HIGH YIELD | NAVIGATING THE CURVE | OUTLOOK

2024 Outlook: High Yield Bonds

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Higher Volatility in 2024 May Present Attractive Entry Points for High Yield Bonds

KEY POINTS

1. As global central banks near the end of a historical cycle of tightening monetary policy, we believe a moderate recession is a more probable outcome in 2024.
2. Increasing dispersion in valuations across rating segments, sectors and individual issuers will continue to provide opportunity and the ability to capture attractive entry points.
3. We have maintained our cautious positioning and continue to prefer defensive sectors that trade wide of historical norms, such as health care, given the sector's historically defensive characteristics.

What We Are Seeing

The high yield market continues to benefit from a historically attractive yield that compensates investors for a "higher quality" market based on credit quality and a record level of secured issuance. However, our outlook remains somewhat cautious as we approach 2024. As global central banks near the end of a historical cycle of tightening monetary policy, we believe a moderate recession is a more probable outcome in 2024, as the Federal Reserve (Fed) maintains a higher for longer stance and patiently observes the effects of tighter financial conditions rippling through the broader economy.

In high yield, average corporate fundamentals are starting from a place of relative strength. However, we have witnessed notable softening in 2023, as revenue and EBITDA (earnings before interest, taxes, depreciation and amortization) growth have fallen, resulting in higher leverage and lower interest coverage levels. We expect these metrics to remain under pressure, as slowing growth is further reflected in corporate earnings. Elevated idiosyncratic risk is contributing to greater dispersion in valuations, increasing measures of distress and an escalation in default activity. Dispersion and distress will likely increase further, as the volume of maturing bonds present a need for refinancing. While refinancing at current market yields presents only moderate challenges for the BB-rated cohort, it presents a far greater challenge for the typical CCC-rated bond, where the average coupon is 7.45% and the average yield-to-worst is 14.54%.[1]

Primary issuance increased marginally in 2023, with a clear focus on refinancing and a preference toward the issuance of secured bonds. We expect this activity to accelerate in 2024, as companies address maturing capital structures and utilize all tools at their disposal to achieve the lowest possible cost of capital.

What We Are Watching

Increasing dispersion in valuations across rating segments, sectors and individual issuers will continue to provide opportunity and the ability to capture attractive entry points. We believe prudent credit selection will be rewarded and enable investors to avoid value traps in the upcoming year.

Wider peak spreads appear inevitable given heightened levels of uncertainty due to an upcoming U.S. election year, continued potential for a U.S. government shutdown, geopolitical conflict and the impact of tightening financial conditions on the health of high yield issuers. An unexpected pick-up in inflation resulting in upward pressure on yields presents an additional risk.

What We Are Doing

We have maintained our cautious positioning and continue to prefer defensive sectors that trade wide of historical norms, such as health care, given the sector's historically defensive characteristics and average spread that ranks in the widest quartile relative to the trailing 10-year period. We are underweight most cyclical sectors given where we are in the economic cycle coupled with generally uncompelling valuations.

Despite the beta-led compression we've witnessed throughout most of 2023, we expect the inevitable return of volatility where prudent credit selection will be rewarded and the ramifications of reaching for riskier yield will be punitive.

As always, we are mindful that the higher volatility will present attractive entry points and we stand ready to add risk in a disciplined manner when opportunities arise.

[1] ICE BofA. As of November 20, 2023.

Risk Considerations: *Investments in income securities may be affected by changes in the creditworthiness of the issuer and are subject to the risk of non-payment of principal and interest. The value of income securities also may decline because of real or perceived concerns about the issuer's ability to make principal and interest payments. An imbalance in supply and demand in the income market may result in valuation uncertainties and greater volatility, less liquidity, widening credit spreads and a lack of price transparency in the market. As interest rates rise, the value of certain income investments is likely to decline. Investments rated below investment grade (typically referred to as "junk") are generally subject to greater price volatility and illiquidity than higher rated investments.*

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