SKY HARBOR
CAPITAL MANAGEMENT

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US High Yield – 2019 Outlook Summary

The following is a summary of our larger, in-depth 2019 Outlook report, which is available upon request.

Executive Summary

The following report represents our analysis of the state of the US high yield market, with a focus on both the risks and opportunities inherent to the asset class as we enter a new year. Following Q4'18 volatility that eroded US high yield returns to sub-0% levels on a YTD basis, we expect to begin 2019 with what we view as attractive valuations in the context of conservative high yield credit metrics and broad economic strength. Ultimately, we expect 2019 high yield returns to be somewhat below current yields, as the potential for spread widening and upward pressure on rates offset the benefits of a still benign default environment. However, we expect high yield to outperform other fixed income asset classes, largely a function of improving fundamentals, technical tailwinds and attractive yields post-selloff. Given our view that an end to the cycle is not a near-term event, we believe recent spread widening represents an opportunity to add exposure to the asset class.

While our overall view of high yield is supportive, we acknowledge that certain subsets of the market (most notably CCC rated securities) carry heightened secular and/or idiosyncratic risks. This dynamic, coupled with our rating-specific spread and return targets, make us biased toward Single-B and BB credits. On a sector basis, we favor non-cyclicals with modest dependence on foreign growth, as well as those that score well within our EV-adjusted spread per turn of leverage analysis. If we are wrong, and market yields increase relative to our base case, we find both broad and short duration high yield attractive by virtue of elevated breakeven levels and rapid expected recoveries following an immediate yield shock. Key takeaways from our analysis are as follows:

- High yield market returns in 2018 are approximately 20th percentile relative to the last twenty years; our 2019 estimated total returns are approximately 40th percentile
- CCC credits outperformed for most of the year, but fell behind Single-Bs following the selloff that began in early October
- Despite an elongated recovery, we see little chance of a recession in the next 12 months
- Cumulative GDP growth through the current expansion continues to trend below prior recoveries, showing little evidence of the buildup of market excesses that typically precede recessions
- Major economic indicators continue to trend positively; leading indicators (Conference Board US Leading Index of Ten Economic Indicators, Senior Loan Officer Survey) show no sign of degradation
- The yield curve may invert in H1'19, but our analysis shows that recessions typically lag inversions by nearly 1.5 years
- Risk assets typically begin to underperform 5 to 9 months prior to a turn in the cycle; our timeline suggests high yield can perform favorably through 2019 before investor concerns are dominated by recessionary fears
- Net leverage has improved since Q1'17 and is in line with cycle averages of ~ 3.4x
- Interest coverage, a key determinant of future defaults, remains well above cycle averages at ~ 4.6x
- Default rates have rapidly declined, largely driven by the alleviation of commodity-related stress; we expect defaults to remain modest in 2019
- Recovery rates have improved rapidly, and we expect non-recessionary conditions and the lack of sector concentration to allow above-average recovery trends to persist into 2019
- By sector, 2018 fundamental improvement was strongest in Energy, Healthcare and Basic Industry; weakest in Consumer Goods, Retail and Leisure
- Broad and short duration yield-to-worst levels are the highest the market has seen since H1'16 (a period in which commodity volatility was pressuring 1/3 of the high yield index)
- Asset valuations, which had been the greatest weakness of US high yield throughout 2018, now look attractive post-selloff (based on our spread regression model)
- Credit remains the best compensated risk factor in the market; term risk compensation has improved but remains below cycle averages; compensation for illiquidity risk has improved but remains below cycle averages
- By rating, Single-B and CCC credit appears attractive relative to index spreads and historical percentile ranks; BB credit valuations have improved post selloff (they appear to have sold off more than expected from early October through late November) and approximate fair value
- Debt growth has been most prolific in Services, Media, Healthcare and Energy – typically an indicator of future sector stress
- Most often cited fundamental risk factors (foreign growth exposure, rising labor & freight costs, cyclicality) should have the most muted impact on Media and Telecom, and are most concerning for Capital Goods and Technology
- Rising interest rates, protectionism and China remain top investor concerns, with these three dominating sentiment for over a year
- NFIB Small Business Optimism readings nearing record-high levels should bode well for high yield fundamentals
- While aware of acute fallen angel risk given the proliferation of BBB rated debt, we envision rising stars outpacing fallen angels in 2019
- We expect net supply to remain negative in 2019, creating a technical tailwind for the US high yield market
- Current spread and yield levels on the US high yield index typically coincide with total returns of 3.5% to 4.5% in subsequent 12-month periods
- Our spread, rate, default and recovery models imply ICE BofAML US High Yield Index (H0A0) returns of ~ 3.5% in 2019, and ICE BofAML 1-5 Year BB-B US Cash Pay High Yield Constrained Index (JVC4) returns of ~ 4.3% in 2019

For inquiries regarding the underlying analyses and full report, please contact your SKY Harbor representative or email info@skyhcm.com.

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