Trust must be earned

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High Yield Market Outlook and Positioning

INVESTMENT TALKS

Ken MONAGHAN
Co-Director of High Yield;
Portfolio Manager

Tim DOWLING
Client Portfolio Manager,
Fixed Income

Outlook: The lingering effects of high interest rates, reduced credit availability, weakening employment and diminishing consumer savings could lead to a US recession, thus increasing defaults and credit spreads.

- ***Fourth quarter high yield index performance*** *was strongly positive, with a major rally in November and December offsetting October's weak performance.*
- ***Inflation data continued to drive the markets:*** *In contrast to earlier in 2023, declining rather than increasing inflation swung the markets to gains.*
- ***Central banks are talking tough, but will they be?*** *We have asked this question for the last few quarters. We now know the answer and it is "no."*
- ***"Higher for longer" was about managing financial conditions:*** *It now appears the Fed's "higher for longer" stance was about keeping bond yields high to slow the economy instead of a true commitment. The Fed's last interest rate increase was in July and the market expects the Fed to remain true to form by cutting rates less than a year after attaining peak rates. The European Central Bank is in a similar position.*
- ***Heavy US Treasury issuance is a headwind for fixed income:*** *Although "real yields" have fallen since their peak in October, we expect the large US Treasury issuance required to fund the sizeable deficit will continue to maintain the inflation-adjusted yield on US fixed income near the post-Great Financial Crisis high.*
- ***Defaults are edging up:*** *Defaults have been increasing this year, particularly for loans. We expect higher rates to continue to push defaults upward.*
- ***We remain cautious on risk:*** *Forward economic indicators continue to flash warning signs regarding growth, raising the likelihood of weaker credit performance.*

Fourth Quarter 2023 review

Returns for the ICE BofA US High Yield Index in October launched the fourth quarter on a weak note (-1.24%), as pessimism over the path of inflation translated into caution regarding the Fed with the possibility of additional rate increases being priced into the futures markets. Fed speakers also sought to maintain their "higher for longer" stance, thus encouraging the market to maintain expectations of tight financial conditions further out on the curve. The US Treasury 5-year note continued its almost straight-line yield increase from July, and the 10-year US Treasury briefly traded over 5%, its highest yield since 2007. Adding to the gloom, "real yields" (the component of Treasury yields in excess of inflation) also ascended to their highest point since 2007, as investors contemplated the large Treasury supply needed to fund the US budget deficit.

Releases of October economic data in November quickly flipped the narrative. Inflation and labor market data swung market sentiment to optimism regarding Fed rate cuts, which sparked rallies in Treasuries, high-quality corporates and risky assets such as stocks and high yield bonds. November US high yield returns were strong outright (+4.55%) and adjusted for Treasuries (+2.32%).

In addition to a continuation of market positive data, the December Fed meeting provided further fuel for the rally. The "dot plot" release of Fed voters' economic and policy projections portrayed the Fed as expecting to cut rates by 75 basis points during 2024, a crystal-clear signal to the market of easier money ahead. Even though other economic releases, including leading indicators, portrayed a weakening economy, market participants read the weak data as positive in a classic "bad is good" reaction and bid up almost all asset classes. The ICE BofA US High Yield Index returned 3.69% in December, pushing fourth quarter returns to 7.06% and 2023 returns to 13.46%.

Exhibit 1: Higher quality outperformed during the fourth quarter of 2023

ICE BofA Index	December 2023 (%)	4th Quarter 2023 (%)	Full Year 2023 (%)	Yearend Yield-To-Worst (%)	Yearend Option Adjusted Spread (basis points)
US High Yield	3.69	7.06	13.46	7.69	339
US High Yield BB	3.25	7.34	11.44	6.37	205
US High Yield B	3.61	6.78	13.96	7.76	341
US High Yield CCC	5.83	6.60	20.36	13.03	902
US Investment Grade BBB	4.18	8.24	9.46	5.39	129
Global High Yield	3.48	6.71	12.97	7.69	385
Global High Yield BB	3.22	6.89	11.36	6.45	267
Global High Yield B	3.43	6.49	14.18	7.94	396
Global High Yield CCC	5.33	6.07	17.70	14.58	1090
EM High Yield	3.39	6.19	8.76	9.35	526
European High Yield	3.06	6.21	14.68	6.54	411
US High Yield Distressed	8.60	6.23	24.41	21.65	1831

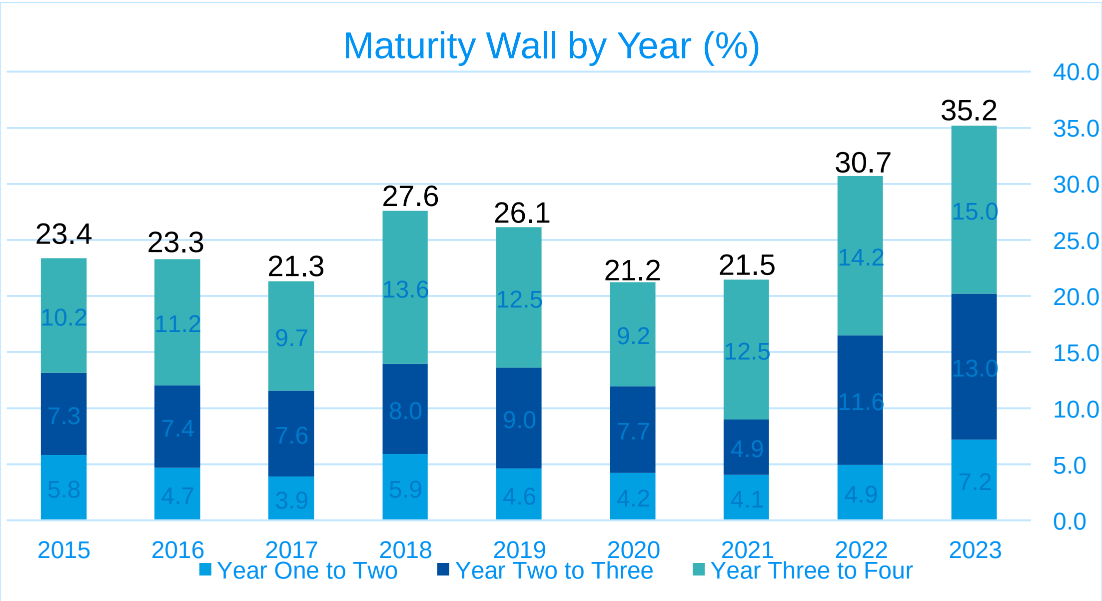
Data as of Dec 29 2023. Source: ICE Data Services and Bloomberg Finance L.P. Return data reflects price changes and interest payments. Indices are unmanaged and, unlike fund returns, do not reflect any fees or expenses. It is not possible to invest in an index. **Past performance is no indication of future results**. **See page 5 for index and term definitions**.

The fourth-quarter rally drove the US High Yield Option-Adjusted Spread down to 339 basis points over US Treasuries, a level not seen since early 2022 just after the Fed launched its rate increase program. Spreads are now at the 15th percentile since 1996, making further tightening relatively challenging.

However, the tight spread/lower yield environment should enable a refinancing wave. With Treasury yields falling significantly during the fourth quarter, issuers should find it more attractive to refinance front-end maturities. As visible in Exhibit 2, issuers have avoided refinancing low coupon bonds, causing the “maturity wall” to grow. Looking forward, dealers are expecting a rebound in new issuance.

Exhibit 2: US High Yield Yearend “Maturity Wall”

High interest rates have discouraged early refinancings



Source: Bloomberg, Dec 29 2023

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

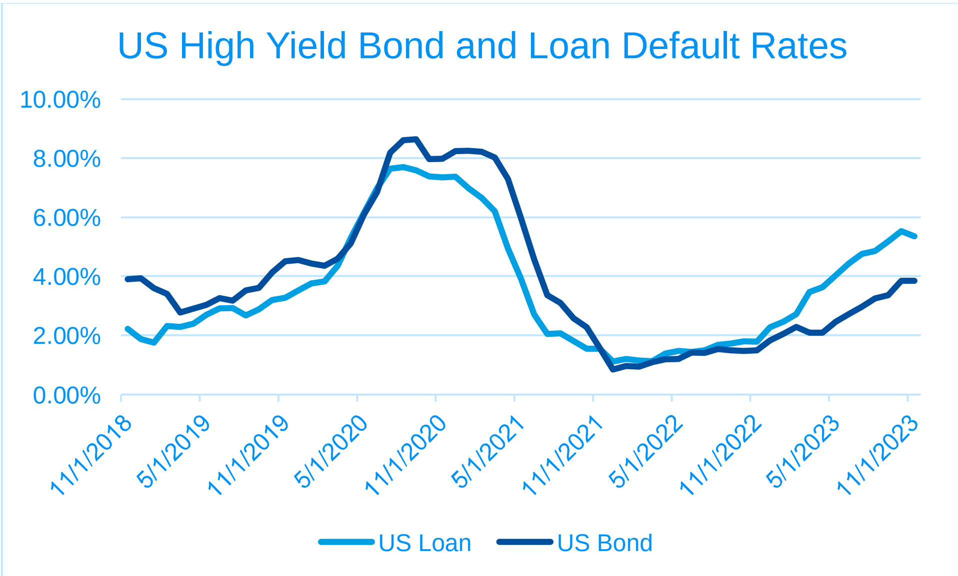
Strong fourth-quarter returns have reduced US high yield spreads from 403 basis points over Treasuries at the end of the third quarter to 339 basis points at yearend. Generating positive performance with spreads at these levels is much more challenging than at the long-term average spread of 537 basis points since yearend 1996[1].

Of course, positive performance can also potentially be generated from falling Treasury bond yields. Although high yield, with its 3.3-year effective duration at yearend, is not the most efficient asset class to generate gains from falling Treasury yields, it still can. The case for falling Treasury yields currently is built on the depth and cadence of Fed rate cuts, which we believe will be a function of decreasing service sector inflation and how much the US economy slows. Although we believe in the “don’t fight the Fed” maxim, we think the market is now richly valued with an extreme dependence on the delivery of the almost six 25 basis points rate cuts priced in by the futures market.

Additionally, we continue to be concerned about defaults. Defaults increased significantly during 2023, rising from 1.83% at December 2022 to 3.84% at November 30, 2023[2]. We believe it’s important to note that this increase occurred while the economy expanded at an estimated 2.2%.[3] Leading indicators point to economic softness during the first half; some sectors, such as Chemicals, are already experiencing recessionary conditions. We believe defaults are likely to increase further as economic weakness joins idiosyncratic factors as a source of stress for highly leveraged issuers.

Exhibit 3: Defaults Are Trending Higher

The default rate has rebounded from the very low post-COVID levels



Source: Moody’s as of Nov 30 2023, default by issuer count

Positioning themes: Trends, opportunities and challenges

Our analysts again reduced the aggregated weight of their recommendations, suggesting they believe valuations are rich compared to their issuers’ outlooks. On the portfolio level, we consider this indicator, yet temper it for the effect of recent performance, as we’ve observed tightening during a quarter can stimulate more cautious positioning recommendations. Themes for the quarter from our fourth-quarter top-down and sector reviews include:

“Things are great to things are good”: Multiple analysts reported hearing this refrain from management teams.

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[1] Source: ICE BofA US High Yield monthly OAS starting 12/31/1996

[2] Source: Moody’s as of November 30, 2023 (latest available)

[3] Source: Bloomberg, average of US Real GDP 2022 actual and Year Over Year 2023 forecast as of January 3, 2024.

Further post-COVID normalization: Some industries are experiencing significant increases in capacity. Recently, airfares have been declining as the airlines restore flights and demand moderates.

The energy transition may be volatile: Our auto analyst reported intensifying industry concerns that the coming increase in electric vehicle (EV) production may be met by anemic demand. Although some EV manufacturers have been reducing 2024 production plans, inventories for many models are high. We believe more extensive charging infrastructure may be required before EVs truly become mainstream. Additionally, during the fourth quarter, the dependence on low interest rates for solar and wind development was highlighted as alternative energy “yieldco” stocks fell as projected growth rates were dialed back.

Fossil fuel prices and tight spreads are presenting challenges for Energy sector performance: We are becoming increasingly concerned about the sustainability of crude oil prices. The Organization of the Petroleum Exporting Countries (OPEC) has cut production by 6 million barrels a day, yet has failed to arrest the slide in crude oil prices. Global demand has been weak, driven by soft economic conditions; weak demand has been coupled with growing production in North America, Mexico, Brazil and Guyana[4]. However, the weak demand may be counterbalanced by political instability in the Middle East, manifesting this time as attacks on shipping in the Red Sea although longer shipping times may be less of a challenge for energy self-sufficient North America than Europe. Meanwhile, natural gas prices in the US have crashed, although we know relief is coming for producers as more liquefied natural gas export capacity comes online. All the same, as Energy spreads are below the market average, we are becoming increasingly cautious on the sector.

[4] Source: TD Securities, Industry Insights, Dec 20, 2023.

Definitions

Duration: The measure of a bond's or fixed income portfolio's price sensitivity to interest rate changes.

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

Maturity wall: The wall of staggered corporate debt maturities that built over time as more speculative-grade companies increased their borrowing and methodically refinanced debt securities ahead of scheduled maturity.

Option-adjusted spread: The yield spread that must be added to a benchmark yield curve to discount a security's payments to match its market price, using a dynamic pricing model that accounts for embedded options.

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 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.

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