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Amundi ASSET MANAGEMENT

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INVESTMENT TALKS

High Yield Market Outlook and Positioning

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- ***First quarter high yield performance was strong but volatile****: The ICE BofA US High Yield and Global High Yield Indices showed very strong gains through early February, with total returns exceeding 5%, then faded, yet closed the quarter +3.72% and +3.3%, respectively*[1]*.*
- ***Inflation data drove the markets:*** *Sticky inflation data during February produced a wave of risk aversion and higher Treasury yields.*
- ***The banking system is now a concern:*** *Problems at Silicon Valley Bank, Signature Bank, First Republic Bank and Credit Suisse produced an avalanche of bad news during March. Investors are now effectively marking banks' bond holdings to market and assessing the stability of deposits.*
- ***Central banks are talking tough, but will they be?*** *Banking instability has been added to the US Federal Reserve's and European Central Bank (ECB)'s list of worries, with the market now projecting peak rates to arrive in the US this spring and in the Eurozone this fall. When the Fed and the ECB pivot to lower rates is the key question.*
- ***Defaults remain low:*** *Monetary policy works with lags. The banking problems will reduce credit creation. We expect defaults to rise as the effects of both work through the system.*
- ***We remain cautious on risk:*** *While spreads are reasonable on a long-term basis, we believe credit spreads are likely to widen as recession effects become more widespread.*

First quarter 2023 review

High yield market conditions opened January on a positive note, with decreasing yields and tightening spreads as investors put cash balances to work that had grown over the year-end holidays. The release of US December inflation figures in mid-January furthered the narrative of inflation coming under control, fueling market optimism. However, the release of the January inflation figures in February had the opposite effect, with slower declines in inflation provoking statements from US Federal Reserve officials that rates would need to remain higher for longer, thus depressing markets.

In early March, the markets put aside inflation worries as concerns turned to the banking system. Although unrealized losses on US banks' bond investments had been growing across 2022 as interest rates increased, the market swung to the realization that some banks' capital bases would have been substantially eroded except for the beneficial accounting treatment for held-to-maturity and held-for-sale investments. In what seemed like moments, the US saw its first social media-enabled bank runs, with deposit withdrawals potentially threatening system-wide stability. Regulators took swift action to stabilize the system, although their actions pushed some investment-grade-rated bank bonds towards default.

As the US banking system stabilized, the markets brought Credit Suisse to the brink of failure. Swiss authorities soon forced Credit Suisse into the arms of UBS and wiped out Credit Suisse's most junior bonds, known as "AT1s" or "Contingent Convertibles" (also "CoCos").

Oddly, by late March, the markets were rallying, perhaps in anticipation that banking sector weakness might accelerate a pivot to lower rates by the Fed and the ECB despite comments by both central banks to the contrary. The Fed's January and March meetings saw 25 basis point increases to the federal funds rate target, a decrease from the 75 basis point increases seen last year and a potential indication that peak rates are near. With the market now assuming credit extension by banks would decrease, we believe the case for slower economic conditions will be accompanied by lower inflation. At the end of February, the market had projected that the federal funds rate would be 5.28% at year-end 2023; at quarter-end, this projection had fallen to 4.35% as the market priced in rate cuts.[2]

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[1] All index references are to ICE BofA indices

[2] Source: Bloomberg, March 31, 2023

High Yield Indices Turned a Corner in the First Quarter of 2023

ICE BofA Index	First Quarter 2023	Full Year 2022	Yield-to-Worst
US High Yield	3.72%	-11.22%	8.50%
US High Yield BB	3.37%	-10.57%	6.79%
US High Yield B	3.81%	-10.58%	8.87%
US High Yield CCC	4.85%	-16.32%	15.17%
US Investment Grade BBB	3.56%	-15.86%	5.56%
Global High Yield	3.30%	-11.39%	8.67%
Global High Yield BB	2.84%	-10.89%	7.09%
Global High Yield B	3.70%	-11.56%	9.07%
Global High Yield CCC	4.48%	-14.33%	17.37%
EM High Yield	1.63%	-14.78%	10.68%
European High Yield	3.39%	-9.33%	7.69%
High Yield Distressed	4.51%	-27.36%	20.68%

Data as of 3/31/23. Source: ICE Data Services and Bloomberg Finance L.P. Return data reflects price changes and interest payments. Indices are unmanaged and, unlike fund returns, do not reflect any fees or expenses. It is not possible to invest in an index. **Past performance is no indication of future results**. **See page 5 for index and term definitions**.

Within US High Yield, returns were strong for the quarter, with CCCs leading the BB and B rating tiers even after underperforming in March. For the quarter, CCCs even outperformed the High Yield Distressed Index, which includes bonds from all rating categories with spreads wider than 1000 basis points at the beginning of the period. "Excess returns," which are returns adjusted for Treasury yield changes, showed the same pattern as outright returns with the lower-quality rating tiers leading higher quality. Global High Yield showed a similar return pattern to US High Yield. Regionally, the US led Europe and emerging markets (EM); EM returns were relatively weak, with the index generating a negative return after adjusting for US Treasuries.

Outlook: stubborn inflation and reduced credit availability lead to a US recession

Our team's view is built on our below convictions:

- Inflation will remain stubbornly high, which the Fed will combat by keeping rates "higher for longer"
- The turmoil in the banking sector will reduce the availability of loans
- The combination of high rates and reduced lending will cause a recession, stressing issuers' balance sheets and pushing credit spreads wider.

We have previously written how inflation is likely to prove slow to decline to the Fed's 2% target. Although many parts of the US economy appear to be slowing, employment conditions remain favorable although somewhat weaker than last year. We believe that an increase in unemployment will be necessary to record an official recession and are expecting that employment data will soften over the coming months.

Even before the eruption of banking instability in March, we had been becoming increasingly concerned regarding US banks' willingness to provide loans. The Fed polls senior loan officers from approximately 100 banks on whether they are tightening or easing the standards behind new loans. The survey reported the "easiest" lending conditions ever in the summer of 2021, moving into restrictive conditions in the summer of 2022 and continuing to tighten through the last report in January 2023.[3]

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[3] Source: US Federal Reserve

A consequence of the banking turmoil has been that deposits have shifted from smaller banks to larger banks.[4] Although all deposits are guaranteed to a limit of $250,000, deposits at larger banks are assumed to benefit from those banks being "systemically important" and "too large to fail." We believe this shift will create an economic challenge, as smaller banks are more likely to provide loans to small businesses. Many small businesses rely on loans to finance inventories and expansions; without those loans, we believe economic activity and employment is likely to suffer. Even though most US commercial banks had less concentrated deposit bases than Silicon Valley Bank, Signature Bank and First Republic Bank, we believe the shock waves from these banks' problems will be felt through throughout "regional" banks and weigh on economic growth.

Positioning themes: Trends, opportunities and challenges

At our recent quarterly positioning reviews, our analyst team, based on their bottom-up issuer assessments, recommended to the portfolio managers that they keep the aggregated weights of their sector slightly below the benchmark level. This is in line with the fourth quarter review, so represents the credit analysts' view that market opportunities viewed from the issuer level are unchanged.

As we conducted our sector-by-sector review of the market, a number of cross-sector themes emerged:

De-carbonization is growing as a business opportunity: our analysts covering utilities, energy midstream, autos and metals all reported issuers seeking to capitalize on de-carbonization. Utilities are preparing for greater electrification as generation of electricity shifts from fossil fuels to renewables with home heating and transportation electrifying. High yield power producers with carbon-heavy generation are plotting their shifts away from burning coal and natural gas. Energy midstream companies are seeking opportunities in carbon capture and storage. For auto OEMs and suppliers, electrification is a make-or-break proposition extending through the value chain as car makers have shifted to remaking entire vehicles, not just the drive train. Finally, electrification will require a wide variety of metals, including copper for wiring, lithium and cobalt for batteries, and steel for transmission towers and wind turbines.

The economy is continuing to normalize post-COVID: lower costs were reported in multiple sectors, possibly offsetting labor price increases. Retailers and consumer goods companies are seeing supply chain bottlenecks ease. Margins are declining for homebuilders from peak levels, yet still wide enough to allow for some subsidization of high mortgage rates. Auto manufacturers and retailers are still benefiting from restricted production, yet we are seeing evidence margins are declining.

Consumers are being more careful with their spending: consumer goods companies are experiencing challenges pushing prices higher as volume growth has been anemic. Leisure companies are seeing some caution, primarily from lower income consumers.

Regional positioning themes: Europe had been relatively inexpensive compared to the US, the gap was reduced a bit during the quarter. We believe EM continues to present challenges, particularly as the increase in Treasury yields has the potential to set off more defaults of stretched EM sovereigns.

An interesting note regarding the recent bank defaults and the nuances of credit investing: Silicon Valley Bank and Signature Bank were rated investment grade when they failed. First Republic Bank, which has not failed and has received deposits from a consortium of banks to support it, has been downgraded to high yield, entering the high yield indices in April. Credit Suisse had senior bonds rated investment grade and junior bonds rated high yield; the senior bonds are being assumed by UBS and some of the junior bonds, which were rated high yield but not in the high yield indices due to their structures, have been written to zero.

[4] Source: US Federal Reserve statistical release H.8 ASSETS AND LIABILITIES OF COMMERCIAL BANKS IN THE UNITED STATES, March 23, 2023

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 PCE price 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

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