US High Yield 3Q2023 Outlook

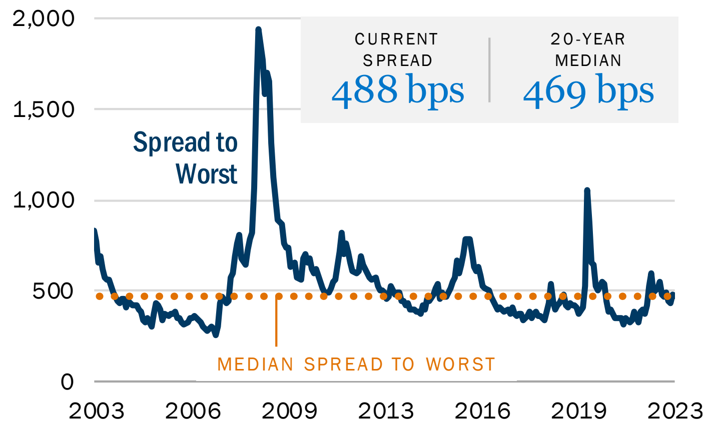
If interest rates continue to increase, we maintain the U.S. high-yield market is better positioned than most fixed-income asset classes due to its higher spreads, bigger coupons and shorter maturities.

High-yield returns have usually been positive during previous rising interest rate environments because of the correlation between rising rates and economic growth. However, today's high-yield market is clearly more vulnerable to rising interest rates than it has been historically, as overall credit quality has improved and coupons have shrunk.

On a more positive note, credit trends in the U.S. high-yield market remain stable. The quality of high-yield bonds has improved significantly in the past decade. As of December 31, 2022, the ICE BofA U.S. High Yield Index now comprises 50% BBs (on a par value basis), up from 43% at the end of 2011. At the same time, CCCs have declined to 12%, down from 18% since the end of 2011. (BBs' percentage of the market did decline modestly in 2022, from 54% in 2021, due to the significant volume of bonds that were upgraded to investment grade and exited the high-yield market).

Moreover, the U.S. High Yield market leverage is at its lowest level in 10 years, and interest coverage of 3.5x is higher than the 10-year average of just 2.2x (Source: JP Morgan). The largest high-yield issuers today are generally large publicly traded companies; according to JP Morgan, 69% of the U.S. High Yield market has publicly traded equity.

FIGURE 1: US HIGH YIELD MARKET SPREADS



As of May 31, 2023
Index: ICE BofA US High Yield Index
Past Performance is not indicative of future results. It is not possible to invest directly in an index. See disclosures for index description.
Source: ICE Data

Even if the U.S. economy heads into a recession, we believe it is unlikely that default rates will spike far above historical norms. Valuations are more expensive after the recent rally but far from excessive in our view. The current spread of 449bps is now tighter than the historical average of 469bps and toward the middle of the "non-panic range" of 350-550. We would expect spreads to remain in this range absent any significant change in market risks.

Given these factors, we are positioned relatively defensively from a credit quality perspective, focused on shorter duration, higher quality bonds.

There are many risks in financial markets today; however, stable fundamentals and reasonable valuations suggest that U.S. high yield continues to represent a reasonable, lower duration fixed-income investment option.

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About Risk: High yield securities (junk bonds) have speculative characteristics and present a greater risk of loss than higher quality debt securities. These securities can also be subject to greater price volatility.

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The following indices may be referred to in this document:

ICE BOFA US HIGH YIELD INDEX

The ICE BofA US High Yield Index tracks the performance of U.S. dollar denominated below investment grade corporate debt publicly issued in the U.S. domestic market. The ICE BofA US High Yield Index tracks the performance of U.S. dollar denominated below investment grade corporate debt publicly issued in the U.S. domestic market. Qualifying securities must have a below investment grade rating (based on an average of Moody's, S&P and Fitch) and an investment grade rated country of risk (based on an average of Moody's, S&P and Fitch foreign currency long term sovereign debt ratings). In addition, qualifying securities must have at least one year remaining term to final maturity, a fixed coupon schedule and a minimum amount outstanding of $100 million. Original issue zero coupon bonds, "global" securities (debt issued simultaneously in the eurobond and U. S. domestic bond markets), 144a securities and pay-in-kind securities, including toggle notes, qualify for inclusion in the Index. Callable perpetual securities qualify provided they are at least one year from the first call date. Fixed-to-floating rate securities also qualify provided they are callable within the fixed rate period and are at least one year from the last call prior to the date the bond transitions from a fixed to a floating rate security. DRD-eligible and defaulted securities are excluded from the Index.

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