Comparing Today to the Past

Hotchkis & Wiley

Newsletter – June 2017

"The best prophet of the future is the past."

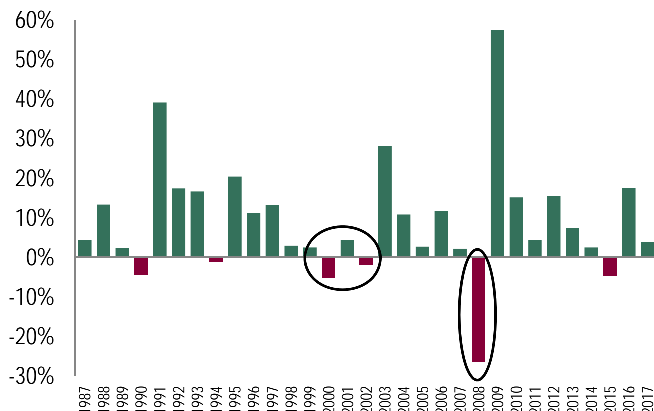
-George Gordon Byron a.k.a. "Lord Byron", English poet and politician (1788-1824)

There is no substitute for experience. In all facets of life, experience acts as our baseline when it comes to contemplating the future. This is why revisiting history is such a common practice among financial academics and practitioners. For better or worse, we count ourselves among the practitioners that enjoy a walk down memory lane; we have found the practice to be a healthy exercise flooded with valuable lessons. It has taught us that while no two periods are identical, we should listen to "this time is different" arguments with a skeptical ear—there is a lot to be learned from today's resemblance to the past. There are elements of the current high yield market that resemble tricky periods of the past. In this newsletter, we will compare today's market to prior periods to see if we can better inform our judgment of the future.

First, the worst

A few observations stand out from Chart 1, which displays calendar year returns for high yield. Perhaps surprising to some, high yield returns have been remarkably consistent with only a small number of negative years. Notably, 2008 was a tough period for the high yield market and it remains in investors' minds when contemplating the asset class. The tremendous recovery in 2009 compensated for the difficult year; nonetheless, 2008 is not a period that we would be eager to repeat. With the exception of the commodity-induced carnage of 2015, negative high yield returns have uniformly coincided with recessions.

Chart 1: High Yield Calendar Year Returns
BofA ML US HY Index, 1988-2016

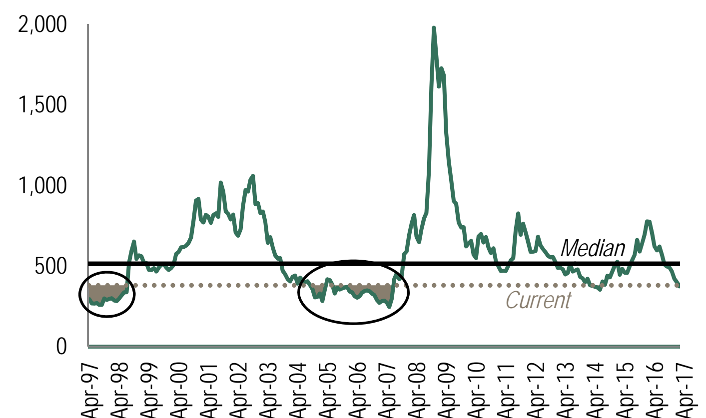


In this note, we will pay particularly attention to how the current high yield landscape compares to historical periods just prior to recessions. We will view the market through a familiar lens by segmenting the market's characteristics into three categories: 1) valuation, 2) fundamentals, and 3) technicals.

1. Valuation

Today's valuations are not very exciting; the financial press argued that today has an eerie resemblance to the two most recent pre-recession periods. As can be observed from Chart 2, these were the only two periods over the past 20 years when valuations were worse off—not a reassuring sign for anyone contemplating new investment in the asset class. These previous periods coincided with robust economic conditions; tight spreads are a contemporaneous indicator of credit cycle health. The important question for high yield investors is how long could tight valuations persist?

Chart 2: High Yield Spread Over Treasuries
BofA ML US HY Index, Last 20 Years



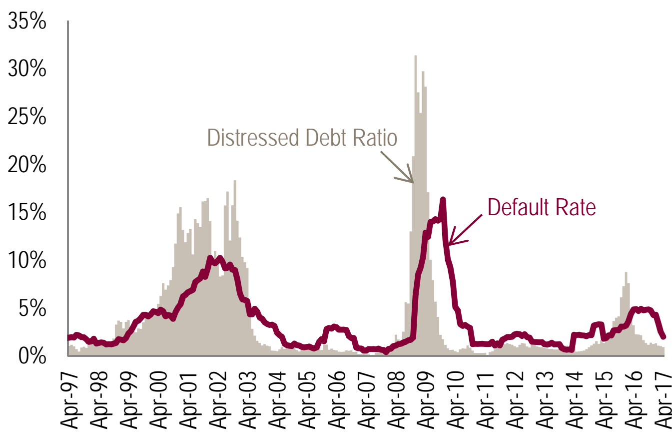
2. Fundamentals and Technicals

Many fundamental characteristics of the high yield market act as coincident indicators to market performance. The default rate, for example, rises during a recession and acts as a good proxy for the current health of the market. By the time the default rate is elevated, however, the high yield market has already

retreated. It is not an effective warning sign. The upgrade/downgrade ratio, amount of distressed debt, and even most financial leverage metrics are equally ineffective warning signs—by the time the characteristics reach dangerous levels it is too late. Accordingly, we will focus on high yield market characteristics that have acted as precursors to difficult performance environments. We are grouping fundamentals and technicals together because several of the most effective predictors share elements of both. For example, we generally think of the new issue calendar as a technical factor, but the underlying composition of new issuance can have a meaningful influence on market fundamentals.

The distressed debt ratio, the percentage of the market that is trading at distressed levels (50% of par or less), has been a good short term leading indicator of rising default rates. Chart 3 shows the relationship over the past 20 years. The current distressed debt ratio is less than 1%. This benign level is not a signal of lurking trouble. Like the default rate, the distressed debt ratio can remain low for long periods.

Chart 3: Distressed Ratio and Default Rate

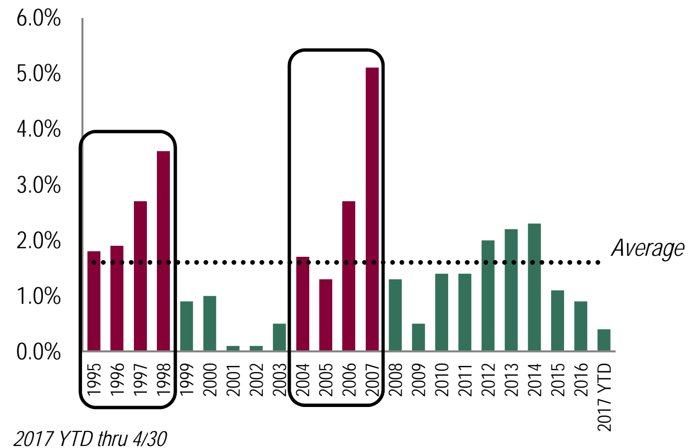


The Primary Market

Our experience has taught us that the primary market, or new issuance, provides useful warning signs. When the primary market gets aggressive, it is time for caution because it is likely that an imbalance is beginning to develop in one form or another (e.g. tech spending in the late 1990s, M&A in 2007). Aggressive issuance can take various forms, several of which we highlight in the following charts.

Chart 4 depicts the amount of low rated new issuance (CCC and below) as a percentage of the total high yield market. It is perhaps more common to view low rated new issuance as a percentage of all new issuance rather than as a percentage of the total market, but this can yield misleading results in years when new issuance was unusually light or unusually heavy. By the end of 1998, low rated issuance from the four prior years accounted for 8% of the total market; by the end of 2007 low rated issuance from the four prior years accounted for 10% of the total market. This form of aggressive issuance adds risk to the market and has accurately prophesized that difficult times lay ahead.

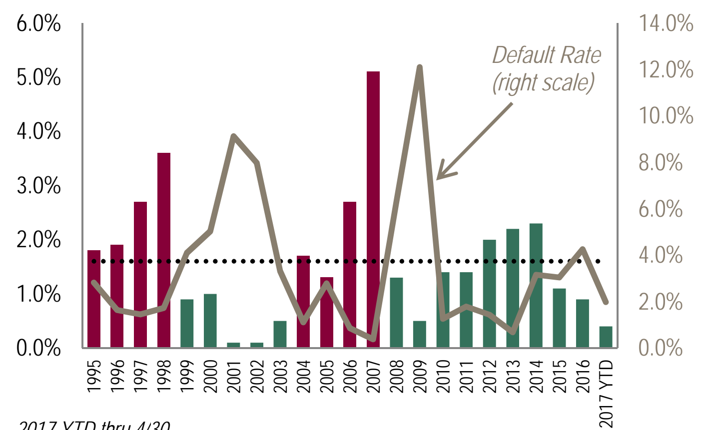
Chart 4: Low Rated New Issuance (% of market)
New Issuance Rated CCC & Below, excludes refinancing



2017 YTD thru 4/30

Chart 5 is the same as Chart 4 with the default rate superimposed on the rest of the data. Unsurprisingly, the increased prominence of low rated debt has led to increased defaults.

Chart 5: Low Rated New Issuance (% of market)
New Issuance Rated CCC & Below, excludes refinancing



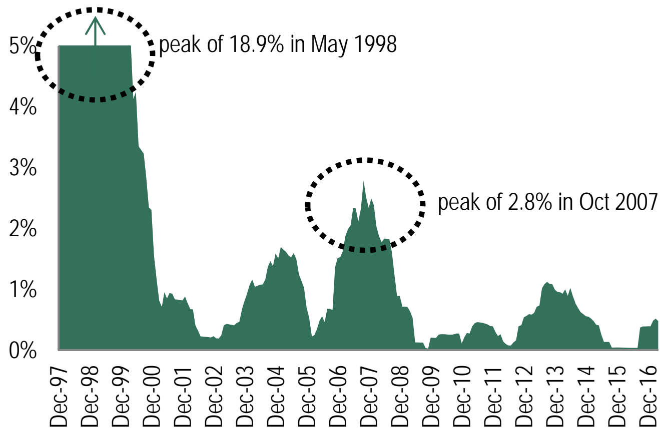
2017 YTD thru 4/30

Chart 6 highlights another form of aggressive new issuance. A preponderance of high yield issues pay a regular cash coupon. Occasionally, a company issues debt that does not pay a coupon (zero coupon bonds), debt that pays its coupon by issuing more debt (pay-in-kind, or PIK bonds), or debt that has the option to

Past performance is not a guarantee or a reliable indicator of future results.

pay its coupon with cash or by issuing more debt (PIK Toggle). Each of these is riskier than a traditional cash-pay bond, and the increased popularity of non-traditional issuance has been another effective indicator of trouble on the horizon.

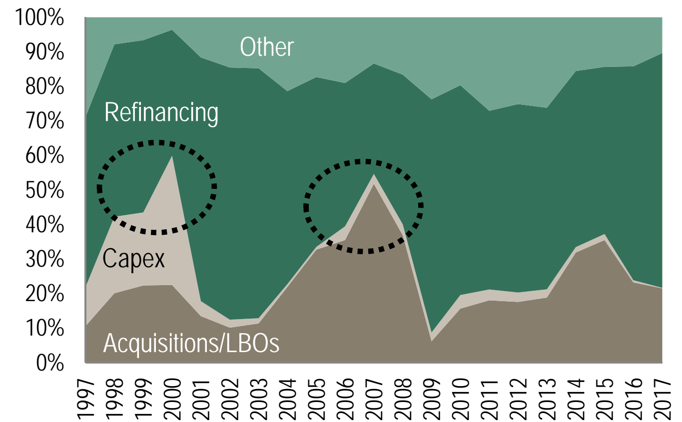
Chart 6: Non-Traditional New Issuance (% of market)
Zero Coupons, PIKs, PIK/Toggles



A company that issues new debt receives cash, which it uses for something. What exactly that *something* is should matter a great deal to the new creditors/bondholders because some uses are riskier than others are. Refinancing, for example, is generally a lower-risk use of proceeds because the company's total debt remains largely unchanged—it issues new debt to pay off old debt. The terms of the new debt may be modified but the company's financial leverage and business operations are predominantly unaffected. When a company uses the proceeds to make an acquisition, however, this not only puts incremental debt on the balance sheet but also introduces operational/integration risks. Using the proceeds to expand the existing business (increasing growth capital expenditures) also increases financial leverage, and it too can create operational uncertainties.

Chart 7 tracks high yield new issuance by the use of proceeds. The combination of LBO activity and increased capex exceeded 50% of all new issuance only twice in the last 20 years—both periods came immediately prior to the two large high yield market corrections.

Chart 7: New Issuance Use of Proceeds (% of New Issuance)



2017 thru 3/31

The four previous charts highlight different ways to measure aggressive issuance. These are not the only means to measure this important facet, nor are they mutually exclusive—quite the opposite, in fact. Most PIK bonds, for example, also have low ratings. Regardless of the measurement used, the important takeaway is that aggressive new issuance has preceded both periods of difficult high yield market performance. While we observed some nascent signs of this beginning in 2013, it has reverted in recent years and we observe no such signals today.

The Secondary Market

The secondary market, which encompasses everything outside of the new issue market, can also demonstrate certain warning signs. The most useful of these signals, however, relate to the primary market factors we covered in the previous section. Chart 8, for example, shows the total change in high yield debt. If a company issues $1 million of debt to pay off $1 million of existing debt, the total debt outstanding does not change. If a company issues debt to make an acquisition or expand its business (growth capex), the total debt outstanding increases. Chart 8, therefore, ties closely with Chart 7—both serve as effective warning signs and neither is particularly worrisome today. Note that other common leverage metrics (e.g. debt-to-EBITDA) are not effective indicators because they are driven by changes in the denominator disproportionately, which typically coincides with the overall business cycle; i.e. earnings decline during a recession but not usually before a recession.

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Chart 8: Total HY Debt (Year over year % Change)

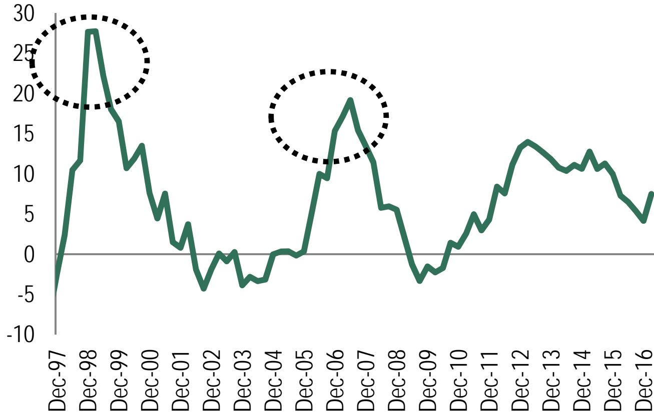
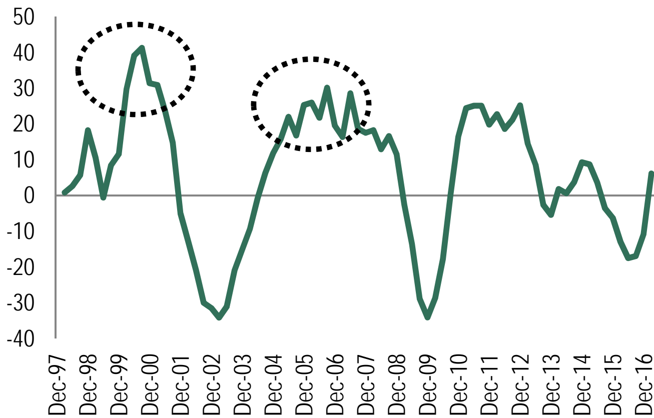


Chart 9 depicts changes in capital expenditures, which also ties to Chart 7. Increases in capex have also preceded high yield market corrections, and we observe no warning signs currently.

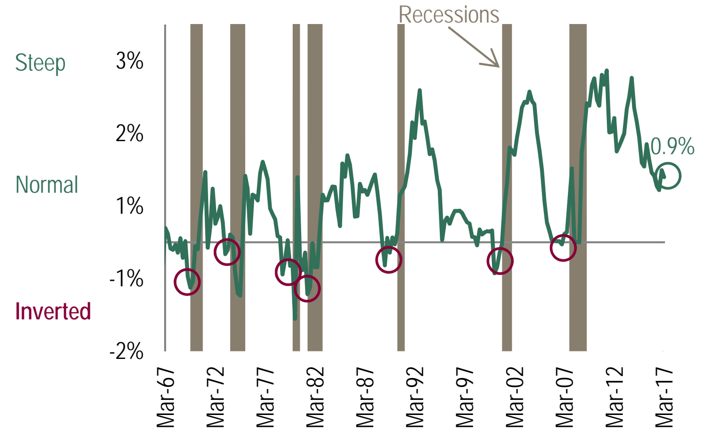
Chart 9: Capex Spending (Year over year % Change)



Economic Factors

We are credit pickers, not economists. Forecasting GDP, consumer behavior, inflation, etc. falls outside of our core competency. We base investment decisions on our bottom-up evaluation of individual credits. This does not mean, however, that we are ignorant of the economic landscape. In fact, we pay close attention to it because it can be informative as to where we are in the business cycle. One of the simplest, and perhaps most useful variables is the Treasury yield curve. Some would classify this as a financial market variable rather than an economic variable but classifications be damned. An inverted yield curve has preceded every recession of the past 50 years. As highlighted in Chart 10, the curve has flattened in recent years but remains normal/upward sloping—a reassuring sign.

Chart 10: Treasury Yield Curve (10-Yr – 2 Yr)



The following table contains data from Cornerstone Macro, a firm with particularly insightful macroeconomic views. We have shown this table in prior newsletters because it provides a simple yet comprehensive summary of the most efficacious recession indicators, according to the firm. Eighteen months ago only one of the signals indicated elevated recession risk, while today there are four. Their main takeaway is that the economy has become more fragile over the past couple of years but the next recession is most likely a ways down the road.

Signal	Indicate Recession?
10 Yr Global Rate Change	No
Energy Inflation	No
Fed Funds Rate and Change	No
HY Bond Yield Change	No
Investment as % of GDP	No
Loan Deliquencies	No
Real Personal Income	No
Treasury Yield Curve	No
Corporate Profits	Yes
Mortgage Rate Change	Yes
Output Gap	Yes
Wage Growth	Yes

Source: Cornerstone Macro as of 5/31/17

The Federal Reserve has also published some work on recession risk, corporate bond spreads, and the interest rate curve. It leverages research done by Gilchrist and Zakrajsek, which decomposes credit spreads into two basic components—bond-specific default risk and overall credit market sentiment. The latter, coined *excess bond premium* ("EBP") has been a good predictor of recessions historically. The Federal Reserve

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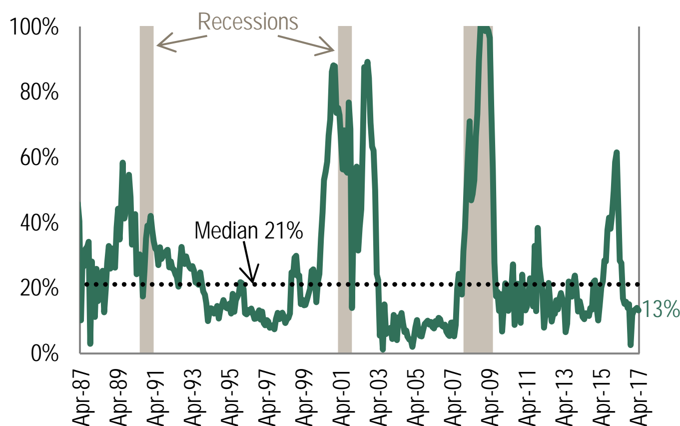
has used the data to estimate the probability of recession in the next twelve months. As shown in Chart 11, the current probability of 13% is below the historical median and not a particularly alarming signal.

Chart 11: Federal Reserve Recession Risk
Probability of a recession in the next 12 months



Summary

It can be difficult to get excited about the high yield market when spreads are narrower than average, but it is important to remember that the asset class can still produce satisfactory returns. Unpleasant years have been exceedingly rare. With valuations elevated, today does not represent the best high yield entry point in the market's history. Based on a host of fundamental, technical, and economic data, however, it is also far from the worst.

Hotchkis & Wiley High Yield Research

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Data reference to "High Yield Market" refers to the BofA Merrill Lynch US High Yield Index. Charts 1-2: Bloomberg, BofAML; Charts 3-5: JPMorgan; Charts 6-9: BofAML; Chart 10: Bloomberg, NBER (National Bureau of Economic Research); and Chart 11: Federal Reserve, NBER. **Diversification does not assure a profit or protect against loss in a declining market.**

The BofA Merrill Lynch US High Yield Index tracks the performance of below investment grade, but not in default, US dollar-denominated corporate bonds publicly issued in the US domestic market, and includes issues with a credit rating of BBB or below, as rated by Moody's and S&P. The index does not reflect the payment of transaction costs, fees and expenses associated with an investment in the Fund. It is not possible to invest directly in an index.

Spread is the percentage point difference between yields of various classes of bonds compared to treasury bonds. LBO stands for leveraged buyout. GDP stands for gross domestic product. Upgrade/Downgrade ratio is the number of ratings upgrades divided by the number of ratings downgrades (by the major ratings agencies). Capital Expenditure (CAPEX) is funds used by a company to acquire or upgrade physical assets such as property, industrial buildings or equipment. Debt-to-EBITDA ratio is the comparison of financial borrowings and earnings before interest, taxes, depreciation and amortization. Credit quality weights by rating were derived from the highest bond rating as determined by S&P, Moody's or Fitch. Bond ratings are grades given to bonds that indicate their credit quality as determined by private independent rating services such as Standard & Poor's, Moody's and Fitch. These firms evaluate a bond issuer's financial strength, or its ability to pay a bond's principal and interest in a timely fashion. Ratings are expressed as letters ranging from 'AAA', which is the highest grade, to 'D', which is the lowest grade.

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