

HIGH YIELD MARKET UPDATE

2020 – CLOSING AN UGLY CHAPTER

Personally, it was crazy to watch. One child ended a long-term relationship only to find a new one in a COVID restricted world. Another child lost her dream job in the entertainment industry only to find (after 50+ interviews) a new job with a fast growing and dynamic start-up. My oldest child took a risk to start a new venture in the art world where the home has taken on much more importance in our lives. My father – a veteran of two wars – had to celebrate his nonagenarian (90th) birthday alone and behind a plastic shield. However, he was safe and healthy in his living facility.

Professionally, it was a bear – the toughest year of my 30+ years of investing. The year started great as risk assets and small cap found a bid and our strategy performed well. In early March, OPEC started an oil war that crushed U.S. energy investments. By late March, the lockdown ensued, and we found our portfolio in a literal performance hole. Within days, we had run liquidity projections on every issuer in the portfolio counting the number of months they could survive WITHOUT REVENUES. We applied our experience and nimbleness to buy every Fallen Angel that we could find at reasonable prices. With visibility returning to the economy by early summer, our portfolio began to recover. Energy lagged, but our overweight to homebuilders/building products and Fallen Angels became the workhorse in the portfolio. By Fall, our portfolio performance was improving, and by the end of 2020, we had recovered to end the year with a decent return relative to our peers.

2020 was also an important landmark for investors in high yield. There were **10 trends** that we believe are relevant for investors.

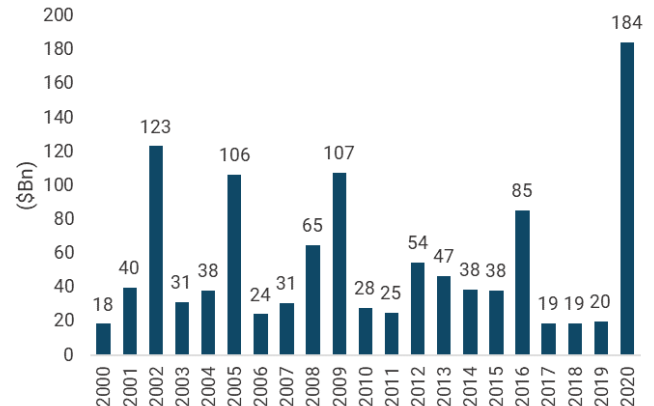
1. The high yield asset class grew 25% in size in 2020 driven by Fallen Angels.

Over the previous 4 years, our asset class had been shrinking as issuers used the private debt markets and loan markets as a source of capital. In addition, upgrades to investment grade and a lack of leveraged

buyout (LBO) activity accelerated the shrinkage. However, with the economic collapse, we welcomed almost \$200B in Fallen Angels, dominated by energy, travel and leisure. These issues presented great buying opportunities to get high quality names like Expedia, Live Nation and Carnival Corp.

Chart 1: Downgrades at a Multi-Year High

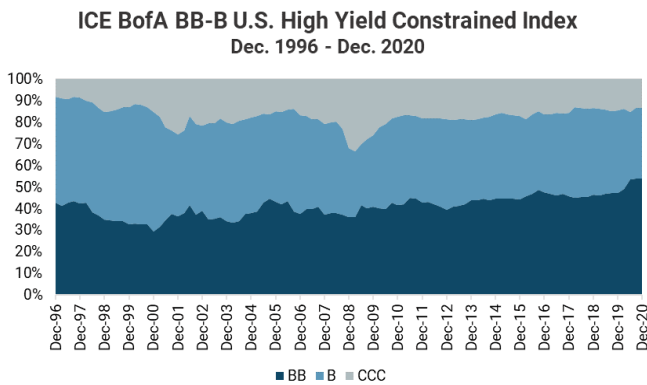
Gross Downgrades into HY, Face Value
Jan. 2000 - Dec. 2020



2. The high yield market is changing and is now of higher quality.

For years, the high yield market has been experiencing a shift toward higher quality issuers. This is a clear positive for investors as it should result in lower defaults and better recoveries. However, investors are accepting lower yields and spreads, limiting return potential for the asset class. When looking at current spread levels to historical levels, this needs to be taken into consideration. Yes, spreads are lower, but quality is higher.

Chart 2: Index Quality Improving

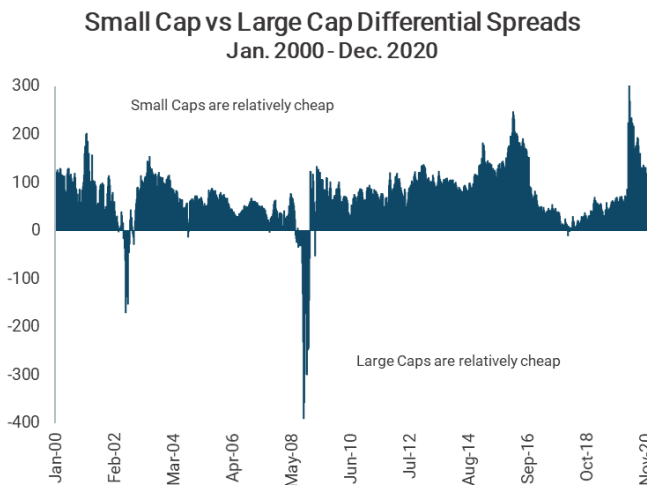


3. The dispersion between SMID and Large Cap hit historic levels.

We have seen swings in performance between large and small capitalization issuers, but 2020 was extreme. We attribute this to a few key factors:

- Street balance sheets have been shrinking and are generally biased toward larger issuers,
- Pricing has become more volatile for the sector relative to the past, and
- The Fed buying program focused on ETFs that generally do not invest in these smaller issuers.

Chart 3: SMID and Large Cap Differential Spread



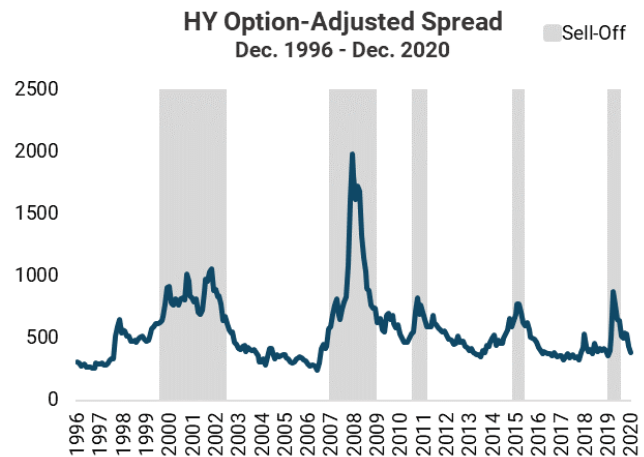
4. Sell-offs in high yield while vicious in nature have become shorter in duration.

As we have discussed in the past, drawdowns in high yield continue to be violent, but the length of time for the wider spreads continues to shorten.

As the chart below shows, since the 2000 telecom collapse, we have seen drawdowns shorten from years, to months and now weeks. There are two primary factors for this:

- As an established mainstream asset class, we attract investors globally that can react almost immediately, and
- There is simply too much cash on the sidelines.

Chart 4: Shortening Drawdown Periods



5. Cannibalism between asset managers has become du jour.

High yield bond and loan managers generally stay out of the media let alone the courtrooms (except to restructure their investments). In 2020, we saw a number of lawsuits *between managers* over aggressive behaviors in exchanges and reorganizations. Managers have been using old loopholes in Indentures and Loan Agreements to elevate their positions over other holders. Managers often work together in “wolfpacks” in these transactions. Even some old-time experienced managers that represented themselves as highly ethical and responsible joined the fray. It is not surprising to see these actions, especially in distressed situations.

There are more investors today with lots of cash chasing lower yields that will do anything to pick-up additional return. It reminds me of investors picking up a few nickels while a steam roller approaches. It may work in the short term, but it is a dangerous game that will likely end in tears. This is clearly an area of concern, but we are reminded of a major private equity firm that took on a similar approach a few years ago only to see

investors shy away from their investments. That firm and its new CEO were profiled in the Wall Street Journal about the need to improve their reputation with investors after a number of situations soured.

6. Structural creativity went to another level.

Just when you thought lawyers and bankers had exhausted all structuring creativity, a new approach to layering has evolved. In 2020, we saw the introduction of Senior Priority Guarantee language on transactions. It is not uncommon for some bonds to have guarantees ahead of other bonds in an effort to improve asset coverage and provide for higher bond ratings. If you sit back and look at the history of bond structures, you will see that we continue to get creative.

Exhibit 1: History of Bond Structures

1980s	1990s	2000s	2020s
Secured Bank Debt	Secured Bank Debt	ABL Bank Debt	ABL Bank Debt
Unsecured Bonds	Secured Bonds	Secured Bank Debt	Last In First Out Bank Debt
Subordinated Bonds	Guaranteed Bonds	Secured Bonds	First In Last Out Bank Debt
	Unsecured Bonds	Guaranteed Bonds	Secured Bonds
	Sr. Subordinated Debt	Unsecured Bonds	Sr. Guaranteed Bonds
		Sr. Subordinated Debt	Guaranteed Bonds
			Unsecured Bonds
			Sr. Subordinated Debt

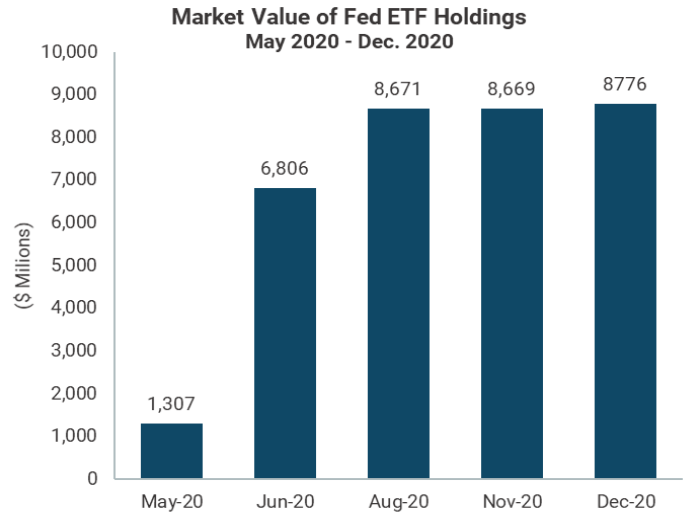
While our heads spin at times at the complexity of capital structures, it also provides great investment opportunities within specific issuers and potential excessive return opportunities.

7. The Federal Reserve has fundamentally decided to backstop high yield.

Moral hazard is fundamental to investing, especially in a risk asset class like high yield. The Federal Reserve, with good intentions, has removed that risk for high yield investors by implementing a sizeable buying program that focused on Fallen Angels and high yield ETFs. Companies go bankrupt when they run out of cash. In bankruptcy, companies lay off employees. Because of the pandemic, the Fed stepped in to provide liquidity by supporting the high yield market so that they could raise capital to supplement cash flows and stem layoffs. In our opinion, this was a short-sighted decision that could backfire in the long run. Investors will see this as perpetual support for the asset class and issuers that otherwise should restructure because of leverage or secular challenges will be kept alive.

Capitalism works best when markets are free to operate, create, and destroy. The Fed has removed an important tenant of capitalism by undertaking this bond buying program.

Chart 5: Fed Bond Purchases in 2020



8. ESG is here to stay and now driving investment decisions.

We have seen ESG guidelines move from equity investing into high yield mandates. It is challenging in our asset class as many secularly declining industries navigate into high yield. For example, the Coal industry, which is often viewed as ESG unfriendly, represented over 5% of the high yield market at one point. Level 3, a telecom infrastructure provider, recently did an ESG oriented issue that had a covenant requiring the company to reduce its greenhouse gas emissions by 10% by 2025. The issue was categorized as a “Sustainability-Linked Senior Note” and we will continue to see issuers focus on improving their environmental footprint, expanding their workforce diversity, and providing for better overall governance.

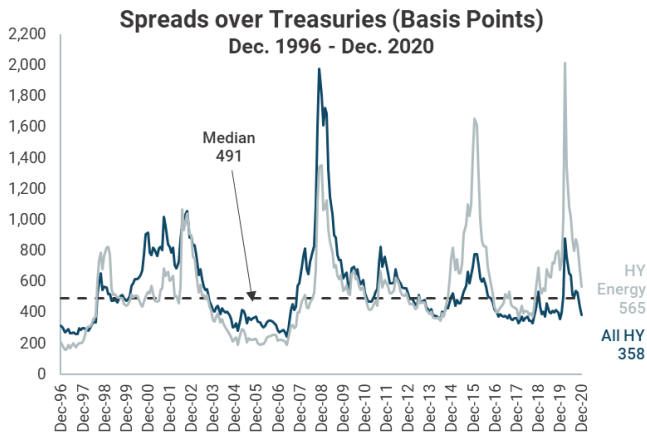
As portfolio managers, we continue to use ESG factors as a screening tool not because it is the “du jour” topic of the day, but because companies that cannot manage through these issues will not have access to capital and will default. It is a credit factor that must be incorporated in our decision-making process.

9. High yield energy investing has fundamentally changed.

In 2020, over 30 energy issuers defaulted – 30% of the overall market. The default rate for energy is running 5X higher than the standard default rate in high yield. Historically, energy was a safe haven for high yield investors (and actually traded tight relative to the overall market) as these issuers had cash flow and hard assets that only fluctuated modestly with commodity prices. With the advent of shale drilling and the fundamental shift toward renewable energy, volatility has increased. Moreover, management teams became undisciplined and cheap capital fueled bad capital allocation decisions.

By 2020, banks reigned in lending and the high yield market underwent a buyers’ strike. The net result is that flow of easy money ended, and as Warren Buffet once mused - “you only see who is naked when the tide goes out”. Going forward, we see opportunities in this space with large operators, preferably with a global focus, and with management teams that are clearly focused on cash flow and debt reduction. Smaller operators that depend upon debt markets will be left out.

Chart 6: Credit Spreads - Energy and all High Yield

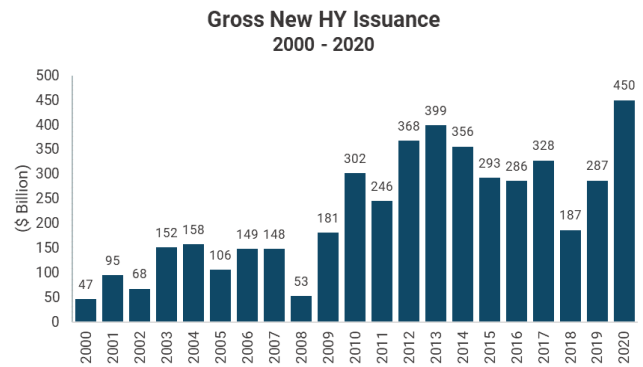


10. New issuance hit historic volumes and is likely to stay elevated for years.

High yield new issuance hit \$440B in 2020 compared to \$300B in 2019. That volume was about 40% higher than the average over the past 10 years. Approximately 25% of the new issuance was used to build cash war chests to help companies through the pandemic. The trend continues to be the same with the majority for

refinancing of higher quality issuers and only a small portion for M&A and LBO related activity. We expect volumes to remain elevated for a period of time as companies refinance loans with low rates. In addition, the tenor of bond issuance has shrunk from 8NC4 structures to 7NC3 which shortens durations. Just to put this into perspective, if the entire high yield market were refinanced at these lower rates, interest cost savings for high yield issuers would collectively be \$25B lower!

Chart 7: High Yield Bond Issuance (Annually)



2021 – WHAT LIES AHEAD?

So, what do we expect for 2021? Through all the drama of 2020, high yield basically returned its coupon as a return, which is rare in the annals of high yield. For 2021, we see the following:

Returns

We see high yield market returns hovering around the 5% area with a range anywhere from 3% to 7%. With a current carry of around 6% for high yield, we expect modest spread tightening of 50bps or so, offset by modest back-up in rates. Defaults should be lower than average as the energy sector has basically restructured and the market continues to improve in quality. The Fed, in our opinion, will be accommodative for longer which will suppress any large treasury moves.

Defaults

With the higher quality of the overall market and the restructuring of significant portions of the energy and telecom sectors, we expect defaults to be well below the historical 4% - 5% range: most likely in the 2% area. The risk to this forecast is a prolonged recovery that would impact the travel and leisure sector. This sector represents almost 6% of the high yield market and is clearly at risk.

New Issue Calendar

With approximately 25% of the market callable and current coupons approximately 150 basis points (bps) lower than the new issue market, we can expect a robust calendar for 2021 in the \$300B to \$350B range. That is about 30% below 2020's record calendar. The current coupon payments for high yield are in the \$75B range and most of that is reinvested. With high callability and interest income, portfolio managers will be focused on trying to keep portfolios fully invested – this is a technical indicator that is very supportive for high yield.

So how do we position in this environment?

- Keep our underweight in BB and overweight in single Bs with a modest allocation to CCC credits.
- Keep treasury duration slightly short of the index but keep credit duration long given the continued recovery.
- Keep cash levels low.
- Continue the SMID orientation in the portfolio, but with a laser focus on asset coverage and making sure that any illiquidity premium is properly reflected in the portfolio.

- Focus our research ideas on the travel & leisure and midstream sectors, and look for opportunities in real estate related sectors.
- Opportunistically buy loans that compete in yield and carry with high yield. With a Fed that is lower for longer, we do not expect any material upward movement in LIBOR.

In conclusion, it was a tough year personally and professionally. The chapter has now closed, and we are entering a new chapter that has strong technical underpinning, a fundamentally improvement backdrop, and decent valuations. We are in the recovery phase of the economy which will bode well for credit. Equity valuations are high and investment grade valuations are tight. High yield is in a sweet spot that we believe bodes well for investors. Happy hunting.

Ray Kennedy and The High Yield Team

All investments contain risk and may lose value. Investing in high yield securities is subject to certain risks, including market, credit, liquidity, issuer, interest-rate, inflation, and derivatives risks. Lower-rated and non-rated securities involve greater risk than higher-rated securities. High yield bonds and other asset classes have different risk-return profiles and market cycles, which should be considered when investing.

Data sources: Chart 1: BofA Global Research, HWCM; Charts 2-4, 6: ICE BofA Indices, HWCM; Chart 5: Federal Reserve, HWCM; Chart 7: JPMorgan, HWCM. Exhibit 1: HWCM.

Market Disruption: The recent global coronavirus pandemic has caused and continues to cause disruption in the global economy, unprecedented business and travel disruption and extreme fluctuations in global capital and financial markets. H&W is unable to predict the consequences of the upheaval caused by coronavirus pandemic, which, depending on the severity and the length of the outbreak, has the potential to negatively impact the firm's investment strategies and reduce available investment opportunities.

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