HIGH YIELD FUNDAMENTALS POSITIVE, BUT MARKET SUSCEPTIBLE TO SHIFTS IN SENTIMENT

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The pickup in market volatility in the first two months of 2018 as fears about inflation, valuation levels and diminishing central bank largesse took their toll on investor sentiment has led some investment professionals to warn that the stage is now set for a protracted correction in credit risk premia.

At Eaton Vance, we believe this view to be too pessimistic. Clearly, we are moving towards the end of the credit cycle, but – in the case of global high-yield bonds – we see a number of factors which are supportive of the near-term prospects for the asset class.

The key positive is fundamentals, which have continued to improve and remain adequately healthy to be supportive of global high yield. Consider the following:

► US corporate leverage, while elevated relative to post-crisis lows, decreased in the fourth quarter of 2017, the fifth such decline in a row.

► US interest coverage remains healthy and near all-time highs. It continued to increase in the fourth quarter of 2017.

► In Europe, corporate leverage remains at all-time lows, while interest coverage in the fourth quarter of 2017 increased for the 11th quarter in a row and remains at all-time, post-crisis highs.

► Trailing 12-month default rates among high-yield issuers in both the US and Europe declined over course of 2017 – to 1.27% and 1.09% respectively.

► Distress ratios for high-yield bonds (see charts) in both Europe and the US, historically a useful leading indicator for defaults, remain low relative to history.

► Encouraging fourth quarter earnings reports for high-yield issuers to date continue to indicate that, on average, the fundamentals of high-yield issuers remain healthy.

Other factors supportive of the near-term prospects for the asset class include:

► Signs of economic improvement in the US and Europe, which will help strengthen balance sheets and should continue to support low default rates;

► US tax reform, which represents a net-benefit for approximately 75% of high-yield issuers in the US market; and

► A supportive technical picture in the short term for corporate credit in Europe. The ECB has signalled its intention to continue its CSPP (corporate sector purchase programme) and PSPP (public sector purchase programme) programmes until September of this year.

It is worth noting that the global high-yield market has held up relatively well during the recent market turmoil, particularly in relation to the reaction in the equity market. As at 27 February 2018, global high yield, as represented by the ICE BofAML Global High Yield Index, had declined by 1.04% in US dollar terms since hitting a multi-year peak on 25 January 2018, while global equities, as represented by the MSCI World Index, had declined 4.8% since hitting a high on 26 January 2018.

It is also salient to note that, in both the US and Europe, single B credits slightly outperformed their BB counterparts during February. We would expect that fundamental concerns about increasing default rates would weigh more on the lower-rated credits in the market. However, this price action suggests that what we are witnessing currently is a repricing and technical shift in the market rather than a change in the fundamental outlook for the asset class.

Notwithstanding supportive macro and fundamental drivers for the high-yield market, there are, nonetheless, reasons why investors might want to adopt a highly selective (active) and somewhat cautious approach to this asset class at this juncture.

► Lending standards continue to ease, both in the high-yield and leveraged loan market, with Moody's Covenant Quality Index – an index that measures bondholder protections – close to its all-time worst reading;

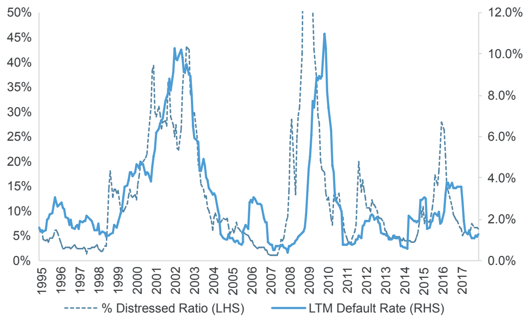
► Despite a repricing wider in February, the spread-to-worst in the high-yield market is close to post-crisis tights and current valuations discount a lot of good news in world economies. As at 26 February 2018, the option-adjusted spread on the ICE BofAML Developed Markets High-Yield ex-Subordinated Financial Index stood at 344 basis points, well below its long-term (since January 1999) median figure of 509 basis points. Current valuation levels limit potential upside and make prices more susceptible to shifts in sentiment – similar to what we have just seen; and

► Central bank support is diminishing. The Federal Reserve has been increasing the pace at which it raises rates and has recently begun to reduce its balance sheet. Furthermore, in January 2018 the European Central Bank (ECB) cut its level of asset purchases by 50%. The withdrawal of liquidity and tightening of financial conditions is Eaton Vance's principal concern in 2018 for high-yield bonds. Risk assets may be much more sensitive to reductions in central bank purchases than is widely recognised. Exactly how markets will react as this process progresses and what that means for the ability of highly levered companies to access capital markets is unknown. It certainly represents a headwind, but the magnitude is less certain.

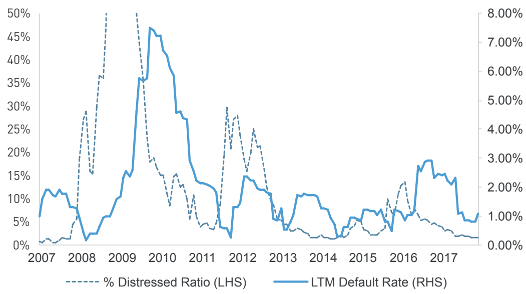
Weighing up both the potential risks facing global high yield as well as the many factors supportive of the near-term prospects for the asset class, we are adopting a slightly defensive skew in our global high-yield offerings. The Eaton Vance Global High Yield Bond Strategy currently (as at 15 March 2018) has a lower average duration than its benchmark, the ICE BofAML Developed Markets High-Yield ex-Subordinated Financial Index, and is under-risked the CCC segment, with a tilt toward lower-yielding, higher-quality issues.[1] In the CCC segment, we consider including select CCC-rated issues where we are being paid an outsized return for the risk we believe we are taking.

Our positioning is informed by both the tightness of valuations and an expectation of increasing volatility. We feel our slightly defensive posture and our continuing focus on generating attractive risk-adjusted returns will enable our strategy to outperform during heightened volatility when markets weaken, while seeking to capture most of the upside when markets rebound.

US high yield default rate and distress ratio remain low



European high yield default rate and distress ratio remain low



Source for both charts: JPMorgan as of 31/12/2017. LTM default rate means the default rate for the last 12 months. Distress ratio refers to the percentage of the high yield market trading wider than1000 basis points spread to worst.

FOOTNOTE

1 Under-risked does not mean Eaton Vance is underweight the CCC segment in its Global High Yield Bond strategy. The strategy is, in fact, overweight CCCs, but exposure here is either in higher-quality, lower-yielding bonds, or bonds of issuers where the firm's analysts have high conviction.

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