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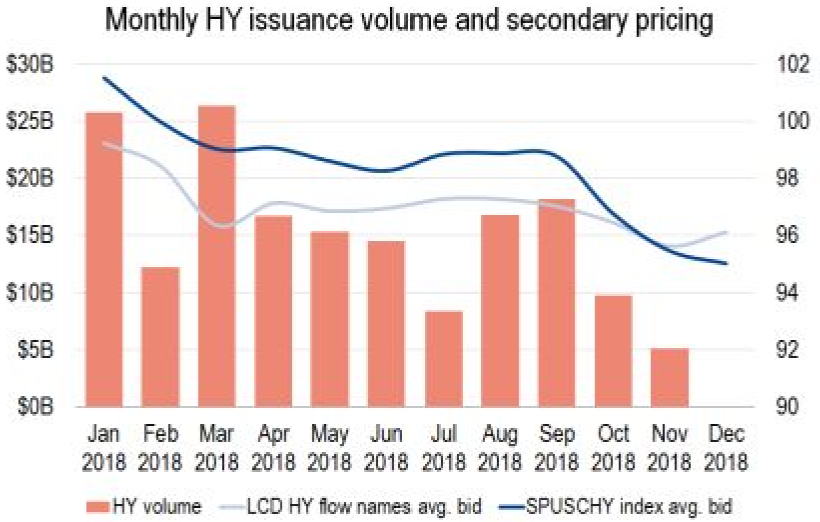
2019 HY Outlook: Slim volume eyed amid volatility, loan preference

The wave of volatility that seeped into the financial markets in the third quarter of 2018 only intensified through year-end, shuttering the high-yield primary market in December to produce the only calendar month without new issuance since LCD started tracking the data in 2005. At $168.8 billion, U.S. high-yield recorded its lowest full-year volume since 2009.

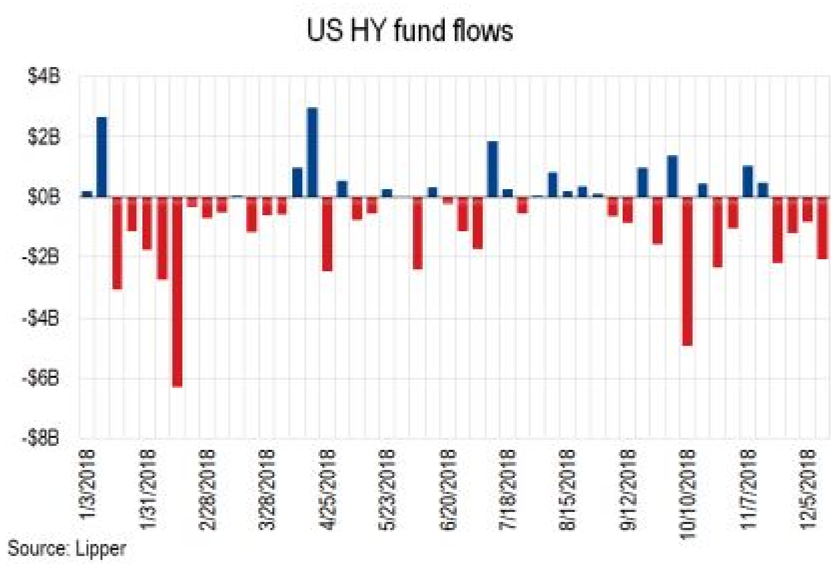


Source: LCD, an offering of S&P Global Market Intelligence

The grim close to the year dovetailed with the increasing preference among borrowers to raise funds in the relatively hot leveraged loan market, as issuers and investors alike grew defensive ahead of projected interest rate hikes. Uncertainty surrounding geopolitical concerns, namely China trade tariffs, and price declines within the energy sector added to the soggy backdrop.

“Through September, the high-yield market performed well, supported by economic growth, strong corporate fundamental trends, a lower sensitivity to rates than other asset classes, and significant reduction in issuance from 2017 levels,” says Nichole Hammond, senior portfolio manager at Angel Oak Capital Advisors. “High-yield spreads hit their post-crisis tight levels in OAS terms on 10/3/18. Since then, there has been some concern in risk markets about peak earnings, slowing global growth, the pace of the Fed, and the ongoing trade dispute with China.”

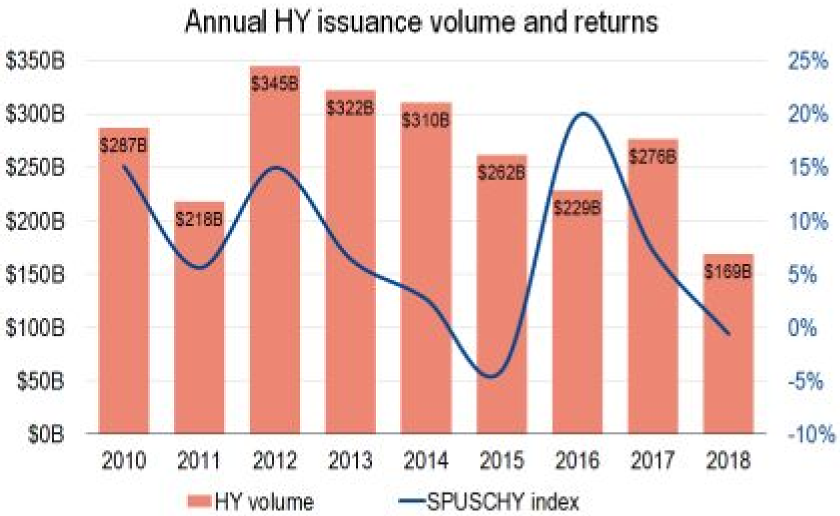
Outflows mounted over the closing weeks of the year. Investors had pulled more than $30 billion from U.S. high-yield funds net of the year to Dec. 12, according to Lipper weekly reporters.



Source: Lipper

Withdrawals roughly doubled from the $14.9 billion of net outflows over all of 2017, following an $11.1 billion inflow in 2016. The OAS average across the S&P U.S. High Yield Bond indices gapped from T+292 on Oct. 3, to T+416 on Dec. 10, including a 260 bps move wider in the CCC category. The unwind was harrowing in its rapidity, as the average bid across LCD’s 15-bond sample of liquid flow-name high-yield issues tumbled 3.625 points from the first October reading of 98.75, to 95.125 just ahead of the Thanksgiving break.

Exacerbated by the late-year lull, full-year issuance volume tumbled 39% from the $276.2 billion recorded for 2017. The final 2018 tally for new prints fell far short of Street expectations for the year, which were in a range of $270–315 billion.



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Predictions for the year ahead indicate a year-on-year uptick in volume, though minimal, as current market themes spill over into 2019.

Volume: Loans to pull back?

As predictions currently stand, investment-banking research generally relates forecasts for 2019 issuance of $180–200 billion.

Among the optimists are Bank of America Merrill Lynch, Citi, and J.P. Morgan, each of which peg full-year volume at $200 billion. J.P. Morgan's team, spearheaded by Peter Acciavatti, further forecasts $100 billion in net high-yield new issuance.

Citi foresees the same volume for high-yield bonds, and notes bearish sentiment in terms of leveraged loan volumes.

"In our view, loan issuance will fall 25% to $350 billion in 2019," say strategists at Citi. "Loan issuance will decline significantly primarily due to our expectation of a choppier market and, therefore, fewer attractive refinancing opportunities."

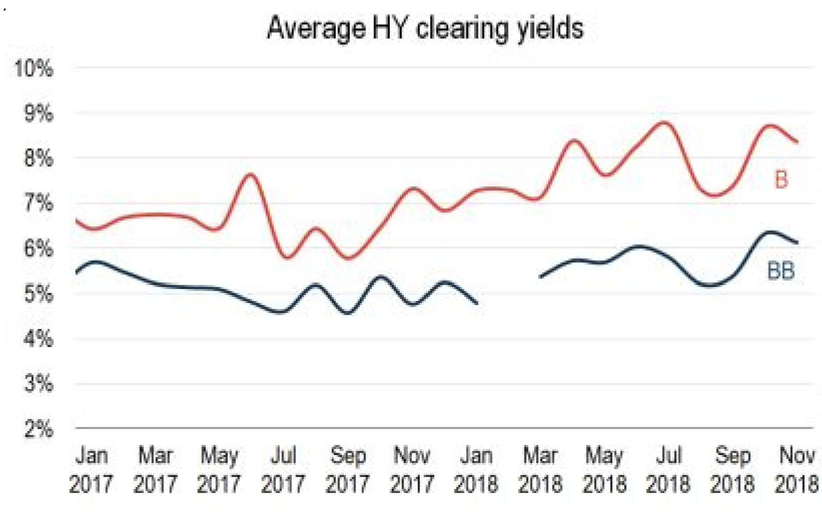
Meanwhile, Barclays forecasts new high-yield issuance of $180–200 billion for 2019, and Morgan Stanley expects $183 billion. Wells Fargo projects new high-yield issuance at $190 billion, against $385 billion of leveraged loans.

UBS sees no shift in the loans-versus-bonds trend. "High-yield issuance specifically should remain depressed given issuer preference for leveraged loans and elevated sensitivity to changes in high-yield funding costs," the bank wrote in its 2019 outlook.

However, if the buyside appetite for leveraged loans does reverse course, the outcome is likely to be beneficial for the high-yield market.

"If loan issuance slows because there is no demand via flows into the asset class, and investors find valuations attractive in high-yield, you could see issuance migrate back to the high-yield market," says Jonathan Stanley, managing director and portfolio manager at Newfleet Asset Management.

Refinancing will be a key driver for 2019 volume, but through the lens of heavy trailing activity and eroding economic incentives for issuers.

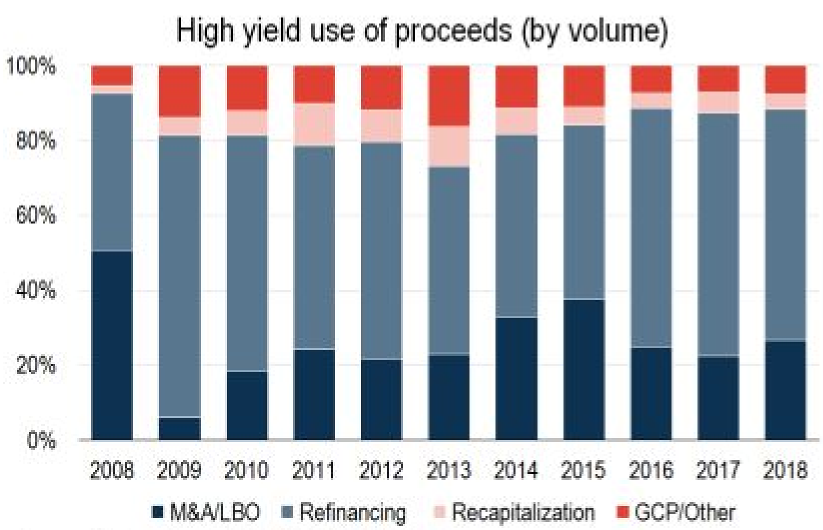


Source: LCD, an offering of S&P Global Market Intelligence

“It’s important to remember that the whole high-yield market has been through two cycles of refinancing and there are only a handful of companies looking at maturity walls right now. Companies that have maturity walls in 2020 will try and get those refinanced while the primary market is accessible,” says Mike Brown, co-portfolio manager for Advent Capital Management’s high-yield bond strategy.

M&A financing is a wild card, though that carve-out, too, faces mounting macro headwinds and a clear preference among borrowers and investors for loan-dominated funding packages. Already on the horizon are **Colfax—**which could print new paper in connection with the company’s $3.15 billion acquisition of DJO Global from Blackstone—and **Johnson Controls**, which may seek to issue new notes in relation to the company’s sale of its **Power Solutions** business to Brookfield Business Partners, Caisse de depot et placement du Quebec (CDPQ), and other institutional investors for approximately $13.2 billion.

According to LCD, M&A-driven issuance represented a 27% carve-out of overall U.S. high-yield issuance this year, up from 22% in 2017.



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Returns: Outlook mixed

As of Dec. 13, 2018, the year-to-date return for the S&P U.S. Issued High Yield Corporate Bond Index was negative 0.29%, further echoing the broader market tone. (Though sharp 4Q losses cut leveraged loan returns for the year roughly in half, the S&P/LSTA Leveraged Loan Index nevertheless returned a superior 1.9% for the same year-to-date span.) The outlook from investment banking research desks shows signs of improvement on this front in the year ahead, though predictions vary, and are generally no better than a coupon-clipping outcome.

Barclays has pegged high-yield return expectations at 3.5–4.5% for 2019, while Morgan Stanley has set a far more bearish prediction, at 0.5%. Splitting those views, Citi analysts are expecting a 2.7% total return.

J.P. Morgan is eyeing an approximately 5–6% total return, with the upside driver originating from fewer-than-expected rate hikes, which would temper recessionary concerns.

Wells Fargo has set its base case high-yield total return forecast at 6–7%, as high-yield spreads grind tighter on the back of the late 2018 expansion.

Notably, triple-C as a ratings category was the strongest card in a weak hand for high yield during 2018, though the expectation is for the asset class to give back some of those relative gains in the coming year. (For reference, the triple-C category of the S&P U.S. Issued High Yield Corporate Bond Index returned 1.36% for the year to Dec. 13.)

But, while returns may flag, portfolio managers aren't sounding the alarms yet in terms of the default rate.

"I think that what has surprised people with triple-Cs were that some of the companies that were challenged, the management teams were savvy to address this head on and push out maturities," says Lale Topcuoglu, senior fund manager & head of credit at JO Hambro Capital Management. "I think as the economic outlook changes, I don't see that triple-C performance continuing. I think it's about having access to easy money. Does that mean higher defaults? No. The documentation is so poor that a lot of these companies have the ability to play around in the capital structure to extend their lifelines."

Sectors: Energy woes stage a comeback

As the market was clearing out at 2017's close, many participants expressed to LCD that energy sector concerns were in high-yield's rear view. And this appeared to be the case as WTI crude pushed passed the $74 mark in June, after dipping below $36 in June 2016. Buoyed crude prices opened the door for healthy issuance: According to LCD, 22% of overall U.S. high-yield bond issuance in 2018 flowed from the Oil & Gas sector, up from 14% one year earlier.

However, energy sector conditions soured into the third quarter, as oil producers failed to engineer sustained price gains. The larger concern for high-yield is whether the broader market will be able to shake volatility stemming from the sector this go-round.

"Energy itself is about 14% of the high-yield market," says JO Hambro's Topcuoglu. "What energy does—because of the weight of it—has a broad effect on the high-yield index. We tend to not invest too much in energy. A lot of these companies, even at $80 oil, they don't generate a lot of free cash flow. High-yield energy has come under pressure, but that is because they haven't done much to improve their capital structures."

And prices may not be the only issue weighing on the sector.

"Energy is getting hit from many directions," says Newfleet's Stanley. "Slower global economic growth is now being forecasted and that isn't good for energy. Energy companies have also become more efficient and are able to operate at a lower price, and companies in the U.S. can still now make money."

Away from energy, many other industries remain on the radar screens of investors.

"The Retail sector continues to be impacted by the ongoing secular changes in the industry," says Robert Houle, senior portfolio manager, US High Yield, AXA Investment Managers. "Cyclical sectors including Building and Construction, Building Materials, Chemicals, Metals and Mining, and Capital Goods are topical currently, as returns within these sectors can be driven by investors' views regarding the current stage of the business cycle and the outlook for US and global economic growth. We are also closely monitoring the Telecommunications sector given secular headwinds for certain issuers."

Fallen angels: Spotlight on GE

As 2018 was nearing an end, the topic of fallen angels began to gain mainstream attention. The spotlight shined most harshly on **General Electric** and the company's balance-sheet management, which led many to extrapolate its impact on high-yield from a fallen-angel outcome for the erstwhile gilt-edged credit. Oleg Melentyev, head of High Yield and Leveraged Loan Strategy at Bank of America Merrill Lynch, says that "at $48 billion in index-eligible bonds, GE could become the largest fallen angel in domestic market U.S. dollar high-yield market history."

Risks to the GE profile evoke the twin fallen-angel cuts to **Ford** and **GM** in 2005 (not to mention the downgrade risks currently facing the U.S.automakers amid cyclical headwinds and simmering trade concerns). The fallen-angel slides for those massive capital structures in 2005 led to a sharp—if transitory—spike of nearly 200 bps at the broad high-yield index level.

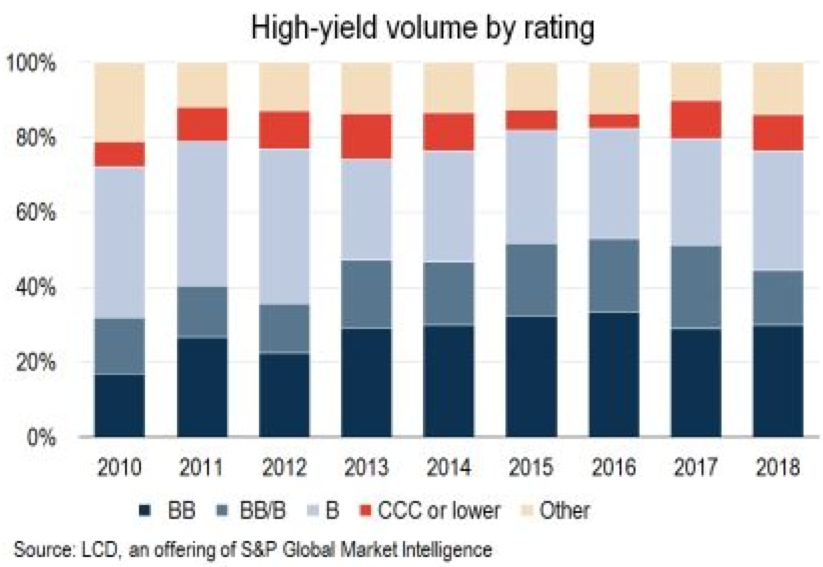
The pool of bonds on the IG cusp has deepened considerably since the financial crisis. Analysts at S&P Global Ratings note that, as of year-end 2018, the total forecast balance sheet debt for U.S. non-financials in the triple-B space swelled to just under $3 trillion, up some 171% since 2007. However, the agency notes that while industry consolidation and acquisition activity have created sizable debt concentrations among certain sectors and issuers, this "debt tends to be concentrated among the most stable sectors and issuers, with the majority of [triple-B] issuers leveraged below 3x in 2018 and 2019."

"We think GE is far from becoming a junk bond," says Advent's Brown. "We don't see it as a certainty of going to fallen angel status, and if it does, we think it will take a while because they have assets they can sell." Brown notes that fallen angel risks are more pronounced among triple-B energy and retail credits.

Meanwhile, S&P Global Ratings and Moody's in December made **Xerox** a fallen-angel issuer, shunting its $5.3 billion of rated debt onto the high-yield market at a moment of particular weakness. Among the larger debt capital structures at BBB–, **SCANA**'s $6 billion of rated debt is under review for possible downgrade at S&P Global Ratings, while current non-financial BBB– issuers with negative outlooks include **Discovery** ($17 billion), **Viacom** ($12.2 billion), **Macy's** ($7.4 billion), **Motorola Solutions** ($6.4 billion), and **TransAlta** ($2.2 billion).

Even still, if high yield does see an influx of fallen-angel debt, this may not be the worst thing for the asset class.

"The attention on fallen angels has been focused on size," says Marc Aylett, co-portfolio manager for Advent Capital Management's high-yield bond strategy. "Later on down the line, if a lot of those triple-Bs do decline into high-yield, it would put pressure on the high-yield market, but I think with issuance down, that we would welcome the supply."



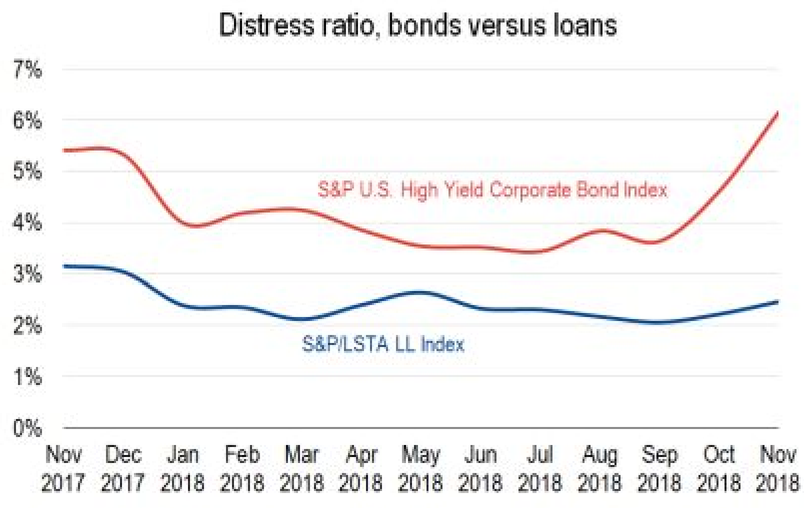
Notably, the 2005 experience showed index-level high-yield spreads retracing roughly half of the initial widening within six months of the Ford/GM downgrades. This year, high-yield spread aggregates largely took in stride the $35 billion of fallen-angel **Teva Pharmaceutical Industries** debt that washed over high-yield desks in the opening sessions of January.

Further, LCD's Marty Fridson has pointed out that life insurance companies—which are key buyers of IG debt—that paid par for an investment-grade bond can continue to carry the bond at par for statutory accounting purposes, even as prices erode through downgrading, generally as long as the rating falls no lower than triple-C. Any sale by the life insurer at a discount to par would cut into its statutory capital, and weigh on its capacity to underwrite new policies and generate incremental premium income. "The bottom line is that as long as the life insurance company does not think the issuer is headed for default, it has a strong disincentive to sell a fallen angel," according to Fridson. He noted that "the investment rules under which IG portfolio managers generally operate are not as inflexible as media accounts sometimes suggest," and that institutional investors recognize that enforcing fire sales at the instant of a sub-IG ratings cut would be counterproductive for all concerned.

Defaults

The rocky finish to 2018, meanwhile, belies what remain generally sedate forecasts for defaults next year.

The U.S. trailing LTM speculative-grade corporate default rate was unchanged month-to-month at November's close, at 2.64%, according to S&P Global Fixed Income Research (GFIR). GFIR analysts expect the default rate to decrease to 2.5% by September 2019, from 2.7% in September 2018, and 3.2% in September 2017.



Sources: LCD, an offering of S&P Global Market Intelligence; S&P/LSTA LL Index, S&P US HY Corporate Bond Index

Sentiments expressed via Street research suggest some upside risks to that view, but without much concern of a material breach of longer-term averages.

BAML says its default rate model produced a 4.0% issuer-weighted forecast for the next 12 months, which is the upper band of most projections.

Morgan Stanley projects a 2.9% high-yield default rate. Analysts at UBS are not far off from this, with an eyed 3.0% default rate (versus 3.1% current) through the third quarter of 2019, along with Wells Fargo.

Barclays expects a "par-weighted default rate of 2.0–3.0% and an issuer-weighted rate of 2.5–3.5% for high yield bonds in 2019." This the bank says, is based on both top-down and bottom-up approaches.

Citi predicts a 2.5% default rate for the year. And J.P. Morgan strategists place both the high-yield bond and loan default rates at 1.5%, which is "below the 3.0–3.5% long-term averages."

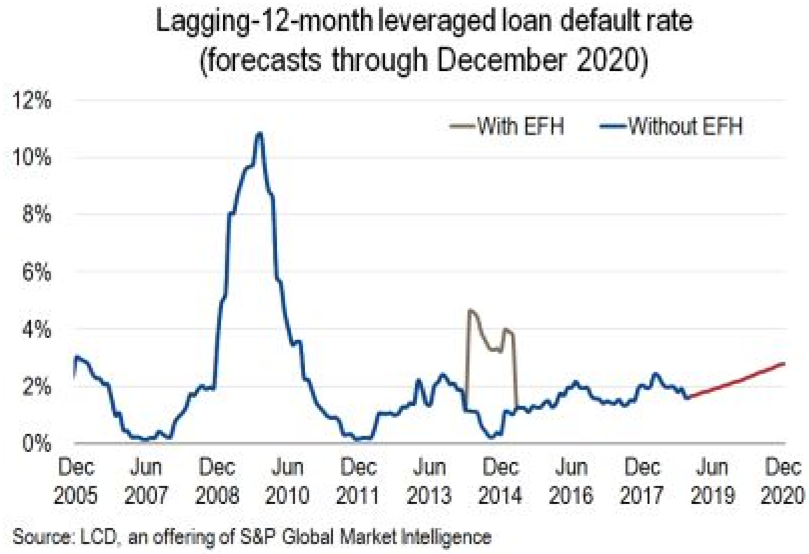
Loan survey

Despite the mounting macro headwinds, loan managers continue to expect little acceleration of defaults in the year ahead. Indeed, the majority once again pushed out their forecasts of when the rate would climb above its 3.1% historical average.

According to LCD's loan default survey conducted in December, 42% of portfolio managers now expect the default rate will not breach this milestone until 2021. At the same time last year, 67% expected this would be a 2020 event. And for the first time, a contingent of the respondents (17%) now expects the rate to stay below 3.1% at least until 2022.

Source: LCD, an offering of S&P Global Market Intelligence

In the interim period, loan managers on average predict the rate will climb to 2.16% by year-end 2019, from a current rate of 1.63%.



This marks a significant improvement in sentiment. When polled at this time last year, the consensus among loan managers called for a default rate at year-end 2019 of 2.65%. Polling puts the loan default rate at 2.79% at the end of 2020. — Jakema Lewis

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