Q4 2019 CORPORATE CREDIT OUTLOOK

Running in place

Despite slowing economic growth, the fundamental backdrop underlying the corporate credit market remains supportive heading into year-end.

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As Executive Director of Investment Research, Robert leads the team that analyzes the fundamentals behind market movements, macroeconomic trends and the performance of specific industries – as well as their potential impact on investors. His nearly two-decade tenure in the financial services industry includes experience as a loan portfolio manager and senior credit analyst focused on corporate loan issues. Robert serves as the firm's primary subject matter expert on the corporate credit markets and select alternative investment solutions, developing targeted communications and educational resources.

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High yield bonds represented by the ICE BofAML High Yield Master II Index. ICE BofAML U.S. High Yield Master II Index is designed to track the performance of U.S. dollar-denominated below investment grade corporate debt publicly issued in the U.S. domestic market. Loans represented by the S&P/LSTA Leveraged Loan Index. S&P/LSTA Leveraged Loan Index is a market value-weighted index designed to measure the performance of the U.S. leveraged loan market.

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Running in place

Executive summary

In our midyear 2019 corporate credit outlook, we highlighted that credit market conditions were reasonably stable and that volatility, were it to occur, would likely emanate from the equity markets. Looking at markets today, not much has changed to move us from that position. That's not to say that markets haven't had some periods of excitement since the end of the second quarter. The month of August, in particular, which saw equities down at one point by more than 5% as the Treasury curve inverted and 10-year rates fell by more than 50 basis points, had the potential to portend a period of greater volatility. But returns midway through September have largely recouped August's losses and have markets, at least for now, seemingly feeling better.

For the balance of 2019, we see little to change our broad outlook for high yield bonds and senior secured loans. We expect corporate credit markets to finish the year on a positive note, albeit with returns primarily generated from the embedded income component of both the bond and loan markets. As has been the case over the past quarter, we continue to think that high yield bonds are in a slightly better position than senior secured loans, but both markets are likely to experience a high degree of correlation to each other.

We believe key risks to this outlook, especially over the short term, will likely emanate from outside credit markets. Issues such as flare-ups in trade tensions, geopolitical developments in the Middle East, or signs of a worse-than-expected slowdown in U.S. growth could all result in a market-wide sell-off of risk assets, which we expect would include corporate credit. Conversely, optimism across markets, as seen in the first half of September, could cause total returns for credit to exceed income returns. Credit spreads, while tight, remain well off their post-financial crisis lows. Furthermore, lower-rated credits, which have underperformed higher-rated credits to date, could provide an additional source of return over the balance of the year if mid-September's optimism continues.

Optimism remains despite signs of slowdown
Moderating growth in the U.S. has flowed through to revenue and cash flow statistics for high yield bond and senior secured loan issuers. Second quarter revenue and EBITDA growth statistics were similar to the first quarter and collectively represent the slowest start to a year since 2016. However, slow growth is not negative growth, and overall fundamentals for companies remain generally solid. Default rates remain low, and leverage and interest coverage statistics remain better than 10-year averages.

All data as of September 15, 2019, unless otherwise noted.

Credit spreads, which serve as a proxy for valuations, are currently tighter than 10-year averages but remain well above lows witnessed since the end of the financial crisis. Reasonably stable credit fundamentals, combined with what we believe are appropriately tight credit spreads, are key factors in our outlook for positive but primarily income-driven returns in Q4.

Market technicals remain favorable

Supply/demand dynamics for both high yield bonds and senior secured loans have improved further since the end of the second quarter. While the contributors to favorable dynamics are different between the two markets, the net result is the same; both markets have had more demand than supply.

The technicals data has been so strong year to date that it's almost a given that full-year 2019 results will end the year favorably. However, there are scenarios that could cause Q4 to buck the trend of the previous nine months. For both markets, one of the wildcards is the pace of new issuance. Given the low yield environment combined with generally tighter spreads, will a growing number of borrowers look to issue debt as the year draws to a close? If a flood of new issuance coincides with reduced investor demand, it could be possible to see the strong technical environment of these markets reverse toward year-end.

Short-term risks remain outside of credit

In looking ahead to the last three months of 2019, we continue to believe that the primary risks to the credit market lie outside of the credit market. Stable credit fundamentals combined with strong market technicals will make it very difficult in our view for credit markets to meaningfully sell off independent of other markets.

A noticeable deterioration in trade negotiations, geopolitical risks or general economic conditions may very well cause credit markets to move lower, but we don't see that happening in a vacuum. Any of these issues could result in a broad risk-off trade, which may include credit. In the absence of bad news, we continue to see favorable conditions for high yield bonds and senior secured loans to generate positive returns over the fourth quarter, composed primarily of the income returns these markets offer.

Return outlook

KEY TAKEAWAYS

- Q3 returns contribute to strong year-to-date performance.
- Income return dominates and will continue to drive fourth quarter returns.

In line with the expectations we established in our Q3 outlook, high yield bond returns have been positive quarter to date,[1] with each month posting gains. However, returns have yet to match the strong pace set in the first half of the year. Senior secured loan returns have also been positive this quarter, with solid returns in July and the first two weeks of September offsetting a slight loss in August.

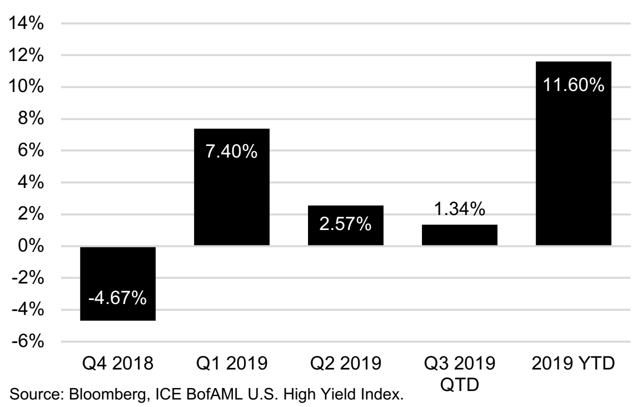
Decomposing the returns shows that income was the dominant driver – in fact in both July and August, price return for the high yield index was slightly negative. We expect this phenomenon to continue as we believe that major market-moving events (i.e., the likelihood of additional Fed rate cuts) have already been priced in and will lead to steady prices and carry-driven returns.

Even though we believe we are in the later stages of the current cycle, we still view the environment for credit as favorable. However, the market seems poised to react if certain macro headwinds become more pronounced – a meaningful slowdown in growth, trade war escalations, geopolitical risks and Fed actions, or lack thereof, can all inject further volatility. We believe that value still exists in leveraged credit, but it may be harder to discern as we get later in the cycle. Fundamental analysis, while key at any stage of a cycle, will become increasingly important in a market where yield, or carry, is the primary driver of returns.

Both the high yield bond market and senior secured loan market have similar average yields to maturity at 6.31% and 6.58%,[1] respectively. In our midyear credit outlook, we called for roughly a 3% return for the second half of 2019. The high yield bond market is right on track – returning 1.31%[1] quarter to date through mid-September. Assuming stable price returns over the balance of the year, this would imply roughly 1.6% in additional return by year-end. We believe this return outlook is reasonable for the high yield market.

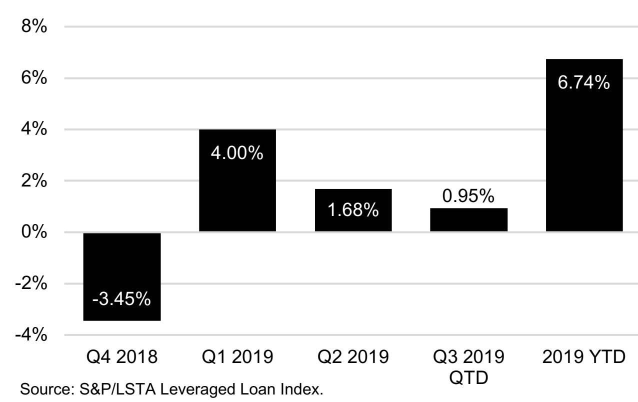
Last quarter we noted a slight preference in our outlook for high yield bonds versus loans, and this has materialized in returns. Loans have returned 0.95%[1] quarter to date through mid-September. While technical conditions (i.e., supply shortage) in the loan market could allow for some price return, we still see income providing the primary source of return. Given the current yield, this would imply roughly 1.5% in return over the remainder of the year, generally in line with our outlook last quarter.

HIGH YIELD BOND RETURNS



Source: Bloomberg, ICE BofAML U.S. High Yield Index.

SENIOR SECURED LOAN RETURNS



Source: S&P/LSTA Leveraged Loan Index.

1 Bloomberg.

Returns by rating

KEY TAKEAWAY

- Higher-rated assets continue to outperform YTD.

The fourth quarter of 2018 seems like a distant memory – especially as most markets have regained all of their losses and more. However, peeling back the layers shows that the rally in credit is atypical for what appears to be broad-based strength. As the charts on the right indicate, in both the high yield bond and senior secured loan markets, investors have favored higher-quality issues over lower-quality ones. Despite the strong rebound in 2019 – a situation during which lower-rated credits typically outperform – BB rated issuers have led the way, followed by B and CCC rated issuers.

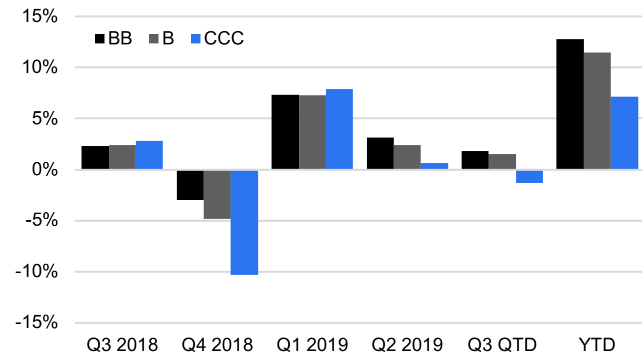
The question we find ourselves asking is, what is driving this phenomenon? Is it a sign that investors lack conviction in the year-to-date rally? Are they just being cautious? Is it duration driven? We believe the answer is a bit of all of the above.

First and foremost, we view this year's higher-rated outperformance as a reason for caution. There is no shortage of headlines indicating that the current expansion is "late cycle," and investors may be exercising restraint as a hedge to prospects of slowing economic growth.

Higher-rated bonds typically have lower yields and thus have longer durations compared to lower-rated issuers. Shifting Fed interest rate policy expectations and falling Treasury yields created a strong tailwind for higher-duration fixed income securities. While the high yield market as a whole traditionally trades with low correlation to changes in interest rates, we believe there may have been some benefit to the lowest-yielding and highest-rated portion of the market.

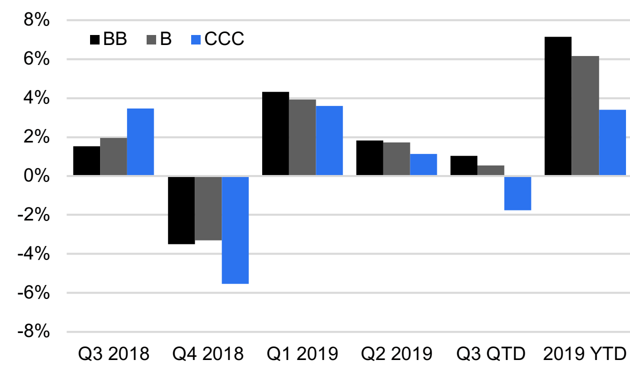
Similar observations – other than the desire to extend duration – can be made about the loan market. Record outflows from the asset class have persisted for the entire year, and higher-rated issues continued to outperform. This trend has seen a slight reversal

HIGH YIELD BOND RETURNS BY RATING



Source: Bloomberg, ICE BofAML U.S. High Yield Index.

SENIOR SECURED LOAN RETURNS BY RATING



Source: S&P/LSTA Leveraged Loan Index.

month to date in September, with lower-rated credits outperforming in both the high yield bond and senior secured loan markets, but the persistence of this trend for the year is notable.

The preference for higher quality comes at a cost, however. The average yield of the BB high yield index is 4.67%, compared to 12.33% for CCCs.[2] In the loan market, BBs are yielding 4.29% while CCCs are yielding almost 1,000 basis points more at 15.44%.[3]

We expect to see the trend of higher-rated outperformance continue in Q4. However, if markets become more comfortable with the outlook, outperformance by lower-rated issuers could be a source of upside to an otherwise yield-driven return profile for credit.

2 Bloomberg.

3 S&P/LSTA Leveraged Loan Index.

Spread environment

KEY TAKEAWAYS

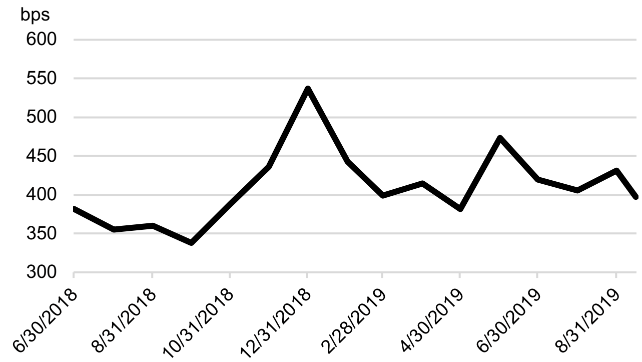
- High yield spreads tightened in Q3 and remain slightly tighter than 5-year averages.
- Loan spreads widened but still remain in line with 5-year averages.
- Spread levels in both markets support a carry-driven return forecast.

High yield bond spreads have tightened somewhat since June but still sit significantly off post-crisis lows. Notably, most of that tightening came in the first two weeks of September, when spreads compressed from 431 basis points to 397 basis points in just two weeks[1] as credit markets rallied and Treasury rates rose. As we discussed in our return outlook, given that spreads are currently relatively tight, we anticipate the majority of credit returns for the rest of the year to be driven by carry (income return).

In the loan market, spreads widened during the third quarter but still remain 70 basis points lower than the peaks in Q4 2018.[2] We believe current spread levels, which are slightly tight to 5-year averages, are reasonable for the current macro outlook. Low defaults and slow-but-steady growth support a spread environment tighter than "average."

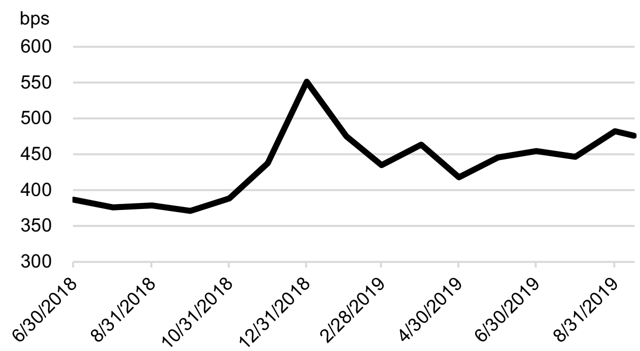
Another interesting dynamic to watch is the yield gap between senior secured loans and high yield bonds, which has been negative for almost the entire third quarter thus far. Given that loans are typically senior in the capital structure and secured, they have historically traded with a lower yield. While the negative turn may indicate that loan yields, and thus spreads, have room to contract, we believe there are other factors impacting this relationship. In particular, the increased issuance of lower-rated loan borrowers has pushed single-B borrowers to nearly their highest overall composition of the loan market on record. This shift in composition, which has not been seen in the high yield market, may be mostly responsible for the widening of loan spreads in relation to high yield.

HIGH YIELD BOND SPREADS



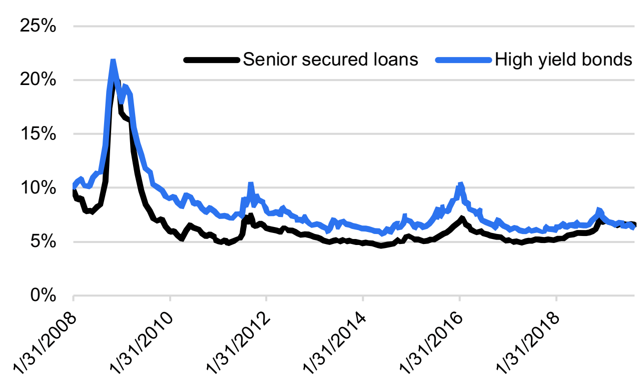
Souce: Bloomberg, ICE BofAML U.S. High Yield Index.

SENIOR SECURED LOAN SPREADS



Source: S&P/LSTA Leveraged Loan Index.

YIELD GAP: HIGH YIELD BONDS VS. LOANS



Source: Bloomberg, ICE BofAML U.S. High Yield Index, S&P/LSTA Leveraged Loan Index.

Credit fundamentals

KEY TAKEAWAYS

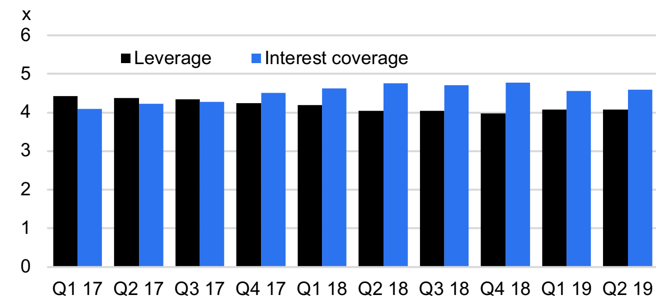
- Revenue and EBITDA growth in high yield and loans were positive in Q2, but 1H 2019 saw the slowest pace of growth since 2016.
- Leverage levels and interest coverage ratios were unchanged.

EBITDA growth for high yield bond issuers turned positive in Q2 after posting a negative year-over-year rate in Q1. However, Q2's growth rate of 1.4%[4] is still much slower than 2017–2018's double-digit pace. The first half of 2019 is the slowest period since weakness in the energy sector weighed on 2016's results. For context, the average year-over-year quarterly EBITDA growth rate during the previous two years was 12.7%.[4] Year-over-year revenue growth in the high yield market also declined, coming in at just 0.1%.[4]

Both EBITDA and revenue growth for loans were positive; however, both rates were below last quarter's. Similar to the high yield market, these rates are still significantly below their 2-year averages (7% EBITDA growth and 10% revenue growth). These stats bear watching going forward given the impact fundamental earnings can have on both credit statistics and default rates. Weaker EBITDA would result in higher leverage levels and weaker interest coverage if companies do not reduce debt outstanding in advance of lower EBITDA levels. While we think these stats are not at worrisome levels today, a few more quarters of weaker earnings could quickly cause leverage levels and interest coverage stats to deteriorate.

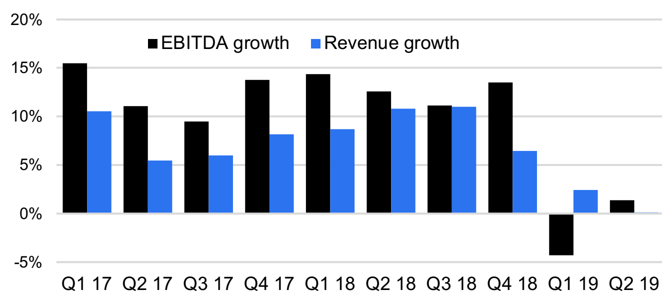
High yield leverage and interest coverage ratios both held steady. Leverage levels are at the higher end of their 10-year range, but interest coverage levels are also at the higher end, suggesting that companies have ample cash flow to continue paying their debt service costs. While each ratio deteriorated slightly in the loan market, we do not see major cause for concern as levels are still comfortably within their 10-year ranges. Current market expectations for Q3 GDP growth are only slightly below those for Q2, so we do not expect any significant deterioration in credit fundamentals as 2H 2019 data is released.

HIGH YIELD LEVERAGE AND INTEREST COVERAGE



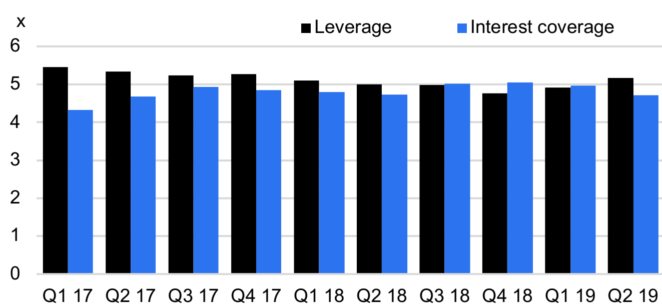
Source: J.P. Morgan, as of June 30, 2019.

HIGH YIELD EBITDA AND REVENUE GROWTH



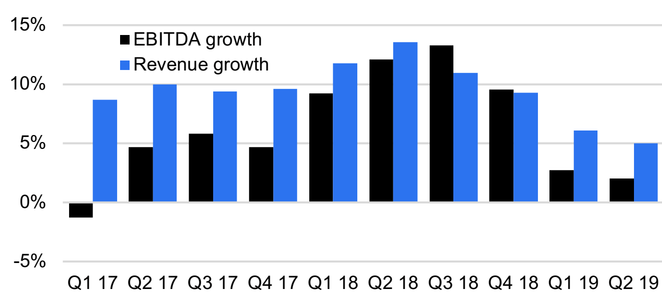
Source: J.P. Morgan, as of June 30, 2019.

LOAN LEVERAGE AND INTEREST COVERAGE



Source: S&P/LSTA Leveraged Loan Index, as of June 30, 2019.

LOAN MARKET EBITDA AND REVENUE GROWTH



Source: S&P/LSTA Leveraged Loan Index, as of June 30, 2019.

4 J.P. Morgan.

Default rates

KEY TAKEAWAYS

- High yield defaults increased, driven primarily by the energy sector.
- Loan defaults increased slightly but remain near historic lows.

Default rates in the high yield bond market increased in the third quarter, while rates for the senior secured loan market remained relatively unchanged. The trailing 12-month default rates for high yield bonds and senior secured loans at the end of August were 2.54% and 1.48%, respectively.[4] In the high yield market, this rate is currently at a 17-month high.

The roughly 1% uptick in default rates since June was predominantly due to names in the energy sector. In particular, the largest default of the year and 14th largest in history occurred in the energy sector in August. Ex-energy, the high yield default rate is 1.30%.[4] For context, these rates are still below the long-term averages for high yield and loans of 3.46% and 3.07%.[4]

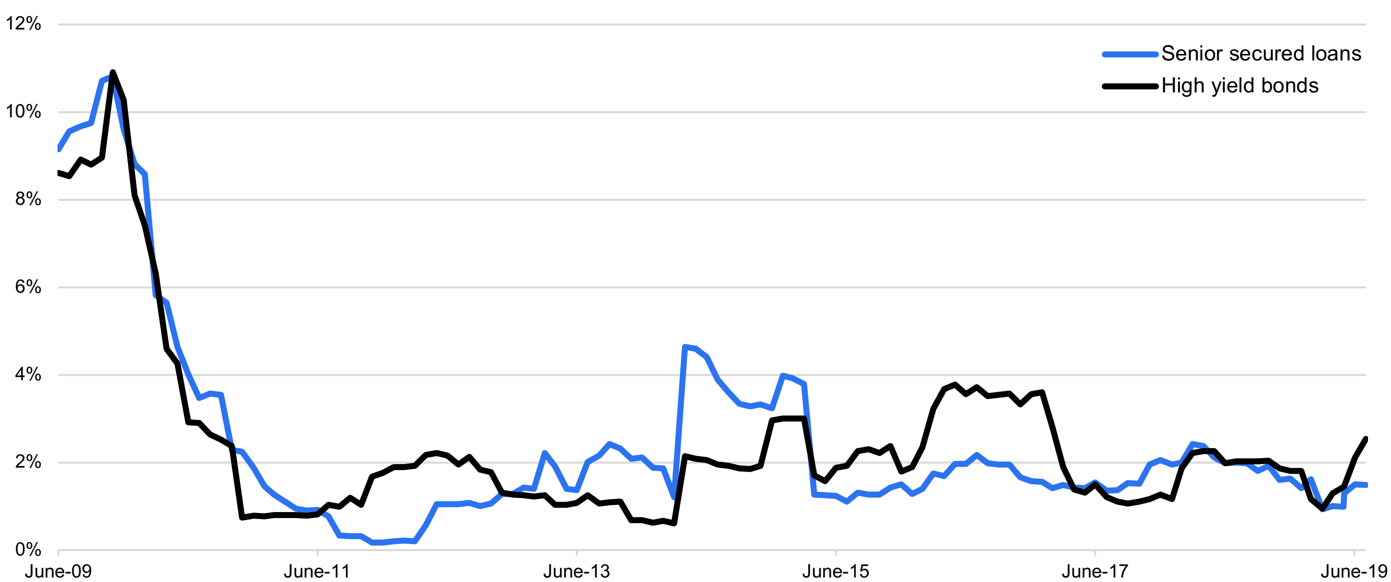
One indicator of possible future defaults that we're watching closely in both the loan and high yield markets is the distressed ratio. For loans, this is defined as the percentage of loans trading below 80 cents on the dollar. Periods of higher default levels are typically preceded by rising distressed ratio levels – the distressed ratio peaked at 81% in November 2008 before major defaults started in 2009.

As of August 31, 2019, the distressed ratio for loans sits at 4.03%,[2] which is a 33-week high. While this number is above long-term averages, fundamentals such as EBITDA growth, leverage levels and interest coverage ratios have not increased in worrisome amounts alongside the distressed ratio. We will continue to monitor the ratio, but do not believe it merits cause for concern at this point.

The distressed ratio in the high yield market is defined as the percentage of bonds (by market value) with spreads wider than 1,000 basis points. As of September 15, this ratio sits at 6.23%,[1] the highest since January of this year. We attribute this uptick predominantly to the volatility seen in the markets in August. As equity volatility increased, the flight to quality that ensued drove some high yield investors out of the lowest-quality bonds, sending their prices down and spreads up.

We will continue to monitor the distressed levels in the market but believe that credit fundamentals are still solid and will keep default rates below their long-term average for the balance of 2019.

TRAILING 12-MONTH DEFAULT RATES



Source: S&P/LSTA Leveraged Loan Index, J.P. Morgan.

Supply/demand technicals

KEY TAKEAWAYS

- High yield continues to experience a supply deficit.
- The loan market supply surplus reverses, supporting prices going forward.

As risk assets continued their year-to-date rally and the prospect of Fed rate cuts became a reality, retail investors have continued to favor high yield bonds over loans. The overall supply/demand picture for high yield has remained one of significant excess demand.

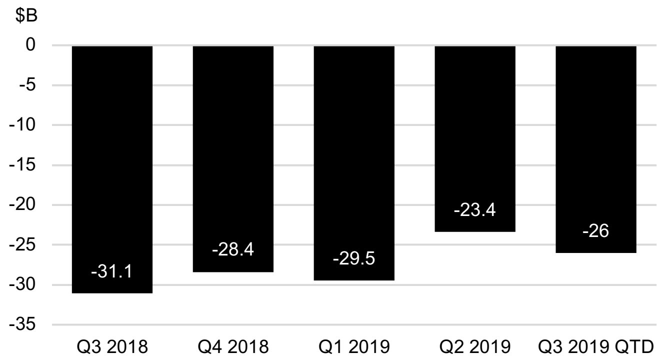
High yield bonds are being used increasingly to retire loans, but the demand from investors has been more than ample to soak up new issue supply. Any increased volatility in equity markets, however, tends to negatively impact high yield flows. In both May and August 2019, negative months for equities, investors pulled money from high yield. What's important to note is that in both cases, the high yield market was down less than equities, and in August high yield still posted a positive return. We see this as further evidence that high yield is not driving the trends we're seeing in the market – rather, upticks in equity volatility have investors pulling back from riskier assets across the board.

The technical picture in the high yield market today has been favorable and supports our outlook for positive returns. However, another bout of equity volatility could upset this balance.

Loan funds have seen continuous outflows for 43 weeks as investor demand for floating rate products waned following the Fed's dovish pivot. While retail fund flows have been negative, mutual funds and ETFs only account for a small portion of the overall loan market, so retail demand, or lack thereof, can be subsumed by institutional demand. That has largely been the case so far in 2019 as the market has been buoyed by CLO issuance, which is only slightly off pace compared to 2018's record-setting year.

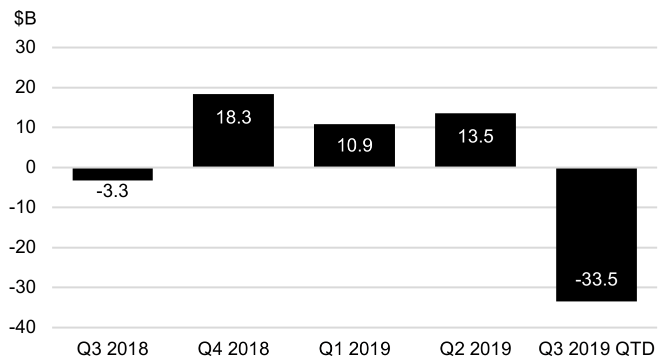
Notably, the supply/demand balance this quarter in the loan market has switched from significant excess supply to a supply deficit as net new issuance has been negative. We believe this technical backdrop will support asset prices and our forecast of a primarily carry-driven return.

HIGH YIELD BOND MARKET SUPPLY DEFICIT



Source: J.P. Morgan.

LOAN MARKET SUPPLY SURPLUS/DEFICIT



Source: S&P/LSTA Leveraged Loan Index.