AXA Investment Managers

Marketing Communication. Capital at Risk

US High Yield Outlook

The US high yield (HY) market surprised many in 2023, with the broad market consensus coming into the year expecting investment grade (IG) to outperform HY and, within HY, higher quality BBs to outperform lower quality CCCs. This consensus was wrong. Despite continued volatility in the US Treasury market, the HY market has benefitted from a healthy fundamental backdrop and resilient US economy that, despite diverging trends across sectors and issuers, has performed stronger than anticipated.

	As of December 31st, 2023		As of January 3rd, 2024	
USD Currency	**2023 Total Return %**	**2023 4Q Total Return %**	**Yield to Worst**	**Option Adjusted Spread**
S&P 500 Index	26.26	11.68	1.51*	N/A
US High Yield CCC and lower	20.36	6.60	13.52	952
Russell 2000 Index	16.88	14.02	1.59*	N/A
Euro High Yield Index (H USD)	14.68	6.21	6.72	420
US High Yield B Rated	13.96	6.78	8.10	375
US High Yield Index	**13.46**	**7.06**	**8.00**	**371**
Credit Suisse Lev Loan Index	13.04	2.85	9.20	398
US High Yield BB Rated	11.44	7.34	6.62	231
Euro Corporate Index (H USD)	10.43	6.07	3.63	144
US Corporates BBB Rated	9.46	8.24	5.47	134
US Corporate Index	8.40	7.91	5.23	109
US Corporates 1-10 yrs	7.34	5.56	5.16	102
US Treasury 10 year	2.83	6.60	3.90	1

Source: ICE BofA, S&P Dow Jones Indices, FTSE Russell

*** 12M gross dividend yield**

Up until the end of October, the main performance driver in 2023 for the US HY market was income, with yield levels much higher as a result of 2022's sell-off providing attractive entry points for total return. The end of the year then saw a huge rally across the whole fixed income spectrum, meaning that price appreciation also contributed substantially to the full year return. Although the macro picture remains uncertain heading into 2024, the combination of attractive yields and low dollar prices means that US HY remains well placed to deliver attractive total returns in a wide range of different economic scenarios.

US High Yield key focus points for 2024

It starts with the macro…

For the third year in a row, the inflation narrative remains key. Although the Federal Reserve (Fed) is widely considered to be at the peak of its interest rate cycle in light of falling inflation and the expectation of some sort of economic slowdown, the path of Fed policy in 2024 remains very uncertain. We see three simplified scenarios to consider HY performance in this context:

1 Economy runs too hot

Inflation remains higher than expected, supporting the "higher for longer" narrative, which gripped markets in October but then reversed in November and early December. In this scenario, HY can once again outperform IG based on higher carry and lower duration. However, we would expect even greater dispersion within the highly levered, lower quality portion of the US leveraged finance market (bonds and loans), which will need to address the burden of higher interest expense.

2 Economy cools but avoids significant decline

Inflation continues to decline at a moderate pace with a steady economic backdrop, allowing the Fed to consider a modest amount of rate cuts in the second half of 2024. This is our base case and, in many ways, appears to be the current market consensus at the time of writing. This also presents a "goldilocks" scenario for HY investors. The higher quality, rates sensitive portion of the market would benefit from the stabilisation and decline in interest rates, while the lower quality portion of the market benefits from a stable economy and a slow down in rising interest expense. We would still expect significant dispersion and idiosyncratic drivers of performance within the lower quality segment of the market.

3 Economy runs too cold

Inflation declines driven by significantly weaker economic environment and the lagged effects of monetary tightening. Risk premiums rise, having a negative impact on credit spreads. A more dramatic drop in US Treasury yields helps to support the total return of the high yield market, but IG outperforms HY.

But it's the micro that will ultimately drive the story:

Irrespective of which macro scenario plays out, as primarily bottom-up fundamental investors we remain focused on the more predictable part of what we can control: the ability of issuers that we own to pay coupons on a timely basis and pay back or refinance principal. Although not all companies will thrive in this environment, increasing dispersion between "winners" and "losers" provides the opportunity for active investors to prove their worth. Key themes to watch in 2024 will be:

- **A high focus on analysing mixed company earnings and EBITDA**

  We are witnessing a non-uniform US economy create dispersion in results across sectors and issuers, illustrating different points of their economic and earnings cycles. Whilst parts of Basic Industry (particularly Chemicals) and diversified Capital Goods/Machinery have already been through a phase of destocking and are starting to emerge on the other side, many consumer-facing companies (Hotels, Leisure) have continued to fare quite well but may come under pressure, particularly smaller retailers, as the fight for the consumer wallet intensifies in 2024.

- ### Credit rating trends - particularly in the leveraged loan market

The more immediate impact of higher rates is being felt in the leveraged loan market, which has floating rate interest costs and has witnessed significant increases in average coupons on the strength of higher rates. This is affecting particularly highly levered loan issuers, some of which are experiencing negative operating trends alongside an increase to interest costs. With ~60% of the leveraged loan market now rated mid single-B or lower[1], the threat of multi-notched downgrades for issuers unable to adjust their capital structures to reverse these negative trends remains the biggest risk for that market and US leveraged finance in general.

- ### Increasing ingenuity from many HY companies to address the higher rate environment

The elevated cost of debt today is incentivising company management teams to de-lever corporate balance sheets. For many years while borrowing costs were low, management teams were not incentivised to decrease the amount of debt in the capital structure, since they wanted to take advantage of cheap debt. Today, debt is much more expensive, even relatively speaking for higher rated HY companies. As a result, HY companies are showing increasing ingenuity in finding ways to reduce the quantum of debt on their balance sheet, whether by using free cashflow, asset sales or equity raises to pay down debt, so that the amount of interest expense is not dramatically different from when rates were cheap. This creates the possibility of ratings upgrades, which presents a compelling opportunity across the HY rating spectrum for credit improvements. Lower coupon secured HY issuance has also picked up significantly in 2023 as a means to keep interest costs as low as possible. In fact, around two-thirds of US HY new issuance in 2023 was secured, taking secured bonds as a percent of the market to ~30%.

- ### Defaults and distressed exchanges likely to increase, but not significantly above long-term averages

We continue to forecast a pick-up in the HY default rate off a very low base in 2021 but, crucially, only to manageable levels broadly in line with historical averages. Top-down macro models may continue to forecast a more severe default rate projection but, as in 2023, we expect a fundamental, bottom-up approach to be more helpful to investors in forecasting defaults. Key to the market's expectation for the 2024 default rate is the extent to which distressed exchanges are considered, given the increase in out-of-court settlements taking place. We see a clear distinction between exchanges that create alignment between management teams and bondholders, compared to some exchanges that are more coercive to bondholders, which is important to bear in mind underneath the headline numbers.

Technical picture for US credit is mixed, but still supportive in US HY

- ### Does the strong HY technical finally start to soften?

The impact of such a strong HY technical in supporting prices during times of increased uncertainty may have been understated in the past. Recently, this strong technical has been driven by rising stars, low net new issue volumes and manageable outflows. In 2024, if loan market technicals soften, HY net new issuance could start to pick up. While we do not expect fallen angels to substantially increase in 2024, we would expect rising stars to decline, which could reduce the impact of this major pillar of the strong technical in 2023.

- ### Shifting technical between the three major components of US leveraged finance: loans, bonds and private debt

The supply and demand technical in the leveraged loan market currently looks the weakest, as legacy CLOs exit their reinvestment period and CLO creation is unable to keep pace. We could see both the HY bond and private debt markets increase market share if demand for loans turns negative. The role that private debt plays in any economic slowdown warrants attention. Overall, we view the growing private debt market as a positive driver in keeping HY and leveraged loan defaults low, as large pools of capital get put to work to refinance more troubled issuers in the loan and HY bond market.

1 Source: Credit Suisse Leveraged Loan Index.

The influence of carry in driving positive HY total returns is here to stay in 2024

• Valuations remain attractive despite uncertainty around spreads

We expect the market to continue to question spread levels in the US HY market until there is more clarity on the economic environment. Whether spreads move wider or tighter, ultimately we think we are in a positive return environment for the HY market and fixed income in general. We note that over the past 12-18 months, calls for wider spreads never fully materialized even during periods of volatility and market weakness, as investors focused on high single digit yields entering the market, creating a floor to the sell-off. Put together, we expect that carry will continue to be the cornerstone of a favourable backdrop for US HY returns in 2024.

Source: AXA IM, ICE BofA, as of 3 January 2024

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