BARINGS

FIXED INCOME

High Yield: Poised to Capture Relative Value

2019 October - 3 min read

Despite mounting uncertainty in the broader markets, high yield delivered broadly positive returns in Q3. As we continue to move through the late stages of a prolonged cycle, credit selection will be critical.

Highlights

Positive Performance, But Volatility Lingers
Despite mounting geopolitical headlines, high yield markets delivered broadly positive returns in the third quarter, continuing what has generally been a positive year for the asset class overall. Performance for the quarter across the core high yield asset classes was relatively close, with U.S. and European high yield bonds returning 1.03% and 0.92%, respectively—and U.S. and European loans returning 0.92% and 1.09%, respectively.[1]

On a year-to-date basis high yield bonds have outperformed loans as increasingly dovish central banks continued to direct flows back into fixed rate asset classes. However, senior secured loans have also provided a healthy return so far in 2019, as demand from newly formed collateralized loan obligations (CLOs) offset the lack of interest from retail investors in the U.S. Throughout the year, as market sentiment has favored bonds over loans, the yield differential between the two asset classes has narrowed. With loan and bond yields comparable, we have seen—in a somewhat contrarian view to what has been happening in the market—an opportunity in loans, particularly in the U.S., where the economy appears to be marginally stronger than in Europe.

Credit Selection is Key
Broadly speaking, high yield issuer fundamentals remain stable, and the market appears more disciplined compared to the years preceding the global financial crisis. Driven by a reasonably healthy economic backdrop over the last few years, corporate earnings have been solid overall, and leverage levels largely stable. In addition, due in part to lower financing costs over the last decade, interest coverage ratios appear relatively healthy.

Defaults—the biggest potential risk for high yield investors—continue to hover slightly below long-term historical averages, and we do not expect to see a material increase in the near term. That said, we are mindful that various risks remain—ongoing Brexit negotiations, global trade tensions and commodity prices, to name a few. Concerns around slowing economic growth and the possibility of a recession are also top of mind for many investors. Rather than trying to time investment decisions around these factors, we see value in taking a rigorous, bottom-up approach to credit selection, aiming to choose credits that can withstand short-term volatility and hold up through credit cycles.

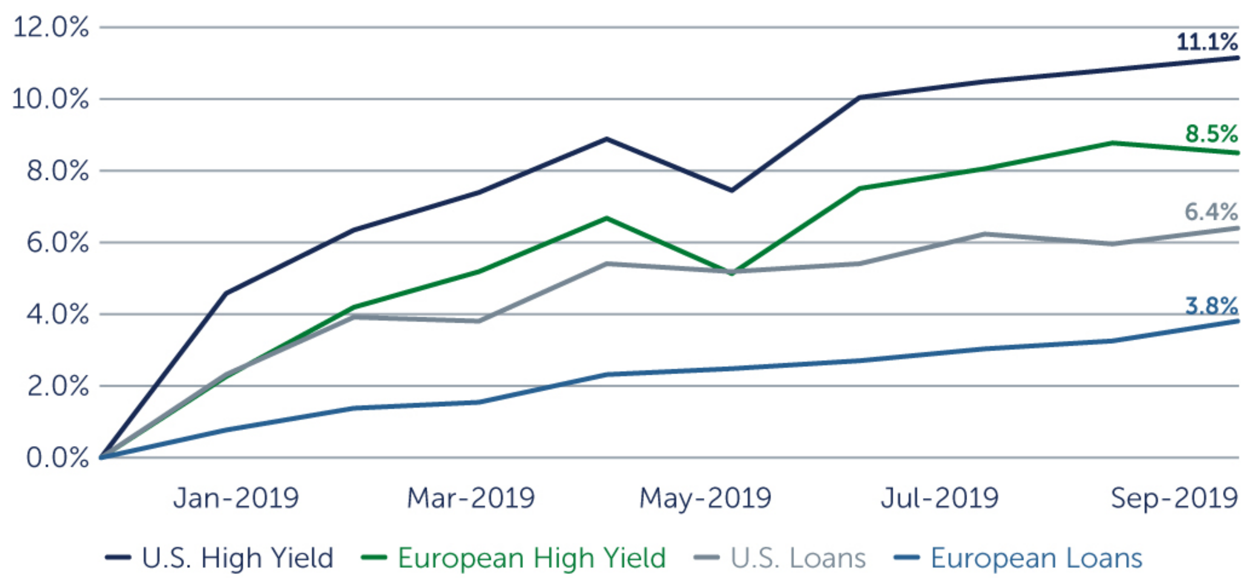
Higher-Rated Credits in Favor
The high yield markets have historically been punctuated with periods of temporary dislocation, during which various technical factors or risk flare-ups can cause any one segment of the market to outperform or underperform for periods of time. For instance, the volatility at the end of 2018—as well as general uncertainty surrounding economic growth—has resulted in increased demand for higher-quality credits, and that segment of the market has outperformed year-to-date. Though it may be too early to identify as a trend, we started to see a shift at the end of the third quarter—particularly in high yield bonds—in which single-B credits outperformed BBs. This is not altogether surprising, as companies have been reporting healthy financials overall, and investors have started to turn their attention back to the search for yield.

Outlook

- While high yield looks fairly stable from a fundamental standpoint, there are a number of global macroeconomic risks on the horizon that could introduce further volatility into the markets going forward.

- Rather than trying to time investment decisions around potential risks, we think there are benefits to a strategic, through-the-cycle approach to high yield—but one that is flexible enough to allow a manager to allocate tactically based on where the best relative value is at any given time in the global market.
- While we continue to see value across the traditional high yield markets (bonds and loans in the U.S. and Europe), we are also looking to the non-traditional segments of the market—in areas like distressed debt, CLOs and emerging markets corporate debt—to identify potential opportunities for additional value.

CONTINUING POSITIVE PERFORMANCE FOR HIGH YIELD "CORE FOUR"*



*CUMULATIVE RETURNS ARE FROM JANUARY 1, 2019 THROUGH SEPTEMBER 30, 2019.
SOURCES: BARINGS, ICE BAML U.S NON-FINANCIAL HIGH YIELD CONSTRAINED (FOR U.S. HIGH YIELD), ICE BAML EUROPEAN CURRENCY NON-FINANCIAL HIGH YIELD CONSTRAINED (FOR EUROPEAN HIGH YIELD), CREDIT SUISSE LEVERAGED LOAN INDEX (FOR U.S. LOANS), CREDIT SUISSE WESTERN EUROPEAN LEVERAGED LOAN INDEX (FOR EUROPEAN LOANS). AS OF SEPTEMBER 30, 2019. EUROPEAN HIGH YIELD AND EUROPEAN LOANS ARE BOTH NON-USD AND HEDGED TO EUR.

1. Sources: Bank of America Merrill Lynch; Credit Suisse. U.S. market returns provided in U.S. dollars and European market returns provided hedged to euros. As of September 30, 2019.

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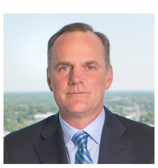

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