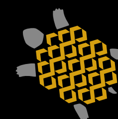
GLOBAL LEVERAGED FINANCE QUARTERLY REVIEW

SHENKMAN

Volatility is back



First Quarter 2018

Rates, Trade & Elections

Last October we wrote a report asking "Where is the Vol?" – well, it arrived in the first quarter 2018. The volatility appeared to be driven by macro events and not an increase in concerns over credit quality. While these factors could slow down the pace of economic growth, we believe it is highly unlikely they will change the general direction of growth, which should lead to credit upgrades outpacing downgrades. Although volatility increases were experienced in most developed countries security markets, there appeared to be a greater spike in the U.S. than Europe, allowing for some performance differentiation by region.

The most significant volatility triggers occurred in the U.S. – most notably Treasury yields moved upwards on news about government funding needs after the new tax reform laws. Moreover, major tariff announcements triggered concerns over escalating trade skirmishes. European events have contributed too, as the Italian election as well as some mixed economic data out of Germany have factored into market volatility.

The trade issues and Italian election may have dominated headlines, but for debt markets, the sudden move in rates probably had some of the greatest impact. Importantly, the rate moves hurt the investment grade and government markets much more than the leveraged debt markets. By quarter end, however, the benchmark government rates had retreated from their peaks and appeared much calmer – certainly more so than equity markets that appeared to swing more violently in response to news about trade. With greater volatility (or perhaps a return to more normal levels) credit selection can play a greater role in performance than during period where momentum is driving everything in the same direction.

The focus on trade may become an increasing factor on overall performance of below investment grade debt. The European Union economies are in an interesting spot on international trade. The OECD reports as of December 31, 2016 trade makes up 43% of GDP for the European Union, while it is only 28% on average for OECD countries and 13% for the U.S. While not completely unscathed, the European Union has generally been able to avoid being at the center of the recent trade struggles – as it appears the U.S. and China are primarily focused at throwing haymakers at each other. If the trade wars end up just being the first steps in a longer positive trade negotiation, much of this will not matter. If trade skirmishes escalate into a war, however, there will likely be few winners. If Europe can stay out of the center of the battle, it may actually fare better than elsewhere in the world – though it has its own risks.

Asset class performance: Loans lead the pack while high yield is holding up well

The dominant feature impacting the debt markets during the first three months of 2018 was the movement in rates. The markets may have responded more to the suddenness in the move upward than the actual amount. The move in LIBOR may have been the most dramatic shift during the first two months of 2018. Within the debt capital markets, the asset class that benefitted most from the LIBOR increase was the leveraged bank loan market, whose floating rate structure helped to outperform almost all other major fixed income markets. Moreover, the structurally lower volatility characteristics within the short duration segment of the high yield bond market were very apparent, as this segment outperformed the broader high yield bond market.

Exhibit 1: Asset Class Performance

As of March 31, 2018	Mar-18	1Q 2018
Shenkman Capital Global High Yield Composite (Gross)*	-0.39%	-0.50%
Shenkman Capital Global High Yield Composite (Net)*	-0.45%	-0.67%
U.S. Corporate Index (C0A0)	0.22%	-2.20%
Global High Yield Bonds (HYDC)*	-0.48%	-0.67%
U.S. High Yield Bonds (H0A0)	-0.62%	-0.91%
U.S. Short Duration (H42C)	0.12%	0.43%
European High Yield Bonds (HP00)**	-0.20%	-0.41%
S&P LSTA U.S. Leveraged Loan Index	0.28%	1.45%
S&P European Leveraged Loan Index**	0.13%	0.85%

*USD Hedged **Returns in local currency
Source: ICE Data Indices, Bloomberg, S&P

While the high yield bond market as a whole posted a negative return in the first quarter, it fared better than major investment grade indices. The increase in yields in the below investment grade bond market may have reached the point that it could start to attract new money to this asset class, especially as the widening has not been driven by heightened credit concerns. Investors may also find more interest in this asset class given its relatively short duration and that the widening in the intermediate and longer dated part of the government bonds curves moderated by the quarter end.

Global High Yield: greater return dispersion across regions and industries

During the first quarter, there were significant differences in performance by currency denomination. The Euro and U.S. Dollar markets differed in performance by rating category and by industries. These differences highlight an advantage of maintaining flexibility in weightings across regions and currencies.

A reversal of fortunes between the U.S. and Europe was driven in part by the less material interest rate moves in Europe. The U.S. high yield bond market meaningfully underperformed the European market which, despite lower coupons, faced less volatility and outperformed. Ultimately, both markets appear to be facing rising rates and balance sheet unwinds. However, based on statements from respective central banks, the implications are that the U.S. should move faster than the very cautions European Central Bank (ECB).

In terms of industry returns, there were significant differences within U.S. and Euro high yield markets. In fact, none of the five best or worst performing industries from either market was replicated in the other market. Interestingly, there were two industries that ranked among the best performers in the U.S. and among the worst in Europe – Food and Drug Retailers (1.06% vs. -1.38%) and Transportation Excluding Air/Rail (0.38% vs. -1.43%) – on a total return basis. This highlights how different the opportunities can be between the two markets. Performance by rating category also varied. In the USD portion of the market, the CCC rated tier outperformed, primarily driven by strength in January. Meanwhile, single B rated securities performed the best in Europe.

Exhibit 2: Top 5 Industries – Total Return Q1 2018 (%)

U.S.		Europe	
Aerospace / Defense	1.46	Consumer Products	4.61
Food & Drug Retailers	1.06	Media Diversified & Services	1.65
Media Diversified & Services	0.67	Reits	0.96
Railroads	0.57	Leisure / Entertainment	0.87
Transportation Excluding Air / Rail	0.38	Hotels	0.40

As of March 31, 2018. Source: Shenkman Capital

Our strategic positioning: interest rate risk, duration and relative value

We continue to express many of our views that were in place during the fourth quarter of 2017. Compared to the U.S., we believe that interest rate risks are less severe in European markets and favor earlier stage cyclical credits. While trends in the underlying credits are ultimately the critical driver of our investment decisions, we have continued to view the spreads on European single Bs attractive relative to equivalent U.S. single B spreads and relative to Euro BBs.

Within the Shenkman Capital Global High Yield Composite, we have maintained our lower duration in U.S. dollar investments and slightly longer duration in our Euro holdings – though our overall Euro Option-Adjusted Duration (OAD) was consciously reduced. In addition, we slightly increased our overweight to single B exposure, primarily through additions in Euro denominated issues. In terms of industries, we increased holdings in the packaging sector (primarily in Euros), while reducing exposure to chemicals and electric utilities (primarily U.S. companies). Both the industry reductions were driven in large part by relative value. Finally, we slightly increased our exposure to Euro denominated securities in the portfolio – specifically our exposure to Germany and France increased while our UK exposure declined.

Outlook: volatility to continue towards "normal" levels

We anticipate continued economic expansion in both the U.S. and Europe, but the markets are likely to face bouts of increased rate and political volatility. Heightened rate volatility may be caused by the markets adjusting to the style of communications from the new regime at the U.S. Federal Reserve. Politically driven volatility will likely come from both sides of the Atlantic but may be greater in the U.S. While Europe is far from immune to political drama (e.g. looming Brexit deadline and tenuous political coalitions), we believe the political environment in the U.S. may cause greater volatility in the securities markets there than what will be seen in Europe.

Even with the potential for heightened volatility outlined above, we believe a selected portfolio of global high yield bonds can outperform most other major fixed income markets and produce attractive results in 2018. The combination of coupon and the potential for credit improvements should lead to positive performance for the leveraged bond markets. In such an environment, credit selectivity will be critical, and identifying the correct currency exposure can also add alpha.

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3. The Shenkman Capital Global High Yield Composite has an inception date of August 1, 2014, and consists of comparable accounts that employ Shenkman Capital's global high yield investment strategy and excludes multi-sector and structured funds and accounts that are not fully discretionary or have investment guidelines and restrictions that impair Shenkman's ability to implement its investment strategy (e.g., prohibitions on investing in, or requirements to maintain minimum exposures to, certain types of assets) and accounts that have certain restrictions on investing in securities and loans rated below B3/B-. Eligible accounts that are experiencing significant inflows or outflows and/or which are not yet fully invested may be temporarily excluded from the Composite.

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4. The ICE BofAML U.S. Corporate Index (C0A0) has an inception date of December 31, 1972, and tracks the performance of U.S. dollar denominated investment grade corporate debt publicly issued in the U.S. domestic market.

The ICE BofAML Developed Markets High Yield Constrained Index (HYDC) has an inception date of December 31, 1997 and contains all securities in The ICE BofAML Global High Yield Index (HW00) from developed markets countries, but caps issuer exposure at 2%. The ICE BofAML Global High Yield Index (HW00) has an inception date of December 31, 1997 and tracks the performance of USD, CAD, GBP and EUR denominated below investment grade corporate debt publicly issued in the major domestic and Eurobond markets.

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The ICE BofAML 0-2 Year Duration BB-B U.S. HY Constrained Index (H42C) is a subset of the HUC4 that consists of all securities that have a duration-to-worst of 2 years or less. The ICE BofAML U.S. High Yield, BB/B Rated, Constrained Index (HUC4) has an inception date of December 31, 1996, and is a subset of the ICE BofAML U.S. High Yield Index (H0A0) that consists of all securities rated BB1 through B3, based on an average of Moody's, S&P and Fitch, but caps issuer exposure at 2%.

The ICE BofAML European Currency High Yield Index (HP00) has an inception date of December 31, 1997 and tracks the performance of EUR and GBP denominated below investment grade corporate debt publicly issued in the eurobond, sterling domestic or euro domestic markets.

The S&P/LSTA U.S. Leveraged Loan Index is a daily total return index that tracks the current outstanding balance and spread over LIBOR for fully funded term loans. The facilities included in the S&P/LSTA Leveraged Loan Index represent a broad cross section of leveraged loans syndicated in the United States, including dollar-denominated loans to overseas issuers.

The S&P European Leveraged Loan Index is a market-value-weighted index designed to measure the performance of the European institutional leveraged loan market, and tracks the current outstanding balance and spread over EURIBOR for fully funded term loans. The facilities included in the S&P European Leveraged Loan Index represent a broad cross section of leveraged loans syndicated in Europe.

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