JANUARY 2016 TIMELY THINKING

High-yield market update: What's driving the market sell-off?

SUMMARY

The high-yield market came under substantial selling pressure late in 2015, which continued into the new year. Kelley Baccei, high-yield portfolio manager and Mike Weilheimer, director of high yield, offered their perspective on the forces behind the sell-off and where the market may be headed. They address four key questions:

- Is the high-yield market responding more to fundamental or technical factors?
- How would you characterize the state of liquidity in the high-yield market now?
- How and when do you think the market will start to stabilize and recover?
- Do you expect to see a material pick up in energy defaults in the coming years? At this point, do you see value in energy or is it time to reduce exposure?

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Is the high-yield market responding more to fundamental or technical factors?

Kelley Baccei: It has turned out to be both. The recent sell-off in high yield was initially driven by problems with fundamentals in the energy space. But those fundamentals definitely spilled over into overall technical selling that's plaguing the high-yield market. I would say that sentiment is pretty terrible – it's very much a "risk-off" phase in general that's affecting all of high yield. Other sectors have come down after energy started trading off.

Mike Weilheimer: Right. I think energy, metals and mining, have been particularly hard hit with oil and commodity prices falling as far as they have. We also had a little scare in the pharmaceutical space, where a couple of pharmaceutical companies had their marketing practices questioned. These problems have rippled into the rest of the market.

Baccei: The selling pressure that started in December was exacerbated over the course of the month, especially as people sought to adjust their portfolios to show less exposure to certain tranches of the market at year-end. That led to what I would call more capitulation selling: Bids got even lower as buyers responded to the extra demand for liquidity.

Weilheimer: Definitely. Spreads became materially wider – probably as wide as they've been in over three years now. I think at some point the market will more thoughtfully reevaluate things.

How would you characterize the state of liquidity in the high-yield market now?

Weilheimer: To talk about "liquid high yield" – and other asset classes, for that matter – is something of a misnomer. I find it more useful to talk about the *cost* of liquidity. You can absolutely find bids and liquidate positions. Just maybe not at the prices where you would like or where they were marked the day before. That's the case recently, as a lot of money is flowing out of the asset class following the scares we've had.

It's the same thing on the upside, though. When money comes back and the market stabilizes, all of a sudden bond prices jump dramatically from where they were the previous day, and you can't find the offers like you could before.

Baccei: Liquidity has been lower with the reduction of dealer inventories – they definitely have been declining over the past several years. However, we are seeing different sources of liquidity coming into our market.

For example, I was recently speaking with a trader who said he's seen private equity funds return to the market that haven't been involved for the last five years. Price levels are getting interesting enough for these private equity funds to buy back bonds of companies that they own, along with companies that might be sponsor-owned or public companies that are trading at levels they find attractive. Some investors are reevaluating and saying, "Well, why should I own the stock when I can buy the bonds and be structurally senior and get in at these distressed levels." That all creates liquidity in the market.

How and when do you think the market will start to stabilize and recover?

Weilheimer: One way to get a handle on a possible turn in the market is to look at the experience of triple-C issuers – the lowest rung on the credit scale, next to defaulted. Right now, most of triple C's are shut out of the high-yield market, but not all of them. For example, there are different types of triple C's – defensive sectors such as health care will still be able to access the market. I don't think that we're going into recession, and if that assumption is true, I believe there will be a point at which high-yield bond prices will level off – in fact, we may be at that point right now.

Then you'll start to see some money come in and prices begin to move up, in my view. I think most triple C's will have access to the market over the next year. But clearly the bottom third of the triple C market may not. We try to stay away from that market.

Do you expect to see a material pick up in energy defaults in the coming years? At this point, do you see value in energy or is it time to reduce exposure?

Weilheimer: The energy sector is symptomatic of the bifurcation of the whole market. There are good energy companies and bad ones. I would say a lot of those bad energy companies – with a cost structure needing oil at $60, $70, $80 or $90 a barrel – are going to default, and that might be a third of the market in a severe case. Those bonds are probably trading on average 25 cents on the dollar, so there's not that much downside left.

Prices on higher-quality energy companies have been dragged down, too. But I think that's where you're going to see some value once stability returns to the oil market. In such energy names, we believe you could see five, eight or 10 points of upside potential. Our investment approach has always been to stick with the higher-quality end of the market, thank goodness.

Baccei: I would also like to point out the importance of independent, expert credit analysis. "Ratings" and "credit" aren't always synonymous. Sometimes the ratings agencies get it wrong. For instance, the energy sector has a very small percentage of triple C's, yet double B's in energy are trading at distressed levels.

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