FEG INSIGHT

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EAT, DRINK, AND BE MERRY!

FEG's 2018 Credit Market Outlook

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The phrase "eat, drink, and be merry for tomorrow we die" has been used throughout literature for centuries. The expression is essentially an amalgamation of several biblical verses (including Isaiah 22:13, Ecclesiastes 8:15, Corinthians 15:32, and Luke 12:19), and is generally understood to mean we should enjoy our life as much as possible because we will not live forever.

Depending upon your religious leanings, the meaning of the phrase ranges from accepting one's lot in life—whatever that may be—to an expression of pure hopelessness.

In 1997, The Dave Matthews Band included the lyrics "eat, drink, and be merry for tomorrow we die" in the song "Tripping Billies" to paint a picture of how much fun they were having together on the beach, knowing at some point it would come to an end.

But what does all of this have to do with the credit markets in 2018? Before answering that question, a review of 2017 in connection with the prior year's credit market outlook "What Do We Know?" is in order.

Performance was strong in 2017, building upon the previous year's gains to generate a 7.5% return for high yield bonds following a 17.5% return in 2016.[1,2] Consider FEG's 2017 credit market outlook:

> *"Despite high yield bonds doing an about face from early 2016, trading above par ($100), and yielding 6.3% (a near two-standard deviation low yield), experience has shown us that high yield bond prices can remain elevated for years as investors can maintain a willingness to hold these assets even at high dollar prices in order to receive the coupon payments. From a tactical perspective, an entry price at the levels mentioned above did not make sense."*

Eat, drink and be merry with no concern for near-term death proved to be a winning strategy for investors in 2017, but what about the dying? More importantly, from an investor's perspective: when?

BRING OUT YOUR DEAD!

FEG places great emphasis on the quality of underwriting standards prevailing in the new issue market for corporate bonds. Most importantly, the percentage of low quality corporate bonds, rated B or lower, is worth watching because the measure helps identify market standards that may be growing too lax.

With data provided by Professor Edward Altman of the New York University Stern School of Business, the "Mortality Rates by Original Rating" table applies an actuarial perspective to historical bond defaults. Historically, more than 20% of bonds rated B at issuance and 45% of bonds rated CCC default by year four. Lower-rated bonds intuitively are more likely to default than bonds with higher ratings at issuance, but the default rates are material, as they provide a more realistic framework to the unknowable.

In 2012, new issuance of high yield bonds rated B or lower reached an all-time high of $215 billion. B-rated bonds accounted for more than 40% of all high yield issuance that year and CCC-rated bonds accounted for almost 9%—a whopping 50% of all new issuance!

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MORTALITY RATES BY ORIGINAL RATING
All Rated Corporate Bonds (1971–2016)

		YEARS AFTER ISSUANCE									
		1	2	3	4	5	6	7	8	9	10
B	Marginal	3%	8%	8%	8%	6%	4%	4%	2%	2%	1%
	Cumulative	3%	10%	17%	**24%**	28%	31%	34%	35%	36%	37%
CCC	Marginal	8%	12%	18%	16%	5%	12%	5%	5%	1%	4%
	Cumulative	8%	20%	34%	**45%**	47%	53%	56%	58%	58%	60%

Data source: Edward Altman and Brenda Kuehne

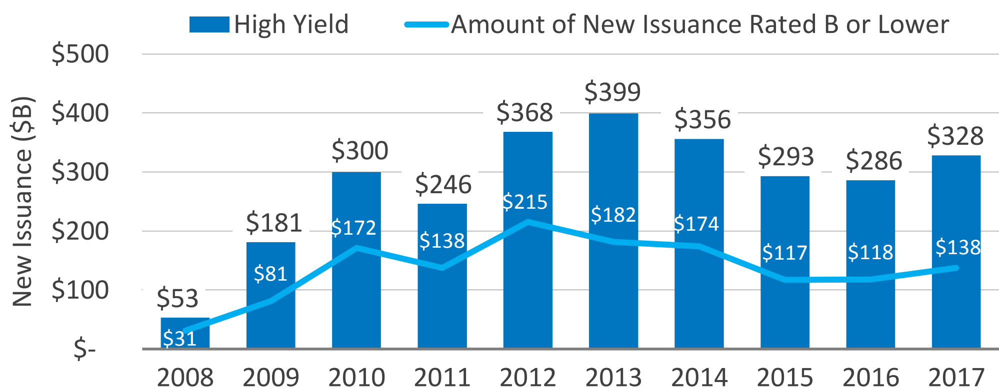
In conjunction with Altman's mortality rates, this increase in lower-rated new issuance following several strong years of performance in risk assets suggested the time was ripe for an up-tick in defaults.[3] This was indeed the case four years later, as default rates rose from 1.6% in 2012 to 4.1% in 2016, amounting to a "mini" distressed cycle centered around energy-related issuers. As the market reversed course in early 2016, default rates for 2017 fell to 1.8%.[4]

Periods of prolonged strength in the prices of risk assets typically lead to future weakness. The up-tick in lower-quality new issuance in 2017 followed back-to-back years of more than $100 billion in low-rated new issuance.

While this is not necessarily a reason to run for the hills, the recent experience of 2016 shows just how quickly default rates can rise following a sustained period of meaningful low quality issuance.

Intuitively, investors should understand that during periods where demand for credit is strong, issuers and underwriters tend to push the envelope in terms of quality. Indeed, a high degree of low-rated issuance may act as tinder to potentially spark a default rate fire in the next downturn. With an understanding of "what" could potentially become distressed in the next downturn, the question of "when" the next downturn may take place is on the minds of many investors today.

HIGH YIELD BOND NEW ISSUANCE AND AMOUNT OF NEW ISSUANCE RATED B OR LOWER



Data sources: J.P. Morgan, Bloomberg, L.P., Lipper FMI

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I FEEL HAPPY, I FEEL HAPPY!

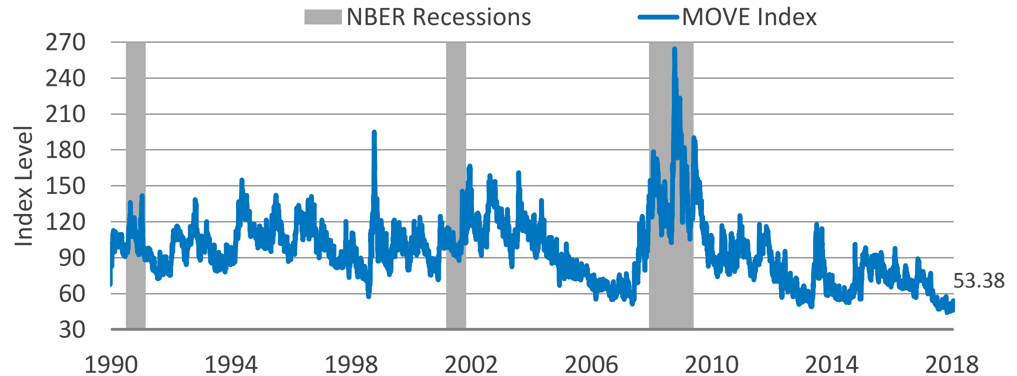
Judging from the strong returns generated by "risky" assets over the past two years, investors appear unconcerned about the level of risk they are willing to bear by holding an abundance of fairly valued to overvalued assets. Overall, the market appears fairly comfortable—if not happy—with its view of the economy and markets in general near term.

The Merrill Lynch Option Volatility Estimate Index (MOVE) is the bond market's equivalent of the Chicago Board of Options Exchange Volatility Index (VIX), and both are often cited as "fear gauges." We will focus on the MOVE Index, as it is more applicable to a credit discussion than the VIX.

Similar to the VIX, the MOVE continued to show complacency throughout 2017 and into 2018, falling below 50 for the first time since May 2013.

When this gauge is overlaid onto past recessions, sustained increases in the MOVE coincided with each of the past three recessions, in addition to a few "fake-outs." While the MOVE does not provide a good indication of when the next downturn may come, it does show significant complacency about the current environment. Based on history, it is reasonable to assume that a rising or rapidly increasing MOVE should be expected to take place leading up to the next economic downturn.

MERRILL LYNCH MOVE INDEX AND BUSINESS CYCLES



Data sources: Merrill Lynch, Bloomberg, L.P., NBER; Data as of January 25, 2018

FEG believes that outside of an exogenous shock—such as rapidly declining oil prices in 2015 and early 2016—the next meaningful increase in default rates is likely to take place during, and perhaps because of, the next U.S. recession. The following chart shows Moody's trailing 12-month moving average default rates as of September 30, 2017 and the U-3 Unemployment Rate, along with past recessions, which are highlighted in gray bars.

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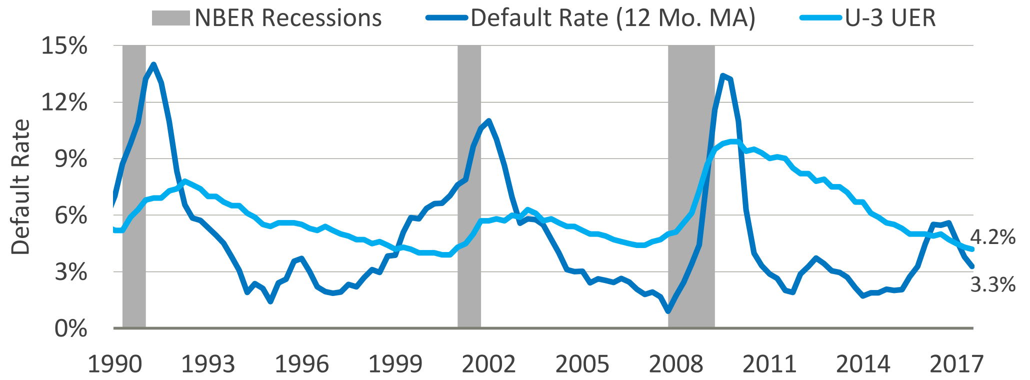
U.S. HIGH YIELD DEFAULT RATE, CYCLES, AND U-3 UER



Data sources: ICE BofA/ML, Moody's, Edward Altman, NBER, BLS; Data as of 3Q 2017

As the economy shifts closer toward “full employment,” wage inflation typically ensues; this along with other late-cycle behavior, can lead the Federal Reserve to raise overnight borrowing costs. Whether or not the Federal Reserve “overshoots” on its current rate-hiking regime and tips the economy into recession is unknown. If it does overshoot FEG believes default rates are likely to rise.

There have been instances of spiking default rate “head-fakes” in the past, as default rates began to increase and subsequently reverse course, most recently in 2015 through 2017. In these instances, a recession did not materialize. The chart above illustrates much higher default rates during recessions, with a peak just thereafter, suggesting recessions are closely linked with greater opportunities for tactical allocations into credit (and more opportunities for investments in distressed situations). As for anticipating the precise timing of the next downturn, an up-tick in default rates may again prove to be the “canary in the coalmine,” as they were in the late 1990s and as depicted in the chart.

With recent fiscal changes in the form of tax cuts and improved global economic growth, there still may be some life left in the credit markets. Conversely, the Federal Reserve may see the labor markets and increasing inflationary pressures as the catalyst for more aggressive monetary policy than what is currently factored into the markets. Ultimately, no one knows when the credit cycle will turn and the next recession will arrive, only that it will. Until then, there appears to be little compensation in credit for the associated risks.

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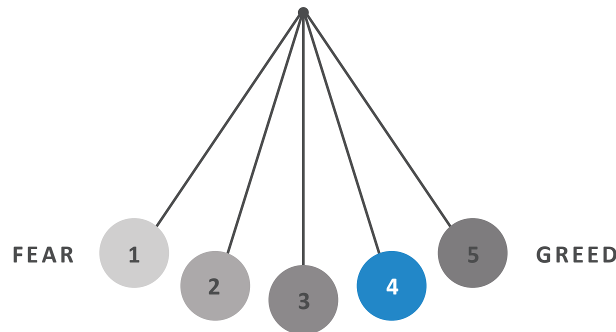
EAT, DRINK, AND BE MERRY!

The final tool FEG uses each year in the credit market outlook is the "fear/greed" pendulum. Last year's outlook moved the pendulum from a ball two position (more fearful) to a ball four position (more greedy).

While the market is indeed showing signs of extreme greed, investors also are reducing exposure to high yield bonds—mutual fund investors pulled more than $20 billion in assets from high yield funds in 2017 following strong inflows in 2016.[5] The market does not indicate excessive greed, as option-adjusted spreads versus Treasuries are historically low at 3.6%, but a far cry from the 2.4% witnessed in June 2007, just before the credit crisis.



Although there is an argument for an excessive greed ball five position, calling for an imminent downturn, the factors described earlier show a fairly to slightly over-priced market, which suggests remaining at ball four is more appropriate.

For the time being, investors may continue to eat, drink, and be merry, as long as they remain mindful that one day we all die, as will this bull market.

[1,2] ICE BofA/ML High Yield Master II Index
[3] Historical Default Rates – Straight Bonds Only, Not Including Defaulted Issues in par Value Outstanding, 1971-3Q 2017. Altman/Kuehne, *Special Report on Defaults and Returns in the High Yield Bond Market Third Quarter 2017 Review*
[4] Altman/Kuehne, *Special Report on Defaults and Returns in the High Yield Bond Market Fourth Quarter 2017 Review*
[5] J.P. Morgan; Bloomberg; Lipper FMI (High Yield Supply and Demand), Fourth Quarter 2017

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