PPMAMERICA

HIGH YIELD:
RISING INCOME
BUT NOT WITHOUT RISK

High yield total returns were negative in 2018, as price declines more than negated the increasing yield of the universe.[1] Price returns were down -8.26% over 2018, while the yield returned 5.99%.[2] However, the price declines acted, in our opinion, as a valuations reset, allowing us to identify potential credits with a dislocation between their valuation and underlying fundamentals. We believe 2018's negative total return belies the underlying strength of the asset class.

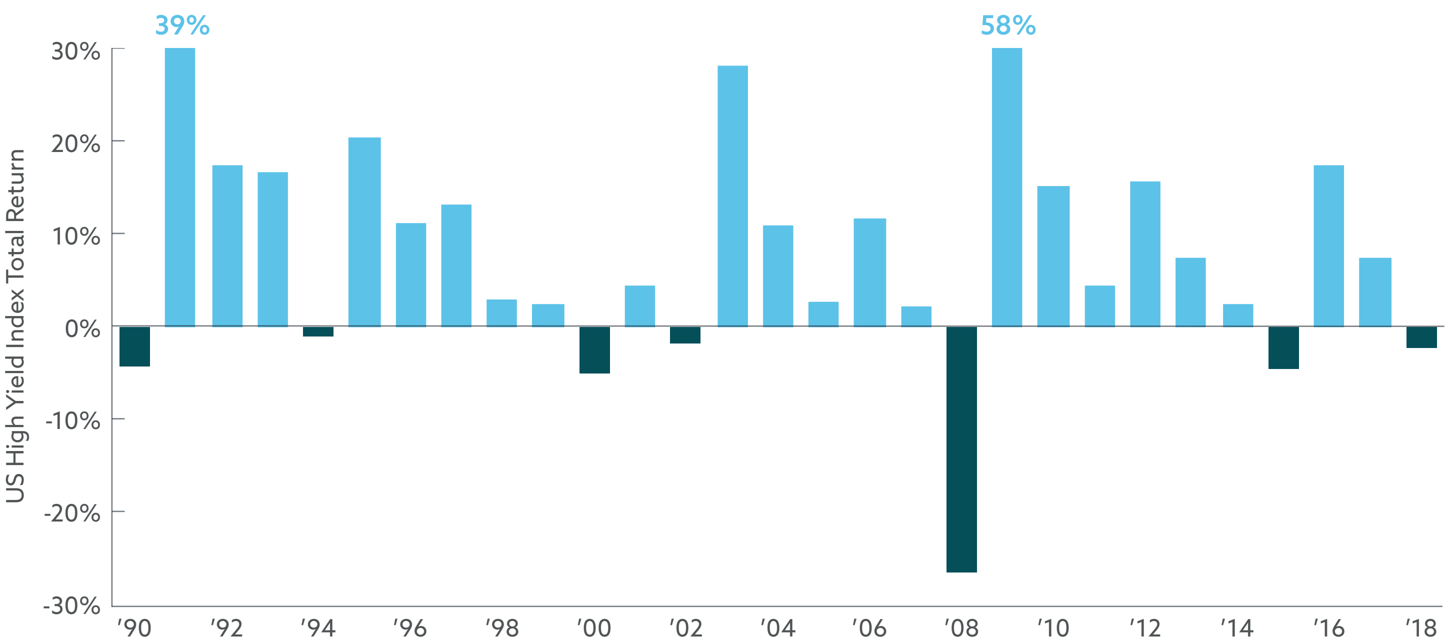
(1) Unless otherwise stated, data is as measured by the ICE BofAML US High Yield Index. (2) ICE Data Services. 17 January 2019.

By the end of the year the yield of the high yield Index stood above 7% (7.03% by 24 January) which is a significant yield to offset price declines. This increased by 210 bps from the start of 2018 as rates have risen and prices have fallen. An old saying in high yield is that income never goes out of fashion, and this increasing yield is a testament to that sentiment, as the average yield on high yield since 2010 has been 6.79%, compared to 3.44% for investment grade and 2.22% for equities.[3]

The par-weighted price of the Index had also fallen to 92.31 by the end of December, although with a January rebound it was back at 95.32 by 24 January.[4] However, we believe that were prices to appreciate, there could be significant total return potential for high yield, as the combination of higher yields and capital appreciation would drive overall returns.

External influences represent the largest risks. The rise of BBB-rated credits brings the risk of fallen angels and, in such a scenario, likely negative technical pressure on the asset class, while high yield corporates continue to issue bank loans that lack covenants or are part of LBOs. The Fed tightening too aggressively remains a primary risk. Finally, trade rhetoric continues to rise and fall. There remains hope a deal can be completed with China, but it is a real possibility tensions increase.

HIGH YIELD HISTORICALLY REBOUNDS FOLLOWING NEGATIVE YEAR[5]



(3) ICE Data Services. FactSet. As measured by the ICE BofAML US Corporate Bond Index and the S&P 500. 18 January 2019. (4) ICE Data Services. 24 January 2018. (5) ICE Data Services. 15 January 2019.

FUNDAMENTALS ARE SUPPORTIVE

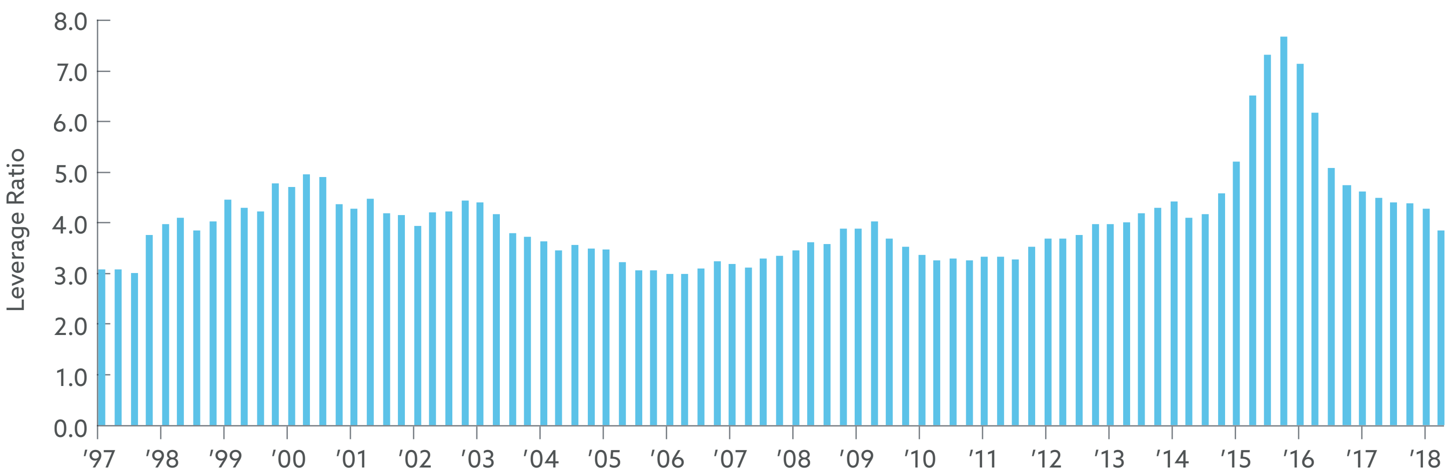
Why do we think that prices could appreciate? The fundamentals of the high yield universe appear to be in relatively solid shape. Much has been made of the length of the current economic cycle, but high yield went through something of its own credit cycle through 2015/2016. This period saw an earnings recession and energy sector crunch (energy is approximately 16% of the high yield Index).[6]

We have seen leverage metrics for high yield companies coming off their highs, with the leverage ratio decreasing from 4.7x to 3.8x since 2017.[7] Much of this has been brought about due to strong earnings results following 2017's tax reform package, as this has helped keep more levered companies in check.

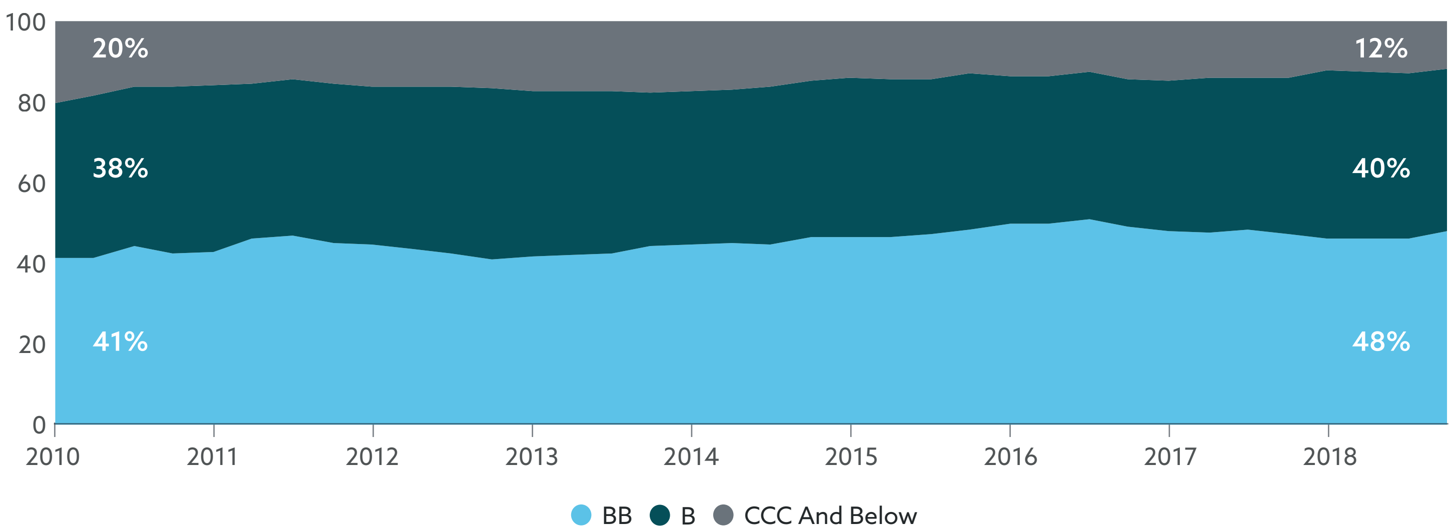
As a result, the Index is overall rated at a higher quality than it has been historically, with BB rated bonds increasing from 41% of the Index in 2010 to 48% now. CCC and below rated bonds have decreased over the same time period from 20% to 12%, again showing a migration up in quality.[8]

The number of fallen angels (those credits that drop from investment grade into high yield) has also been low over this period. There has also been a consistent trend of rising stars outweighing falling angels, which has been shrinking the size of the high yield universe, and highlighting how it is higher in quality than historically. However, the size of the BBB segment of investment grade, and risk of downgrades in the event of an economic slowdown does remain.[9]

HIGH YIELD LEVERAGE RATIO DECLINING FROM PEAK[10]



THE INDEX HAS MOVED INTO HIGHER QUALITY RATINGS[8]



(6) ICE Data Services. As measured by the ICE BofAML US High Yield Index. 26 November 2018. (7) BofA Merrill Lynch Global Research. Data as of 30 September, the latest data available. 3 January 2019. (8) ICE Data Services. 17 January 2019. (9) Credit Suisse. 16 January 2019. (10) BAML High Yield Chartbook. Data to 30 September, the latest availabile. 3 January 2019.

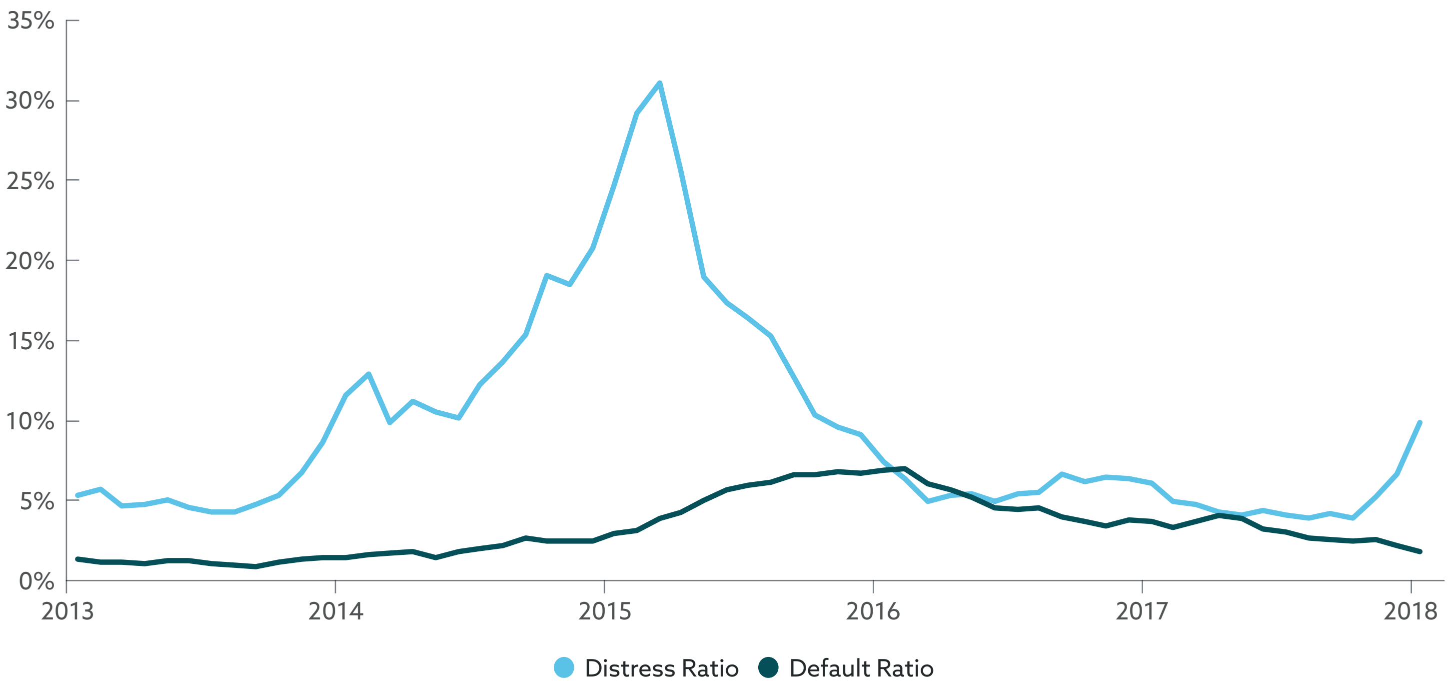
DEFAULTS ARE MANAGEABLE

Default rates are also near their cycle lows, and are forecast to remain at depressed levels through 2019. The current default rate is at 1.8%, well below its historical average of 4.5%, and forecasts are for the rate to remain in this range through 2019.[11] However, if we were to remove the Energy and Consumer/Retail sectors, the rate across the rest of the high yield universe is even lower.[12]

Obviously removing the sectors that are most prone to default, and then commenting on default levels, is worthy of caveat, but it highlights the idiosyncratic nature of what few defaults there have been. Further, as we saw in 2015/2016 a spike in default rates can almost be seen as a positive, as it shakes out weaker companies and encourages balance sheet reform of those that remain. Forecasts are for retail defaults to fall significantly in 2019 as over-levered brick and mortar retailers have been making significant progress to clean-up their balance sheets.

A broader indicator, the distress ratio (bonds that are trading at over 1000 bps spread) is also at manageable levels. According to latest BAML data, this ratio sits at 9.9%. This is up from its cycle lows reached earlier in the year of 5.4%, but it is still well below the peak seen in 2016 of 31.1%.[13]

DISTRESS RATIO RISING BUT MANAGEABLE, DEFAULTS REMAIN LOW[14]



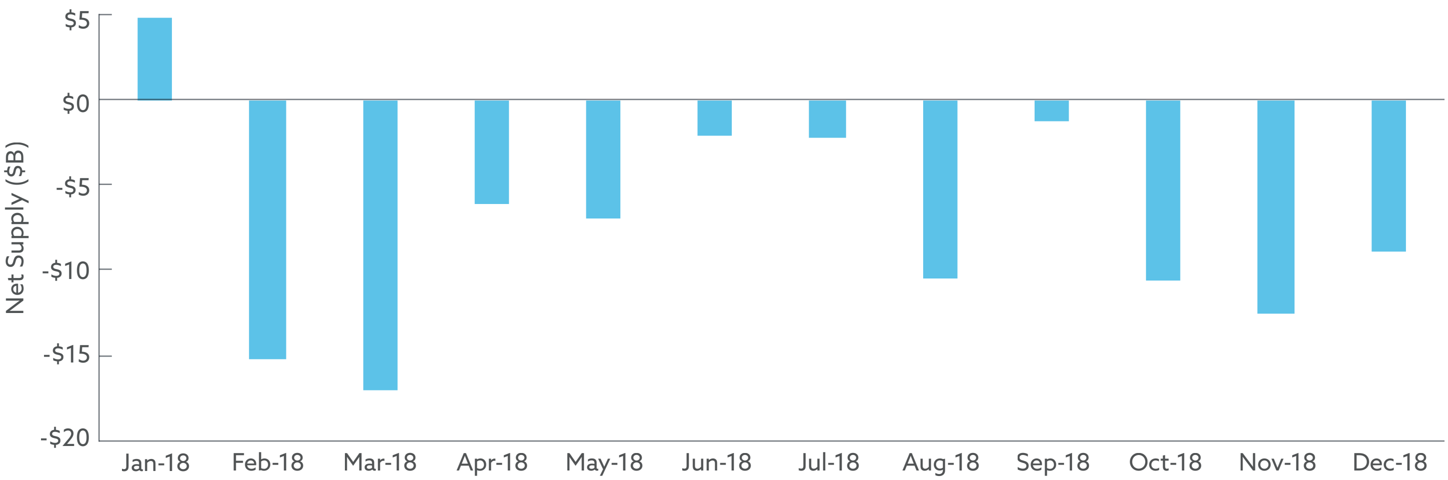
(11) Average calculated from January 2000. Default forecast from Credit Suisse. 3 December 2018. (12) Credit Suisse. 3 December 2018. (13) BofA Merrill Lynch Global Research. 3 January 2019. (14) BofA Merrill Lynch Global Research. 3 January 2019.

TECHNICALS REMAIN AN IMPORTANT FACTOR

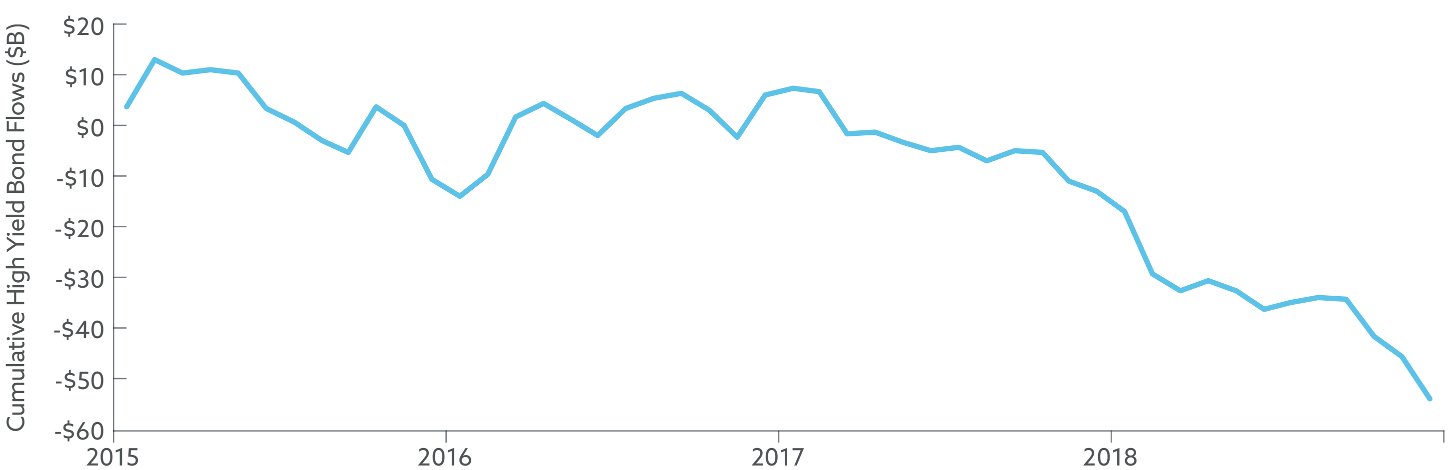
The two elements that underlie technicals are the supply of new high yield bonds entering the marketplace, and the demand from mutual funds and ETFs for the bonds. Since 2015 high yield has seen annual negative net issuance, as redemptions and maturities have been larger than fresh supply to the tune of $181B.[15] Supply over 2018 typifies this trend, seeing negative net supply 11 out of the 12 months. This has meant that the high yield universe itself has shrunk over this time period while investment grade and bank loans have seen growth as issuers have favored the floating rate component of loans over this period. There has been a return to more healthy issuance levels in January 2019, which we see as a positive for the market as it provides diversity of potential investments and shows confidence in the high yield market.[16]

However, on the demand-side of the equation results have been disappointing for high yield. Over the same time period (since 2015) high yield mutual funds and ETFs have seen outflows totaling $54B. Over the longer term, the majority of assets that flowed into high yield since the great recession have now left high yield, which could suggest more stable flows going forward.[17] However, these outflows not only pressure prices, but are also a problem for portfolio managers as high yield is traditionally a relatively illiquid asset class, and so cash management and liquidity management have grown in importance.

NET SUPPLY NEGATIVE THROUGH 2018[18]



HIGH YIELD BOND FLOWS ALSO NEGATIVE[19]



(15) BofA Merrill Lynch Global Research. 3 January 2019. (16) S&P Global Market Intelligence. 24 January 2018. (17) Morningstar. Based on estimated monthly flows for the US OE High Yield Bond category (including ETFs) through 31 December 2018. (18) BAML HY Chartbook. 3 January 2018. Flows Morningstar as measured by monthly flows etc HY. (19) Morningstar. Based on estimated monthly flows for the US OE High Yield Bond category (including ETFs) through 31 December 2018.

RISKS REMAIN

Global macroeconomic concerns led to a selloff in oil and commodities in Q4, which badly hurt high yield energy names, although a rebound has occurred in 2019 to date. We are also mindful of credit cycle concerns as indicators of economic growth and corporate profitability are slowing from 2018's robust levels. However, we believe a pause in the Fed's hiking cycle or slower but continued growth would be supportive for high yield.

In the more immediate term, the impact of lower oil prices will be felt keenly by many high yield companies as they develop 2019 capex budgets. And equity market volatility will impact high yield, due to its relatively high correlation (0.71 over 15 years).[20] Further, broad market volatility is often viewed as being negative for risk assets such as high yield.

Therefore, as we have always found, high yield remains an asset class driven by idiosyncratic risk. While prices can move and overall Index levels appear attractive, we seek alpha by finding credits with improving fundamental stories, prudent balance sheets, proven management teams and those that are able to weather economic volatility.

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Our mission is to deliver specific client solutions and service to investors around the world with the goal of meeting investors' unique investment objectives. In addition, PPM employees are committed to building our community and supporting local nonprofits that strengthen families and increase economic opportunities.

(20) Morningstar. As measured by the ICE BofAML US High Yield Index against the S&P 500 Index. 17 January 2019.

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The **ICE BofAML US Corporate Bond Index** provides a broad measure of the USD-denominated investment grade corporate debt securities publicly issued in the US domestic market.

The **ICE BofAML US High Yield Index** provides a broad measure of below investment grade, USD-denominated fixed rate corporate debt. It includes corporate bonds with risk exposures to countries that are members of the FX-G10, Western Europe or territories of the US and Western Europe.

The **S&P 500 Index** provides a broad, market capitalization-weighted measure of US large cap stocks. It includes approximately 500 publicly-traded stocks of the largest US companies.

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