

High Yield Credit Investing Late in the Cycle

By Elaine Stokes, Matt Eagan & Brian Kennedy, Multisector Full Discretion Portfolio Managers
John DeVoy, Multisector Full Discretion Investment Strategist

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 Treasuries, 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.

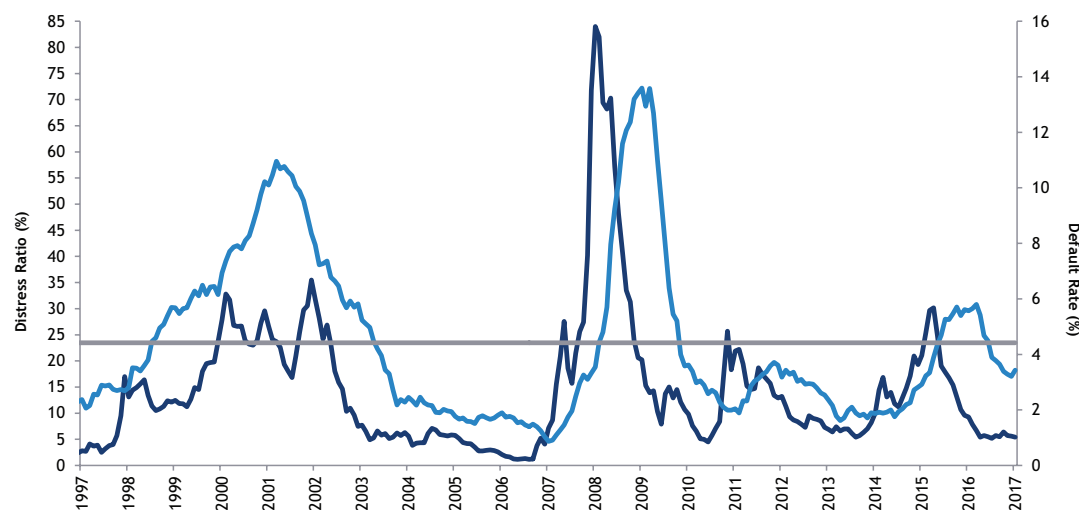
For example, over the past two months the model was predicting a risk premium range of 175 to 250 basis points (250 basis points is the historical median). In prior periods when the model has predicted such a range, high yield has had a positive 12-month excess return 45% to 65% of the time (as measured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

■ Distress Ratio*
■ Default Rate
■ Default Rate 20-Year Average



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

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.

AUTHORS

ELAINE STOKES
VP, Portfolio Manager

MATT EAGAN, CFA
VP, Portfolio Manager

BRIAN KENNEDY
VP, Portfolio Manager

JOHN DEVOY, CFA
VP, Investment Strategist

Disclosure

Past performance is no guarantee of future results.

This is not an offer of, or a solicitation of an offer for, any investment strategy or product. Any investment that has the possibility for profits also has the possibility of losses.

Indices are unmanaged and do not incur fees. It is not possible to invest directly in an index.

Commodity interest and derivative trading involves substantial risk of loss.

This commentary is provided by Loomis Sayles for informational purposes only and should not be construed as investment advice. Investment decisions should consider the individual circumstances of the particular investor. Opinions and/or forecasts contained herein reflect the subjective judgments and assumptions of the authors only and do not necessarily reflect the views of Loomis, Sayles & Company, L.P., or any portfolio manager. These views are as of the date indicated and are subject to change any time without notice based on market and other conditions. Other industry analysts and investment personnel may have different views and assumptions.

This material cannot be copied, reproduced or redistributed without authorization.

***Principal Investment Risks:** Bonds may carry one or more of the following risks: credit, interest rate (as interest rates rise bond prices usually fall), inflation and liquidity. **High yield securities** may be subject to a greater risks (including risk of default) than other fixed income securities. In addition, the secondary market for these securities may lack liquidity which, in turn, may adversely affect the value of these securities and that of the portfolio. **Foreign investments** involve special risks including greater economic, political and currency fluctuation risks, which may be even greater in emerging markets. **Currency exchange** rates between the US dollar and foreign currencies may cause the value of the investments to decline. **Commodity-related investments**, including derivatives, may be affected by a number of factors including commodity prices, world events, import controls and economic conditions and therefore may involve substantial risk of loss. **Equity securities** are volatile and can decline significantly in response to broad market and economic conditions.*

LS Loomis | Sayles is a trademark of Loomis, Sayles & Company, L.P. registered in the US Patent and Trademark Office.

This material has been provided for information purposes only to investment service providers or other Professional Clients, Qualified or Institutional Investors and, when required by local regulation, only at their written request. This material must not be used with Retail Investors.

In the E.U. (outside of the UK): Provided by Natixis Investment Managers S.A. or one of its branch offices listed below. Natixis Investment Managers S.A. is a Luxembourg management company that is authorized by the Commission de Surveillance du Secteur Financier and is incorporated under Luxembourg laws and registered under n. B 115843. Registered office of Natixis Investment Managers S.A.: 2, rue Jean Monnet, L-2180 Luxembourg, Grand Duchy of Luxembourg. **France:** Natixis Investment Managers Distribution (n.509 471 173 RCS Paris). Registered office: 21 quai d'Austerlitz, 75013 Paris. **Italy:** Natixis Investment Managers S.A., Succursale Italiana (Bank of Italy Register of Italian Asset Management Companies no 23458.3). Registered office: Via Larga, 2 - 20122, Milan, Italy. **Germany:** Natixis Investment Managers S.A., Zweigniederlassung Deutschland (Registration number: HRB 88541). Registered office: Im Trutz Frankfurt 55, Westend Carrée, 7. Floor, Frankfurt am Main 60322, Germany. **Netherlands:** Natixis Investment Managers, Nederlands (Registration number 50774670). Registered office: World Trade Center Amsterdam, Strawinskylaan 1259, D-Tower, Floor 12, 1077 XX Amsterdam, the Netherlands. **Sweden:** Natixis Investment Managers, Nordics Filial (Registration number 516405-9601 - Swedish Companies Registration Office). Registered office: Kungsgatan 48 5tr, Stockholm 111 35, Sweden. **Spain:** Natixis Investment Managers, Sucursal en España. Registered office: Torre Colon II - Plaza Colon, 2 - 28046 Madrid, Spain. **In Switzerland:** Provided for information purposes only by Natixis Investment Managers, Switzerland Sàrl, Rue du Vieux Collège 10, 1204 Geneva, Switzerland or its representative office in Zurich, Schweizergasse 6, 8001 Zürich. **In the U.K.:** Provided by Natixis Investment Managers UK Limited which is authorised and regulated by the UK Financial Conduct Authority (register no. 190258). This material is intended to be communicated to and/or directed at persons (1) in the United Kingdom, and should not to be regarded as an offer to buy or sell, or the solicitation of any offer to buy or sell securities in any other jurisdiction than the United Kingdom; and (2) who are authorised under the Financial Services and Markets Act 2000 (FSMA 2000); or are high net worth businesses with called up share capital or net assets of at least £5 million or in the case of a trust assets of at least £10 million; or any other person to whom the material may otherwise lawfully be distributed in accordance with the FSMA 2000 (Financial Promotion) Order 2005 or the FSMA 2000 (Promotion of Collective Investment Schemes) (Exemptions) Order 2001 (the "Intended Recipients"). The fund, services or opinions referred to in this material are only available to the Intended Recipients and this material must not be relied nor acted upon by any other persons. Registered Office: Natixis Investment Managers UK Limited, One Carter Lane, London, EC4V 5ER. **In the DIFC:** Provided in and from the DIFC financial district by Natixis Investment Managers Middle East (DIFC Branch) which is regulated by the DFSA. Related financial products or services are only available to persons who have sufficient financial experience and understanding to participate in financial markets within the DIFC, and qualify as Professional Clients as defined by the DFSA. Registered office: Office 603 - Level 6, Currency House Tower 2, PO Box 118257, DIFC, Dubai, United Arab Emirates. **In Japan:** Provided by Natixis Investment Managers Japan Co., Ltd., Registration No.: Director-General of the Kanto Local Financial Bureau (kinsho) No. 425. Content of Business: The Company conducts discretionary asset management business and investment advisory and agency business as a Financial Instruments Business Operator. Registered address: 1-4-5, Roppongi, Minato-ku, Tokyo. **In Taiwan:** Provided by Natixis Investment Managers Securities Investment Consulting (Taipei) Co., Ltd., a Securities Investment Consulting Enterprise regulated by the Financial Supervisory Commission of the R.O.C. Registered address: 16F-1, No. 76, Section 2, Tun Hwa South Road, Taipei, Taiwan, Da-An District, 106 (Ruentex Financial Building I), R.O.C., license number 2012 FSC SICE No. 039, Tel. +886 2 2784 5777. **In Singapore:** Provided by Natixis Investment Managers Singapore (name registration no. 53102724D) to distributors and institutional investors for informational purposes only. Natixis Investment Managers Singapore is a division of Natixis Asset Management Asia Limited (company registration no. 199801044D). Registered address of Natixis Investment Managers Singapore: 10 Collyer Quay, #14-07/08 Ocean Financial Centre, Singapore 049315. **In Hong Kong:** Provided by Natixis Investment Managers Hong Kong Limited to institutional/ corporate professional investors only. **In Australia:** Provided by Natixis Investment Managers Australia Pty Limited (ABN 60 088 786 289) (AFSL No. 246830) and is intended for the general information of financial advisers and wholesale clients only. **In New Zealand:** This document is intended for the general information of New Zealand wholesale investors only and does not constitute financial advice. This is not a regulated offer for the purposes of the Financial Markets Conduct Act 2013 (FMCA) and is only available to New Zealand investors who have certified that they meet the requirements in the FMCA for wholesale investors. Natixis Investment Managers Australia Pty Limited is not a registered financial service provider in New Zealand. **In Latin America:** Provided by Natixis Investment Managers S.A. **In Chile:** Esta oferta privada se inicia el día de la fecha de la presente comunicación. La presente oferta se acoge a la Norma de Carácter General N° 336 de la Superintendencia de Valores y Seguros de Chile. La presente oferta versa sobre valores no inscritos en el Registro de Valores o en el Registro de Valores Extranjeros que lleva la Superintendencia de Valores y Seguros, por lo que los valores sobre los cuales ésta versa, no están sujetos a su fiscalización. Que por tratarse de valores no inscritos, no existe la obligación por parte del emisor de entregar en Chile información pública respecto de estos valores. Estos valores no podrán ser objeto de oferta pública mientras no sean inscritos en el Registro de Valores correspondiente. **In Uruguay:** Provided by Natixis Investment Managers Uruguay S.A., a duly registered investment advisor, authorised and supervised by the Central Bank of Uruguay. Office: San Lucar 1491, oficina 102B, Montevideo, Uruguay, CP 11500. The sale or offer of any units of a fund qualifies as a private placement pursuant to section 2 of Uruguayan law 18,627. **In Colombia:** Provided by Natixis Investment Managers S.A. Oficina de Representación (Colombia) to professional clients for informational purposes only as permitted under Decree 2555 of 2010. Any products, services or investments referred to herein are rendered exclusively outside of Colombia. This material does not constitute a public offering in Colombia and is addressed to less than 100 specifically identified investors. **In Mexico:** Provided by Natixis IM Mexico, S. de R.L. de C.V., which is not a regulated financial entity or an investment manager in terms of the Mexican Securities Market Law (Ley del Mercado de Valores) and is not registered with the Comisión Nacional Bancaria y de Valores (CNBV) or any other Mexican authority. Any products, services or investments referred to herein that require authorization or license are rendered exclusively outside of Mexico. Natixis Investment Managers is an entity organized under the laws of France and is not authorized by or registered with the CNBV or any other Mexican authority to operate within Mexico as an investment manager in terms of the Mexican Securities Market Law (Ley del Mercado de Valores). Any use of the expression or reference contained herein to "Investment Managers" is made to Natixis Investment Managers and/or any of the investment management subsidiaries of Natixis Investment Managers, which are also not authorized by or registered with the CNBV or any other Mexican authority to operate within Mexico as investment managers.

The above referenced entities are business development units of Natixis Investment Managers, the holding company of a diverse line-up of specialised investment management and distribution entities worldwide. The investment management subsidiaries of Natixis Investment Managers conduct any regulated activities only in and from the jurisdictions in which they are licensed or authorized. Their services and the products they manage are not available to all investors in all jurisdictions. It is the responsibility of each investment service provider to ensure that the offering or sale of fund shares or third party investment services to its clients complies with the relevant national law.

The provision of this material and/or reference to specific securities, sectors, or markets within this material does not constitute investment advice, or a recommendation or an offer to buy or to sell any security, or an offer of any regulated financial activity. Investors should consider the investment objectives, risks and expenses of any investment carefully before investing. The analyses, opinions, and certain of the investment themes and processes referenced herein represent the views of the portfolio manager(s) as of the date indicated. These, as well as the portfolio holdings and characteristics shown, are subject to change. There can be no assurance that developments will transpire as may be forecasted in this material. Past performance information presented is not indicative of future performance.

Although Natixis Investment Managers believes the information provided in this material to be reliable, including that from third party sources, it does not guarantee the accuracy, adequacy, or completeness of such information. This material may not be distributed, published, or reproduced, in whole or in part.

All amounts shown are expressed in USD unless otherwise indicated.

In Canada: This material is provided by Natixis Canada LP., 145 King Street West, Suite 1500, Toronto, ON M5H 1J8.

In the United States: Provided by Natixis Distribution, L.P. 888 Boylston St. Boston, MA 02199. Natixis Investment Managers includes all of the investment management and distribution entities affiliated with Natixis Distribution, L.P. and Natixis Investment Managers S.A.

This material should not be considered a solicitation to buy or an offer to sell any product or service to any person in any jurisdiction where such activity would be unlawful.

This document may contain references to third party copyrights, indexes, and trademarks, each of which is the property of its respective owner. Such owner is not affiliated with Natixis Investment Managers or any of its related or affiliated companies (collectively "Natixis") and does not sponsor, endorse or participate in the provision of any Natixis services, funds or other financial products.

The index information contained herein is derived from third parties and is provided on an "as is" basis. The user of this information assumes the entire risk of use of this information. Each of the third party entities involved in compiling, computing or creating index information, disclaims all warranties (including, without limitation, any warranties of originality, accuracy, completeness, timeliness, non-infringement, merchantability and fitness for a particular purpose) with respect to such information.