It feels as if on a daily basis we are asked whether the current credit cycle in the U.S., now entering its ninth year, is nearing an end. We believe that credit cycles, much like economic cycles, do not die of old age but rather from imbalances that grow to unsustainable levels, resulting in relatively short-lived but sharp corrections. Looking at the U.S. high yield bond market today, we do not see the warning signs that heralded the ends of previous cycles, typically marked by a spike in default rates. To the contrary, we believe the fundamental underpinnings of the current cycle, namely economic growth, benign defaults, and responsible underwriting, remain firmly in place, suggesting credit market health and below-average default rates.

We have witnessed three distinct credit cycles dating back to 1985, each characterized by multiple years of stable spreads interrupted by sharp increases in defaults. Default risk is one of the primary hazards inherent in owning high yield bonds. Therefore, high yield investors demand incremental yield (spread) above Treasury bonds, to compensate them for anticipated future default-related losses and provide them with an attractive return.

Figure 1: High Yield Spreads and Defaults Over Credit Cycles
High yield spreads have historically reflected anticipated default activity 6-12 months in advance of realized defaults

Sources: Credit Suisse High Yield Index, Moody’s, National Bureau of Economic Research, 6/30/17. Charts are provided for illustrative purposes and are not indicative of the past or future performance of any Dreyfus product.
During periods of low defaults, investors can accept lower overall spreads and still generate attractive relative and absolute returns, as shown in Figure 1 above. Eventually, however, we find the greed/fear pendulum swings to avarice and investors accept (and misprice) unhealthy levels of risk manifested in aggressive new issuance (quality, volume, and underwriting terms). These speculative new deals can typically become the fuel for future defaults.

The end of each prior credit cycle coincided with macro shocks and recessions that sent investors scrambling out of risk assets. High yield spreads spiked to over 1,000 basis points, or 10%, and defaults surged to over 10% from their historical average of 4.5%. The worst-performing bonds and the highest defaults were within the most aggressive issuers, typically low-quality CCC-rated credits and aggressive sector-specific issuance. For example, the 2002 peak in defaults was concentrated within CCCs and speculative issuance from telecom companies with unproven, unfunded, and cash-burning business models. The 2009 default wave followed the period of heavy CCC-rated leveraged buyout (LBO) financings with unsustainable financial leverage (Figure 2).

We witnessed a flurry of defaults in 2015-2016 dominated by aggressive 2012-2014 vintage energy sector issuance. High-cost producers with inadequate liquidity found bankruptcy to be their only option in the face of $30 oil. 2016 was the fifth highest default volume year on record with 80% of defaults occurring in commodity credits. The default rate for energy issuers was approximately 20%. We believe that most of the aggressive credits in these sectors have now restructured (the average energy bond trades at $98 today, up from $56 in February 2016).
Aside from the speculative energy issuance, primary market trends since the financial crisis have been healthy. Since 2009, CCC-rated deals have averaged only 16% of total issuance, compared with 29% in 2006-2007. Looking at use of proceeds, less than 4% of issuance has funded LBO activity, down from 30% in 2006-2007. Conversely, refinancing deals have comprised 56% of recent issuance compared to 36% pre-crisis.\(^2\)

We view refinancing as a constructive use of proceeds as it extends maturities and bolsters liquidity, reducing the potential for future default risk. Finally, notwithstanding some erosion in bank loan documents, aggressive deal structures, a tell-tale sign of speculative excess, have been virtually nonexistent. Pay-In-Kind toggle notes (PIK/toggles) and deferred-interest bonds, which accounted for 10% of 2006-2007 issuance have represented less than 2% in recent years.

With commodity credit restructurings now largely behind us, we believe default risk over the next two years is benign. Expected interest hikes by the Federal Reserve should only modestly impact issuers’ cash flow and liquidity, in our view. Aside from the relatively small retail sector which is suffering from secular changes in consumer shopping habits, we believe default risk is largely idiosyncratic. Using conservative bottom-up inputs from our global team of credit analysts, we see the default rate falling to under 2.75% this year, well below the historical average of 4.5%. JP Morgan is even more constructive with a 2017 default forecast of 2.0%, while Moody's expects defaults over the next year to total 2.4%. Absent a recession, we do not see sufficient fuel in today's market to drive defaults meaningfully higher over the next two years. Against a backdrop of supportive macroeconomic conditions and attractive credit fundamentals, we expect this credit cycle to continue.

\(^1\)Source: BoA/Merrill Lynch High Yield Index, as of 6/30/17.

\(^2\)Source: BoA/Merrill Lynch Global Research

### RISKS

**Bonds** are subject to interest-rate, credit, liquidity, call and market risks, to varying degrees. Generally, all other factors being equal, bond prices are inversely related to interest-rate changes and rate increases can cause price declines. **High yield bonds** involve increased credit and liquidity risk than higher rated bonds and are considered speculative in terms of the issuer’s ability to pay interest and repay principal on a timely basis.

Pay-In-Kind Toggle notes (PIK/Toggles) pay interest in cash at one rate or, at the company’s option, pay interest in additional PIK toggle notes. The interest paid in additional notes is set at a higher rate than the cash interest rate.

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