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Amundi ASSET MANAGEMENT

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High Yield Market Outlook and Positioning

INVESTMENT TALKS

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- ***2024 High Yield index performance was strong****, driven by spread compression in spite of rising sovereign yields. Although spreads compressed during the fourth quarter, returns were minimal due to sovereign headwinds.*
- ***CCCs and Distressed outperformed*** *as spreads compressed and some oversold issuers reported positive idiosyncratic developments.*
- ***Inflation data vacillated:*** *Some measures of headline inflation increased during the fourth quarter, as inflation remained persistent and sticky.[1]*
- ***US, European and Chinese growth diverged:*** *The US economic expansion continued, while European growth stagnated and the Chinese economy underperformed expectations stemming from recently launched stimulus programs.*
- ***The major central banks continued easing but are on different paths:*** *With the US and Europe diverging economically, expectations separated for 2025 rate cuts. As US fourth-quarter growth is estimated at 2.6%[2] and inflation continues to be sticky, market participants have dialed back expectations for 2025 rate cuts to two 25 basis point reductions. In Europe, with recessionary conditions in key core countries, market participants are projecting between four and five 25 basis point reductions.[3]*
- ***Defaults, including distressed exchanges, continue to moderate:*** *While defaults have moderated over the last few months, Moody's recently increased its year-end global speculative grade default by issuer forecast to 4.6% on weaker US employment[4]. Moody's also projects the global default rate by issuer count to decline steadily across 2025, reaching 2.7% by next November. We note that the global dollar-weighted default rate is only 1.9% currently and weighted toward loans.*
- ***Spreads approached all-time tights then backed off:*** *High Yield valuations are challenging, with the month-end spread of the ICE BofA US High Yield Index in the 8th percentile since 1996 and month-end spread of the ICE BofA Global High Yield Index in the 6th percentile since 2001. Mid-December spreads were even tighter, with the ICE BofA US High Yield Index in the 4th percentile and ICE BofA Global High Yield Index in the 3rd percentile for the same periods. However, we know High Yield isn't an outlier on valuation as equity prices are also near records and other credit indices are historically expensive.*
- ***2025's Known Unknowns and Unknown Unknowns:*** *it's wonderful to have 2024's election in the rearview mirror. However, now we face divining which of the new administration's campaign promises will actually be implemented. We know we don't know which tariffs will be implemented, how high they will be and how high retaliatory tariffs will be. We also know we don't know what the effects of the new immigration policies, including deportations, will be. Regarding Unknown Unknowns, we believe the sudden and unexpected fall of the Assad regime in Syria, in power for 53 years, illustrates how significant the Unknown Unknowns could be.*
- ***A January effect and then what?****: High Yield tends to perform well in January, a phenomenon linked to the holiday shutdown of issuance in late December and early January, so we would not be surprised to see spreads return to the mid-December tights. Quality has also improved over time.[5] However, we believe spreads are more likely to widen moderately as US economic indicators soften later this year.*

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[1] Source: US Bureau of Labor Statistics, US CPI Urban Consumers NSA for November 2024

[2] Source: Atlanta Federal Reserve Bank, GDPNow Forecast as of January 2, 2025

[3] Source: Bloomberg as of January 2, 2025

[4] Source: Moody's Default Report, December 2024.

[5] Source: ICE BofA beginning December 31, 1996 for US High Yield and December 31, 2001 for Global High Yield. Quality improvement: US High Yield BB Index weight as percentage of US High Yield Index since December 31, 1996.

Fourth-quarter 2024 review: Interest rate headwinds

Although full year 2024 returns for High Yield were strong and spreads tightened during the fourth quarter, fourth quarter returns were weak with losses in both October and December due to yield curve headwinds. 2024 had three negative months, compared to four during 2023[6]. BBs and Bs had a solid year, returning 6.28% and 7.55%, respectively, though BBs lost money in the fourth quarter and the returns of Bs were barely positive. The real story was CCCs and, more specifically, the ICE BofA High Yield Distressed Index[7]. CCCs gained 18.18% during 2024 and the Distressed index 24.73%, after the indices gained 20.36% and 24.41%, respectively, in 2023.

Outlook: Longer-term valuations remain challenging for high yield, supporting defensive positioning, although spreads are likely to tighten in January.

In many ways, the equity-like returns of CCCs and the Distressed Index are not out of the ordinary, as the CCC index's average annual absolute return has been 17.1% since 1997. Additionally, the back-to-back double-digit positive CCC returns are not unusual either, with back-to-back double-digit CCC positive returns being recorded four times since 1997, including 2023-2024. However, three-in-a-row double-digit positive CCC returns have not been recorded, a potential warning sign for CCC returns in 2025.

Exhibit 1: High Yield Index returns, spreads and yields

	Fourth Quarter Total Return	2024 Return	Year-End Spread-To-Worst	Year-End Yield-To-Worst
US High Yield	0.16%	8.20%	310	7.47%
US High Yield BB	-0.50%	6.28%	205	6.43%
US High Yield B	0.34%	7.55%	318	7.54%
US High Yield CCC	2.45%	18.18%	751	11.87%
US High Yield BB & B	-0.17%	6.84%	249	6.87%
US Distressed High Yield	5.62%	24.73%	1,772	22.08%
US Investment Grade BBB	-2.50%	3.55%	103	5.56%
Global High Yield	0.53%	9.26%	324	7.19%
Global High Yield BB	0.12%	7.90%	230	6.20%
Global High Yield B	0.75%	8.70%	333	7.38%
Global High Yield CCC	2.25%	18.57%	864	12.73%
EM High Yield	-0.20%	11.54%	362	8.05%
European High Yield	2.09%	10.41%	339	5.72%

Source: ICE BofA as of December 31, 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.

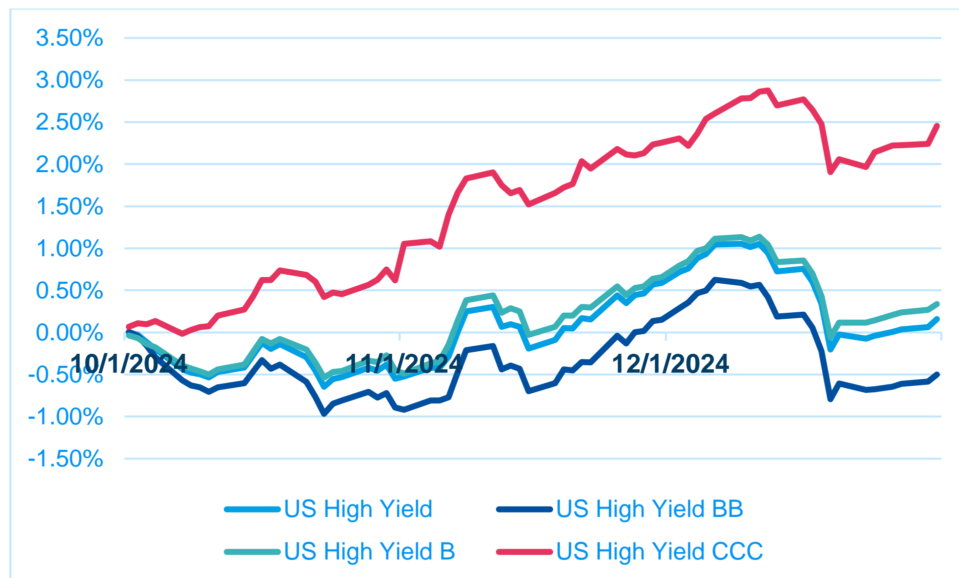
During the fourth quarter, the Distressed Index outperformed the CCC index by 317 basis points. CCC-rated bonds constituted 81.2% of the Distressed Index at the beginning of the quarter. It is important to recognize that the Distressed Index is very concentrated with the five largest issuers in the Distressed Index, constituting 41.2% of the Distressed Index, all rated CCC. The Distressed Index has also been a shrinking portion of the High Yield market. As of year-end 2024, the Distressed Index was only 2.7% of the broad US High Yield Index versus 5.1% at year-end 2023.

A development contributing to strong Distressed and CCC returns in recent years has been the evolution of creditor cooperation (co-op) groups. When issuers encounter significant financial stress, co-op groups may be formed by creditors to enforce contractual rights. In the past, the co-op groups frequently achieved this by blocking detrimental actions based on divide-and-conquer tactics such as covenant stripping and uptier exchanges. Currently, instead of submitting to divide-and-conquer tactics, co-op groups often seek to force issuers to negotiate with their creditors on a unified basis. We note that there can be significant differences in returns within classes benefiting steering committee members and creditors able to supply new equity. In total, we believe creditors' willingness to form co-op groups has enhanced distressed returns, as creditor unity has blunted the ability of distressed issuers to force disadvantageous restructurings.

[6] Source: ICE BofA US High Yield Index

[7] Source: ICE BofA US Distressed High Yield Index, which includes all bonds trading at spreads in excess of 1000 basis points at the beginning of the period.

Exhibit 2: Fourth-quarter 2024 performance of the US High Yield Index by rating tier

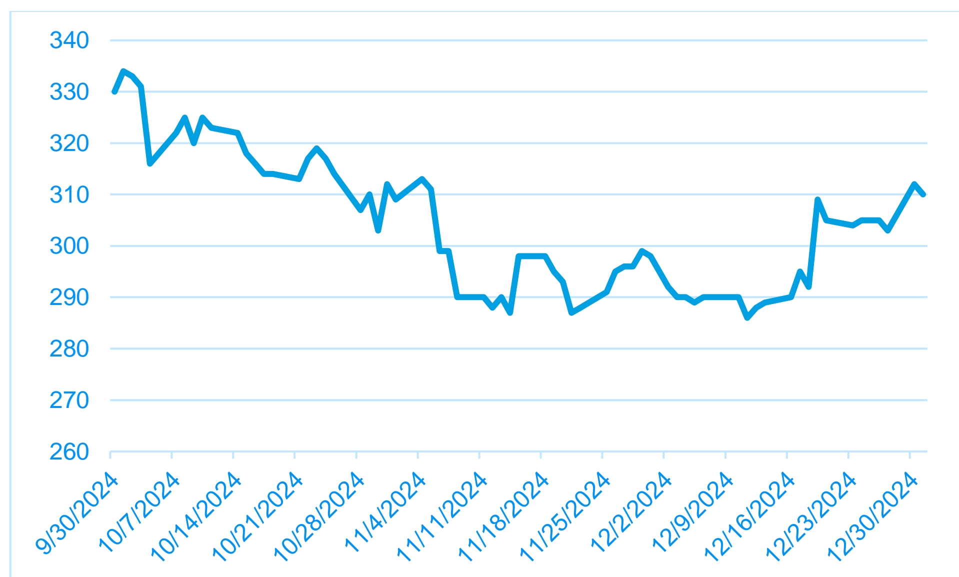


Source: ICE BofA as of December 31, 2024. Indices are unmanaged and their returns assume reinvestment of dividends and do not reflect any fees or expenses. It is not possible to invest directly in an index.

Outlook: Digging into the super low spread playbook

Coming into the election, we believed High Yield spreads were tightening due to the continuing economic expansion, optimism regarding US Federal Reserve rate cuts and the long-term trend toward a higher quality investment universe as more aggressive financings migrated to private credit. The election turbocharged the spread tightening trend, with the spread-to-worst of the ICE BofA US High Yield Index falling below 300 basis points the day after the US presidential election and reaching 286 basis points by December 11th. We believe the post-election tightening was driven by the perception that the new administration would cut taxes and decrease regulation, with these perceived benefits also driving equity market performance. However, by year-end, the High Yield Index's spread-to-worst had rebounded to 310 basis points as sticky inflation data deflated rate cut expectations.

Exhibit 3: ICE BofA US High Yield Index spread-to-worst



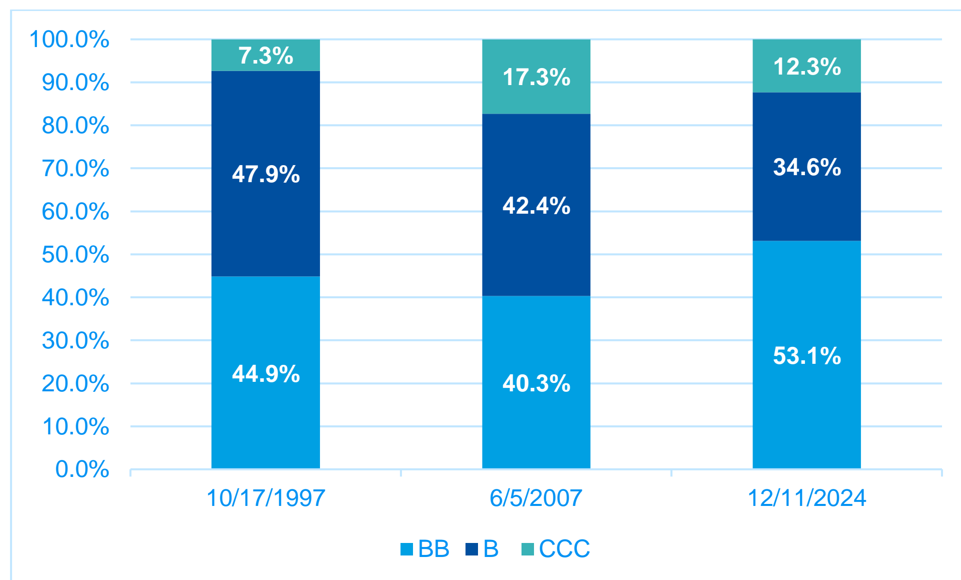
Source: ICE BofA as of December 31, 2024. Indices are unmanaged and their returns assume reinvestment of dividends and do not reflect any fees or expenses. It is not possible to invest directly in an index.

Digging into the playbook from previous super-low spread periods, we identify two multi-month periods during which the US High Yield Index's spread-to-worst remained under 300 basis points. The first period was from February 18, 1997 through May 29, 1998; the low spread-to-worst was achieved roughly midway through the period on October 17, 1997 at 244 basis points. The second period was from January 9, 2007 through June 29, 2007, with the low spread-to-worst for the cycle at 252 basis points on June 5, 2007.

With spreads so tight for most High Yield issuers, the relative cheapness of issuers with the potential for positive idiosyncratic developments compared to issuers with nondifferentiated prospects has compressed. A challenge for High Yield portfolio managers and analysts is to recognize that gains from these smaller scale opportunities are critical to generating excess return during periods of tight credit spreads. Avoiding credit problems remains crucial in these periods, particularly as gains to offset losses will be smaller in scale.

We also look at the rating composition of the universe as represented by the ICE BofA US High Yield Index. As shown in Exhibit 4, the universe has gravitated to a greater BB weight over time, indicating a trend to higher quality for the universe. BBs now have the highest weight of all three rating tiers, in contrast to Bs which had the greatest weight in the two prior sub-300 spread-to-worst periods. US High Yield spreads at year-end were 66 basis points above the all-time tight spread record; we believe this comparative spread metric would be more favorable on a quality-adjusted basis.

Exhibit 4: ICE BofA US High Yield Index rating composition



Source: ICE BofA as of December 31, 2024. The dates displayed are the lowest spread dates for each period, with the current period ending December 31, 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.

Positioning themes: trends, opportunities and challenges

At our quarterly sector review meeting, our analysts slightly decreased the aggregated weight of their bottom-up recommendations, which we see as a reflection of the tight level of credit spreads. Cyclicals remained the only overweight vertical, while the Telecom-Media-Technology, Consumer/Healthcare, Industrial and Financial verticals' recommendations all remained underweight. It should be noted that our sector weight recommendations tend to have a stronger input from bottom-up security selection rather than top-down allocation.

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

The BIG question for many sectors - what will the new administration do?: In general, our analysts reported favorable conditions for their issuers with some signs of softening demand. Analysts covering a broad range of sectors – including Energy, Automotive, Metals, Food-Beverage-Tobacco, Utilities, Media, Banking and Capital Goods amongst others – reported that their issuers' management teams were attempting to formulate plans without having firm ideas of what policy changes will actually emerge from Washington.

- **Deregulation for Banking and Media:** Our expectation is that the traditional pro-business Republican deregulatory bent should be favorable for the profitability of Media and Banking companies.

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- **Tariffs and autos:** Other sectors face much more complex potential challenges, with Automotive being a prime example. On one hand, tariffs on European and Asian imports may benefit US auto manufacturers. On the other hand, tariffs on cars and parts produced in Mexico and Canada would pressure the margins of the US auto manufacturers.

Consumer stress grew: We have written previously about declining consumer savings, which seem to have been receiving less attention recently possibly due to the wealth effect spurred by high equity prices.

- Our Retail analyst reported that consumers exhibited highly value-conscious spending behavior during the fourth quarter, with private label continuing to take share in food.
- Our Banking analyst highlighted growing credit card balances, with banks becoming more selective on new cards and regarding increasing the balances of current cards.
- Our Gaming analyst indicated that regional casino companies have seen decreases in gambling, food and beverage, with even Las Vegas experiencing sluggishness. Although we are mindful of the secular shift to online gaming, we view regional casino gaming as highly discretionary and a good indicator of lower-end consumer economic health.
- Our Building & Construction analyst reported that affordability is an increasing challenge. High interest rates have been hampering new home sales, which builders have been subsidizing to sell homes. Recently, home builders have also started subsidizing some insurance and maintenance costs.

Labor cost increases hurting some issuers' profitability: multiple analysts reported their issuers' margins were being squeezed due to higher labor costs. Homebuilders and Airlines were two sectors with the most acute challenges, although Healthcare reported decreasing labor cost pressures.

Definitions

Beveridge curve: A graphical representation of the relationship between unemployment and the job vacancy rate, with the number of unfilled jobs expressed as a proportion of the labor force. It typically has vacancies on the vertical axis and unemployment on the horizontal.

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 rating: An independent assessment of the ability of a corporation to repay a debt, either in general terms or regarding a specific financial obligation. Credit ratings are letter grades ranging from AAA at the top to C or D at the bottom. Based on S&P's measures, AAA (highest possible rating) through BBB are considered investment grade. BB or lower, including CCC ratings, are considered non-investment grade.

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

Job Openings and Labor Turnover Survey (JOLTS): This measure is produced by the Bureau of Labor Statistics of the U.S. Department of Labor, and involves the monthly collection, processing, and dissemination of job openings and labor turnover data.

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.

Spread-to-worst: The difference between the yield-to-worst of a bond and the yield-to-worst of a U.S. Treasury security with a 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, BB-B 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.

The ICE BofA US Distressed High Yield Index tracks the performance of US High Yield bonds with spreads over 1000 basis points at the beginning of the period.

Important Information

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