remains strong.

Capital markets continue to function well with sizeable quantities of refinancing achieved, consistent with a maturity schedule that is being proactively addressed and a supportive technical environment. Also of note in both Europe and the US is the recent pick up in lower rated credits accessing the market (B- and CCC rated companies). Although increasing the risk profile of credits accessing it, it is encouraging to see higher beta credits also able to manage debt profiles and balance sheets.

Although both of the above points are constructive for high yield assets in the medium term we do of course remain conscious that this is increasingly reflected in today's spreads and there is a risk of complacency setting in among the wider market. Accordingly we remain focussed on sector and stock selection as source of alpha and are heightened to the risks that tend not to be as well compensated at this point in the cycle.

Written by the BlueBay Asset Management Global High Yield Team

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RBC Global Asset Management (U.S.) Inc.
Minneapolis | Boston | Chicago
800.553.2143 | **us.rbcgam.com**