



Ken MONAGHAN
Co-Director of High Yield;
Portfolio Manager



Tim DOWLING
Client Portfolio Manager,
Fixed Income

- **Second-quarter high yield index performance** was positive but lackluster as mildly wider credit spreads and higher Treasury yields offset coupon income to produce returns in line with cash.
- **Inflation data was encouraging:** Various measures of inflation resumed their slow declines after surprising to the upside during the first quarter.
- **Global economic indicators were mixed:** The US continued to expand, yet not without indications that growth may soon fade. Europe was mixed, with the periphery benefiting from strong tourism, while the manufacturing-oriented core struggled to gain momentum. Chinese data continued to indicate softer growth with a more challenging export environment and still moribund residential construction sector.
- **The European Central Bank (ECB) made its first cut while the Fed dialed back projected cuts:** The ECB came through on its long-promised June 25 basis point cut, although pointing to caution on further cuts. The Fed “dot plot” reduced projected cuts by yearend from two totaling 50 basis points to one of 25 basis points as stubborn inflation and strong growth fueled hawkishness.
- **Defaults, including distressed exchanges, continue to moderate:** Defaults have been moderating over the last few months, leading Moody’s to reduce its projected yearend default rate by issuer count to 3.7%, in contrast to yearend 2023’s 4.9%. Moody’s attributes part of the reduction to the open and buoyant market, with refinancing activity clearly providing “self-help” to the default rate.
- **Not the time to load up on risk:** Several of the economic indicators we monitor are indicating softer growth may lie ahead. Although we identify multiple positive factors for high yield, valuations are challenging. With spreads tight and the economy likely to slow, we are positioning portfolios defensively in anticipation of spread widening.

Second quarter 2024 review

Second-quarter returns were positive but un compelling as not offering a premium to cash. Spreads widened, reversing part of the tightening experienced during the first quarter, yet remaining tighter compared to yearend. Equities gained, with the S&P 500 up 15.25% and setting multiple records, making high yield’s spread widening during the second quarter out of line with its normal correlation with stocks.

Exhibit 1: Higher quality outperformed during the second quarter of 2024, with Distressed continuing to lag

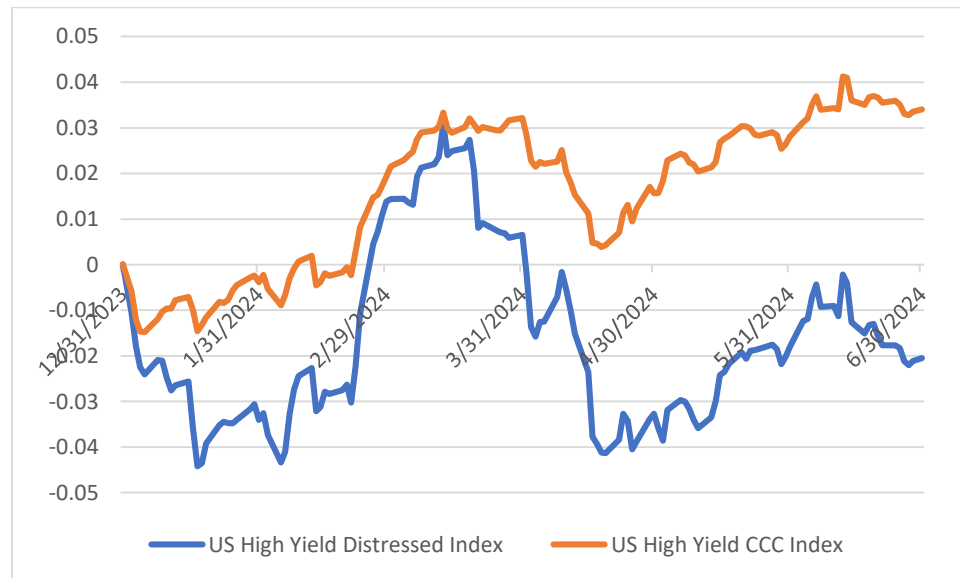
	Second Quarter Total Return	Year To Date Total Return	Quarter End Spread-To- Worst	Quarter End Yield-To- Worst
ICE BofA Index				
US High Yield	1.09%	2.62%	343	7.94%
US High Yield BB	1.32%	2.43%	209	6.59%
US High Yield B	1.03%	2.53%	325	7.80%
US High Yield CCC	0.18%	3.40%	964	14.10%
US Investment Grade BBB	0.28%	0.47%	121	5.73%
Global High Yield	1.45%	3.53%	358	7.73%
Global High Yield BB	1.50%	3.31%	242	6.49%
Global High Yield B	1.30%	3.26%	360	7.88%
Global High Yield CCC	1.38%	5.22%	1,034	14.55%
EM High Yield	2.25%	6.24%	382	8.38%
European High Yield	1.85%	3.99%	387	6.65%
US High Yield Distressed	-2.68%	-2.05%	1,857	23.10%

Source: ICE BofA as of June 30, 2024. Indices are unmanaged and their returns assume reinvestment of dividends and do not reflect any fees or expenses. It is not possible to invest directly in an index.

**Outlook:
Valuations are
challenging for
high yield,
supporting
defensive
positioning.**

An interesting development during the second quarter was the divergence in performance between the ICE BofA US High Yield CCC Index and the US High Yield Distressed Index. The Distressed Index includes all issues trading at spreads exceeding 1000 basis points at the beginning of a period. At March 31, 2024, 78.6% of the Distressed Index was rated CCC, CC or C, and it constituted 3.9% of the US high yield universe. During the second quarter and year-to-date, the Distressed Index underperformed the CCC Index by 2.86% and 5.46%. This underperformance prompts us to inquire if there is an economic signal being generated by the weak performance of the highest-yielding bonds in the high yield universe or if this underperformance has been created by more idiosyncratic factors.

Exhibit 2: Performance of US high yield CCC and distressed indices



Source: ICE BofA as of June 30, 2024. Indices are unmanaged and their returns assume reinvestment of dividends and do not reflect any fees or expenses. It is not possible to invest directly in an index.

At this point, we view the underperformance of the US Distressed Index as being driven by idiosyncratic factors. The five issuers with the largest weights in the Distressed index are DISH (including EchoStar), Bausch Health, SFR (including its US affiliate CSC Holdings), Lumen Technologies (including its subsidiary Level III), and iHeart¹. These five issuers amount to 46% of the Distressed index; most of these issuers have generated weak performance recently. Further, we view the weak performance of these issuers as being driven by long-term, in-motion secular factors, such as the decline in linear TV viewership hurting DISH and SFR and the decline in radio listenership impacting iHeart. Poor corporate financing decisions also are impacting these issuers, as they all extensively relied on debt financing rather than issuing equity.

Similar trends exist in Europe, with the ICE BofA Euro Distressed High Yield Index underperforming the Euro High Yield CCC index by 0.8% in the second quarter and 2.92% year-to-date. The top five European distressed issuers at the beginning of the second quarter were SFR (including its subsidiary Altice), Intrum, SBB, Adler and Vivion. The top five European distressed issuers amounted to 44.4% of the distressed weight. Although SFR, the European / American cable and telephony operator, is the largest distressed issuer in the European index, the largest distressed sector is real estate with a 24% weight. Considering again the question of whether there is an economic signal being generated by the weak performance of these issuers, or whether their weak performance was driven by idiosyncratic factors, we again attribute the weak performance to idiosyncratic factors, particularly these issuers' extensive use of debt, which proved difficult to refinance in a higher-rate environment.

There are some positive developments for holders of distressed bonds. Recently, holders of distressed bonds have been utilizing cooperation agreements, which seek to blunt the divide-and-conquer tactics often deployed by management teams and sponsors. Further, in the US, recent court developments have invalidated actions based on aggressive readings of debt agreements by management teams.

¹ Securities listed are not meant to represent any current or future holding of an Amundi US portfolio, and should not be considered recommendations to buy or sell any security.

Outlook: Opening the Tight Spread Playbook

Know of any cheap markets? We don't. With the S&P 500 having gained 15.25% during the first half of the year, and the VIX having traded below 12 in June, a post-COVID first, it's only natural that high yield spreads have tightened. As of June 30, 2024, the ICE BofA US High Yield Index spread has fallen 19 basis points year-to-date to 343 basis points, while the Global High Yield index has tightened 43 basis points to 358 basis points. Although current spreads are not at their tightest for the year, they are close to the 2024 tightest and post-COVID 2021 tightest.

However, even considering the tight spreads, we can identify four vectors that support today's valuations:

Yields in 74th percentile since 2009 (as of June 30th): The yield compensation for high yield remains relatively attractive. Although high yield spreads themselves are not attractive, Treasury yields currently include a strong premium to expected inflation known as the "real yield". Real yields have increased since 2022 to levels last seen in 2007. The 7.94% yield-to-worst for the US High Yield Index as of June 28th effectively contains higher compensation for inflation than seen in over a decade in addition to the credit spread, making the yield-to-worst attractive to many investors.

New issue quality remains reasonable: According to JP Morgan², low quality (Split B and CCC) issuance year to date through June 30, 2024 at 8% increased only marginally from 2023's 6%. Both of these periods' lower quality issuance weights are well below the 28-year average of 15% and stand in stark contrast to the 24.6% average during 2005 through 2007 leading into the Global Financial Crisis. Clearly, the quality of the flow of new credit risk remains a positive.

Defaults forecasted to decline over the short-term: Moody's baseline forecast³ predicts the US and global speculative grade default rates will decline from 5.3% and 4.9% to 3.1% and 2.9%, respectively, by May 31st, 2025. The Moody's modeling includes economic forecasts plus inputs from their credit transition model and are issuer-weighted. On a dollar-weighted basis, which is a closer measure of the economic impact of these defaults, US speculative grade defaults are at 2.5%, with global speculative grade defaults at 2.4%. If dollar weighted defaults decline in line with issuer weighted defaults, credit costs could remain low for the short-term.

High yield's expected return and volatility may be attractive compared to alternatives: US high yield's annual standard deviation of 14% compares to the S&P 500's 17.7%⁴. Investors may see US high yield attaining a 5% return over the next three years as a safer bet than the S&P 500 achieving an 6.3% return, which would be the volatility-adjusted equivalent.

So, what do we consider the optimal positioning for this environment? Considering all the above, we are turning to the tight spread section of our high yield positioning playbook. We believe increasing the weight of "income producers", the most defensive of the four classifications in our performance driver framework, should be the best way to gather a reasonable amount of spread income while reducing broad market exposure. We will continue to seek attractively priced "spread tighteners", the performance driver category consisting of issuers earning their way to higher valuations; we see security selection within lower tier credits as critical for performance.

Positioning themes: trends, opportunities and challenges

At our quarterly sector review meeting, our analysts decreased the aggregated weight of their recommendations, with the aggregated weight of their recommendations now at the lowest level during the post-COVID period. The most notable weight declines were in Basic Industry, Consumer / Healthcare and Industrials, while the weight of the "TMT" (telecommunications, media, technology & electronics) vertical increased. Interestingly, these weighting recommendation changes reflect some rotation from stronger-performing sectors to weaker-performing sectors on a year-to-date basis.

Themes from our second quarter top-down and sector reviews include:

Signs of economic softening but no hard landing: Multiple analysts reported that their issuers were experiencing weaker sales with business conditions clearly past their peaks. However, for many issuers, backlogs were still being worked down from record highs, which the analysts expected to be supportive. Further, multiple analysts noted that most issuers' balance sheets were in good condition.

Post-COVID-19 normalization continues: Easing of formerly tight labor conditions was reported as tailwinds by several analysts. In healthcare, easing of labor pressures while threats to the reimbursement

² Source: JP Morgan, "Default Monitor," 01 Jul 2024

³ Source: Moody's, "May 2024 Default Report," 14 Jun 2024

⁴ Source: LCD 6-30-24 LLI Factsheet

regimes were minimal was viewed as creating overall benign conditions, which upgraded the relative attractiveness of multiple issuers.

Will slowing private credit growth prove to be negative for high yield performance? Private credit has experienced tremendous AUM growth over the last few years, leading to some weaker high yield issuers being refinanced by private loans. Recently, private credit AUM growth has slowed: will this result in fewer troubled high yield issuers being refinanced by private loans, thus increasing the high yield default rate?

Valuations are the real challenge: Across the board, our analysts found the combination of potentially weaker economic conditions and tight spreads unappealing. A portfolio manager commented the market was not in an environment where investors could “throw darts at the wall and make money.” After the review of top-down indicators and the bottom-up sector reviews, the plan to emphasize income producers while making targeted security selections in lower quality credits was ratified.

Definitions

Duration measures a bond's or fixed income portfolio's price sensitivity to interest rate changes.

The Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.

The Personal Consumption Expenditure Index is known for capturing inflation (or deflation) across a wide range of consumer expenses and reflecting changes in consumer behavior.

Credit spread: The difference in yield between a corporate bond and the sovereign issues (US Treasuries, in the case of US dollar corporate bonds).

Spread tightening: A decline in the relative yield of bonds of similar maturity but different credit quality. In this paper, spread tightening refers to high yield bond yields falling relative to yields of US Treasury bonds of similar duration.

Yield-to-worst: The lowest potential yield that can be received on a bond without the issuer actually defaulting.

Indices are unmanaged and do not reflect any fees or expenses. It is not possible to invest in an index.

The ICE BofA Merrill Lynch US High Yield Index tracks the performance of US high yield bonds.

The ICE BofA Merrill Lynch US High Yield B, BB and CCC Indices track the performance of US high yield bonds of varying credit qualities.

The ICE BofA Merrill Lynch Global High Yield Index tracks the performance of global high yield bonds.

The ICE BofA Merrill Lynch Global High Yield B, BB and CCC Indices track the performance of global high yield bonds of varying credit qualities.

The ICE BofA Merrill Lynch US Investment Grade BBB Index tracks the performance of BBB-grade quality US Corporate Bonds.

The ICE BofA European Currency High Yield Index tracks the performance of European high yield bonds.

The ICE BofA Merrill Lynch Emerging Markets High Yield Index tracks the performance of global high yield bonds.

Important Information

Unless otherwise stated, all information contained in this document is from Amundi Asset Management as of June 30, 2024. Diversification does not guarantee a profit or protect against a loss. The views expressed regarding market and economic trends are those of the author and not necessarily Amundi Asset Management and are subject to change at any time based on market and other conditions, and there can be no assurance that countries, markets or sectors will perform as expected. These views should not be relied upon as investment advice, a security recommendation, or as an indication of trading for any Amundi product or service. This material does not constitute an offer or solicitation to buy or sell any security, fund units or services. Investment involves risks, including market, political, liquidity and currency risks. Past performance is not indicative of future results. Amundi US is the US business of Amundi Asset Management.

RO ID# 3715667

©2024 Amundi Asset Management.