Outlook for High Yield

Another year of carry, take 2...

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- In an environment of gradually rising interest rates, we believe High Yield (HY) can perform well
- We regard HY as fairly valued and expect returns in 2018 to be driven largely by coupon and carry
- Given the strong global outlook, an increasingly well-capitalized banking system in the US and Europe, and continuing high levels of corporate debt re-financing, we do not foresee any significant deterioration of credit in 2018

Reflecting on the past year, 2017 was a year of low volatility[1] across risk asset classes with both US and EUR High Yield posting high single digit total returns[2] that were above most of the Street expectations. Our forecasts for 2017 returns[3] were closer to the actual returns than many of the Street forecasts. Default rates were low[4] and, in contrast with the 2016 Energy sector issues, there were no major sector themes and worries. Overall 2017 was a year where 'risk on' dominated and higher beta industries and lower rated sectors outperformed.

Geopolitical risk was a theme running throughout the year, however the market impact of these successive events became less and less as the year progressed. Early 2017 was dominated by concerns of a possible populist win in the upcoming French election and uncertainty surrounding US policy following President Trump's election. In March, as expected, the UK government triggered Article 50, formally starting the process to leave the EU. In the Summer tensions surrounding North Korea led to a brief spread widening, as did tensions in Catalonia later in the year.

Global central bank policy remained supportive to credit markets, with the US Federal Reserve continuing a measured series of rate increases which were well communicated to the market. The appointment of new Fed Governor Powell was seen as marking policy continuity at the Fed. Given the increasing evidence of sustainable growth in the Eurozone, the ECB began reducing its bond buying program. First the ECB reduced purchase volumes from EUR80bn to EUR60bn per month. Then in October the ECB announced that volumes would reduce to EUR30bn per month from January 2018 and that the program would continue until at least September 2018. Similar to the Fed's path of rate hikes, these moves were well flagged, reducing their market impact. Also the levels of corporate bond purchases remained relatively stable through the year.

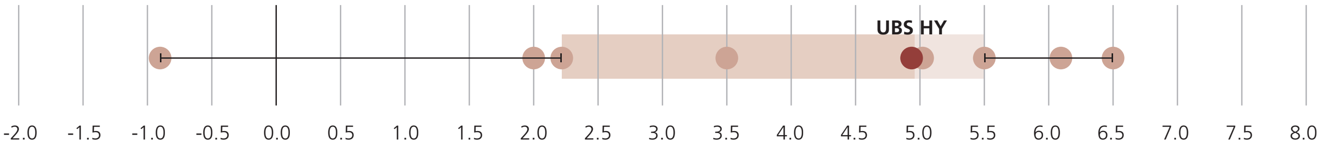
Technicals remained supportive, with subdued net supply in both US and EUR high yield. There were continued high levels of new bond issue proceeds being used by issuers to refinance debt and extend debt maturity profiles. Over the past couple of years the Loan market has provided increased competition to the high yield market for issuers' funding requirements. This has been most pronounced in the single-B part of the market. The Loan market has become increasingly 'Covenant-lite' – thus offering issuers with less restrictive terms to borrow money. These aggressive lending conditions in the Loan market partly reflect large recent investor inflows into Loan funds as well as very high levels of CLO issuance.

In November there was a brief period of spread widening[5] driven by events at a relatively small number of credits in the Telecommunications and Healthcare sectors. One dozen names accounted for roughly half the spread widening. Although the magnitude of the volatility was not that great (c.25 bps spread widening), it had a disproportionate impact on market sentiment given the relative calm of the year up until that point. We viewed this as an attractive opportunity to add risk to portfolios.

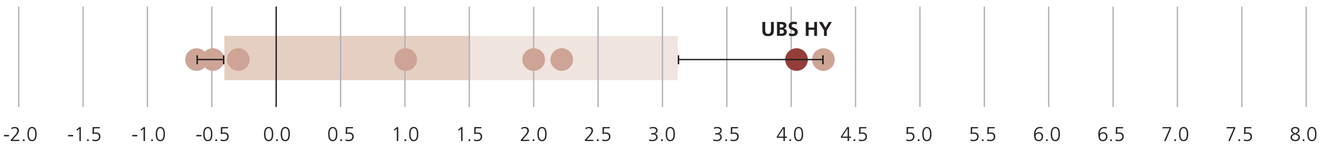
The big macro-economic surprise for the year was the strength of the Eurozone economy, in both the core and periphery. The US economy continued to strengthen and in both the US and Europe inflation data remained significantly below market expectations.

2018 UBS AM total return forecast versus external forecasts

Total return (%) – US High Yield



Total return (%) – Euro High Yield



Source: UBS Asset Management. Data as at December 2017.
Our return estimates are based on a forecasted trading range of spreads, terminal spread level at year-end and government bond yield levels. We also incorporate loss expectations generated from the difference between the consensus default rate forecast and our own default rate forecast. We assume that spreads are negatively correlated with government bond yields. This does not constitute a guarantee by UBS AG, Asset Management. Past performance of investments is not necessarily an indicator of future results.

Outlook – what to expect in 2018
We expect two Fed hikes during 2018 and think that high yield as an asset class can perform well in an environment of gradually increasing rates, especially given its spread 'cushion'. However, for those clients more concerned about interest rate risk, floating rate notes could offer an attractive level of income with almost no interest rate risk.

Before going into our 2018 forecasts, how accurate were UBS Asset Management's 2017 forecasts? For both markets our return forecasts were significantly above the Street average, and ours were closer to the actual returns[6]. For the US we forecasted a total return of 7.7% (Street 4.7%) and the actual was 7.3%. For EUR we forecasted 4.8% (Street 2.1%) and the actual was 6.7%. For 2018 we forecast total returns of 4.9% for US High Yield, 4.0% for EUR High Yield and 5.3% for floating rate notes.

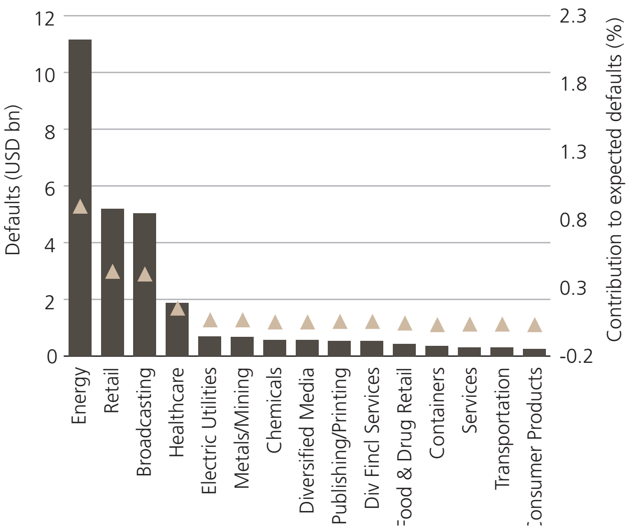
Lower defaults in 2018
Each December our high yield credit analysts produce a comprehensive bottom-up estimate of defaults and distressed exchanges for the following year. Our internal default forecasts are lower than those for 2017, especially for Europe. To put our 2018 forecast in context, the long-run average annual default rate for high yield is approximately 4.2%[7].

Given the low 2018 default rate forecast for both the US and Europe, industry themes are less significant than for previous years. In the Energy sector we are forecasting several distressed exchanges in the Exploration & Production sector, as well as some in the Oil Field Services sector. However we expect Energy defaults to be relatively muted this year as fundamentals have stabilized following the rise in the oil price and many of the weakest names in the sector have already restructured or defaulted.

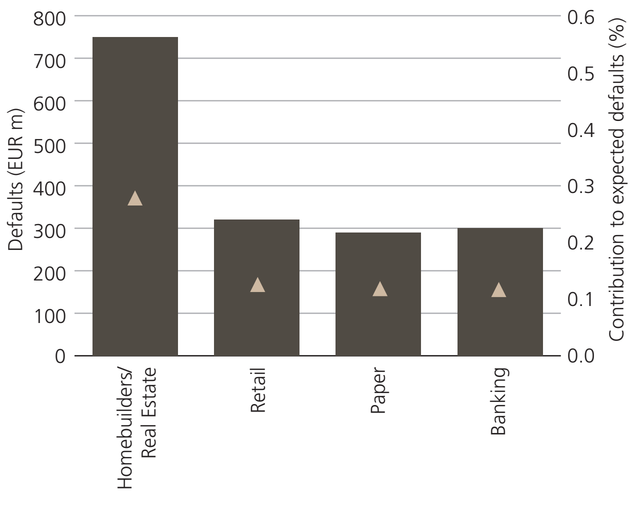
Defaults in the Retail sector are likely to be dominated by US mall stores that continue to suffer from the rise of internet shopping. In both the US and Europe investment funds have plenty of money to put to work in both the loan and bond markets, and capital markets are open to issuers. So this liquidity, combined with the reach for yield, has enabled certain companies to refinance when otherwise they would have certainly become distressed – and we expect this trend to continue.

With a stronger economic outlook globally as we start the year and an outlook for defaults well below long-run average levels[8] we view high yield as fairly valued. Our forecasts are at the high end of the range of street forecasts. Interestingly, there is a wider range of Street forecasts for EUR than the US. We expect returns for 2018 to be largely driven by coupon and carry, rather than by capital appreciation, given current low spread levels.

US High Yield defaults expected to be 2.3%



EUR High Yield defaults expected to be 0.6%



Source: UBS Asset Management, data as at December 2017.
Note: This does not constitute a guarantee by UBS AG, Asset Management. Bar shows USD/EUR amount of total defaults. Triangle shows contribution to total expected default percentage.

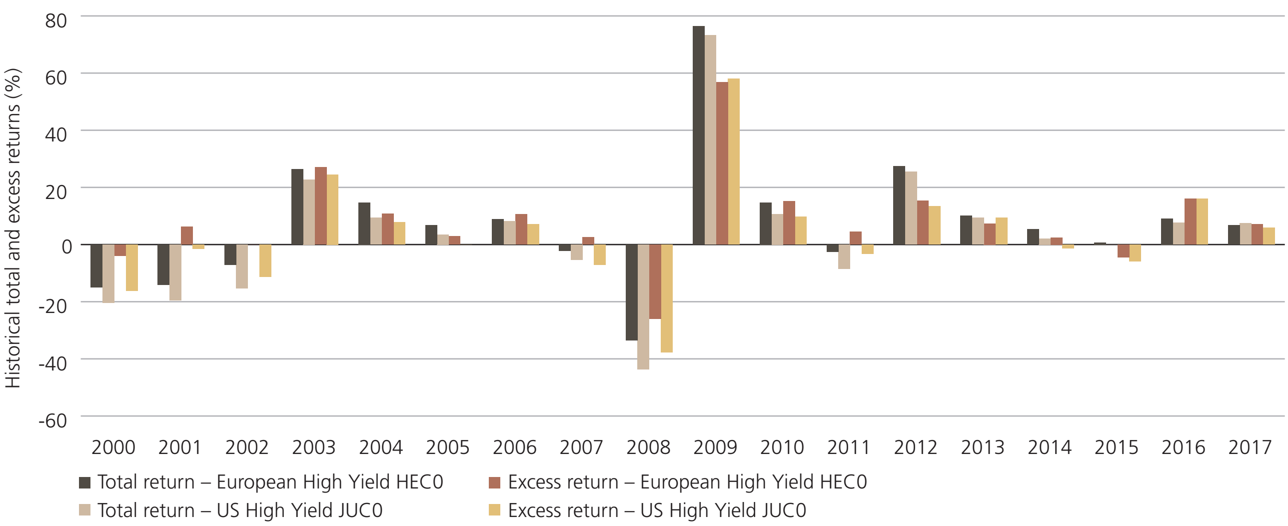
One key point to stress is the dynamic nature of the high yield universe, especially in Europe where the market is smaller. One example is the sharp reduction in the Banking sector as a constituent part of the market over recent years – from around 25 percent to approximately 15 percent. Other examples of many 'rising star' upgrades to Investment Grade over the next year are likely to be found in the more cyclical industries, such as Steels, Chemicals and Paper, which are benefitting from the upturn.

This rapidly changing investment universe highlights the importance of an active approach that benefits from a wide global fixed income team and expertise.

After many months of discussion, the US tax reform bill was finally approved at the end of the year. Corporations will benefit from lower statutory tax rates and full deductibility of capital expenditures compared with the current tax code. A provision that will have a more nuanced impact is the earnings-based limitation on interest deductibility. In general, the most highly levered companies within high yield could experience an increase in tax burdens, ignoring any potential offsets. More broadly, we believe there will also be indirect positive impacts on M&A, debt issuance, and capital expenditures. At the margin, there might be an increase in high yield issues being acquired by investment grade companies rather than by private equity. Private equity sponsors will be less incentivized to borrow heavily. And investment grade companies will have more cash flow for acquisitions (as well as more highly valued equity).

How long can the current low default environment last? With a strong global macro-economic outlook, an increasingly well capitalized banking system in both the US and Europe and still high levels of refinancing of debt by corporates, we expect any significant deterioration of credit quality to be at least 12 to 24 months' away.

Calendar year returns



Source: ICE Bank of America Merrill Lynch Indices, as at 31 December 2017.
Past performance is no guarantee of future results.

References

1 VIX 31 December 2017
2 ICE BofAML 31 December 2017
3 UBS Asset Management "Outlook for High Yield, Another year of carry" January 2017
4 Moody's 31 December 2017
5 Ice BofAML, November 2017
6 UBS Asset Management "Outlook for High Yield, Another year of carry" January 2017
7 Moody's 31 December 2017
8 Moody's 31 December 2017

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