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U.S. high-yield bond market commentary

Executive summary

- The U.S. high-yield bond market, as measured by the Bloomberg Barclays U.S. High Yield 2% Issuer Cap Index, gained 7.26% during the first quarter.
- For comparison purposes, the overall taxable bond market, as measured by the Bloomberg Barclays U.S. Aggregate Index, returned 2.94% during the first quarter.
- In Western Asset Management's ("Western") view, high yield continues to offer an attractive risk/reward profile. The U.S. high-yield default rate is low, and it's expected to decline as the year progresses.
- Western believes 2019 is set to be a good year for high yield, but that headline-driven volatility is likely to remain.

Market recap

U.S. Treasurys generated a positive return during the first quarter of 2019, as did the spread sectors (non-U.S. Treasurys). Both short- and long-term U.S. Treasury yields declined during the quarter, driven by the "dovish pivot" by the Federal Reserve Board ("Fed"), signs of moderating global growth and tame inflation (yields and prices move in the opposite direction).

Looking at the U.S. economy, according to the Commerce Department, fourth-quarter 2018 gross domestic product (GDP) annualized growth was 2.2%, versus its previous estimate of 2.6%. In contrast, the economy expanded 3.4% during the third quarter. Moderating growth in the fourth quarter was attributed to decelerations in private inventory investment, personal consumption expenditures (PCE) and federal government spending, along with a downturn in state and local government spending. These factors were partly offset by an upturn in exports and an acceleration in nonresidential fixed investment. Furthermore, imports increased less in the fourth quarter than in the third quarter of 2018. The initial estimate for first-quarter 2019 GDP is scheduled to be released on April 26.

The labor market remained tight during the first quarter. The unemployment rate was 4.0% in January 2019. It then dipped to 3.8% in February, and it was unchanged in March. The workforce participation rate was little changed during the first quarter, as it moved from 63.2% in January to 63.0% in March.

After four increases in 2018, the Federal Reserve Board ("Fed") kept its target rate unchanged in a range between 2.25% and 2.50% during the first quarter. At its January meeting the Fed said, "In light of global economic and financial developments and muted inflation pressures, the Committee will be patient as it determines what future adjustments to the target range for the federal funds rate may be appropriate ...." Then, at its March meeting, most Federal Open Market Committee members indicated that they did not feel additional rate hikes would be needed in 2019, and they anticipated only one increase in 2020. The Fed also provided additional guidance on the winding down of its balance sheet, explaining that it would be completed by September 2019.

After rising sharply in 2018, both short-term and longer-term Treasury yields declined during the first quarter of 2019. When the year began, the yield on the two-year Treasury was 2.48% and it ended the quarter at 2.27%. Its low for the period of 2.22% occurred on March 27, and it rose as high as 2.62%, on January 18. The yield on the 10-year Treasury began the year at 2.69% and it ended the quarter at 2.41%. Its low for the period, 2.39%, occurred on March 27, and it rose as high as 2.79%, on January 18.

The U.S. high-yield bond market, as measured by the Bloomberg Barclays U.S. High Yield 2% Issuer Cap Index, gained 7.26% during the first quarter. The high-yield market was supported by generally strong corporate earnings, accommodative central bank monetary policies, low defaults, supportive market supply/demand technicals and rising oil prices. Collectively, this led to credit spread tightening and offset concerns over slowing global growth and a number of geopolitical issues.

Outlook

In our view, high yield continues to offer an attractive risk/reward profile. The U.S. high-yield default rate is low, and it's expected to decline as the year progresses. Corporate earnings remain strong, albeit with some companies calling for lower guidance,

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and the fundamentals of the U.S. and global economies remain sound. We see no imminent threat to a continuation of the credit cycle. While the risk of Federal Reserve Board overtightening has largely abated, we recognize that other risks, such as the U.S.-China trade spat and political developments in Europe, remain. However, there are signs that negotiations are proceeding toward an amicable conclusion. We believe 2019 is set to be a good year for high yield, but that headline-driven volatility is likely to remain.

All investments involve risk, including loss of principal. Fixed-income securities involve interest rate, credit, inflation and reinvestment risks; and possible loss of principal. As interest rates rise, the value of fixed income securities falls. High yield bonds are subject to greater price volatility, illiquidity, and possibility of default.

Glossary

High-yield bonds possess greater price volatility, illiquidity and possibility of default.

Investment-grade bonds are generally rated BBB and above.

Spread refers to the difference between Treasury securities and non-Treasury securities of similar maturity but different credit quality.

Credit quality is a measure of a bond issuer's ability to repay interest and principal in a timely manner. The credit ratings discussed are based on a security's rating as provided by Standard and Poor's, Moody's Investors Service and/or Fitch Ratings, Ltd., and they typically range from AAA (highest) to D (lowest), or an equivalent and/or similar rating. The credit quality of the investments in a fund's portfolio does not apply to the stability or safety of the fund. These ratings are updated monthly and may change over time. Please note that the closed-end funds have not been rated by an independent rating agency. Investment-grade bonds are bonds that are rated Aaa, Aa, A and Baa by Moody's Investors Service and AAA, AA, A and BBB by Standard & Poor's Ratings Service, or that have an equivalent rating by a nationally recognized statistical rating organization or are determined by the manager to be of equivalent quality. A below-investment-grade bond or high-yield security has a rating of BB or lower; it pays a higher yield to compensate for its greater risk.

Duration is a measurement that signals how much the price of a bond is likely to fluctuate when there is a change in interest rates. The higher the duration number, the more sensitive a bond will be to interest changes.

Gross domestic product (GDP) is an economic statistic that measures the market value of all final goods and services produced within a country in a given period of time.

U.S. Treasurys are direct debt obligations issued by the U.S. government and backed by its "full faith and credit." The U.S. government guarantees the principal and interest payments on U.S. Treasurys when the securities are held to maturity.

The **Bloomberg Barclays U.S. High Yield 2% Issuer Capped Bond Index** is a component of the U.S. Corporate High-Yield Bond Index, which covers the universe of fixed-rate, non-investment-grade corporate debt of issuers in non-emerging market countries. It is not market capitalization-weighted; each issuer is capped at 2% of the index.

The **Bloomberg Barclays U.S. Aggregate Index** is a broad-based bond index comprised of government, corporate, mortgage and asset-backed issues rated investment grade or higher and having at least one year to maturity.

Yield curve is the graphical depiction of the relationship between the yield on bonds of the same credit quality but different maturities. The yield curve shows the relationship between yields and maturity dates for a similar class of bonds.

An investor cannot invest directly in an index. Unmanaged index returns do not reflect any fees, expenses or sales charges.

U.S. high-yield bond market sector commentary

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