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Developed High-Yield Bond Market Review

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Historical Returns of the HY Bond Market

	YTD	Past 12 Months	2023	2022	2021	2020	2019	Since 2000 (annual equivalent)	Annualized Volatility of Returns	Return/ Volatility
US										
Bloomberg US Corporate Bond Index	-1,4%	+2,9%	+8,5%	-15,8%	-1,0%	+9,9%	+14,5%	+4,9%	5,6%	0,88
Bloomberg US Corporate High Yield Bond Index	**+0,9%**	**+10,2%**	**+13,4%**	**-11,2%**	**+5,3%**	**+7,1%**	**+14,3%**	**+6,5%**	**5,2%**	**1,24**
EU										
Bloomberg Pan-European Aggregate: Credit Index	-0,1%	+5,7%	+8,3%	-16,4%	-0,8%	+2,8%	+7,7%	+3,3%	3,7%	0,89
Bloomberg Pan-European High Yield Index	**+1,7%**	**+11,3%**	**+12,8%**	**-11,1%**	**+4,2%**	**+1,8%**	**+12,3%**	**+5,7%**	**6,0%**	**0,95**
EM										
Bloomberg Emerging Markets Hard Currency Aggregate Index	+0,9%	+7,3%	+9,1%	-15,3%	-1,7%	+6,5%	+13,1%	+6,9%	5,5%	1,26
Bloomberg Emerging Markets High Yield	+4,2%	+15,6%	+13,1%	-12,4%	-3,2%	+4,3%	+11,5%	+7,8%	7,0%	1,11
Equity indices										
S&P 500 INDEX	+9,5%	+28,2%	+26,3%	-18,1%	+28,7%	+18,4%	+31,5%	+7,4%	19,6%	0,38
STXE 600 (EUR) Pr	+6,9%	+14,8%	+16,6%	-9,9%	+25,8%	-1,4%	+27,9%	+4,7%	18,8%	0,25
MSCI ACWI	+7,4%	+22,3%	+22,8%	-17,9%	+19,0%	+16,9%	+27,3%	+6,0%	15,8%	0,38

- Over the past 12 months and in 2023, High Yield (HY) bonds have significantly outperformed general fixed income (FI) market, highlighting their appeal to investors seeking higher returns.
- Amid the negative market conditions of 2022, HY bonds emerged as a more resilient asset class, outperforming the general FI markets. This is attributed to their typically lower duration profile and higher coupons/yields, which provide a cushion in negative market conditions.
- Over long-term, HY bonds have delivered average annualized returns comparable to equities, with lower volatility. This unique combination underscores the value of HY bonds in diversified investment portfolios.

Current State of the Bond Market

- The U.S. yield curve is currently inverted, with short-term yields surpassing those of long-term bonds—a signal that market participants anticipate lower rates ahead.
- Option-adjusted spreads (OAS) for both IG and HY bonds are below their long-term averages. This suggests that there is a limited potential for further spread tightening.
- Current yields on IG bonds are below those offered by money market rates, presenting a less attractive interest carry. HY bonds provide a higher carry, though the margin is modest. This is largely because indices are weighted towards older bonds with lower coupons.

	Credit rating	M. Duration	Yield to worst	Average coupon	Average price	Average current yield	OAS over Treasuries	Average OAS since 2020	Average OAS spread since 2000
US 3-month bill			**5,1**						
Bloomberg US Corporate Index	A3/ BAA1	7,2	5,5	4,1	91,4	4,5%	88	121	148
Bloomberg US Corporate High Yield Index	B1/B2	3,7	7,8	6,2	92,9	6,7%	301	412	501
Germany bund 3-month			**3,7**						
Bloomberg Pan-European Aggregate Index	A1/A2	5,6	3,7	2,3	92,7	2,4%	94	117	120
Bloomberg Pan-European High Yield Index	BA3/B1	3,0	6,6	4,6	93,6	4,9%	357	435	507
Bloomberg EM USD Aggregate Index	BAA2/ BAA3	6,3	7,1	4,9	87,4	5,6%	256	342	343
Bloomberg Emerging Markets High Yield Index	B1/B2	5,3	9,7	5,9	81,6	7,2%	514	691	545

Technicals of Fixed Income Market Sectors

- High negative beta of High Yield (HY) spreads mean that they narrow during equity market rallies and classify as risk-on assets.

- HY bonds show minimal sensitivity to shifts in interest rates (beta to movement of Gov bonds), tying more closely to the health of the corporate sector and broader economic cycles. This distinguishes them from IG bonds, which are more responsive to interest rate movements, highlighting their role as conservative investments.

- The low correlation between HY bond yields and government bond yields marks HY as a distinctive segment for diversifying fixed income portfolios.

	Index	Index OAS to Treasury beta to equity index	YTM beta to UST10Y Yield	Correlation of YTM with UST10Y
US	The Bloomberg US Corporate Bond Index	-0,64	0,28	0,66
	The Bloomberg US Corporate High Yield Bond Index	**-1,04**	**-0,06**	**-0,12**
EU	The Bloomberg Pan-European Aggregate: Credit Index	-0,66	0,30	0,35
	The Bloomberg Pan-European High Yield Index	**-0,92**	**-0,07**	**-0,12**
EM	Bloomberg EM USD Aggregate	-0,84	0,06	0,21
	Bloomberg Emerging Markets High Yield	-0,86	-0,01	-0,03

Historical High Yield Spreads

US Corporate High Yield OAS Spread

Pan-European High Yield OAS Spread

US HY spreads reached historical technical "floor", signaling further tightening appears limited.

EU HY has still some upside in terms of spread tightening, but still looks somewhat expensive comparing with historical average levels.

Long-term High Yield Returns

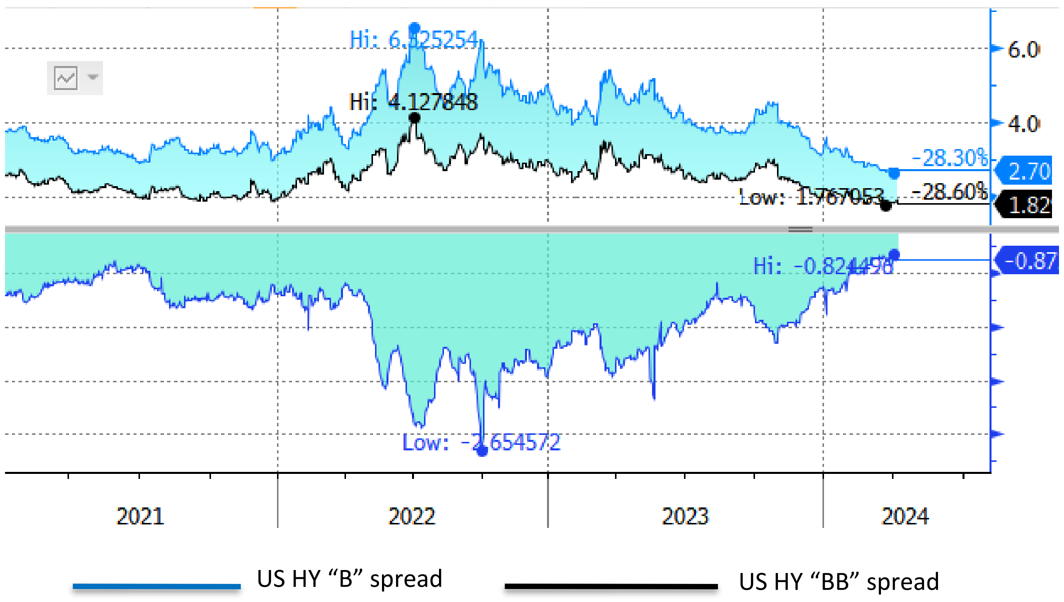
US Corporate High Yield YTW, Bloomberg

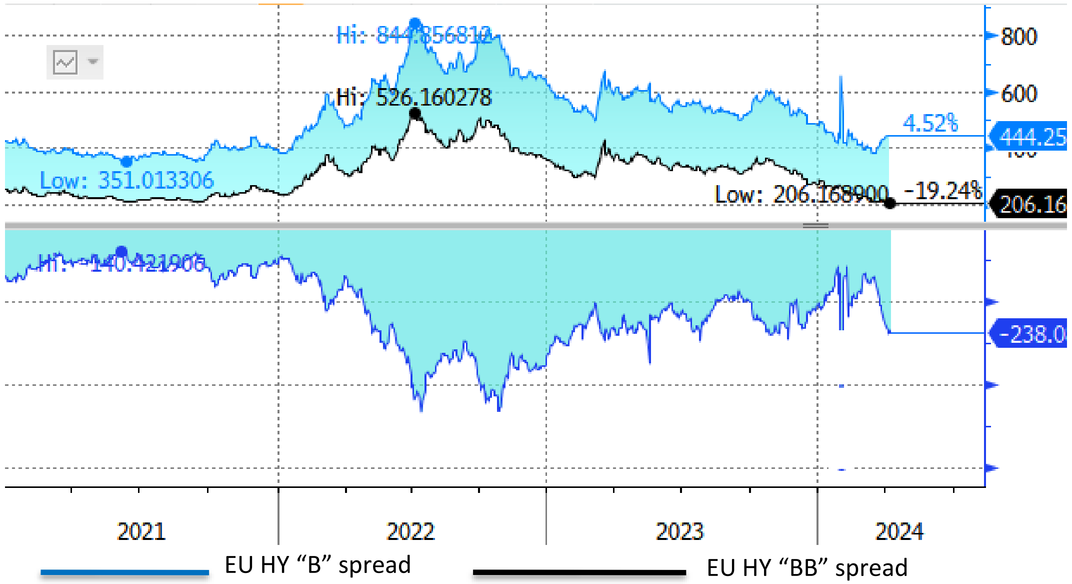
EU Corporate High Yield YTW, Bloomberg

- Investing in HY bonds, the primary factor for long-term returns is not price appreciation but rather the high yield to maturity/coupon and the compound interest multiplier.
- Despite the current low spread environment, the YTM of both USD and EU High Yield bonds remains compelling, offering attractive yield opportunities for long-term fixed income investors.
- HY bonds can enhance the overall yield of a fixed income portfolio, even when spreads are narrower, due to their inherently higher interest rates compared to other bond segments.

Credit Sector Spreads

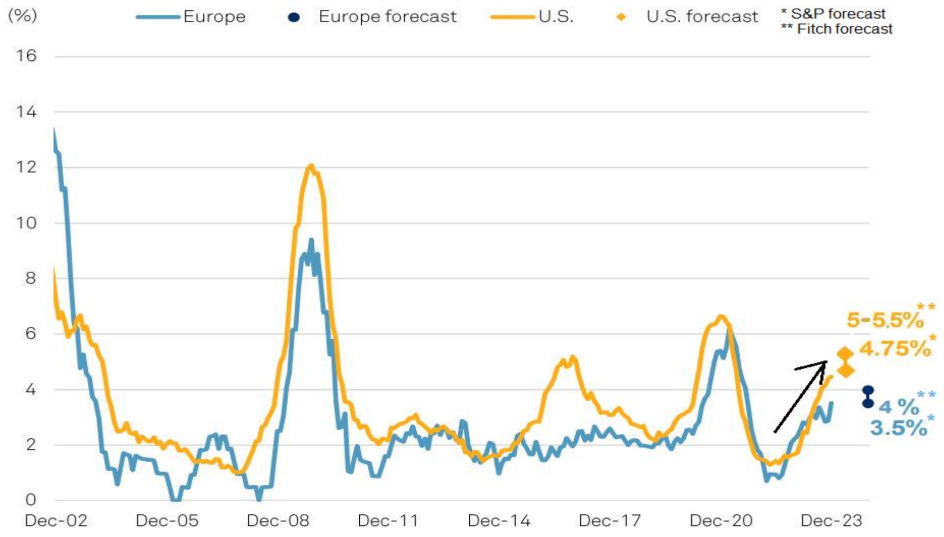
Spreads in USD segment of HY show that investors do not benefit much when they go down in the credit quality – the difference in spreads for BB and B segments is in its tightest in the recent history.





Spreads between BB and B segments EUR HY have widened to 240 bp so there is a room for investors to capitalize on lower credit quality but one should do a robust credit research to pick the right security.

Default rates



EU and US High Yield defaults rates. Source: S&P, Fitch

US Corporate High Yield OAS Spread. Source Bloomberg

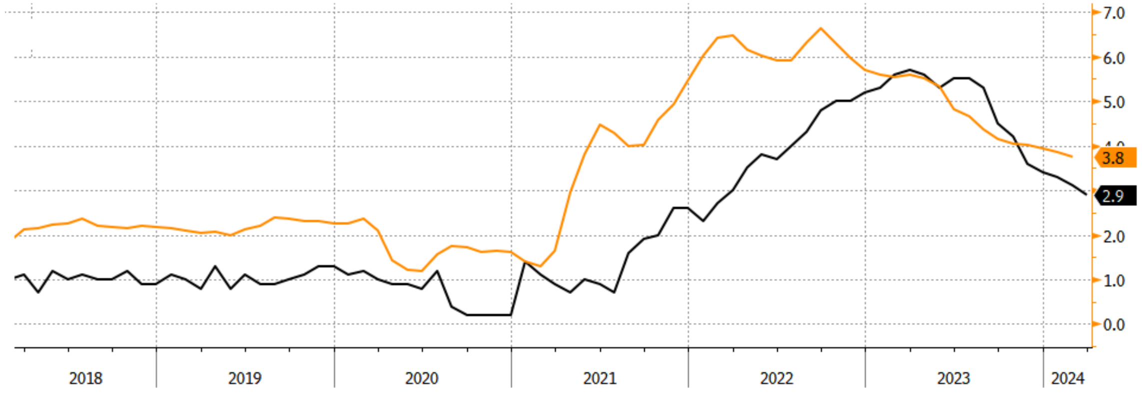
- From the lows in 2021, there's a clear upward trend in default rates for both USD and EUR HY bonds, with forecasts predicting increases to 5-5.5% for US HY and 3.5-4% in Europe by 2024.
- Despite rising default risks, HY bond spreads have compressed since 2022, diverging from the historical pattern where spreads and default rates moved in tandem.
- This divergence suggests that current spread levels may not fully reflect the heightened default risk, posing a challenge for investors in accurately pricing risk.

Economic Factors: GDP & Inflation

	2022-Q1	2022-Q2	2022-Q3	2022-Q4	2023-Q1	2023-Q2	2023-Q3	2023-Q4
US	**-2,0**	**-0,6**	**2,7**	**2,6**	**2,2**	**2,1**	**4,9**	**3,4**
Euro area – 20 countries	**0,6**	**0,8**	**0,5**	**0,0**	**0,0**	**0,1**	**-0,1**	**0,0**
Germany	1,0	-0,1	0,4	-0,4	0,1	0,0	0,0	-0,3
France	-0,1	0,3	0,6	0,0	0,0	0,6	0,0	0,1
Spain	0,3	2,5	0,5	0,5	0,5	0,5	0,4	0,6
Italy	0,1	1,4	0,3	0,0	0,5	-0,2	0,2	0,2
UK	**0,5**	**0,1**	**-0,1**	**0,1**	**0,2**	**0,0**	**-0,1**	**-0,3**
Japan	**-0,7**	**1,2**	**-0,2**	**0,4**	**1,0**	**1,0**	**-0,8**	**0,1**

GDP Growth rate for the biggest developed economies

US YoY core CPI ex-housing

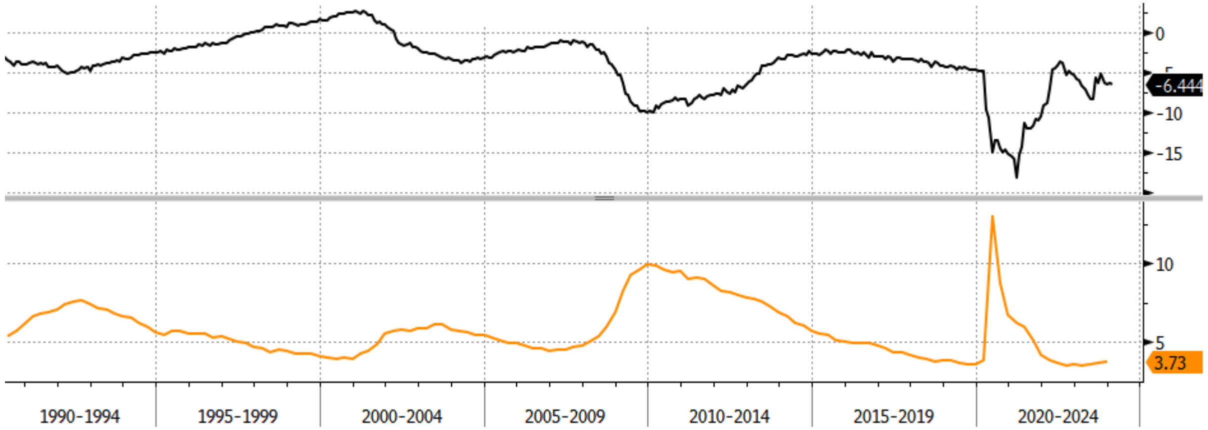


Core US YoY CPI

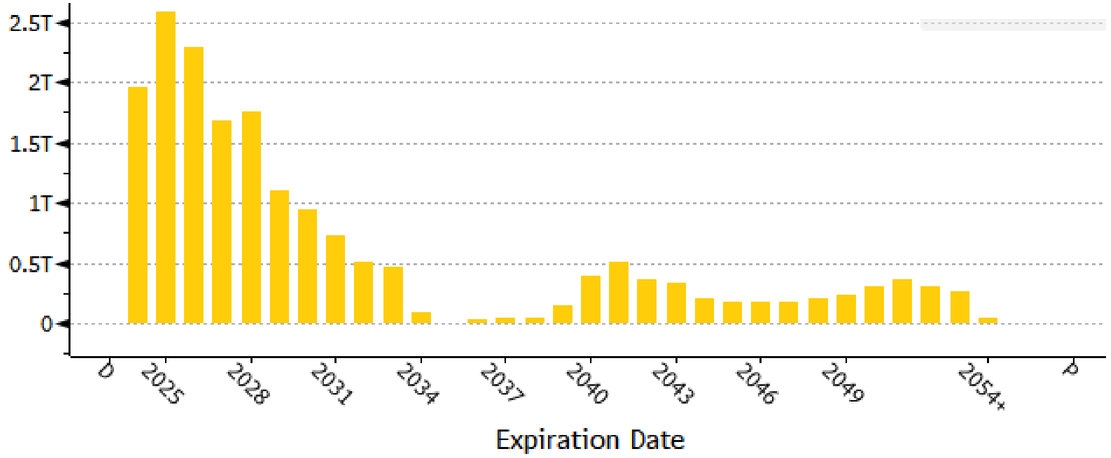
Core EU YoY CPI

- Global GDP growth is diverging, with the US showing resilience while the Eurozone, UK, and Japan face slower, weakening economic growth. This variance sets the stage for different central bank actions, particularly between the ECB and the Fed.
- Inflation trends reveal a nuanced picture: both the EU and US are seeing declines in core inflation, yet the US's reduction is slowing, suggesting enduring inflationary pressures.
- A closer look at US core CPI, excluding the significant housing component (~42% of the Core inflation component), reveals acceleration, underscoring the complex scenario the Fed navigates between robust GDP growth and persistent inflation.

US Fiscal policy



US Budget Deficit (upper graph) vs Unemployment rate (bottom graph), Bloomberg



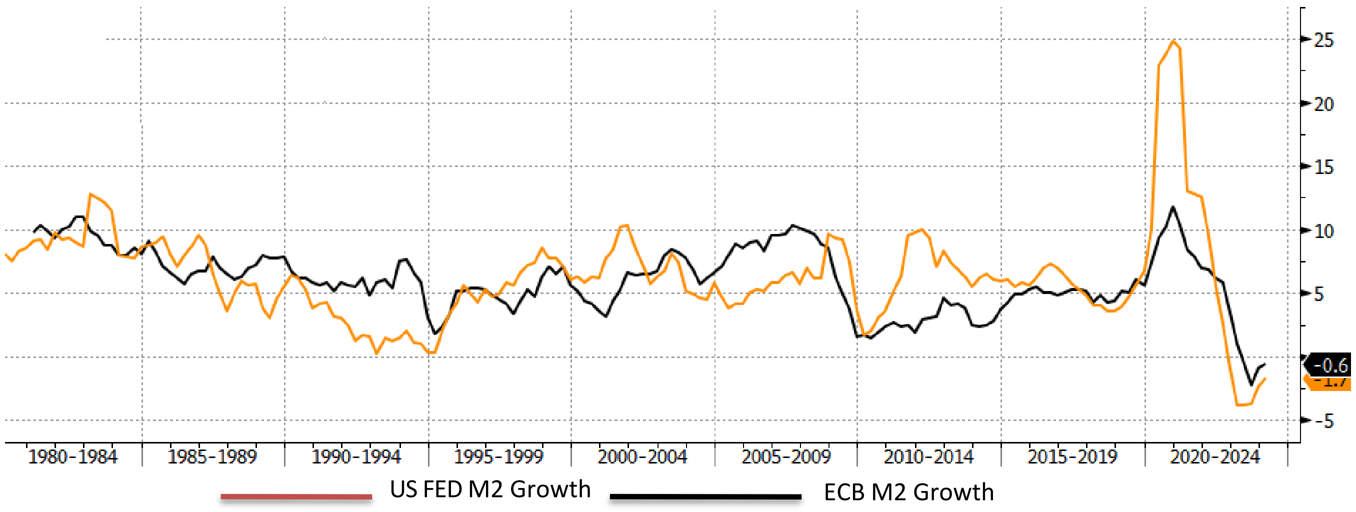
Distribution of US Government debt maturities, Bloomberg

- Expansive U.S. fiscal policies, including the Infrastructure Investment and Jobs Act and the Inflation Reduction Act, have contributed to a significant widening of the budget deficit. At current 6.4% level, the deficit was consistently observed since the period leading up to 2008.

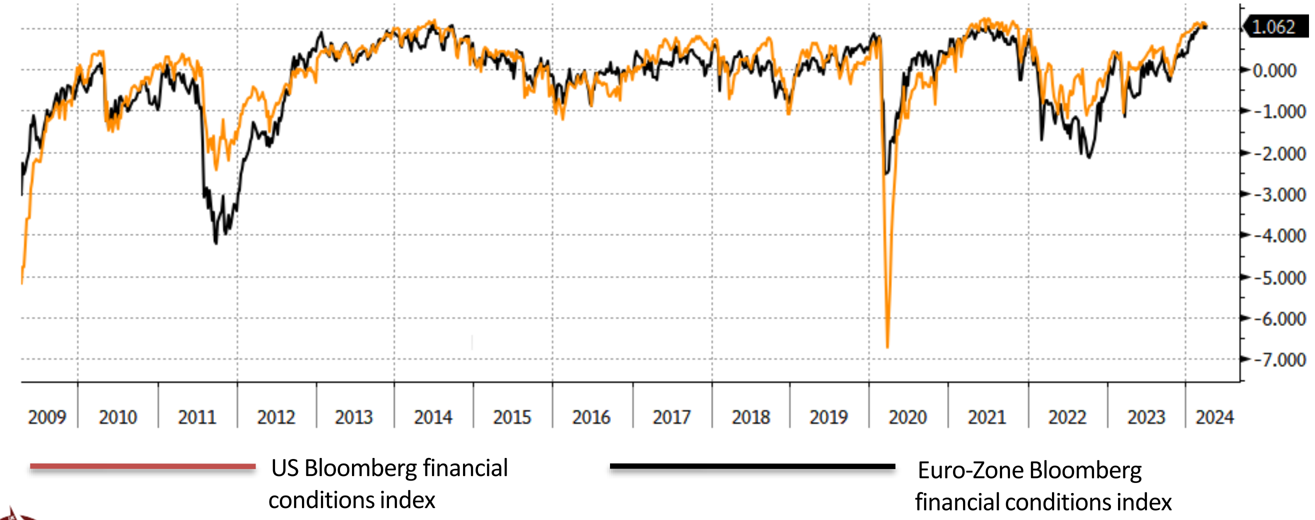
- This fiscal expansion, in the context of a low unemployment rate, carries potential inflationary pressures. This interplay between aggressive fiscal policy and a tight labor market complicates the Fed's inflation control strategies, potentially influencing the effectiveness and direction of monetary policy decisions

- Moreover, the U.S. faces the challenge of refinancing over $4.5 trillion in government debt within the next two years. The increase in government spending and a significant need for debt refinancing are expected to expand the supply of U.S. Government bonds substantially, exerting upward pressure on US government bond yields

Monetary policy

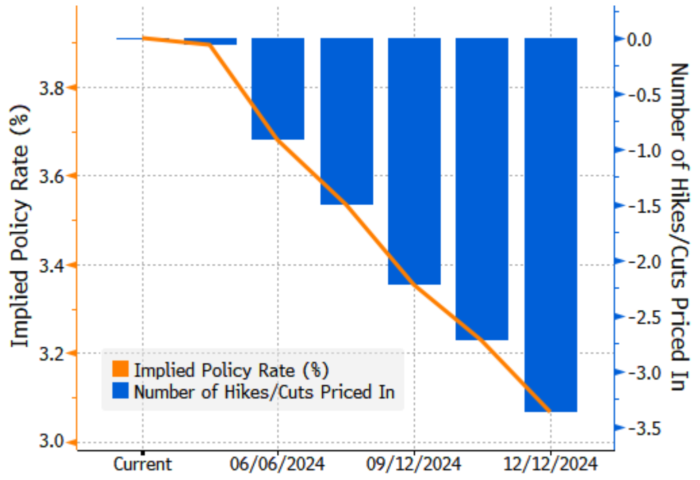


Following a prolonged period of easy monetary policy, central banks have made a significant U-turn towards Quantitative Tightening (QT). As a result, money supply aggregates have moved into negative territory, a phenomenon not previously observed according to available data.

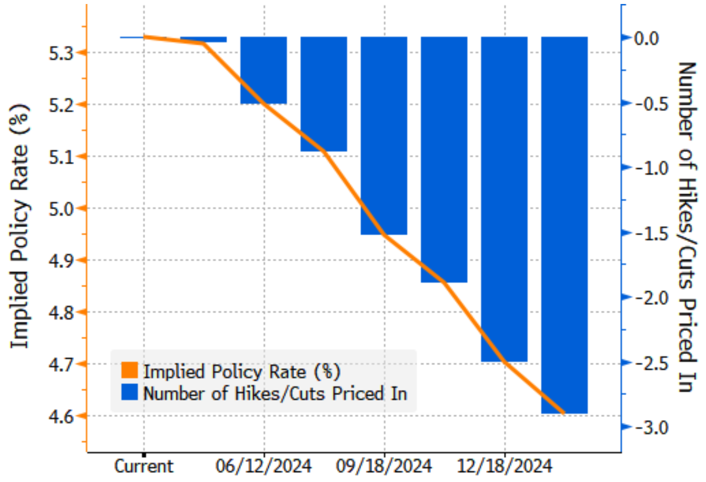


Despite this financial conditions in both Euro-Zone and US are extremely positive which supports enthusiasm for risky assets.

Forward interest rate & implications



Implied ECB policy rate as of 04/09/2024, source Bloomberg



Implied US FED policy rate as of 04/09/2024, source Bloomberg

Performance of selected asset classes 100 days before – 100 days after the first interest cut (since 1998)

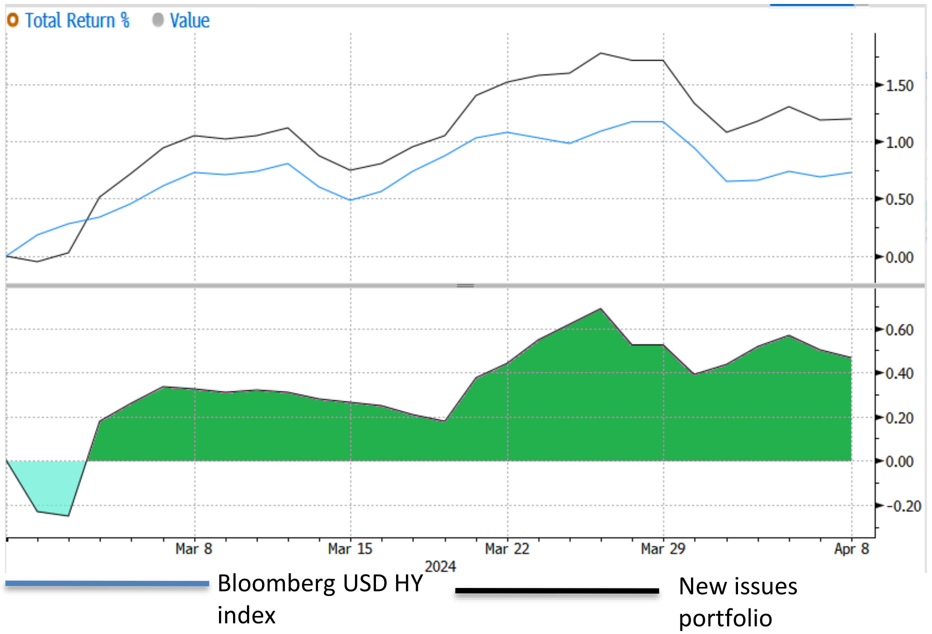
	Best case	Average	Worst case
S&P 500 INDEX	18,3%	-3,9%	-32,6%
Bloomberg US Corporate High Yield Bond Index	9,10%	-2,8%	-21,1%
Bloomberg US IG Corporate Bond Index	10%	4,3%	-2,6%

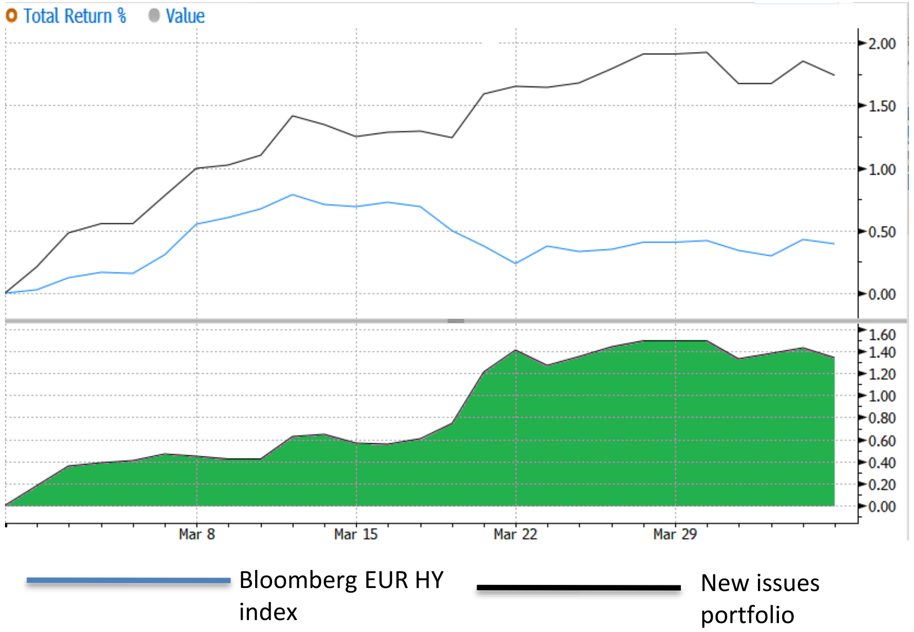
6 negative S&P performances out of 9

- The market data implies and it is widely expected that FED and ECB will cut rate ~3 times this year. It is not warranted as the Central Bank are data dependent and the pricing and expectations may change.

- History shows that in 6 cases out of 9 it was a negative sign for risky assets in general and HY bonds in particular. As rate cuts were driven by adverse economic environment.

New issues: Alpha generation opportunity





- In the recent years, the issuance of HY bonds was subdued due to unfavorable market conditions. As a result, there is a significant pent-up demand from issuers looking to release new bonds to refinance existing issues that are nearing their maturity. Now issuers are capitalizing on the rising market; however, they are compelled to offer a premiums, higher coupons, and better terms for investor protection in the deal structure.

- While new issuances aimed at replacing older ones are formally neutral for the credit quality of the issuing company, they often lead to an increase in prices due to the extension of maturity dates, confirmation of the company's access to the capital market, and investor confidence.

- This analysis underscores this strategy's validity in current market environment, showing that new issues can provide excess returns relative to the broad market indices in flat or even adverse market conditions.

Summary

- Tight spreads and a cautious stance by Central Banks suggest a challenging environment for the broad HY market going forward. Technical and fundamental factors indicate that tight spreads may persist for some time; however, even in this scenario, the potential for return upside appears limited.

- The state of the US HY markets demands caution due to tight technical factors and a less favorable central bank policy outlook. EUR HY, with its wider spreads, presents a relatively better opportunity despite weak economic growth and rising default rates.

- The near-historic low levels of HY spreads, coupled with high default rates, necessitate robust credit research and security selection, moving beyond reliance on a general 'risk-on' market sentiment.

- Capitalizing on new HY issuances can benefit alpha generation in the environment of a flat or slightly negative market, offering yield premiums and better protection in deals structures.

- The anticipation of the Central Banks’ rate cuts should be approached with caution. History demonstrates that rate cuts often precede broader economic challenges, which could negatively impact the performance of risk assets, including HY bonds. Additionally, the current inversion of the yield curve serves as an indication of the probability of a recession.

- Current geopolitical tensions, including 2 major military conflicts and US-China trade disputes, alongside supply chain disruptions, can increase costs, thus putting upward pressure on inflation. Moreover, these factors can elevate market volatility and impact HY markets. These dynamics necessitate a cautious approach, integrating geopolitical risk analysis into investment strategies to mitigate potential impacts on asset performance.

- For the 2024 outlook, the combination of the U.S. Presidential elections, political gridlock, possible U.S. Government shutdown, alongside substantial budget deficits and an increased necessity for U.S. government bond issuance, sets the stage for potential 'black swan' events.

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