2019 Outlook

A few themes shape our view for 2019, a year that we expect to be challenging with heightened volatility, but ultimately rewarding, buoyed by attractive valuations and supportive macroeconomic fundamentals.

Higher volatility – The recent plunge in prices was a relatively rare event. At the nadir the drop in the Standard and Poor's 500 exceeded the declines experienced during the 2010 Greek financial crisis, the 2011 downgrade of the US credit rating, and the 2015-2016 oil price crash. Although the recovery of equities thus far in January alleviates our fears of a prolonged correction, we cannot brush off the selloff and ascribe its causes merely to tactical factors, illiquidity, or algorithmic trading. Such shocks are endemic of a change in investor sentiment and a return of market volatility. The tightening of financial conditions and the end of quantitative easing also heighten the risk. Volatility in all asset classes is likely to increase. The higher volatility will lead to dispersion among sectors and individual credits, making asset diversification away from equities and deep fundamental analysis even more important.

Global slowdown – Global growth is likely to slow compared to 2018, driven primarily by tightening monetary policy, rising protectionism among the world's major countries, and the waning of the initial effects of the US tax cuts. That being said, the reduction in growth rates is likely to be slight. UBS predicts global growth of around 3.6% in 2019 versus 3.9% in 2018; the OECD predicts 3.5%.

China cooldown – The Chinese economy has shown signs of stress as the country suffers the early effects of the trade war, and total indebtedness (public and private) approaches 300% of GDP. The manufacturing purchasing managers index has fallen to its lowest level in three years, and domestic consumption taxes have slumped significantly when compared to the previous year. In response to these developments, the People's Bank of China has announced the third cut in its bank reserve rate requirement in the last three years, which should release more liquidity and temporarily support economic growth.

Modest risk of recession – Although some pundits have pointed to the partial inversion of the yield curve that occurred in late 2018 as presaging a recession in late 2019 or early 2020, the slope of the yield curve remains positive, implying continued economic growth. Robust corporate profits, low unemployment, and high liquidity bolster a bullish narrative. The statistical models of the Federal Reserve Banks of Cleveland and New York predict only a 20% to 25% probability of recession over the next 12 months.

Slower pace of monetary tightening – While Federal Reserve Chairman Jerome Powell characterized the Fed as being on "Autopilot" during the December FOMC meeting, signs point to an inflection in Fed policy. President Trump has consistently criticized the Federal Reserve, and the market's reaction to the increase in current interest rates is reminiscent of 2013's "taper tantrum," which at the time slowed down the Fed's tapering of quantitative easing. In January, Powell raised the possibility of a slower pace of tightening, as he said that the central bank would be "patient" in raising interest rates in 2019, which the market has interpreted as a dovish signal, leading to a rally in risky assets. Therefore, while our base case remains for two interest rate hikes, already a slower pace than 2018, a possibility exists that interest rates will not rise at all and thus remain at current levels throughout the year. Given the Fed's often touted data-dependency, a faster than expected cooling of the economy would likely lead it to slow down even further its pace of monetary tightening, which could support asset prices.

Low inflation – The Federal Reserve has targeted an inflation rate of 2%. Despite the tightening labor market, inflation shows no sign of exceeding the 2% target. The inflation rate was 1.9% for the 12 months through December 2018. The low inflation rate should insulate the real returns of risky assets.

Modest decrease in default rates – Both major credit rating agencies forecast a continued reduction in the high yield corporate debt default rate, with Moody's and Standard and Poor's forecasting a 2.6% and a 2.25% default rate by June 2019, down from roughly 3% today. This decline is due to the positive growth in the economy, the slower pace of interest rate increases, and the relatively low number of bond maturities happening in 2019. In our view, this year will likely be the last year of declining default rates before they rise in 2020, a year with an unusually large amount of maturities that will have to be refinanced at significantly higher coupons.

Benign Environment for High Yield – An environment of modest, slower growth that portends low default rates and adequate liquidity tends to be supportive of high yield. The recent correction saw credit spreads widen by over 200 basis points and has returned the high yield market to an attractive valuation. The investment banks have revised their forecasts for high yield bonds to now provide investors above average returns in 2019. For example, JPMorgan strategists raised their forecasted 2019 performance from the 3.3% initially projected in November to 8% today.

Stable oil price – The price of oil fell by $30 per barrel over late 2018. In recent years changes in oil prices have moved inversely with changes in high yield credit spreads. Forecasts for the price of oil suggest upside. As 25% of high yield issues relates to energy, a flat to increasing price of oil should bolster the high yield market**.**

Lack of New Issuance – Last year saw the fewest new issues of high yield bonds since 2009. Estimates for 2019 forecast even less. The lack of supply should be bullish for the tightening of credit spreads.

Low refinancing risk – Relatively few companies will need to refinance their debt in 2019. The rate of refinancing should pick up in 2020 but will be less than the wall of maturities in the early years of the credit cycle. The lack of competition from other high yield issuers with the continued availability of liquidity should ease the ability of issuers to access the market.

Conclusion - We remain cautiously optimistic for 2019 and believe that our focus on shorter duration, smaller issues and our emphasis on deep fundamental analysis lends itself to the current environment of rising interest rates and higher volatility. The average duration of 1.7 years insulates the portfolio from interest rate risk while the frequent calls and tenders generate cash that allow us to opportunistically reinvest at higher yields. The smaller issues in our portfolio do not overlap with the holdings of high yield ETFs or the broader, large issue high yield market, exhibiting less severe price declines and providing a diversified, mostly uncorrelated income stream during corrections. Because of their smaller size and idiosyncratic nature, these bonds demand a liquidity premium and generate superior returns relative to larger issues for similar default risk. Our investment process stresses knowing what we own through thorough internal research, including written analyses, conversations with peers in a team format, calls with management, company visits, and industry research, to avoid default risk. We entered the recent correction with substantial cash that we deployed at lower prices and higher yields. These opportune purchases will bolster returns in 2019. Finally, our hedge mitigates the volatility of the bond portfolio during selloffs. We expect to beat our benchmark, the HYS, and our peers while providing lower volatility, substantial diversification and capital preservation.

Sincerely,

The Concise Team