LOOMIS | SAYLES

MANAGER INSIGHT

High Yield Credit Investing Late in the Cycle

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KEY TAKEAWAYS

- Investors are nervous about the narrow level of high yield credit spreads and are questioning valuations given where we are in the credit cycle.
- We believe the high yield market can provide compelling investments within most stages of the credit cycle and that investors without exposure to this market may bear an opportunity cost.
- Late in the credit cycle, applying a disciplined strategy that incorporates a focus on risk premiums, cash flow stability and credits higher up in a company's capital structure can benefit high yield investors.

We believe the high yield market can provide compelling investments within most stages of the economic cycle and that not having exposure can represent an opportunity cost to a portfolio. In our November 2017 paper titled "The State of High Yield," we focused on assessing the market's typical yield advantage, technicals and fundamentals. In this paper, we discuss our approach to seeking attractive high yield investments even in the late stage of the economic cycle.

Risk Premiums

We acknowledge that within the high yield market, broad-based price appreciation from recent levels is unlikely. However, we believe that underlying fundamentals should remain supported by a positive outlook for corporate profits and a low probability of defaults or economic recession.

In addition, regardless of the overall market valuation, we look for credits with valuations that, by our estimates, look mispriced. One of the ways we determine overall market valuation is by analyzing risk premiums.

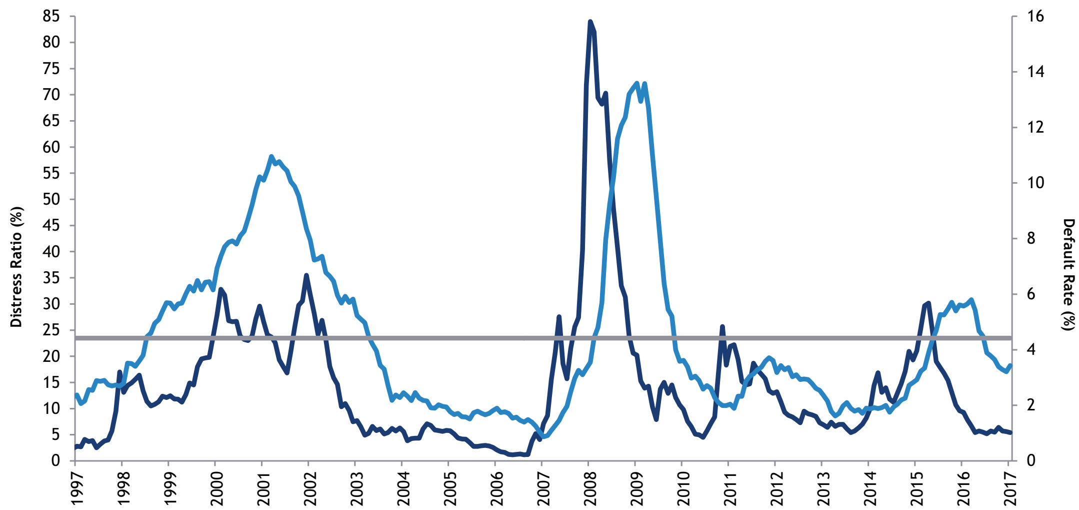
High yield spreads represent risk relative to comparable Treasurys, but they do not tell investors what the potential profit or loss from a default and/or downgrade might be. For this insight, Loomis Sayles has built a high yield risk premium model that begins with yield spreads and incorporates additional variables that we have identified as having high predictive power in estimating defaults and downgrades within the Bloomberg Barclays US High Yield Index over the next 12 months. As part of our overall assessment of the market, we subtract these expected losses, leaving us with an estimated profit that could potentially be earned in high yield over the next 12 months.

For example, over the past two months the model was predicting a risk premium range of 175 to 250 basis points (250 basis points is the historical median). In prior periods when the model has predicted such a range, high yield has had a positive 12-month excess return 45% to 65% of the time (as measured by the Bloomberg Barclays US High Yield Index).

DECLINE IN DEFAULT RATE AND DISTRESS RATIO

Source: Bloomberg, Merrill Lynch, Moody's, history through October 2017, monthly data.

Past performance is no guarantee of future results.



**Percent of bonds in the Merrill Lynch High Yield Master Index with spreads 1000 basis points over Treasurys.*

Stable Cash Flows

Investors have witnessed a significant increase in leverage in the high yield market. And while net new high yield bond issuance has been negative and is projected to be so again in 2018, companies are faced with managing debt-heavy balance sheets. To identify those high yield companies best positioned to manage their capital structure, we work with the analysts in an effort to pinpoint those entities whose cash flows are projected to be fairly stable. With less sensitivity to economic swings, these firms can be in a position to maintain favorable interest coverage ratios as well as higher stability of credit ratings.

Moving up in Capital Structure

With the prolonged extension of the credit cycle, we are more cautious about very low-quality bonds and are focusing on BB-rated bonds with attractive Sharpe ratios. We believe that higher-rated credits have the potential to be more resilient in volatile periods. As we work closely with the analysts to recognize possible opportunities to invest in credits higher up in a company's capital structure (i.e., swapping out of unsecured bonds into secured bonds or bonds with a superior claim on the company's assets) there is typically only a marginal decrease in spread since they are tight throughout corporate capital structures.

Total Return by High Yield Credit Quality and Economic Regime

	ENTIRE PERIOD	DOWNTURN	CREDIT REPAIR	RECOVERY	EXPANSION/ LATE CYCLE
BLOOMBERG BARCLAYS US HIGH YIELD CCC AND BELOW	7.71%	-4.28%	18.93%	10.35%	3.23%
BLOOMBERG BARCLAYS US HIGH YIELD B	8.43%	0.89%	14.13%	11.82%	4.94%
BLOOMBERG BARCLAYS US HIGH YIELD	9.03%	3.36%	15.05%	12.05%	5.14%
BLOOMBERG BARCLAYS US HIGH YIELD BB	9.42%	7.49%	11.89%	12.26%	6.46%

Source: Bloomberg, data from July 31, 1983, to October 31, 2017.
Past performance is no guarantee of future results.

Conclusion: Even in a Late Cycle Environment, Bottom-Up Investors Can Uncover Value

The underlying fundamentals of the high yield sector remain supportive given our favorable outlook for corporate profits and the low probability of defaults or economic recession. At this stage of the credit cycle, debt levels are high, but overall, we believe balance sheets remain healthy and interest rate coverage is strong.

During the next 12 to 18 months, as the late stage of the US credit cycle extends, we will continue to apply a disciplined investment strategy that incorporates a focus on:

1. Risk premiums and what they can tell us about potential outcomes.
2. Stable cash flows often found in less cyclical companies and industries.
3. Higher-rated credits trading at attractive prices.

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Disclosure

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