U.S. Corporate Debt Market

November 2018

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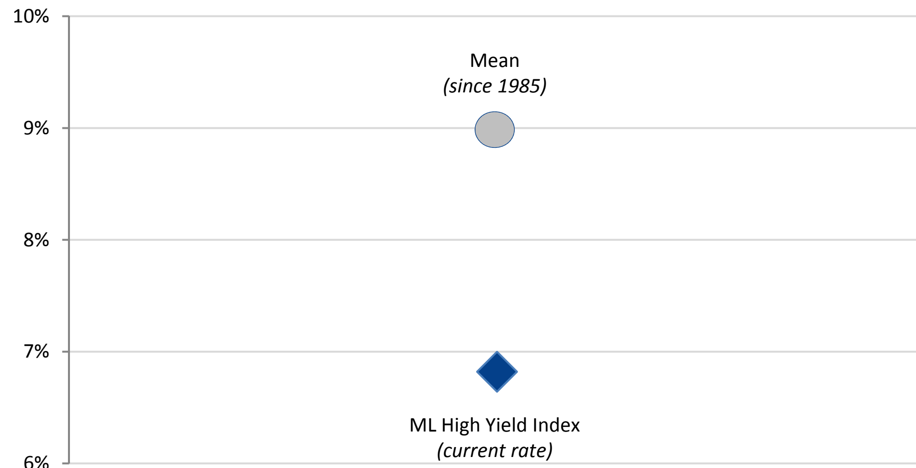
High Yield: Unattractive at Current Levels

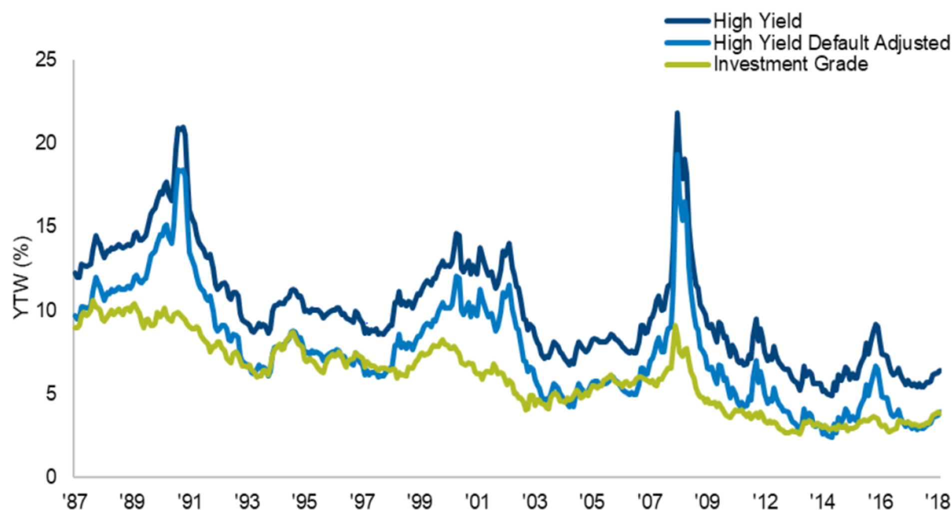
Current Yield Substantially Below Average[1]



High yield bond yields have declined as investors have sought yield in an extended period of low interest rates.

The current high yield opportunity set is in the 9th decile (1st decile is most attractive).

High Yield Unattractive versus Investment Grade[2]

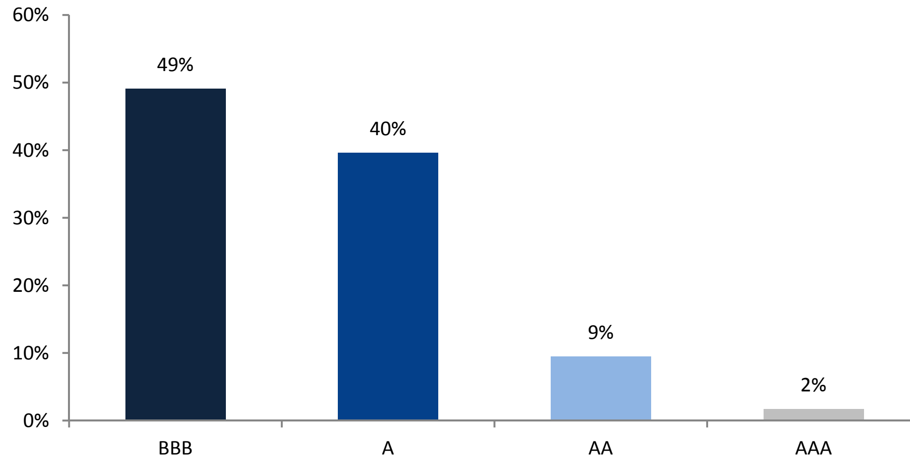


High yield, adjusted for defaults, does not compensate investors for the additional credit risk being taken relative to investment grade.

[1] Merrill Lynch High Yield Master II Index as of 10/31/2018. Source: Bloomberg,
[2] Source: Bloomberg, Moody's, FPA.

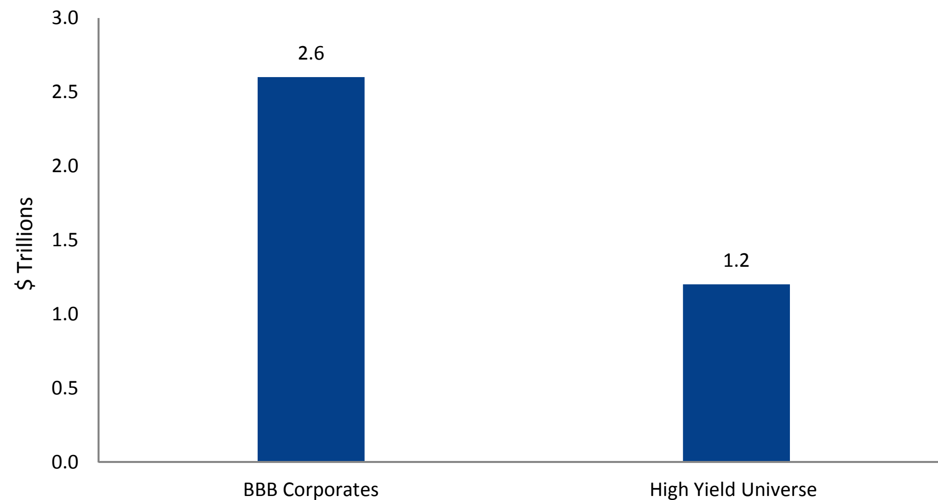
Investment Grade Bonds: Quality is Becoming a Growing Concern

BBB is nearly 50% of Investment Grade Index[1]



The lowest rated subset of the investment grade credit universe (BBB rated bonds), is now the largest subset of the investment grade universe.

BBB Corporate Credit Market Dwarfs Entire High Yield Market[2]



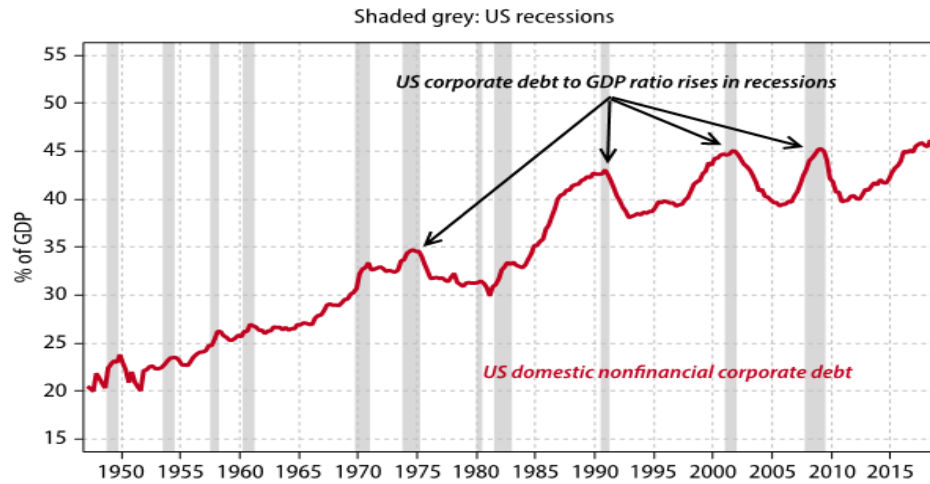
The BBB credit market is now substantially larger than the entire high yield market.

If 15% of today's BBB market were downgraded (in-line with prior cycles) it would equate to a record one-third of today's high yield market.

[1] Source:. Bloomberg, ICE. Distribution characteristics for the ICE BofAML U.S. Corporate Index as of 11/8/2018.
[2] Source: Bloomberg.

U.S. Corporate Debt: Market Structure

U.S. Corporate Debt to GDP Ratio[1]



Corporate leverage has hit an all time high. Typically this happens during recessions, not during expansions.

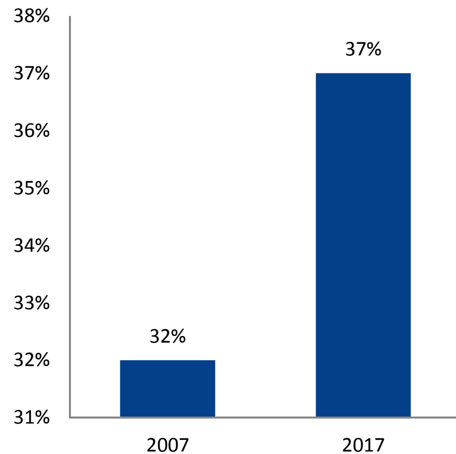
Primary Dealers No Longer Hold Much Inventory[2]

While the amount of corporate debt has increased, primary dealers have significantly reduced their inventory levels. This change in the market's structure may lead to increased volatility in future market sell-offs.

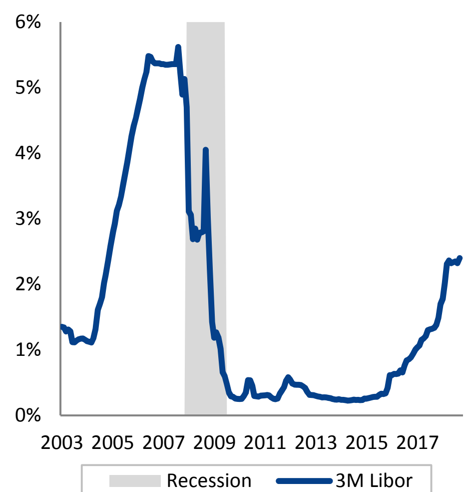
[1] Non-financial corporate debt. Source: Gavekal Data, Bloomberg.
[2] Source: New York Federal Reserve.

Leverage and Rates are Rising, and a Maturity Wall is Approaching

Percentage of Companies with Leverage >5x[1]



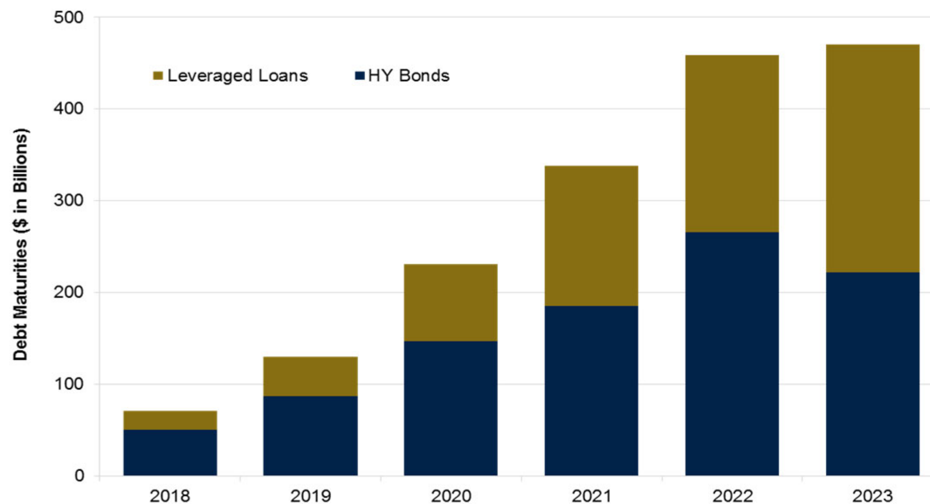
3-Month Libor[2]



The percentage of highly leveraged companies is increasing, and is now higher than pre-financial crisis.

Rising interest rates will put additional pressure on companies with high leverage and looking to refinance their debt.

Future Debt Maturities are Significant[3]



These factors, combined with significant debt maturities in the coming years, are likely to create opportunities for managers focused on distressed credit and equity investments.

In the next distressed cycle it is expected that recoveries on defaults will be lower due to weaker structures (covenant lite, covenant loose, etc.), which will reinforce the need for active credit analysis.

[1] Source: S&P Global Ratings, New Generation Advisors.
[2] Bloomberg, New Generation Advisors.
[3] Morgan Stanley, New Generation Advisors.

Summary – Portfolio Positioning

- We have sold our short-duration high yield investment, increased our allocation to U.S. Treasuries and are positioned to take advantage of opportunities as they arise.

- We maintain our position in MGG (loans to small and medium sized businesses), where the manager controls the underwriting and quality of the loan documents.

- A new distressed cycle will eventually emerge in the U.S. The timing is not predictable, but we have a number of managers who can take advantage of the cycle when it occurs, have the right size AUM (previous winners are now too big), and are experienced in knowing when to pull the trigger.