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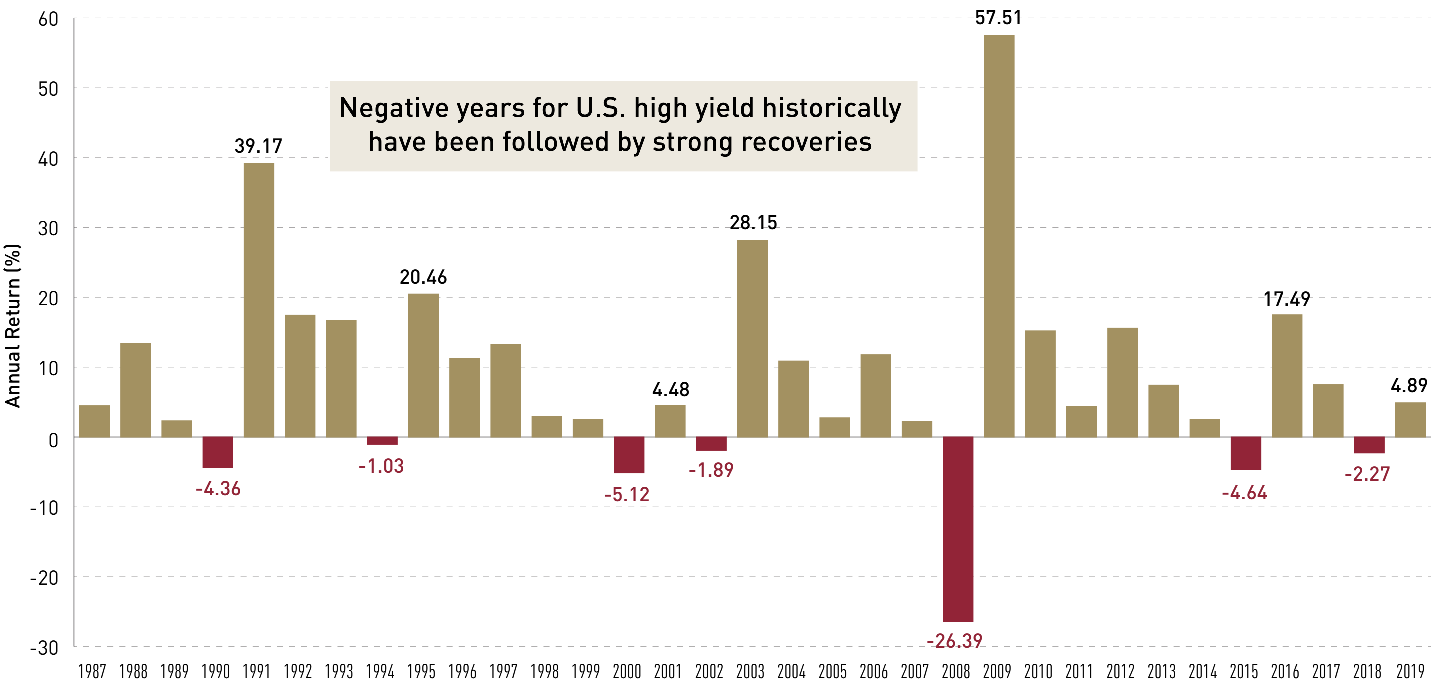
MARKET VIEW

U.S. HIGH YIELD: LESSONS FROM THE RECENT VOLATILITY

Rather than trying to anticipate short-term price moves, we believe investors would be better served by focusing on the asset class's long-term history of risk-adjusted returns.

CHART 1. U.S. HIGH YIELD HISTORICALLY HAS BOUNCED BACK FROM DOWN YEARS

ANNUAL RETURN IN CALENDAR YEARS, 1987-2019 (THROUGH FEBRUARY 8)



Source: ICE Data Indices. Data for 2019 is through February 8. High yield is represented by the ICE BofAML U.S. High Yield Constrained Index.

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IN BRIEF

- After a difficult fourth quarter of 2018 for U.S. high yield, a sharp reversal in sentiment led to a quick recovery in the first few weeks of 2019.
- While the market has bounced back, spreads remain elevated relative to the past few years. Despite the recent period of volatility, we believe the economic backdrop and underlying credit fundamentals should remain supportive of high yield credit.
- Rather than overreacting to market sentiment and trying to time short-term price moves, investors may be well-served to consider the attractive risk-adjusted returns that high yield has delivered relative to other major asset classes when thinking about fixed-income allocations.

CONTRIBUTING STRATEGIST

Stephen Hillebrecht, CFA
Fixed Income Product Strategist

Last week's *Market View* focused on January's dramatic reversal in the U.S. equity market following a difficult fourth quarter. This week, we turn our attention to a similar development in the U.S. high-yield bond market.

The fourth quarter marked a major turnabout for U.S. credit markets after a period of relative calm over the previous few quarters. Market sentiment reversed in early October, following comments from U.S. Federal Reserve (Fed) Chairman Jerome Powell that created uncertainty about the future path of Fed policy. Equity markets began to stumble, not only facing uncertainty over interest rates, but dealing with projections of slowing earnings growth, some weakness in U.S. economic data, and ongoing trade tensions, particularly with China. While the high-yield market initially held up relatively well, the negative sentiment toward risk assets, a less rosy economic backdrop, and a 30% drop in oil prices eventually led to significant credit spread widening in the quarter.

After reaching a post-financial crisis low point of 316 basis points (bps) over U.S. Treasuries in early October, high yield spreads widened by over 225 bps, peaking at more than 540 bps in early January 2019. Amid this uncertainty, many investors reduced their allocations to high yield.

What has happened since? High yield has had its best start to a year in a decade.

Many of the forces that led to a difficult fourth quarter have dissipated, with a more dovish tone coming from the Fed, stronger U.S. economic data, and signs of tentative progress on U.S.-China trade negotiations. The 4.6% rally in the ICE BofAML U.S. High Yield Constrained Index (high yield index) in January 2019 was the best start to the calendar year for the index since 2009, and the strongest return of any month since 2011. With a year-to-date return of 4.9% as of February 8, 2019, the high yield index has wiped out the decline of the fourth quarter, and has outperformed the broad investment-grade bond benchmark (the Bloomberg Barclays U.S. Aggregate Bond Index) over the trailing one-, three-, five- and 10-year periods.

Of course, the high-yield market is not immune to periods of volatility. After all, as a below-investment grade asset class, high yield can be affected by investor fears of a slowing economy, which would typically lead to concerns about credit fundamentals, as well as wider spreads and lower prices on high yield bonds. But negative calendar years for the high yield index are not too common. In fact, prior to its 2.3% decline in 2018, the index experienced only six negative years in the previous 31 calendar years. Each of those negative years was followed by positive returns, with five of those years rallying strongly with double-digit returns (see Chart 1).

Over the long term, high yield bonds historically have generated very attractive returns, on an absolute basis and a risk-adjusted basis relative to the U.S. equity market. In fact, over the 20-year period ended January 31, 2019, the high yield index had a higher return (based on average annual return) than the S&P 500® Index, with only about 60% of the volatility. While that relationship will not always hold in every environment, in general, high yield historically has provided attractive performance over the long term, with one-half to two-thirds the volatility of equities, and higher risk-adjusted returns. As illustrated in Table 1, even if you had invested at arguably the worst possible time—when high yield spreads hit their all-time lows in June 2007, just before the onset of the global financial crisis of 2008—high yield has since delivered similar returns to equities, with only two-thirds of the volatility, resulting in a much higher Sharpe ratio.

Where Are We Today?

The high yield index has recovered about half of the spread widening that occurred in the fourth quarter, but as of February 8, spreads remained over 100 basis points wider than the lows of early October (see Chart 2), and well above where they had been for most of the previous two years.

While spreads are now below the long term average, we believe certain metrics justify spreads at those levels:

- *Defaults remain low*. Based on data from JP Morgan, the trailing 12-month default rate declined to 1.77% in January, well below the long-term average. In a base case scenario of continued U.S. economic growth, albeit perhaps at a more subdued rate than seen in recent years, defaults are broadly expected to remain below average.

TABLE 1. TRACKING U.S. HIGH YIELD'S LONG-TERM PERFORMANCE VERSUS U.S. EQUITIES

	20-Year			06/30/2007 - 01/31/2019		
Index Performance (As of 01/31/2019)	Return	Standard Deviation	Sharpe Ratio	Return	Standard Deviation	Sharpe Ratio
ICE BofAML U.S. High Yield Constrained Index	6.6	8.9	0.6	7.0	10.0	0.7
S&P 500 Index	5.8	14.5	0.3	7.5	15.0	0.5
High Yield as a % of the S&P	114%	61%	167%	94%	67%	129%

Source: Morningstar. Data as of January 31, 2019.

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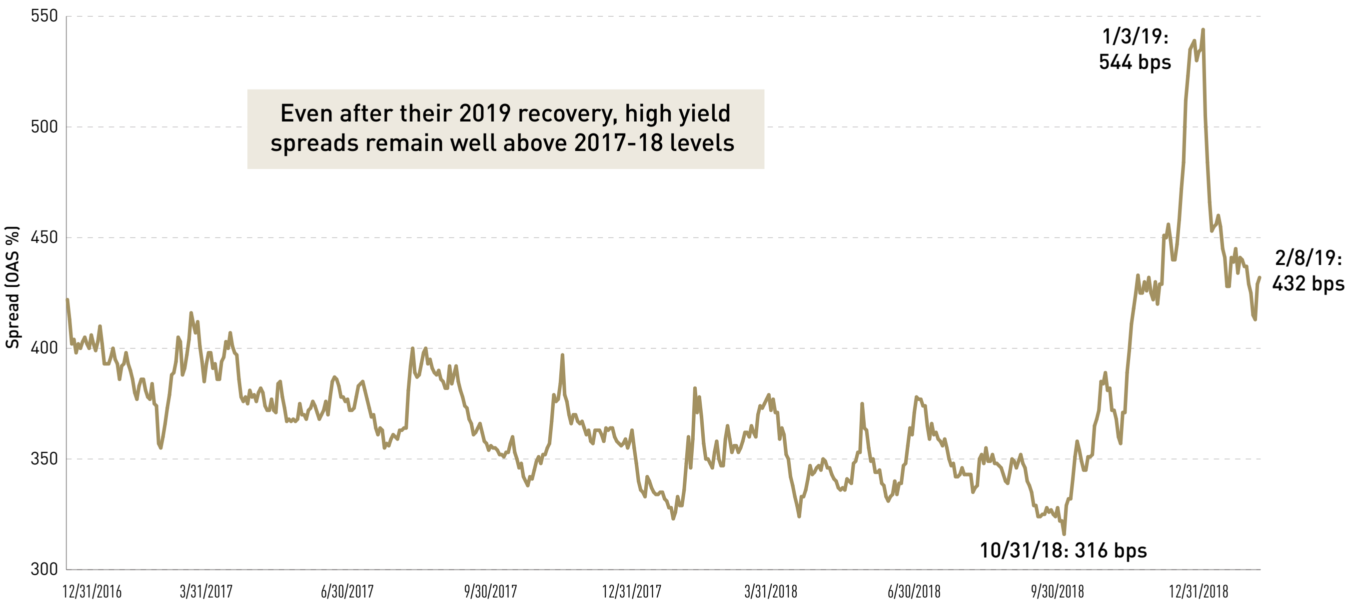
CHART 2. U.S. HIGH YIELD SPREADS REMAIN ELEVATED

SPREAD VERSUS U.S. TREASURIES, DECEMBER 31, 2016–FEBRUARY 7, 2019



Source: ICE Data Indices. OAS=option-adjusted spread.

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- *Credit fundamentals are stable.* JP Morgan data also show that leverage ratios (debt/EBITDA, or earnings before interest, taxes, depreciation and amortization) for U.S. high-yield issuers have declined (see Chart 3 on next page), while interest coverage ratios (EBITDA/interest expense) have improved for the past two years, leading to both metrics to their strongest levels in years. This has led to rating-agency upgrades outpacing downgrades at the highest pace since 2011.
- *The composition of the market has improved.* Over the past decade, the issuance of high yield has been more focused on refinancing activity rather than aggressive leveraging activity, and more focused on BB-rated issuers versus CCC-rated issuers. In fact, based on data from ICE Data Indices, over the past dozen years, about 10% of the high yield index has migrated from CCC and single B rated issues to BB, near the highest levels since before the 2008 credit crisis.

Not only has the quality of the market improved over time, the size of the market has contracted, creating a positive supply/demand dynamic. As we have noted previously, much of the issuance of below-investment grade companies has shifted to the loan market from the bond market. As a result, the total market value of the high yield index has declined to $1.1 trillion as of January 31, 2019, compared to $1.4 trillion in early 2015.

Summing Up

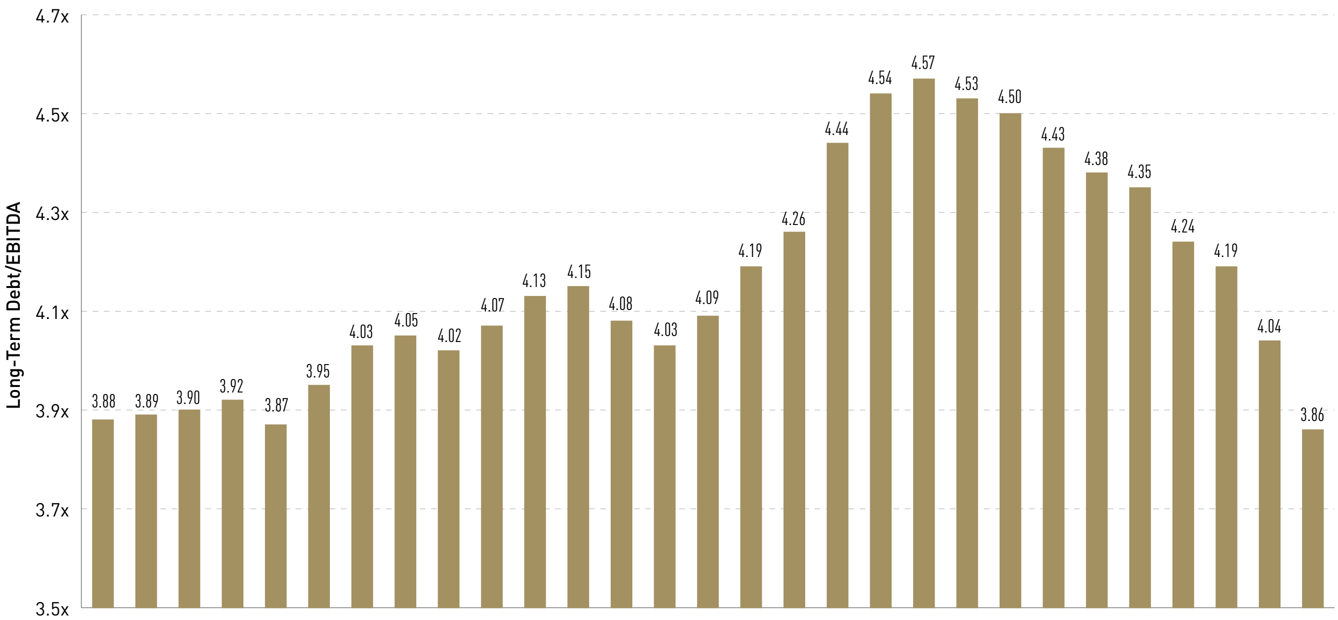
The experience of the high yield market in late 2018-early 2019 was remarkably similar to that of the equity market. The recovery in the first few weeks of the New Year suggests that the price action in the fourth quarter may have been an overreaction to the actual change in fundamentals.

As we have emphasized over the years, the historical risk-reward characteristics of high yield argue for their role as a long-term strategic allocation within a fixed-income portfolio—and not as a vehicle for frequently ill-considered moves driven by market timing.

We would emphasize that market shifts like the one we witnessed in the December 2018-January 2019 period often create opportunities for active management within the high yield market. These shifts allow for active managers to move up and down the credit quality spectrum, and across sectors to identify those credits that offer the best risk/reward opportunities for the given environment.

CHART 3. FINANCIAL LEVERAGE FOR U.S. HIGH-YIELD ISSUERS HAS DECLINED STEADILY

DATA FOR THIRD QUARTER OF 2011–THIRD QUARTER OF 2018 (LATEST AVAILABLE)



Source: J.P. Morgan; Capital IQ. Most recent data available. EBITDA=earnings before interest, taxes, depreciation and amortization.

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A **basis point** is one one-hundredth of a percentage point.

The **Sharpe ratio** is a measure for calculating risk-adjusted return. It is the average return earned in excess of the risk-free rate per unit of volatility or total risk.

Standard deviation is the measure of dispersion of a set of data from its mean. It measures the absolute variability of a distribution; the higher the dispersion or variability, the greater is the standard deviation and greater will be the magnitude of the deviation of the value from their mean.

The **Bloomberg Barclays U.S. Aggregate Bond Index** represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment-grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities.

The **ICE BofAML U.S. High Yield Constrained Index** is a capitalization-weighted index of all US dollar denominated below investment grade corporate debt publicly issued in the U.S. domestic market.

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Lord, Abbett & Co. LLC | 90 Hudson Street | Jersey City, NJ 07302-3973 | T 1.888.522.2388 | lordabbett.com

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