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Assessing the Damage in Global High Yield

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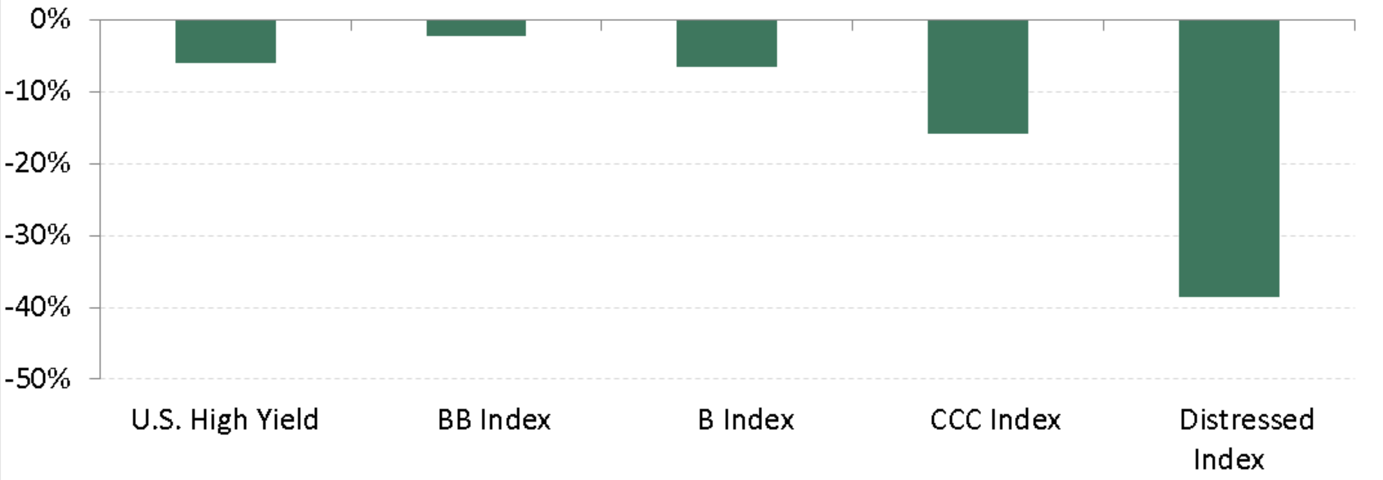
There's no shortage of pundits willing to jump in front of a television camera or offer up a quote touting the "crash" of the high yield market or its relative cheapness. Currently, the asset class confronts issues ranging from retail outflows to fund closures, a lack of dealer liquidity given the combination of an increasingly stringent regulatory environment and the market's growth since the financial crisis. While there is certainly stress in various sectors of the high yield market, this stress has existed since the collapse of oil and commodity prices during the summer of 2014. The latest rout is being driven by retail outflows and managers forced to sell lower quality and distressed credits—typically commodity exposed issuers—in an environment where the market is unwilling to take the other side of the trade. Therefore, bond prices will adjust until the high yield market reaches equilibrium. Given all of this "fear," a closer look at the high yield market may give investors a better sense of the risks today.

Before we dive into the high yield markets, let's assess the performance of risk assets globally at the time of writing this piece. The year-to-date returns through December 18 are as follows: the equal weighted S&P 500 Index is down -6.42% versus -0.58% for the market-cap weighted S&P 500 Index , the Russell 2000 Index returned -5.75%, and the Deutsche Bourse AG German Stock Index and the French CAC 40 returned 8.12% and 11.48%, respectively in local currency terms. From a bond perspective, the Barclays U.S. Aggregate is up 0.81%, the Citigroup World Government Bond Index (Unhedged) returned -3.44%, the Barclays Global High Yield Index Unhedged is down -3.30%, and the JP Morgan GBI-EM Global Diversified Unhedged is down -14.50%.

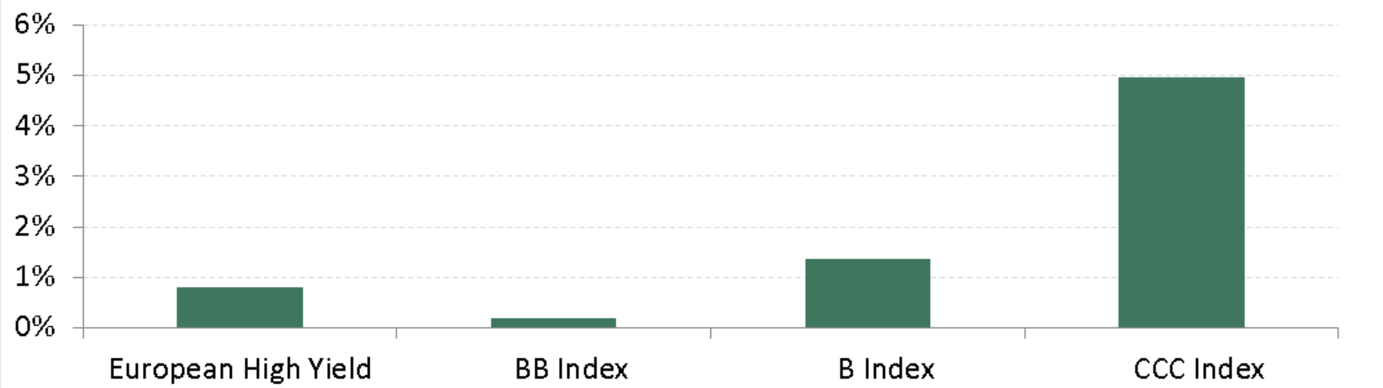
Based on Chart 1 and Chart 2 below, the Bank of America Merrill Lynch U.S. High Yield Index is down -5.60% while the Bank of America Merrill Lynch European High Yield market is up 1.26% in local currency terms, as of December 18, 2015. Within the U.S. high yield market, there has been a significant decline of performance moving from single-B to the CCC and distressed segments of the market, the latter two are down -15.97% and -39.14%, respectively.

Chart 1: U.S. High Yield YTD Performance %



Source: Bank of America Merrill Lynch

Chart 2: European High Yield Performance %



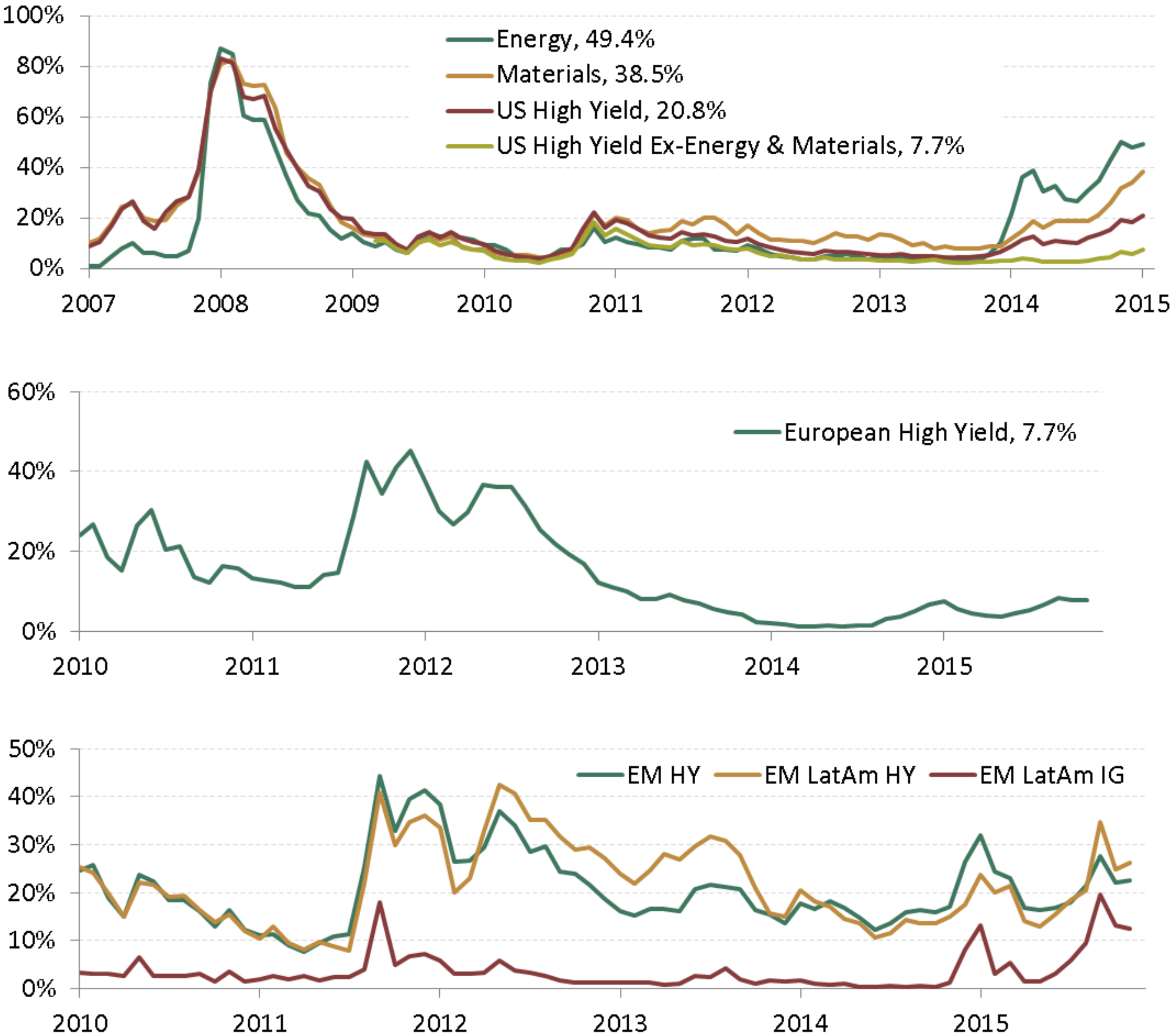
Source: Bank of America Merrill Lynch

Stress Building in Some Areas

There is no doubt that stress has been building in the high yield market the past 18 months. The overall distressed ratio—issues with an option-adjusted spread over 1000 basis points—in the U.S. high yield market is around 20% today versus approximately 8% for European high yield; however, as you can see from Chart 3, the distressed ratio has been driven by the commodity-oriented sectors, specifically energy and materials, which are now around 50% and 40%, respectively. Excluding these two sectors, the distressed ratio in the U.S. falls to 8%.

The collapse of commodities has also impacted the emerging-market corporate credit markets. Distressed credit in emerging market credit is now 22.6%, with particular stress in the Latin American investment grade (12.5%) and high yield (26.2%) markets given exposure to the commodity-related sectors.

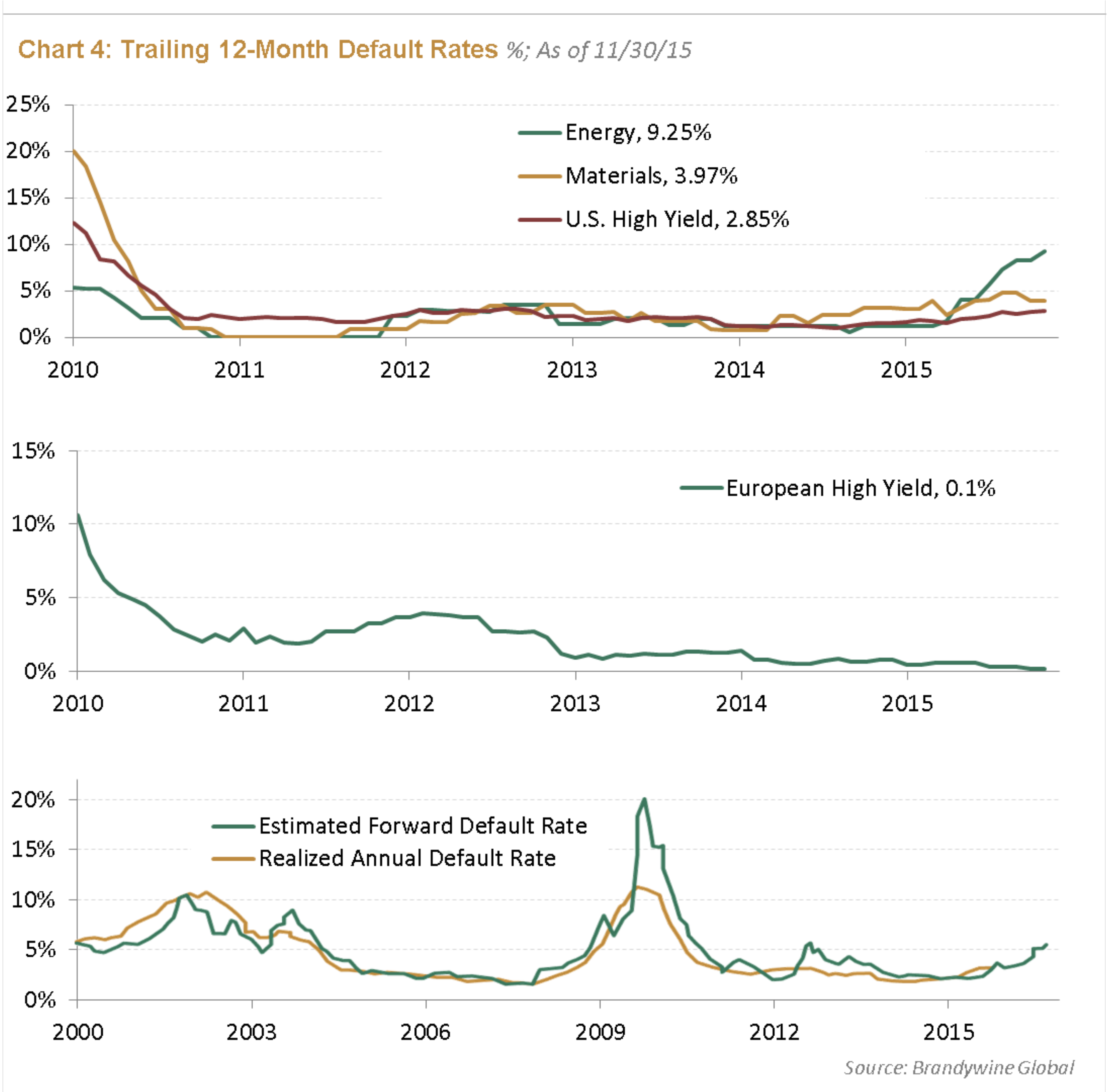
Chart 3: Distressed Ratios %; As of 11/30/15



Source: Bank of America Merrill Lynch

Default Rates to Rise

Default rates have also picked up in the U.S. due to rising defaults in the energy sector, as shown in Chart 4. Our default model forecasts defaults to rise to 5% next year driven by commodity-related sectors. As we wrote in the spring of 2015, given the volume of unsecured issuance with little to no covenants, energy companies will continue to utilize unique financing techniques to keep their option alive, effectively subordinating existing bondholders and potentially lowering future recovery rates. *In our view, understanding the private-equity cycle, avoiding credit impairment through subordination and default, and maintaining patience will all be crucial factors in generating excess return in high yield strategies moving forward.*



Conclusion

Lower quality and distressed debt markets in the U.S. have had a challenging year in 2015, as illustrated by Table 1 below, particularly in the energy and metals & mining sectors. We believe there will be continued stress in these sectors given the uncertainty in global commodity markets heading into 2016.

Table 1

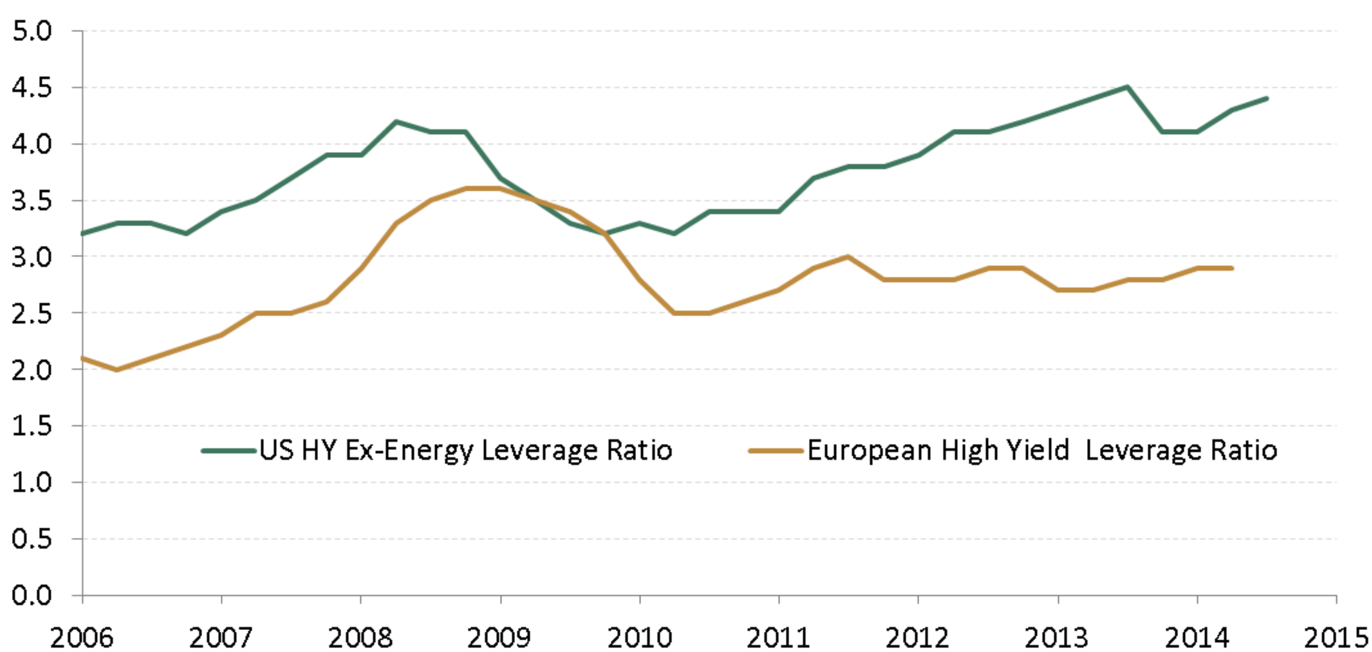
BAML US CCC Index	Total Return % YTD	% Face Value	BAML US Distressed Index	Total Return % YTD	% Face Value
Basic Industry	-26.6%	13.7%	Basic Industry	-44.8%	22.7%
Energy	-48.5%	22.9%	Energy	-57.1%	35.2%
Grand Total	-16.0%		Grand Total	-39.1%	

Source: Bank of America Merrill Lynch

We believe successful high yield analysis and portfolio management entails a blend of company-specific and macroeconomic analysis. Understanding and incorporating the economic cycle into the investment process through quality rotation and prudent sector selection enhances security selection, deepens the margin of safety, and helps anticipate and capitalize on investment opportunities as they develop.

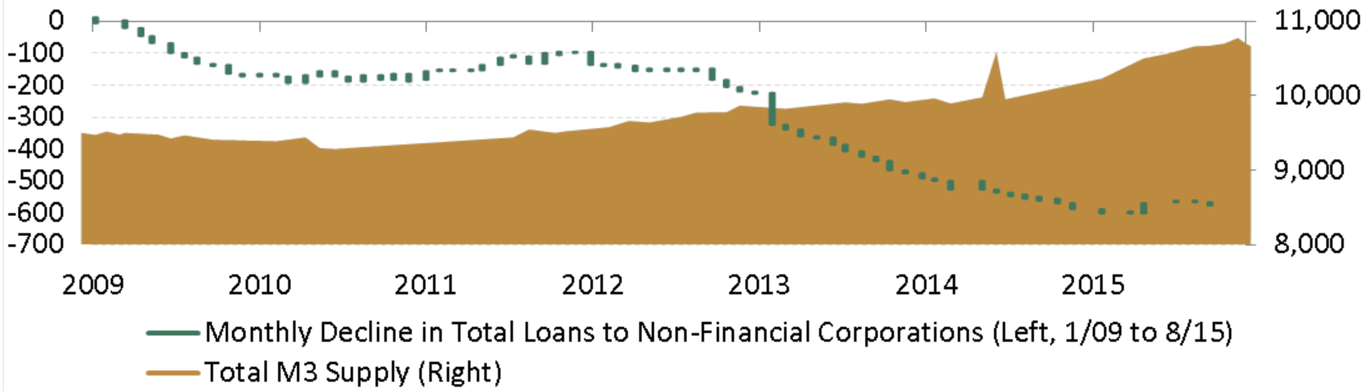
We believe that European corporate and structured credit could offer better opportunities in the global high yield market given their position in the credit cycle relative to the U.S. (Chart 5), monetary policy support from the European Central Bank, the potential for some fiscal support going into 2016, and much lower energy exposure than the U.S. high yield market (6.2% versus 15.5%). Continued deleveraging in the European banking sector will result in companies continued shift towards the capital markets for their funding needs to the capital markets as was the case in the U.S.

Chart 5: U.S HY Ex-Energy Leverage Ratio and European HY Leverage Ratio *As of 6/30/15*

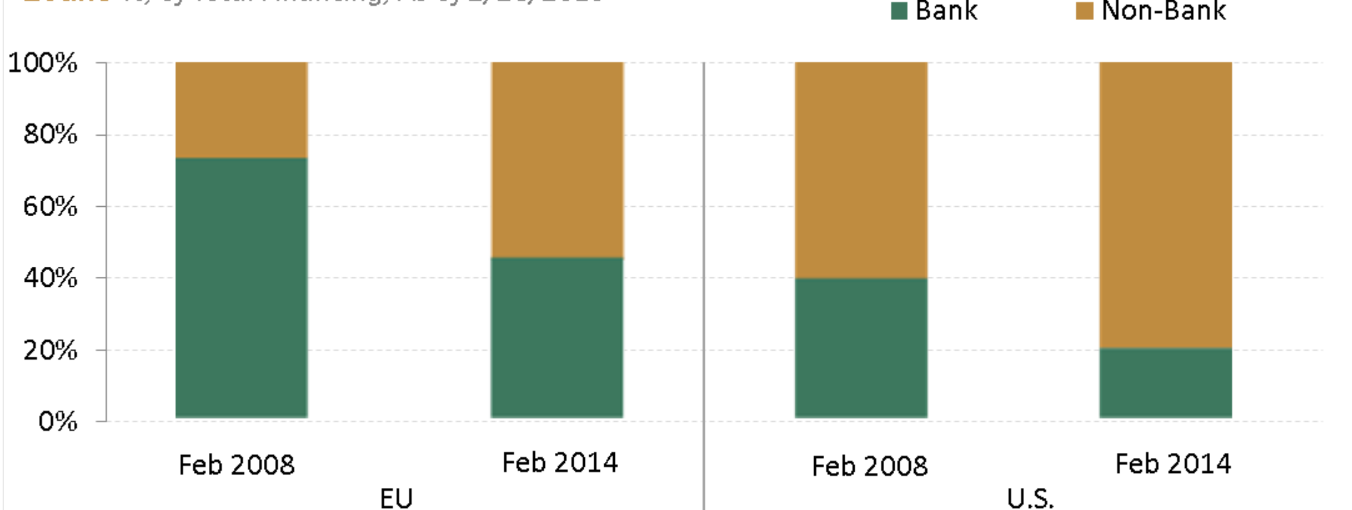


Source: Bank of America Merrill Lynch

Chart 6: Monthly Decline in Total Loans to Non-Financial Corporations and Total M3 Supply
Billions of Euro; As of 8/31/15



Loans *%; of Total Financing; As of 2/28/2015*



Source: RBS Macro Credit Research, WB, EIF

Within the U.S., we remain extremely cautious of the energy and materials sectors and the CCC and below segments of the market as believe stress will be coming to these areas of the market. With the latest bout of volatility, we are finding that value is being created in companies in more stable sectors, which we believe is prudent given risks for a slowdown in global growth.

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