INVESTMENTS®

MIDYEAR 2019 CORPORATE CREDIT OUTLOOK

Crossroads or cruisin'?

INVESTMENT RESEARCH

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Executive summary

The first four months of 2019 saw corporate credit markets on pace for a solid rebound following a lackluster 2018 and tumultuous Q4. Then May happened. Equity markets tumbled. The yield curve inverted. Fed rate expectations switched from up to flat to possibly three cuts by year-end. And credit markets responded accordingly, with both the high yield bond and senior secured loan markets posting negative returns for the first time this year.

So, with all that behind us, where are credit markets heading? If the gains in June are any indication, credit markets may be poised to regain their footing and deliver **positive returns** over the back half of the year, albeit comprised primarily from yield. In our view, high yield bonds appear to be in a slightly better position compared to senior secured loans, although history shows that they trade with a relatively high level of correlation to each other. Any exogenous shock, either positive or negative, is likely to impact both markets in a similar fashion.

Key risks to this outlook include unexpected macro developments: an increase in global trade war tensions, indications that the U.S. economy is headed toward contraction instead of merely a slowdown, and changes in Fed rate expectations. We believe these potential risks would likely be more significant for equity markets, but nonetheless high yield bonds and senior secured loans would likely trade down in sympathy. Conversely, if economic conditions or the outlook for trade meaningfully improve, both high yield bonds and senior secured loans have room for further spread tightening, which could add capital appreciation on top of yield-based returns.

READ THE ANALYSIS FOR EACH INDICATOR:

Optimism in credit despite global growth slowdown

While U.S. economic growth may be moderating from above-trend growth, as outlined in our **midyear economic outlook**, fundamentals within the credit space are generally positive. Recent sales and EBITDA trends have been positive, supporting corporate **default rates** well below historical averages. **Spreads**, which serve as a proxy for valuations in credit, are somewhat below 10-year averages but well above lows experienced in other low default rate environments.

In our view these factors, as a snapshot of **fundamental credit market conditions** today, contribute to our relatively benign outlook for the rest of the year. If anything, the generally solid state of these fundamental statistics could cause credit markets to outperform our expectations in the absence of bad news.

Market technicals bear watching

Similarly, market technicals, or **supply/demand dynamics**, across high yield and loans are balanced. The high yield market has had slightly higher new

All data as of June 30, 2019, unless otherwise noted.

issuance compared to last year but has also brought in over $12B in retail fund flows. Loans, while suffering from nearly $20B in retail outflows year to date, have had an even larger reduction in net new issuance, more than balancing out the reduced demand from retail investors. We do think these statistics bear monitoring, however, as downside risks to our outlook would likely materialize first in supply/demand statistics before becoming evident in the fundamental statistics described above.

For instance, an acceleration in rate cuts (or rate cut expectations) by the Fed could spur additional outflows from retail loan investors, pressuring that market. If this change occurred because of a worsening outlook for the U.S. economy, CLO issuance, one of the largest sources of demand for loans, could fall, resulting in an even larger hit to the demand side of the equation for the loan market. While retail inflows for high yield bond funds could switch to outflows, we believe the technical picture for high yield is slightly more stable than that for loans, contributing to our slightly more positive view for that market. Taken together, both fundamentals (credit outlook) and technicals (market supply/demand) look, at a minimum, neutral, if not somewhat positive.

Main risk falls outside credit markets

So where does the risk lie in credit? We believe the predominant risk today falls outside of the credit markets—in where equities are going and how they respond to trade tensions, slowing growth and Fed interest rate policy. In our view, credit markets are in a position to follow equities, not lead them.

A slower but steady economic environment provides a supportive backdrop for high yield bonds and senior secured loans, but the market is not immune from a broad-based risk-off trade. If the fundamental economic outlook for the U.S. deteriorates significantly, our outlook for credit would change. In that type of environment, corporate earnings would be expected to fall, and default rates would likely rise above long-term averages from their current low levels. For now, we don't see that happening over the second half of 2019, giving us comfort that supportive fundamentals for credit will continue.

All data as of June 30, 2019, unless otherwise noted.

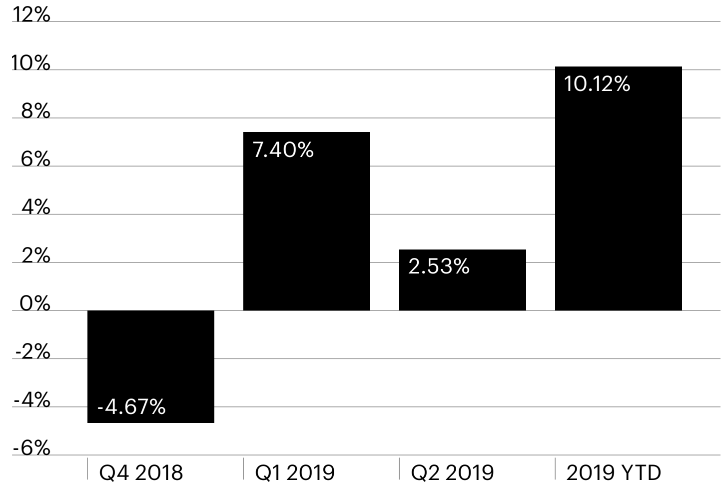
Return outlook

High yield bonds started the year strong, posting solid returns despite a tough May. Senior secured loan returns have been lower, but the asset class has performed well nonetheless and held up better during May's sell-off. The first quarter, plus April, was relatively smooth sailing. Especially in comparison to 2018's tumultuous fourth quarter, risk assets broadly recouped their losses, and then some. Macro headwinds coupled with policy uncertainty injected some volatility in May; however, we expect leveraged credit will follow equity's lead rather than drive volatility itself.

Even though we believe we are in the later stages of the current cycle, we still view the environment for credit as relatively favorable. However, the market seems poised to react if certain macro headwinds become more pronounced—a meaningful slowdown in growth, trade war escalations 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.

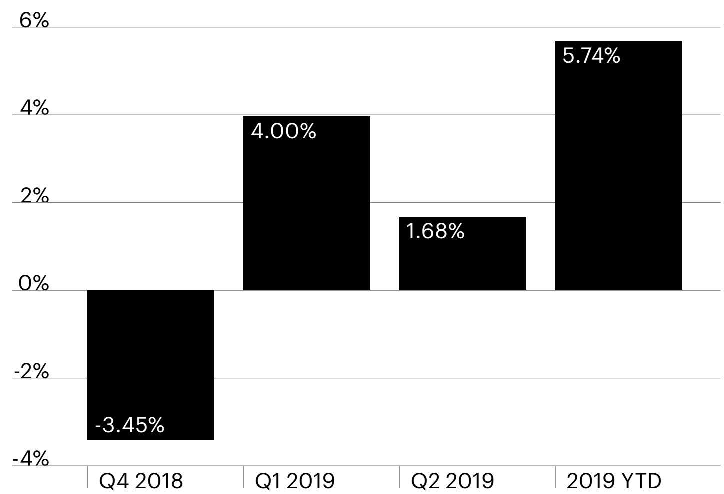
Both the high yield bond market and senior secured loan market have similar average yields to maturity, at 6.44% and 6.70%,[1] respectively. Assuming stable price returns over the balance of the year, this would imply roughly 3% in additional return for both markets by year-end. While it may not be a straight line to get there, we believe this type of return outlook is reasonable.

HIGH YIELD BOND RETURNS



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

SENIOR SECURED LOANS



Source: S&P/LSTA Leveraged Loan Index.

All data as of June 30, 2019, unless otherwise noted.

1 Bloomberg.

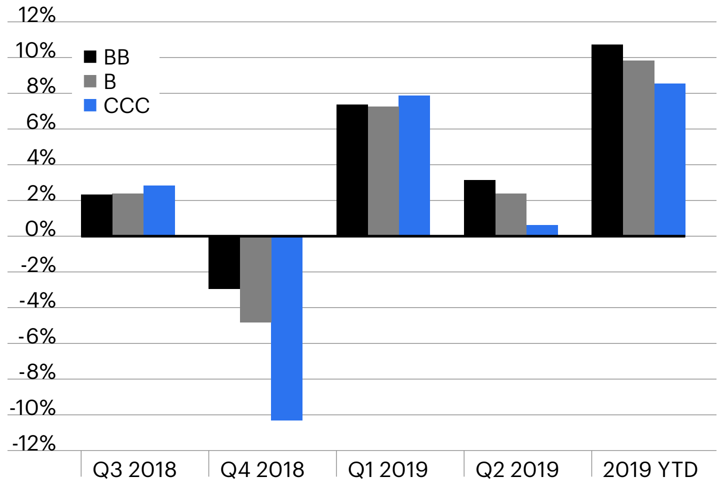
Returns by rating

Beyond observing overall returns for high yield bonds and senior secured loans, it's important to understand where returns are coming from. In particular, are higher- or lower-rated issuers materially outperforming the average return? As the charts indicate, both markets have favored higher-quality issuers over lower-quality ones. Despite the strong rebound in 2019—a situation where lower-rated credits typically outperform—BB rated issuers led the way, followed by B and CCC rated issuers. This is one statistic that was meaningfully impacted by the returns in May, as CCC rated issuers had been outperforming in both high yield bonds and loans before risk assets sold off as equities declined.

In both markets, CCC rated issuers meaningfully underperformed during last year's fourth quarter sell-off. The recovery has been uneven, which could be an indication that investors are cautious about lower-rated issuances following recent bouts of volatility, opting for higher-rated instruments instead.

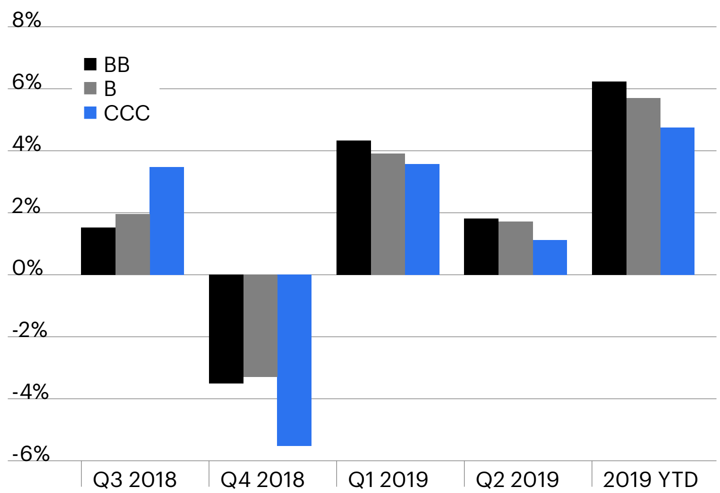
Given the strong returns year to date, we would expect B and CCC to outperform BB rated issuers, but this hasn't been the case. If markets become more comfortable with the outlook, outperformance by lower-rated issuers in the second half of the year could be a source of upside to an otherwise yield-driven return profile for credit.

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.

All data as of June 30, 2019, unless otherwise noted.

Spread environment

High yield bond spreads had recouped most of their Q4 widening before the market sold off in May, sending spreads wider. Despite strong year-to-date returns, spreads as of June 30 are only roughly 50 bps tight to 5-year averages and 40 bps wide to where they were 12 months ago.[1] We believe that spreads will remain near their current levels.

As we discussed in our **credit fundamentals** and **return outlook** sections, we anticipate the majority of credit returns for the rest of the year to be driven by carry (income return). We do think it's possible to see potential upside to this scenario if the Fed cuts rates as expected and economic growth remains steady.

Similar to high yield, senior secured loan spreads have fallen from their Q4 2018 peak but remain wide compared to their recent tight in September 2018. While the market has fully recouped its Q4 2018 losses from a return perspective, global trade tensions, possible slowing growth and investor outflows as a result of changing Fed rate expectations have contributed to the market being unable to fully recover from a spread basis.

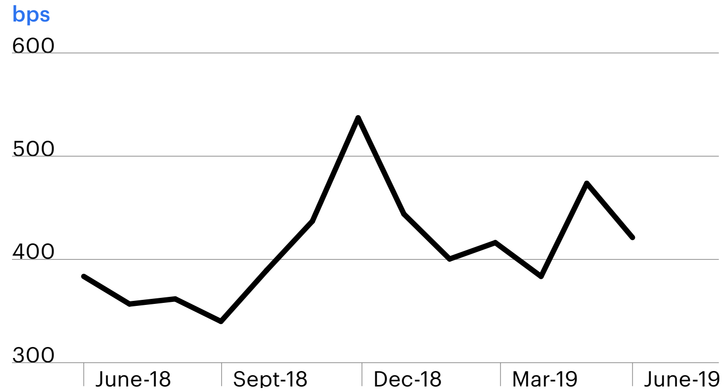
We believe current spread levels, which are slightly tight to 5-year averages, are reasonable for the current macro outlook. Low defaults and slow but steady growth support a spread environment tighter than "average." Whether the loan market can maintain its balance in the context of increased retail outflows, which could cause spreads to rise, bears monitoring.

Another interesting dynamic to watch is the yield gap between senior secured loans and high yield bonds, which turned negative for much of April for the first time since December 2008. 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 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.

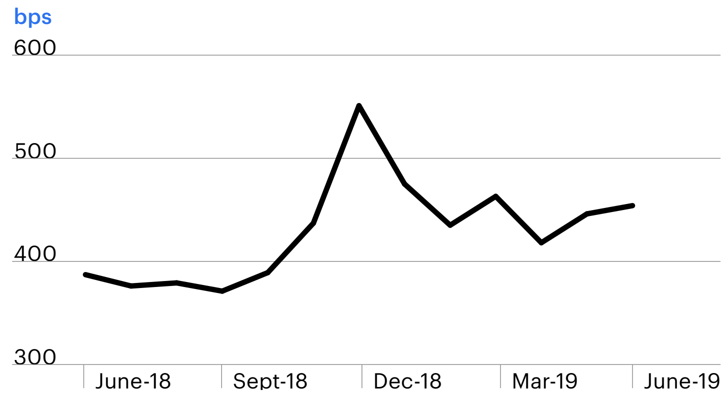
All data as of June 30, 2019, unless otherwise noted.

HIGH YIELD BOND SPREADS



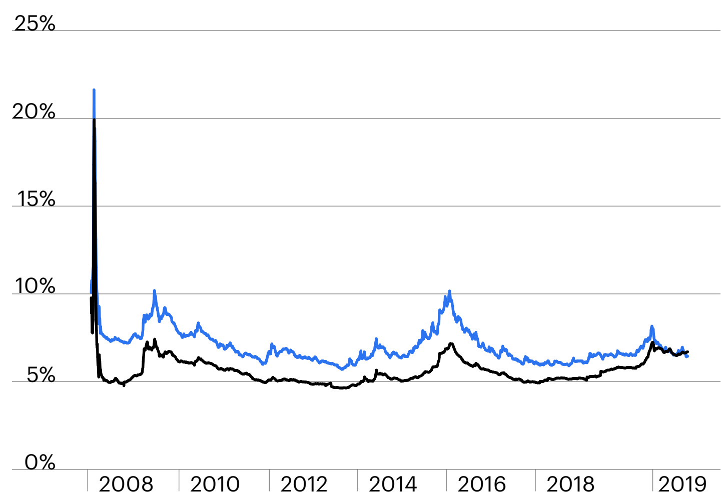
Source: Bloomberg.

SENIOR SECURED LOAN SPREADS



Source: S&P/LSTA Leveraged Loan Index.

YIELD GAP: HIGH YIELD BONDS VS. SENIOR SECURED LOANS



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

Credit fundamentals

Revenue and EBITDA growth for high yield bond and senior secured loan issuers slowed considerably in the first quarter of 2019. These stats bear monitoring as the year progresses given the importance fundamental earnings can have on both credit statistics and, ultimately, default rates. Weaker EBITDA statistics, in particular, would result in higher corporate leverage levels and weaker interest expense coverage if companies do not proactively reduce debt outstanding in advance of lower EBITDA levels. While we think these stats are not necessarily at worrisome levels today, a few more quarters of weaker earnings could quickly cause leverage levels and interest coverage stats to deteriorate.

For the high yield market, Q1 revenue and EBITDA trends were the worst since 2016, when the market was negatively impacted by poor earnings from commodity-related issuers. Revenue and earnings growth rates have generally been running in the mid-single digits to low teens, so the slightly negative EBITDA growth rate in Q1 is notable. Leverage levels are at the higher end of their range over the past 10 years, although interest coverage levels are also at the higher end, suggesting that companies have ample cash flow to continue paying their debt service costs.

Statistics for the senior secured loan market are generally similar to those for the high yield market. While EBITDA growth was positive in the loan market in the first quarter, it was nonetheless the slowest quarter since Q1 2017. Revenue growth was the slowest since Q1 2016. Leverage levels remain close to, yet somewhat below, the average of the past 10 years. Combined with strong interest coverage statistics, these measures do not look worrisome today in our opinion.

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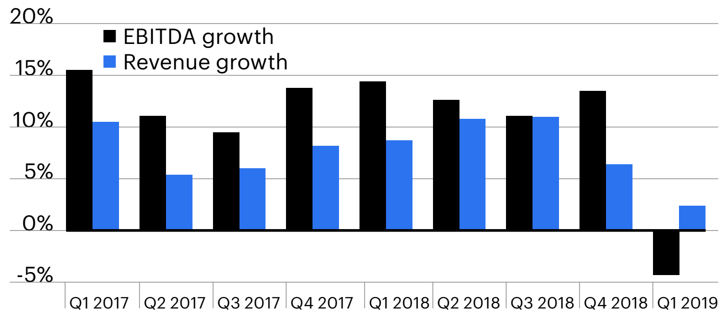
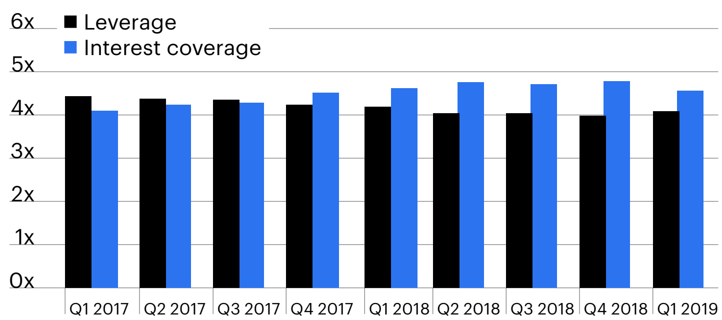
HIGH YIELD EBITDA AND REVENUE GROWTH



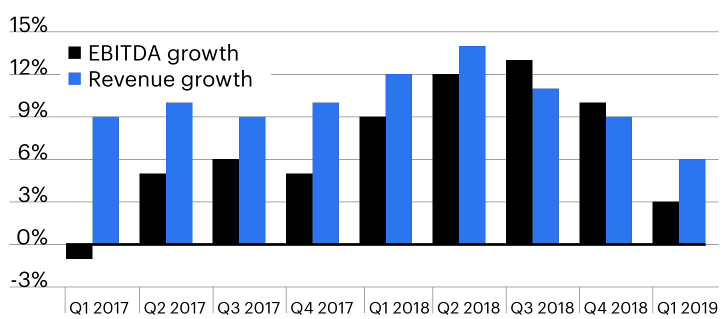
Source: J.P. Morgan, as of March 31, 2019.

HIGH YIELD LEVERAGE AND INTEREST COVERAGE



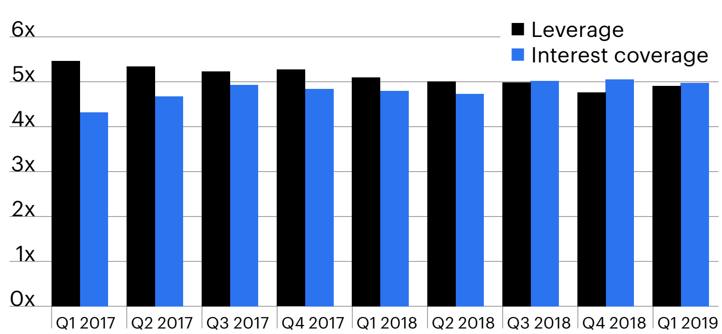
Source: J.P. Morgan, as of March 31, 2019.

LOAN MARKET EBITDA AND REVENUE GROWTH



Source: S&P/LSTA Leveraged Loan Index, as of March 31, 2019.

LOAN LEVERAGE AND INTEREST COVERAGE



Source: S&P/LSTA Leveraged Loan Index, as of March 31, 2019.

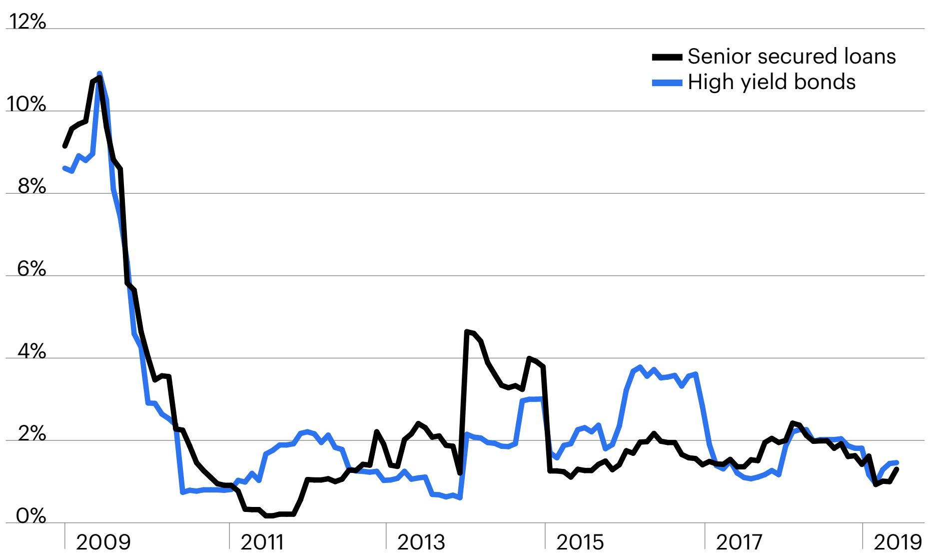
Default rates

In line with reasonably strong revenue and EBITDA growth rates over the past few years, default rates are currently at near-historic lows. The high yield and leveraged loan trailing 12-month default rates as of June 30 were 1.46%[2] and 1.30%,[3] respectively. For context, the long-term averages for high yield and loans are 3.46%[2] and 3.07%.[3]

A good indicator of possible future defaults 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%[3] in November 2008 before major defaults started in 2009. As of May 31, 2019, the distressed ratio sits at 2.36%,[3] in line with the 3-year average. To put this in context, even if every distressed loan today were to default, the default rate would be just 2.36% higher than it currently is—still not much higher than long-term averages.

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 May 31, 2019, this ratio was 5.23%.[1] While somewhat higher than in the loan market, this ratio is still in line with the 3-year average and in line with our expectations given the spread widening following both Q4 2019 and May's bouts of volatility. We believe that due to these relatively low distressed ratios and solid credit fundamentals, default rates are likely to remain 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.

All data as of June 30, 2019, unless otherwise noted.

2 J.P. Morgan.

3 S&P/LSTA Leveraged Loan Index.

Supply/demand technicals

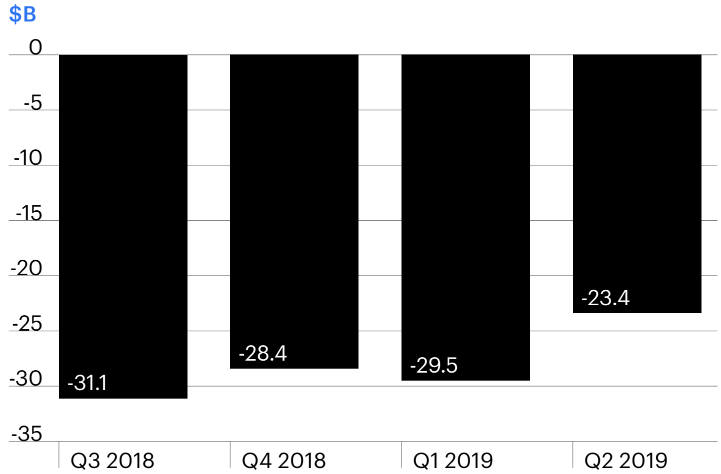
As risk assets rallied, investors migrated to the high yield market, which saw relatively steady retail inflows to start the year. With cash available from dividends and the exodus of over $30B[2] in issuers that were upgraded to investment grade, the overall supply/demand picture for high yield has been one of significant excess demand.

High yield bonds are being used increasingly to retire loans—a reversal from the dynamics at play in prior years—but the demand from investors has been more than ample enough to soak up new issue supply. Similar to the loan market, negative market events could cause retail flows to reverse, potentially upsetting the favorable technical picture in the high yield market today.

Loan funds have seen continuous outflows for 32 straight weeks[3] as investor demand for floating rate products waned following the decline in interest rate expectations following the Fed's dovish pivot. While retail fund flows have been negative, mutual funds and ETFs only compose around 9%[2] 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. In addition, gross and net loan issuances are down roughly 70% and 29%,[3] respectively, year over year.

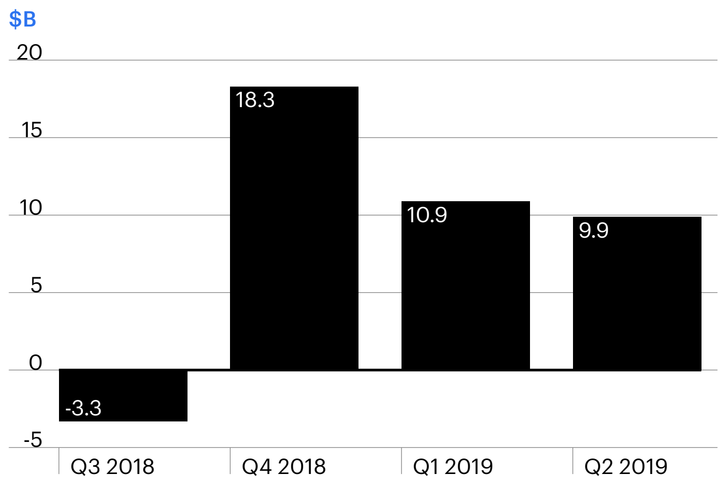
This combination has helped keep the supply/demand relationship in check, which in our view is supportive to overall returns. It certainly bears monitoring. If either of these factors change, it could impact the outlook for steady returns in loans. An increase in expectations for additional rate cuts could cause an acceleration of retail outflows, and increased concerns about an economic contraction could impact CLO creation, further reducing demand.

HIGH YIELD BOND MARKET SUPPLY DEFICIT



Source: J.P. Morgan.

LOAN MARKET EXCESS SUPPLY



Source: S&P/LSTA Leveraged Loan Index.

All data as of June 30, 2019, unless otherwise noted.

INDEXES

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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