2019 Recap: All about the Fed

Against a backdrop of macro and geopolitical uncertainty, the high yield market was resilient in 2019 as the Bloomberg Barclays US Corporate High Yield Index generated impressive total returns of 12% year to date through November 30. Investors were keenly focused on rates throughout the year as the Fed solidified their accommodative monetary stance with three rate cuts between July and October 2019. Combined with a decent economic growth environment, the rate cuts fueled a sustained rally across fixed income assets, including high yield.

In addition to the accommodative US monetary policy backdrop, the high yield market benefited from stable fundamentals, including healthy company earnings and relatively low defaults. Technicals were also supportive, as modest high yield inflows were more than sufficient to meet an average new issue supply calendar dominated by refinancing activity. This combination of stable fundamentals and supportive technicals resulted in a significant move lower in the yield to worst of the high yield index, from almost 8.0% in January to 5.6% as of November 30.

2020 Vision: All about Growth

Looking forward, we expect underlying high yield market fundamentals will remain supportive. Our base case view is that the US economy will continue on a slow, but stable US GDP growth trajectory of 1.8%. This view is predicated on a resilient US consumer, but offset by late-cycle concerns which are exacerbated by trade and election uncertainty. This is likely to limit business investment, which may continue to be a market headwind. Against this uncertainty, and in the absence of any meaningful inflation pickup, we think the Fed will continue to lean on the accommodative side by supporting markets with one or two rates cuts in 2020. In many ways, this macro view is a positive scenario for high yield market given stable fundamentals, expectations for relatively low defaults and supportive market technicals.

Key Takeaways

- Looking out to 2020, we are cautiously optimistic on the high yield market given stable credit fundamentals, relatively low default expectations and accommodative monetary policy.
- Technicals are likely to remain supportive as issuers take advantage of the low-rate environment and investors continue to search for yield.
- Despite low all-in yields, high yield appears to be fairly valued and is reasonably attractive versus other fixed income sectors.
- Risk aversion has created valuation discrepancies within energy, CCCs, and BBs; as clarity toward global growth, trade and geopolitics unfolds, these market segments have the potential to drive high yield bond performance in 2020.

Exhibit 1: High Yield Fundamentals, Valuations, Technicals & Sentiment
Fundamentals are stable, despite slowing growth

High yield fundamentals have been fairly steady over the past several years – we don’t envision that changing in 2020. Further, earnings have been decent in most sectors, and leverage trends have been stable. Most management teams have limited debt growth, while EBITDA is up modestly. Most high yield companies are benefiting from the drop in rates and have been able to lower their interest costs through bond refinancing and floating-rate loan adjustments. This has led to historically strong interest coverage ratios.

However, certain sectors are facing greater challenges than others. Broadly speaking, domestically focused sectors with US consumer exposure are seeing better times than many of the global cyclical-dependent on business investment. Within high yield, communications, consumer cyclical, financial and transportation sectors have been doing well. Meanwhile, basic industry, energy and technology are facing headwinds of slowing revenue and squeezed operating margins. In addition, certain industries like healthcare and pharmaceuticals are challenged by shifting government policies and uncertainty around future litigation.

Looking out to 2020, we think many of the US consumer-related sectors will continue to benefit from a supportive fundamental backdrop – a strong job market, low interest rates and low commodity prices are likely to continue to fuel consumer spending. In addition, we think many of the cyclically challenged sectors, where earnings were down in 2019, will benefit from easier year-over-year comps, relatively healthy balance sheets, and optimistically, some decrease in the business uncertainty created by the trade situation. Continued focus on cost cutting, low commodity prices and decreased freight costs may help maintain margins. While individual credit selection is always paramount in high yield investing, on balance, the fundamental backdrop for the high yield market remains supportive going into 2020.

But wait – aren’t defaults increasing?

While default rates have ticked up modestly, it’s not necessarily what it appears. In 2019, four large US high yield companies—EP Energy, Weatherford International, Hexion and Windstream—defaulted and could file bankruptcy in 2020, we believe the credit deterioration is already priced into these distressed securities. Therefore, we do not anticipate these defaults to materially weigh on high yield total returns. Further, we do not expect the default rate to increase materially in 2020.

The distress bond ratio has also ticked up slightly since the recent lows. But a small increase in the distress ratio is not a reason to panic. Distress levels remain well below the peak experienced during the energy crisis in 2016 (Exhibit 2).

Technical remain supportive as the hunt for yield continues

In addition to the healthy fundamentals, high yield market technicals should continue to be supportive in 2020. As mentioned, our macro view is for further accommodative Fed policy support with potentially one or two rate cuts in 2020 and no change to the extremely accommodative ECB and BOJ monetary policies. As the global search for yield endures, investors may continue look to the high yield asset class for additional spread. While we don’t expect large inflows per se, any pullbacks in valuations are likely to be met with buying from variety of investors. Sustained limited supply of new issuance could offset this demand.

In 2019, the amount of rising stars, or companies upgraded to investment grade, compared to fallen angels, or downgrades to high yield, were at all-time highs (Exhibit 3). We don’t see this trend changing materially. Moreover, private equity investors have not been aggressively pursuing leveraged buyouts, or LBOs, that potentially could create new high yield bonds. Given the choppy financing conditions for lower-rated bank loan paper, we think the new LBO supply will remain very limited. Finally, while refinancing could continue at a fairly brisk pace in 2020, this shouldn’t have a meaningful impact on supply as old bonds are replaced with new debt.

Exhibit 2: US distress ratios have increased modestly, but are well below peak levels

Source: Bank of America Merrill Lynch as of November 30, 2019. Distress is defined as bonds with spreads over 1,000 bps.

Exhibit 3: Rising stars outpace fallen angel activity in 2019

Reasonable valuations, despite low all-in yields

Historically, the yield to worst (YTW) has been one of the most important indicators of future high yield returns. And after the significant move lower in YTW during 2019, we are apprehensive of the high yield market’s ability to repeat the performance experienced in 2019. With yields on the Bloomberg Barclays US Corporate High Yield index currently close to 5.6%, we expect returns will be low for 2020 relative to historical high yield returns. While price appreciation is limited, the higher carry from coupon makes high yield relatively attractive versus other fixed income sectors. Additionally, high yield remains relatively attractive on a yield-to-duration basis (Exhibit 4).

Exhibit 4: High yield bonds are attractive on a yield-to-duration basis

Bloomberg Barclays indices December 2016 – November 2019

<table>
<thead>
<tr>
<th>Index</th>
<th>Yield to worst (%)</th>
<th>Duration</th>
<th>Yield per unit of duration</th>
<th>Credit quality</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bloomberg Barclays US Corporate High Yield Index</td>
<td>5.59</td>
<td>3.10</td>
<td>1.80</td>
<td>B1/B2</td>
</tr>
<tr>
<td>Bloomberg Barclays EM USD Aggregate Index</td>
<td>5.05</td>
<td>6.15</td>
<td>0.82</td>
<td>BAA2/BAA3</td>
</tr>
<tr>
<td>Bloomberg Barclays US Aggregate Index</td>
<td>2.30</td>
<td>5.88</td>
<td>0.39</td>
<td>AA1/AA2</td>
</tr>
<tr>
<td>Bloomberg Barclays US Corporate IG Index</td>
<td>2.87</td>
<td>7.91</td>
<td>0.36</td>
<td>A3/BAA1</td>
</tr>
<tr>
<td>Bloomberg Barclays US Government Index</td>
<td>1.76</td>
<td>6.51</td>
<td>0.27</td>
<td>AAA/AA1</td>
</tr>
</tbody>
</table>

Source: Bloomberg Barclays indices as of November 30, 2019. Credit ratings for the benchmark reflect the benchmark rating.

While high yield spreads are tighter than long-term averages, spreads are still wider than historical tights and in a reasonable range given the macro and default environment. Therefore, while valuations likely limit the potential for material price appreciation in 2020, spreads aren’t so tight that we anticipate material spread widening.

High yield segments to watch

We are monitoring a few key segments of the high yield market that could be impactful in 2020. Risk aversion has created valuation discrepancies within energy, CCCs, and BBs; as clarity toward global growth, trade and geopolitics unfolds, these market segments have the potential to drive high yield bond performance in 2020.

Energy – is it really that bad?

In 2019, the high yield energy sector dramatically underperformed the broader high yield market. This was somewhat surprising given the underlying WTI spot crude market posted a positive year-to-date return over 25% through mid-December. We believe the reasons for underperformance include:

- Investor concerns around many high yield issuers’ ability to generate long-term returns in a $50-60 crude environment.
- Investors’ frustrations with continued high levels of capex by most issuers.
- Weakness in the natural gas market.
- An increase in energy-related defaults and heightened concerns around distressed exchanges and priming.

As we moved throughout 2019, we witnessed significant selling and lack of investor interest, causing valuations to cheapen. But as we look out to 2020, we believe the sector looks interesting based on the following:

- **Fundamentals:** While the market has been focused on the aforementioned negatives, we don’t think it’s as bad as it appears. In the current range-bound crude market, many of the higher-quality and mid-tier companies have the potential to generate reasonable returns. It also seems that capex has peaked, and is coming down as management teams focus on spending within their cash flows. In addition, we expect M&A activity will continue as companies look to eliminate duplicative costs and focus on improving margins.

- **Valuations:** After the significant underperformance in 2019, the high yield energy sector is trading materially wider than the rest of market. Within the Bloomberg Barclays US Corporate High Yield index, the energy sector has a YTW of 9.14% compared to 4.91% for the index excluding energy as of December 10. In a market with limited convexity, this is one sector that has the potential to deliver strong positive returns.

- **Technicals:** While energy remains a large sector within high yield, it seems many dedicated high yield investors are underinvested relative to benchmarks. Therefore, while the market has suffered due to significant selling in 2019, we think the worst of the negative technicals may be behind us. At some point, the energy sector has the potential to attract interest from new buyers given the attractive valuations and balanced fundamentals.

- **Sentiment:** Negative sentiment around energy companies, both in fixed income and equity markets, is as pessimistic as the tone during the energy crisis in 2015. At some point, we expect this negative sentiment will turn the corner and become more positive. All that considered, we are more constructive on the high yield energy market than we have been in many years. This leads us to believe that energy could be a differentiating sector for performance in 2020.
CCCs – are they cheap enough?
Similar to high yield energy, CCCs underperformed in 2019. While there are many reasons for this, including challenged fundamentals for some larger issuers, it is very unusual for CCCs to underperform in a year with such strong high yield returns. In fact, during the past 30 years, there has never been a year with high yield index total returns above 7% where CCCs have not been a positive contributor to performance. Recent underperformance has resulted in relatively cheap valuations within CCCs trading at 11.13% compared with the BBs at 3.70% and B-rated credit at 5.38% as of December 10.

While we are modestly underweight this ratings segment in most high yield strategies, we think this category is an interesting part of the market to continue to look for single-name alpha opportunities given valuations and our generally constructive view on high yield.

BBs – can they get any tighter?
After a very strong year in 2019, BB valuations are near an all-time low YTW of 3.70%, with spreads at levels only witnessed in 2006 and 2007. The supportive fundamentals of this sub-segment are one reason the valuations seem justifiable, but we believe technicals are driving performance. As flows have come into the high yield market, investors have been content to buy ‘safe’ BB bonds with limited perceived credit risks. In addition, the BB market segment has experienced numerous upgrades this year, with few fallen angels, so it has not been a growing part of the market. While we believe the fundamentals will not deteriorate materially, and expect the supportive technical to persist, we do have modest concerns around the extremely positive sentiment around BBs. Finally, at these valuations, we are concerned that BBs could be most exposed in the event Treasury rates surprise to the upside.

Summary
Looking out to 2020, we are cautiously optimistic on the high yield market on the back of stable credit fundamentals, relatively low default expectations, accommodative monetary policy and supportive market technicals. Fundamentals are generally healthy given decent earnings and stable leveraged trends. High yield market technicals should also remain supportive in 2020 – investors searching for yield may look to high yield bonds for additional spread.

While high yield spreads are tighter than long-term averages, spreads are still wider than historical tights and in a reasonable range given the macro and default environment. Despite low all-in yields, high yield appears to be fairly valued and is attractive on a relative value basis versus other fixed income sectors. We will continue to focus on security selection in 2020 and are monitoring valuation discrepancies within certain segments – energy, CCCs and BBs – that could be key performance drivers in the year ahead.

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