

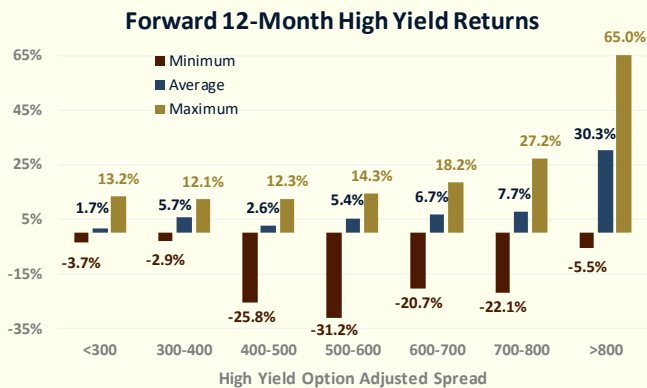


July 16, 2018 | Scott Carmack (Portfolio Manager)

HIGH YIELD STILL IN A SWEET SPOT...FOR NOW

GIVEN CURRENT SPREADS HIGH YIELD IS STILL IN ITS SWEET SPOT

Those who follow me know that I am not too keen on high yield for many reasons. Fundamentally, leverage metrics are increasing, issuance for both high yield and syndicated loans has been robust, and more importantly, given their tight spreads to artificially low treasury yields, the sector is increasingly exposed to interest rate risk. However, from a historical perspective, high yield has been a considerable outperformer in rising rate environments, and the current spread of 347 bps over treasuries has been a sweet spot. Consider the following chart.



Source: Bloomberg Barclays High Yield Corporate OAS Index, Bloomberg Barclays High Yield Total Return Index, Bloomberg 7.16.2018, Author's calculations. **NOTE: Past Performance is not indicative of future results; Investors cannot invest directly in an index.**

The chart plots forward 12-month returns for high yield given its spread over treasuries from 1994-2017. At current levels, the index has averaged a 5.7% return and its worst 12-month return is -2.9%. However, as you can see, the risk return profile deteriorates rapidly as spreads widen to over 400 bps.

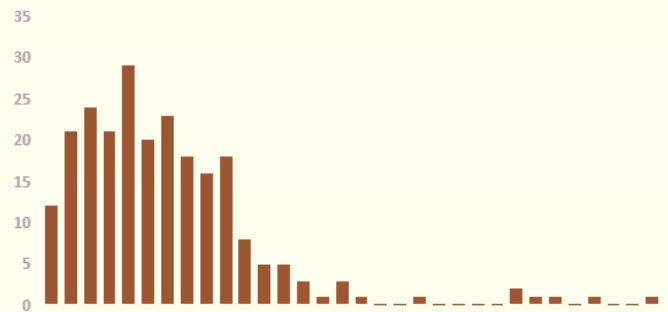
HIGH YIELD SPREAD DISTRIBUTIONS ARE FAT-TAILED MEANING THERE IS ASSYMETRICAL RISK

There are many reasons for asymmetrical risk in the high yield sector, not the least of which, is liquidity. As you can

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see in the following chart, the spread distribution is fat-tailed, meaning high yield spreads tend to "blow-out" when fundamentals suddenly deteriorate, and liquidity dries up.

High Yield Monthly OAS Distribution

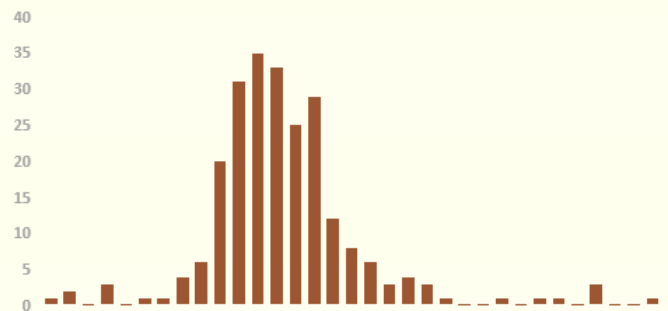


Source: Barclays U.S. Corporate High Yield Average OAS Index (1994-2017)

Source: Bloomberg Barclays High Yield Corporate OAS Index, Bloomberg 7.16.2018, Author's calculations. **NOTE: Past Performance is not indicative of future results; Investors cannot invest directly in an index.**

The return-profile of high yield follows a much more normalized distribution. However, as I will discuss later, it is highly dependent on trend.

High Yield Monthly Return Distribution

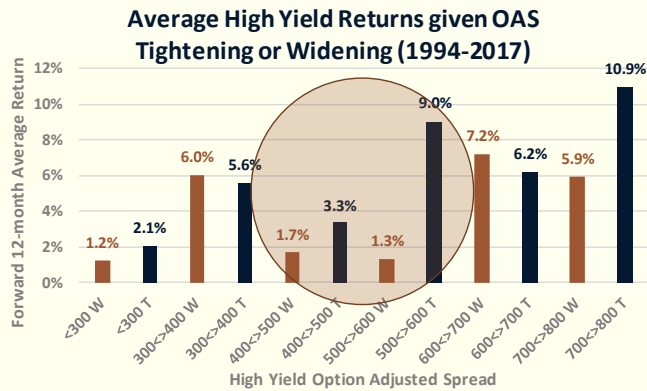


Source: Barclays U.S. Corporate High Yield Total Return Index (1994-2017)

Source: Bloomberg Barclays High Yield Total Return Index, Bloomberg 7.16.2018, Author's calculations. **NOTE: Past Performance is not indicative of future results; Investors cannot invest directly in an index.**

GIVEN THE LIQUIDITY IN HIGH YIELD, RETURN PROFILES CAN DETERIORATE QUICKLY

I have already shown that the risk-reward profile for high yield has historically been much worse when spreads eclipse 400 bps. But there is a glaring dichotomy between returns when spreads are tightening versus when they are widening.



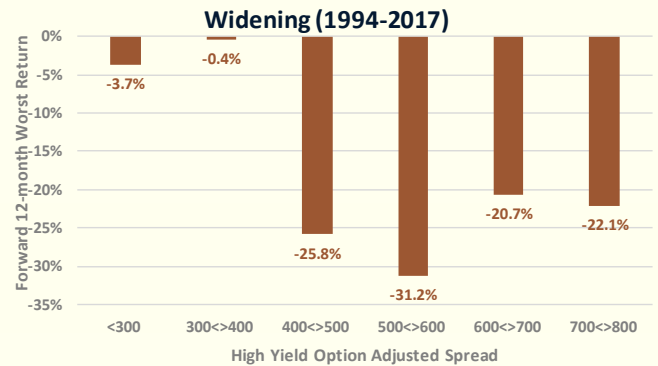
Source: Bloomberg Barclays High Yield Corporate OAS Index, Bloomberg Barclays High Yield Total Return Index, Bloomberg 7.16.2018, Author's calculations. **NOTE: Past Performance is not indicative of future results; Investors cannot invest directly in an index.**

The above chart shows forward 12-month high yield returns against spreads for our original buckets, however, it delineates between months where spreads tightened and widened from the previous month. As you can see, high yield returns are bifurcated by trend. When high yield spreads are between 400 and 500 bps, the average 12-month return is 3.3% when spreads have recently tightened, but only 1.7% when they have widened. The difference is even more glaring for spreads between 500 and 600 bps – when spreads are tightening the average 12-month forward return is 9.0% versus the 1.3% when they are widening. This speaks to the trending nature of high yield, and that the lack of liquidity can cut both ways. Nevertheless, an eclipse of 400 bps in spread today would portend an environment where high yield is trending lower, and where risk-reward profiles are deteriorating, at least historically. Note, I have left off the greater than 800 bps bucket in this chart because at those levels, high yield performance has been strong regardless of trend. 12-month forward returns have averaged 30.3% and the worst forward return was -5.5%. At such levels, high yield has a strong risk-reward profile, and this has typically been the area where investors should add exposure.

If spreads do not widen to 800 bps, it is prudent to wait for indications that there is a reversal in trend. The following charts illustrate the worst 12-month forward returns for

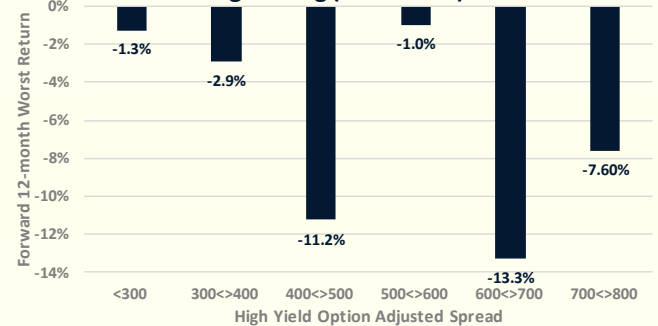
spreads when the previous month has widened and tightened.

Worst 12-month High Yield Returns given OAS



Source: Bloomberg Barclays High Yield Corporate OAS Index, Bloomberg Barclays High Yield Total Return Index, Bloomberg 7.16.2018, Author's calculations. **NOTE: Past Performance is not indicative of future results; Investors cannot invest directly in an index.**

Worst 12-month High Yield Returns given OAS Tightening (1994-2017)



Source: Bloomberg Barclays High Yield Corporate OAS Index, Bloomberg Barclays High Yield Total Return Index, Bloomberg 7.16.2018, Author's calculations. **NOTE: Past Performance is not indicative of future results; Investors cannot invest directly in an index.**

As you can see, drawdowns for the tightening buckets are considerably less than those for the widening buckets. This is a sector where investors do not want to “catch a falling knife.”

CONCLUSION

When placed in historical context, high yield is currently enjoying its sweet spot. At current spreads, the index has enjoyed decent 12-month returns with minimal drawdowns. However, high yield suffers from asymmetrical risk and liquidity can dry-up rapidly. Buyer beware – 400 bps has historically been the Maginot line between safety and bloodshed.

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