A defining feature of the market environment in 2019 was the gradual evaporation of yields around the globe. Accommodative central bank policy pushed down interest rates, sparking an excessive grab for yield for income-seeking investors across all corners of the market. High yield credit was among the beneficiaries, posting double-digit returns in 2019. The year’s strong gains came with a great deal of dispersion, however, as the global hunt for yield and fears of a global slowdown directed demand toward the perceived safety of higher quality, less cyclical segments and pulled support for higher yielding but more economically sensitive areas of the marketplace.

The performance dispersion between higher- and lower-rated credit risk was noteworthy considering the strength of the high yield rally in 2019. Periods of above-average returns for credit investors tend to coincide with the indiscriminate reach for yield, not growing risk aversion. In fact, it has been over 30 years since high yield bonds have posted double-digit returns and CCC-rated bonds have been unable to outpace the broader market. While the current period of dispersion raises natural questions about whether increased investor risk aversion is a precursor to future credit stress, we believe the decoupling of risk highlights a growing opportunity set for alpha generation.

Exhibit 1: 2019 Corporate Credit Performance—High Yield Bonds and Leveraged Loans by Credit Quality

Lower Quality Conundrum

Some of CCC-rated bonds’ underperformance can be attributed to limited sensitivity to moves in interest rates, but mostly to investors’ understandable risk aversion toward CCC-rated risk. Considering the current cycle’s extended length and signs of slowing global growth, investors grew increasingly cautious of lending to structurally challenged capital structures—despite double-digit yields. Relative to the broader high yield bond index, CCCs in aggregate have larger representation of cyclical industries, introducing additional business risk to elevated leverage levels. Today, 40% of the CCC universe trades at distressed levels, but much of this can be attributed to energy and commodities-related companies that have been disproportionately impacted by declining commodities prices and concerns around global demand decay.

In our view, the dual themes of risk aversion and energy-related weakness have overshadowed a number of attractive idiosyncratic opportunities down the credit spectrum. Our base case for a slower-but-stable economic environment provides a supportive backdrop for select CCC segments, and at current valuations, pockets of CCC-rated issues provide enough margin of safety for the wide range of economic scenarios that could unfold over the coming quarters. Yields for the group are more than three times those of the BBs (11.8% vs. 3.9%), meaning CCCs would have to experience relative spread-widening of a few hundred basis points from already elevated levels to continue underperforming.

That’s not to say we want to take broad CCC risk at this point in the cycle. While we expect the spread differential between higher- and lower-rated risk to revert closer to historical levels, a large subset of the CCC universe consists of fundamentally flawed companies that have benefited from investors who are willing to underwrite potential turnaround stories in exchange for higher potential returns. In this case, we believe broader valuations properly reflect the challenges these issuers face in order to remain going concerns. Instead, we look to select CCC issuers that have full-cycle business models and an ability to organically deleverage—a combination that should lead to outsized performance in the near term.

Exhibit 2: Range of Yields Across High Yield Bond Credit Qualities
**Up-In-Quality Shows Signs of Complacency**

Investors deploying an up-in-quality approach were rewarded with outsized returns in 2019, but this perceived safe haven looks inflated at current levels. Because BB-rated bonds are more rate-sensitive, falling interest rates and investors’ reach for yield pushed the segment to the brink of investment-grade valuations. As it stands, BB bond spreads have reached cycle tights and are 66bps from investment-grade yields.

Going forward, the segment offers an increasingly asymmetric outlook when considering the risk of rising valuations. Close to two-thirds of the constituents in the BB index trade with a yield inside of 4%, and at present levels, a 65bps upward move in rates would wipe out the year’s coupon for several newly issued BB bonds. Further, 88% of the callable constituents in the BB-rated index trade at or near their call prices, suggesting further price appreciation is limited, even if interest rates were to fall. Many point to investors’ preference for high quality as a sign of increased discretion, but we believe the reach for “safe yield” has left this segment the most vulnerable to downside risks at current valuations.

**Exhibit 3: Spreads for BB and BBB-Rated Bonds**

![Graph showing spreads for BB and BBB-rated bonds]

Source: ICE BofAML. Past performance is not a reliable indicator of future results. Spreads based on spread to worst. BB values represented by ICE BofAML US Corporate BB Index and BB values represented by ICE BofAML BB US High Yield Index.

**Distress Overshadows Still-Solid Fundamentals**

The increased divergence among credit qualities comes down to the market’s view of expected losses. To be sure, default rates for non-investment-grade credit remain anchored well below long-term averages, but this current period of elevated dispersion has coincided with a marked uptick in distress situations. While the share of bonds trading with spreads more than 10% above similar-maturity Treasurys has moved higher, in aggregate, the environment remains benign. Dispersion is elevated by historical standards (top-25th percentile), but the high yield distress ratio at 7.3% percent of par and the default rate 2.9% of par are only 50th percentile.

A closer look shows credit stress has largely been concentrated in sectors that are facing well-documented disruption (retail and telecom), are commodities-price dependent (energy) or are vulnerable to regulatory or litigation risk (health care and pharmaceuticals). Together, energy, retail, telecom and health care are responsible for more than 70% of total market distress, suggesting credit weakness is more idiosyncratic rather than systemic. Importantly, fundamentals largely remain supportive of high yield outside of a handful of sectors, in our view. Operating profits that are improving, slowing collateralized loan obligation (CLO) creation and headlines about degrading underwriting standards resulted in consistent outflows for the asset class. As bonds have rallied, relative weakness in loans has caused the yields for the two asset classes to diverge, leading to the historically rare occurrence of loan yields exceeding bond yields—despite the former’s marginally better credit profile. This dislocation is unlikely to persist. Though an imperfect exercise due to notable compositional differences between bond and loan indices, historically speaking, when loan yields exceed bond yields, loans have tended to outperform over the ensuing 12 months. Importantly, the Fed’s patient approach to further rate cuts limits further downside to interest rates over the near term, supporting our preference for loans over bonds—particularly higher-rated segments—on a relative value basis.

**Favorable Outlook for Unloved Loans**

Dispersion wasn’t just limited to the credit ratings spectrum. Across the capital structure, leveraged loans struggled to keep pace with bonds due to limited rate sensitivity and carry erosion from accommodative central bank policy. Demand lagged as the exodus of yield-sensitive investors, slowing collateralized loan obligation (CLO) creation and headlines about degrading underwriting standards resulted in consistent outflows for the asset class. As bonds have rallied, relative weakness in loans has caused the yields for the two asset classes to diverge, leading to the historically rare occurrence of loan yields exceeding bond yields—despite the former’s marginally better credit profile. This dislocation is unlikely to persist. Though an imperfect exercise due to notable compositional differences between bond and loan indices, historically speaking, when loan yields exceed bond yields, loans have tended to outperform over the ensuing 12 months. Importantly, the Fed’s patient approach to further rate cuts limits further downside to interest rates over the near term, supporting our preference for loans over bonds—particularly higher-rated segments—on a relative value basis.

**Exhibit 4: Intra-Market Dispersion Is Approaching Cycle Highs**

![Graph showing intra-market dispersion]

Source: ICE BofAML. Past performance is not a reliable indicator of future results. Proportion of bonds in the ICE BofAML US High Yield Index marked outside +/-100bps of overall index level. In CCCs, proportion of bonds marked outside +/-400bps of the rating’s subindex level.
A Word of Caution

A unique, but often uncovered, aspect of the current reach for yield is the role of private debt’s growing presence as a late-cycle risk. According to alternative asset database Preqin, the assets under management of private debt funds have increased more than threefold over the last decade to close to $800 billion, as investors looking for yield have moved to fill the void created by the gradual pullback in traditional middle-market bank lending. Historically, private debt was reserved for niche borrowers—typically financings for small companies that lacked agency ratings or meaningful operating earnings—but now, private debt serves much a larger institutional audience, resulting in significant competition to traditional syndicated, leveraged finance markets.

Today, as investors have pulled sponsorship for the most leveraged, syndicated borrowers, they’ve rotated capital toward private lending solutions, which offer a yield advantage in exchange for illiquidity and lockups. The recent discretion investors have shown in lending to lower-rated issuers hasn’t been apparent in private credit markets, though. Private deals today have become increasingly issuer-friendly and at less favorable terms for lenders. The attractive rates of return that have characterized the asset class have eroded over the last several years as private credit managers, armed with large pools of dry powder and motivated by their fee structures, have been left chasing fewer deals at increasingly less attractive rates. Questions remain about private debt’s ability to perform in less favorable environments than the one seen over the last decade. The relative infancy of the asset class means there is little precedent to gauge the severity of credit defaults and the depths of losses. Given the frothiness of current conditions, we believe the next downturn could be challenging for private debt investors.

Identifying Value Through an Active Approach

Overarching uncertainty has resulted in a pronounced decoupling of risk across credit qualities and capital structures, creating vast alpha opportunities for disciplined credit pickers. In our view, today’s elevated dispersion is less a story of investors anticipating an inflection in the cycle by rotating away from lower-rated segments, and more about yield-sensitive investors indiscriminately buying “safer” high yield. Fundamentals ultimately drive returns, and the ability to assess credit risk independently of ratings agencies can create meaningful opportunities for outperformance when opinions of market direction diverge. For active managers today, diversity in bond pricing reflects a more robust opportunity for credit selection. Skillful credit analysis can uncover total return opportunities in credits whose prices are disconnected from fundamentals, or in those that have been disproportionately impacted by negative sentiment.

As investor risk tolerance wanes and bouts of volatility become more frequent, we will use the growing dispersion as an opportunity to strategically invest in credits with attractive risk-reward profiles. Given our proven track record of navigating different market environments, we believe our portfolio is well-tailored to succeed in this environment, where disciplined underwriting is required and deep credit work is essential.
Fixed income investments entail credit and interest rate risk. In general, when interest rates rise, fixed income portfolio values fall and investors may lose principal value. High income securities (junk bonds) are fixed income instruments rated below investment grade. High income securities are speculative, have a higher degree of default risk than higher-rated bonds and may increase the Portfolio’s volatility. The Portfolio typically invests a significant portion of its assets in lower-rated high income securities (e.g., CCC). Loans carry risks including the insolvency of the borrower, lending bank or other intermediary. Loans may be secured, unsecured, or not fully collateralized, and may infrequently trade, experience delayed settlement, and be subject to restrictions on resale. Private placement and restricted securities are subject to strict restrictions on resale and may not be able to be easily sold and are more difficult to value. International investments involve special risks, including currency fluctuation, lower liquidity, different accounting methods and economic and political systems, and higher transaction costs. The use of derivatives may create investment leverage and increase the likelihood of volatility and risk of loss in excess of the amount invested. Investments will rise and fall with market fluctuations and investor capital is at risk. Investors investing in strategies denominated in nonlocal currency should be aware of the risk of currency exchange fluctuations that may cause a loss of principal. These risks, among others, are further described in Artisan Partners Form ADV, which is available upon request.

This material represents the views of the Artisan Partners Credit Team as of 31 December 2019. The views and opinions expressed are based on current market conditions, which will fluctuate and those views are subject to change without notice. While the information contained herein is believed to be reliable, there are no guarantees to the accuracy or completeness of any statement in the discussion. Any forecasts contained herein are for illustrative purposes only and are not to be relied upon as advice or interpreted as a recommendation.

This material is provided for informational purposes without regard to your particular investment needs and shall not be construed as investment or tax advice on which you may rely for your investment decisions. Investors should consult their financial and tax advisors before making investments in order to determine the appropriateness of any investment product discussed herein.

ICE BofAML US High Yield Index measures the performance of below investment-grade US-denominated corporate bonds publicly issued in the US market. ICE BofAML BB US High Yield Index is a subset of ICE BofAML US High Yield Index including all securities rated BB1 through BBB-, inclusive. ICE BofAML Single-B US High Yield Index is a subset of ICE BofAML US High Yield Index including all securities rated B1 through B3, inclusive. ICE BofAML CCC & Lower US High Yield Index is a subset of ICE BofAML US High Yield Index including all securities rated CCC1 or lower. J.P. Morgan Leveraged Loan Index is designed to mirror the investable universe of U.S. dollar institutional leveraged loans, including U.S. and international borrowers. The J.P. Morgan U.S. Loan Index is a market-weighted index that measures the performance of the most liquid issues in the investment grade, dollar-denominated corporate bond market. J.P. Morgan Leveraged Loan BB Index is a subset of the broader Leveraged Loan Index, including all securities rated B1 through Ba3, inclusive. J.P. Morgan Leveraged Loan Single B Index is a subset of the broader Leveraged Loan Index, including all securities rated B1 through C, inclusive. J.P. Morgan Leveraged Loan Split B/CCC Index is a subset of the broader Leveraged Loan Index, including all securities rated B1 through C with two different ratings by two important rating agencies. The index(es) are unmanaged; include not reinvested dividends; do not reflect fees or expenses; and are not available for direct investment.

Credit Quality ratings are from S&P and/or Moody’s. Ratings typically range from AAA (highest) to D (lowest). Par-weighted default rate measures the dollar value of defaults (based on the par value of issued securities) as a percentage of the overall market that failed to make scheduled interest or principal payments in the prior 12 months. Spread is the difference between two bonds of similar maturity but different credit quality. Option-adjusted spread (OAS) is the spread relative to a risk-free interest rate, usually measured in basis points, that equates the theoretical present value of a series of uncertain cash flows of an instrument to its current market price. OAS can be viewed as the compensation an investor receives for assuming a variety of risks (e.g., liquidity premium, default risk, model risk), net of the cost of an embedded option. Dispersion is a measure for the statistical distribution of portfolio returns. Alpha measures the excess return of an investment vehicle, relative to the return of its benchmark, given its level of risk (as measured by beta). Margin of Safety is the difference between the intrinsic value of a stock and its market price. Yield to Worst (YTW) is the lowest potential yield that can be received on a bond without the issuer actually defaulting. Spread to Worst (STW) is the difference between the yield-to-worst (TTW) of a bond and yield-to-worst of a U.S. Treasury security with similar duration. Par value is the face value of a bond.

Source ICE Data Indices, LLC, with permission. ICE Data Indices, LLC permits use of the ICE BofAML indices and related data on an “as is” basis, makes no warranties regarding same, does not guarantee the suitability, quality, accuracy, timeliness, and/or completeness of the ICE BofAML indices or any data included in, related to, derived therefrom, assumes no liability in connection with the use of the foregoing, and does not sponsor, endorse, or recommend Artisan Partners or any of its products or services.

Artisan Partners Limited Partnership (APLP) is an investment adviser registered with the U.S. Securities and Exchange Commission (SEC). Artisan Partners UK LLP (APUK) is authorized and regulated by the Financial Conduct Authority and is a registered investment adviser with the SEC. APEL Financial Distribution Services Limited (AP Europe) is authorized and regulated by the Central Bank of Ireland. APLP, APUK and AP Europe are collectively, with their parent company and affiliates, referred to as Artisan Partners herein.

Artisan Partners is not registered, authorized or eligible for an exemption from registration in all jurisdictions. Therefore, services described herein may not be available in certain jurisdictions. This material does not constitute an offer or solicitation where such actions are not authorized or lawful, and in some cases may only be provided at the initiative of the prospect. Further limitations on the availability of products or services described herein may be imposed.

In no event shall Artisan Partners have any liability for direct, indirect, special, incidental, punitive, consequential (including, without limitation, lost profits) losses or any other damages resulting from the use of this material.

This material is only intended for investors which meet qualifications as institutional investors as defined in the applicable jurisdiction where this material is received, which includes only Professional Clients or Eligible Counterparties as defined by the Markets in Financial Instruments Directive (MiFID) where this material is issued by APUK or AP Europe. This material is not for use by retail investors and may not be reproduced or distributed without Artisan Partners’ permission.

In the United Kingdom, issued by APUK, 25 St. James’s St., Floor 3, London SW1A 1HA, registered in England and Wales ( LLP No. OC351201). Registered office: Reading Bridge House, Floor 4, George St., Reading, Berkshire RG1 8LS. In Ireland, issued by AP Europe, Fitzwilliam Hall, Fitzwilliam Pl, Ste. 202, Dublin 2, D02 T292. Registered office: 70 Sir John Rogerson’s Quay, Dublin 2, D02 R296 (Company No. 637966).

Eligible Counterparties

Alpha

1/31/2019 – A20509L-vXUS

For more information: Visit www.artisanpartners.com

For Institutional Investors Only — Not for Onward Distribution