Trust must be earned

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High Yield Market Outlook and Positioning

INVESTMENT TALKS

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

- ***First-quarter high yield index performance*** *was positive but unexciting as small price losses were offset by coupon income.*
- ***Inflation data continued to drive the markets:*** *During the first quarter, US Treasury bond yields increased as inflation figures surprised on the upside and growth remained strong.*
- ***The US economy continued to expand:*** *Global growth was weaker as Europe's manufacturing woes continued and China failed to find a source of growth to replace property development.*
- ***US Federal Reserve voters have firmly indicated cuts are coming:*** *however, timing is dependent on inflation slowing, which is challenging with the US economy growing faster than expectations.*
- ***Defaults including distressed exchanges have moderated:*** *Defaults have moderated for high yield bonds. Loan defaults have been increasing due to the collision of higher short-term rates and the loan market's lower credit quality skew. In its February 2024 Default Report, Moody's projected a 5% peak for the issuer count default rate for 2024 with the default rate declining to 3.5% by yearend.*
- ***We remain cautious on risk:*** *Forward economic indicators continue to flash warning signs regarding growth, raising the likelihood of weaker credit performance. Our cautious stance not only reflects our concerns about growth, but also the low level of compensation for risk with credit spreads near three-year lows.*

First-quarter 2024 review

Although first-quarter returns proved to be anemic, at least they were consistent. Across the quarter, monthly returns were positive and spreads moved tighter. Treasury yields trended upward during the quarter, as economic releases failed to provide evidence of the slowdown that many investors were anticipating. Instead, growth and employment releases continued to indicate expansion, although possibly tempering from the well-above-trend 3.4% recorded in the fourth quarter of 2023. Inflation releases indicated stickiness, failing to show the straightline decreases projected by the optimistic.

With inflation's decline stalling, short-term rate expectations stabilized. At yearend, futures implied over six 25-basis point rate cuts during 2024, placing yearend federal funds rate futures at 3.75%[1]. However, at the end of the first quarter of 2024, futures implied fewer than three cuts, bringing yearend federal funds rate expectations to 4.67%.

Within high yield, Treasury yield increases largely negated the effects of tighter spreads, leading to returns near the index's coupon yield. Although CCCs were the best performers in the US and globally, the US High Yield Distressed Index[2] (comprised of issuers with spreads over 1000 basis points) underperformed the broader US high yield market, indicating investors were more interested in high-yielding bonds than in potential workouts.

[1] Source: Bloomberg

[2] Index references are for ICE BofA indices. 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.

Exhibit 1: Lower quality outperformed during the first quarter of 2024, but not distressed

ICE BofA Index	First Quarter Total Return (%)	Quarter End Spread-To-Worst (basis points)	Quarter End Yield-To-Worst (%)
US High Yield	1.51	334	7.75
US High Yield BB	1.10	211	6.49
US High Yield B	1.48	329	7.72
US High Yield CCC	3.22	868	13.14
US Investment Grade BBB	0.19	119	5.58
Global High Yield	2.05	358	7.63
Global High Yield BB	1.79	248	6.45
Global High Yield B	1.93	368	7.81
Global High Yield CCC	3.78	990	14.18
EM High Yield	3.90	415	8.59
European High yield	2.10	387	6.61
US High Yield Distressed	0.65	1932	23.74

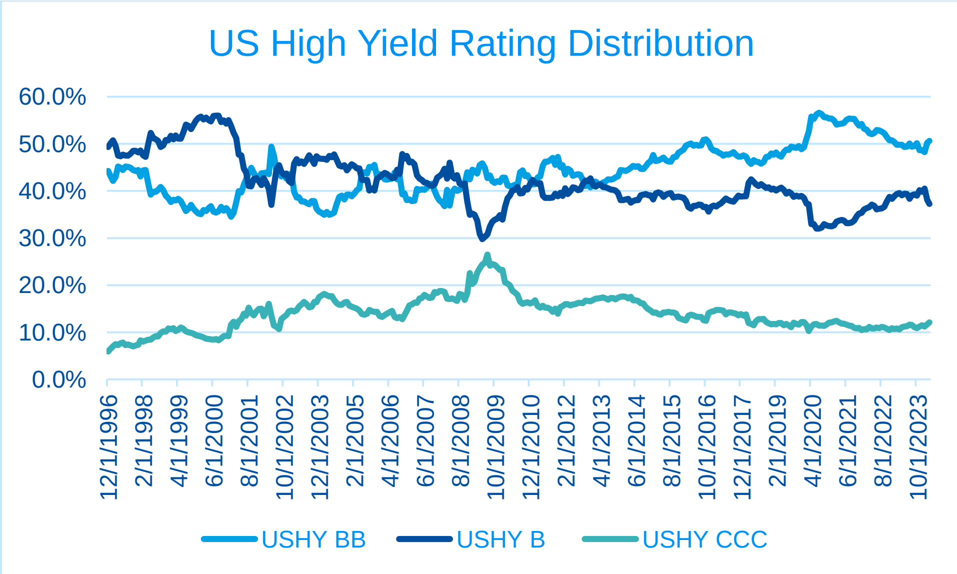
Data as of 3/29/2024. Source: ICE Data Services and Bloomberg Finance L.P. Return data reflects price changes and interest payments. Indices are unmanaged and, unlike fund returns, do not reflect any fees or expenses. It is not possible to invest in an index. **Past performance is no indication of future results**. **See final page for index and term definitions**.

Outlook: Future returns are challenged by tight spreads, a slowing economy, and the uncertain trajectory of inflation

We believe tight spreads, combined with a US economy and inflation too hot to warrant rate cuts, challenge high yield's continued positive performance. Although the Fed's March press release took rate increases off the table, the timing of cuts is far from a certainty. The Fed's March Summary of Economic Projections evidenced Fed voters' March views that three 25 basis point cuts were warranted by yearend; however, various Fed speakers subsequently have weakened this view.

We believe valuations are particularly challenging, with US high yield spreads now at the 11th percentile since 1996. We have previously written about how the overall quality of the market has improved over time. On a big-picture basis within the below investment grade credit category, we believe high yield is likely to attract the highest-quality borrowers, with the leveraged loan market attracting smaller, somewhat riskier borrowers, and private credit the smallest and riskiest. However, high yield's quality has been decreasing, with the BB weight now 50.7%, off substantially from the COVID-19-distorted 56.6% peak in July 2020. Still, the current market weight of BBs is meaningfully higher than it was five and 10 years ago.

Exhibit 2: The weight of BB-rated securities in the US high yield sector peaked in 2020

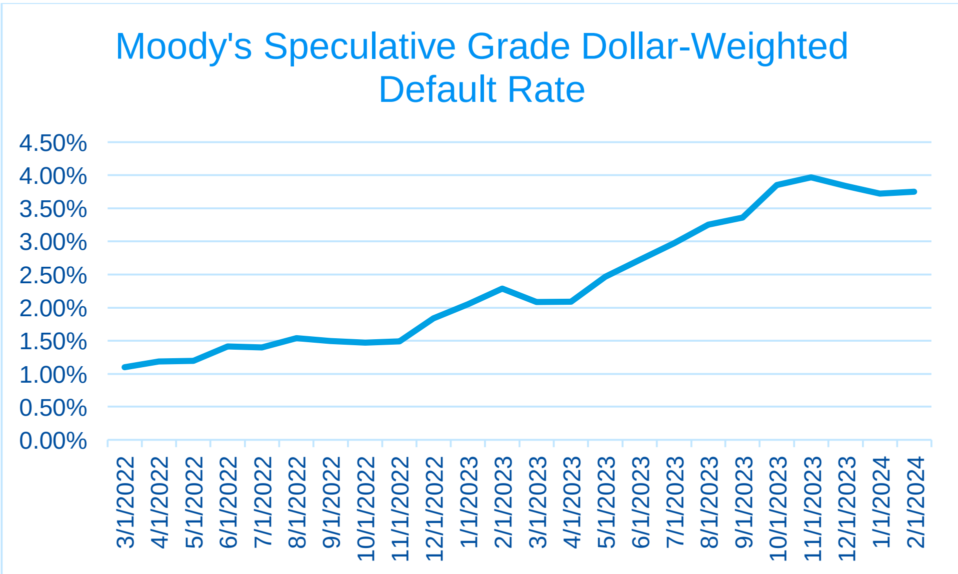


Source: ICE BofA, as of 3/29/2024. Indices are unmanaged and their returns assume reinvestment of dividends and do not reflect any fees or expenses. It is not possible to invest directly in an index.

However, even with the ratings mix changes, dollar-weighted defaults have recently decreased. At this point, although markets have been open to refinancing issuers with approaching maturities, we believe it's too early to call it a true turning point.

Exhibit 3: Default rate of high-yield securities appears to be plateauing

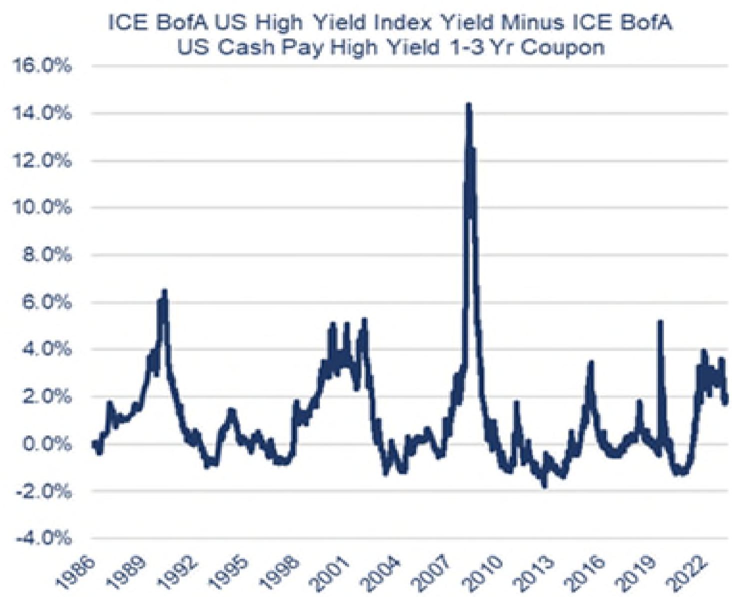
The default rate has recently flattened, but it is too early to know if it will persist



Source: Moody's as of 2/29/2024, default percentages by weight

We also see issuers becoming more comfortable with the current cost of high yield financing. Exhibit 4 shows the market index yield minus the yield of the 1-3 year maturity cohort. As can be seen, the spread between the two indices has fallen to approximately 2%, which we believe expresses the cost for an issuer to refinance lower coupon 2021-vintage bonds at today's higher rates. Supporting this observation, first-quarter US high yield issuance was strong at $92.6 billion, approximately double 2022 and 2023's levels, but remained well behind the $162.3 billion issued during the first quarter of 2021.

Exhibit 4: Relative cost of refinancing



Source: ICE BofA, as of 3/29/2024. 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 increased the aggregated weight of their bottom-up selections even though spreads had tightened across the quarter.The largest increases were in Banking and Leisure. The Banking weight increase was driven by more favorable opinions on certain US regional banks with diversified business models and conservative lending standards; our analyst views the potential for stronger regulation and the progress some banks have made on improving their capital positions as catalysts for improving valuations. In Leisure, cruise companies' fundamentals have been improving rapidly; we believe consumers have been viewing cruises as attractively priced compared to other vacation types. Considering the prospects for further improvement, our analyst believes cruise company bonds are likely to tighten relative to the market.

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

"Not many signs that cyclicals are turning down": Many investors have been expecting the US economy to slow due to higher interest rates and tight credit conditions. However, the US economy in general has been experiencing flattish conditions, with most analysts reporting post-peak conditions with some negative indicators such as decreasing backlogs and lower consumables consumption.

Separating secular and idiosyncratic issues: Our quarterly discussions featured a greater number of discussions than normal seeking to separate secular industry-level concerns from company-specific idiosyncratic concerns. For example, the weakest performing sector was Cable, which widened due to industry-wide concerns over cordcutting and the sector's endless capex cycles. It was also negatively impacted as one of the largest cable issuers inititiated a restructuring. A similar situation is unfolding in Gaming, where we are seeing some regional casinos report weak numbers, which could be a sign of a tapped-out low-end consumer, or a sign that online gaming is winning share.

Energy's Exploration & Production segment's credit quality decreased: We see Exploration & Production (E&P) becoming riskier as high yield issuers with high quality assets, particularly in the Permian Basis in the southwestern US, are acquired by larger, investment-grade companies, resulting in the issuers leaving the high yield indices. Although recent acquisition activity sets up the potential for positive event risk, it also is leaving the subsector more heavily weighted to smaller companies operating less attractive properties, increasing E&P's risk relative to the high yield universe.

We thought the Energy Transition would be volatile, but not this volatile: Electric vehicle (EV) sales are no longer rapidly gaining share. Instead, internal combustion engine vehicles hung onto market share, and the companies producing parts for them benefited. Considering growing EV production, significant price cuts appear to be needed to drive sales. Demand for electricity has been growing due to EVs, heat pumps and artificial intelligence's large language models. US electricity demand had been flat for a decade as households and businesses used electricity more efficiently. Now, electricity supply from intermittent wind and solar has grown, while fossil fuel plants have largely gone offline. Until battery storage becomes widespread, we believe fossil fuel power plant generation will be solidly profitable.

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

RO ID# 3494576

Amundi
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