SKY HARBOR
CAPITAL MANAGEMENT

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US High Yield – 2020 Outlook Summary

The following is a summary of our larger, in-depth 2020 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. A sharp Q4'18 downturn was followed by a strong market rally at the start of 2019, with total US high yield returns reaching double-digit levels by the time of publication. Despite this strength, we remain cautiously optimistic on US high yield as we head into 2020, underpinned by our base case which assumes no recession over the next twelve months, a stable corporate earnings environment, higher but still muted defaults, and the potential for continued technical tailwinds given the proliferation of negative yielding debt on a global basis. Increased dispersion and elevated recovery rates also give us confidence that credit losses are likely to be limited over the next twelve months.

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 per turn of leverage and percentile ranking metrics, make us biased toward Single-B credits. On a sector basis, we favor areas of the market that should benefit from a strong US consumer, those with below-average dependence on foreign growth, and those insulated from policy uncertainty that we expect to increase as we get closer to the US presidential election. Additionally, we seek to opportunistically take advantage of elevated illiquidity premiums, notably in issuers where we have developed a high degree of credit conviction. If we are wrong, and market yields increase relative to our base case, we still find both broad and short duration high yield attractive by virtue of elevated breakeven levels and rapid expected recoveries following an immediate yield shock. Furthermore, although we do not expect a recession to materialize over the next twelve months, an analysis of historical downturns implies the next one will be mild by virtue of the measured pace and above-average length of the current expansionary cycle. Key takeaways from our analysis are as follows:

- Broad US high yield market returns of ~ 12.1% in 2019 (YTD through November 30) are approximately 73rd percentile relative to the last twenty years, and represent the best performance since 2016
- Short duration US high yield market returns of ~ 9.5% in 2019 (YTD through November 30) are approximately 68th percentile relative to the last twenty years, and also represent the best performance since 2016
- BB credits outperformed on both an absolute and beta-adjusted basis for the entire year (+14.3%), followed by Single-Bs (+12.0%); CCC credits significantly underperformed (+3.3%) despite index-wide returns in the double-digit range
- By sector, returns were largely range-bound (most in the +12% to +15% range), with Energy (-0.5%) an outlier to the downside
- Both rating and sector returns were driven largely by duration, as the Fed's dovish pivot in January '19 led to three rate cuts and the rallying of US Treasuries
- Large issues (> $1bn in size) outperformed small issues (< $350mm in size), likely driven by ETF inflows and their preference for holding the most liquid securities in the index
- Despite a record-long expansionary cycle (125 months and counting), we see only modest risk 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 build-up of market excesses that typically precede recessions
- The yield curve (2s/10s) continues to flatten, but has not yet sustainably inverted; typically, recessions do not start until 10-24 months after inversion
- Consensus US GDP growth in 2020 is +1.8%, which falls into the historical "sweet spot" for US high yield bond market performance
- Adjusting for accounting changes to operating leases, net leverage is near cycle and 20-yr averages, while interest coverage remains elevated
- Corporate earnings growth, which had slowed to between flat and modestly negative levels in 2019, is expected to modestly pick up in 2020
- We forecast the issuer-weighted default rate to increase to ~ 4.0% in 2020 (from ~ 3.0% at present) but remain below long-run annual averages
- We forecast recovery rates on defaulted issuers to remain elevated in the 48% to 50% context, well above long-run averages of ~ 42%
- We expect to start 2020 with broad market and short duration HY spreads in the 400bps and 300bps area, respectively, historically 2nd quartile
- Our expectation for limited Fed action in 2020 and an analysis of spread per turn of net leverage metrics leave us biased toward Single-Bs
- Premiums paid to hold smaller/less-liquid issues have been on the rise, and are now above cycle averages; spread duration compensation is low
- By sector, 2019 fundamental improvement was strongest in Consumer Goods, Healthcare, Services and Media; weakest in Technology, Basic Industry, Automotive and Retail
- Investor concerns remain tied to trade war and China; 2020 election risk has recently risen to the top of credit concerns in the BofAML survey
- We expect supply and demand trends to be more balanced than in 2019, although fund inflows could lead to technical tailwinds near term
- For broad market US high yield, we expect year-end spreads of 425bps, 5yr Treasury yields of 1.70%, a 4.0% default rate, and a 45% loss given default estimate to lead to 2020 returns of ~ 5% (modestly less than coupon)
- For short duration US high yield, we expect year-end spreads of 345bps, 3yr Treasury yields of 1.62%, and a 2.0% ratings migration rate to lead to 2020 returns of ~ 5% (modestly less than coupon)
- Key downside risks to our thesis include 1) failure to achieve trade war resolution, 2) a rise in policy uncertainty, 3) continued dollar strength that penalizes US corporates with a disproportionate amount of sales conducted outside of the country, 4) weaker-than-consensus corporate earnings growth, 5) a recession, and 6) a wave of fallen angels following the buildup of BBB debt in the investment grade bond space
- Key upside risks to our thesis include 1) liquidity premium normalizations that lead to small issue outperformance, 2) a return of CEO confidence to levels commensurate with Consumer confidence, 3) elevated dispersion that further reduces credit losses and allows for active manager alpha generation, and 4) breakevens that are supportive of both broad market and short duration high yield (over other fixed income asset classes)

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

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