

» *High Yield Bonds: Outlook for 2022*

High Yield Portfolio Management Team
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HY outlook 2022: In many ways, a repeat of 2021 looks likely

Executive summary

- **The global pandemic** will continue to play a role in 2022, but less so than 2021
- **Valuations** do not leave much room for spread tightening (the emerging markets complex is an exception but timing is important), we also do not see much reason for more than marginal widening in 2022
- **Default rates** will likely increase off their historical lows, but, at around 1%, remain at exceptionally low levels in context
- **Key risks** include setbacks due to Covid-19, more aggressive central bank tightening than envisioned, and the always important energy sector

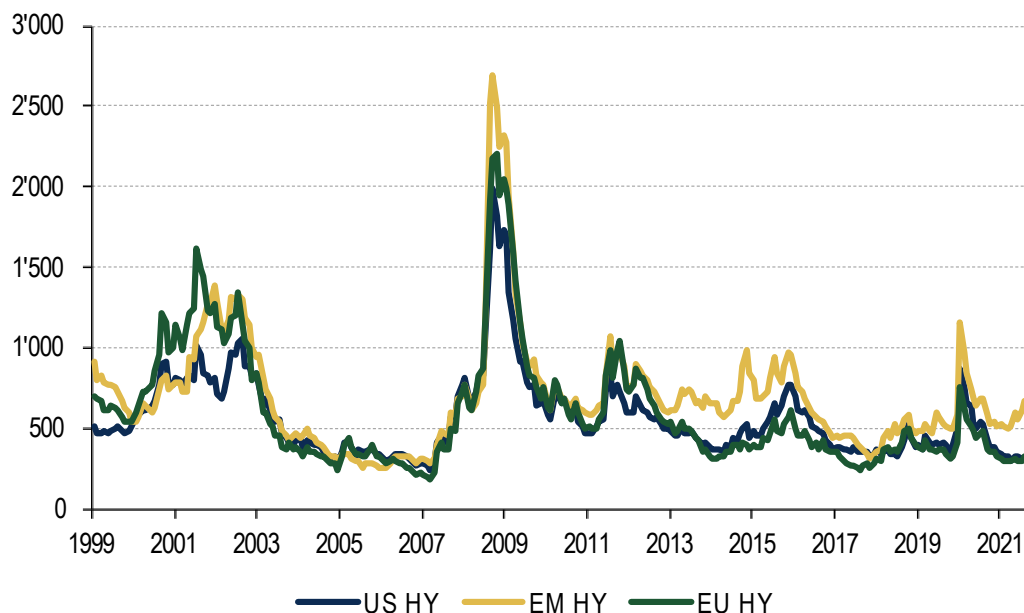
Review: We expected high yield to return low-single digits (for non-USD investors) in 2021 and that proved to be correct. Why?

- **Global pandemic:** Especially for the first half of 2021, we expected continued support from fiscal and monetary policy to dampen volatility, and, absent setbacks in the battle against Covid-19 or any new unexpected crisis, we expected spreads to tighten. We were anticipating a return to a more “normal” world in the second half of the year.
Reaction: We would say that our expectations here were pretty close to the actual path, and we were positioned accordingly, including increasing our CCC exposure, even though our weighting remained below benchmark level.
Impact: Outside of the Chinese property sector, volatility was extremely low and spread tightening occurred as expected. CCCs outperformed, which cost us some performance but through strong security selection in the segment we were able to minimize the overall impact.
- **Energy:** Our view was that the then current level in oil prices would likely persist, despite any expansion in the global economy post the pandemic. Also due to ESG considerations, including fears of stranded assets, many of these companies would face greater difficulty in accessing capital markets. We expected natural gas prices to remain volatile but benefit from potentially better underlying support than oil prices.
Reaction: We were off the mark when it came to oil prices, as we witnessed a relatively continuous and sustained rise in oil prices through 2021 as demand rose more quickly than envisioned, with limited supply growth. We were somewhat better at forecasting natural gas prices but we did not foresee the spectacular price jump, especially in Europe. Due to the rise in prices, issuers have in general not had difficulties accessing the capital markets.
Impact: The energy sector has seen by far the best returns of any sector, cementing its position as the largest of its peer group. We increased our exposure to the sector throughout the year so that we have maintained an overweight position on average. Given the additional influence of rewarding security selection, the energy sector has proven to be a key driver of our outperformance in 2021.
- **Valuations:** Our forecast was that the receding tail risk from the pandemic and a reach for yield, given the persisting low interest environment, should lead to further spread tightening in 2021. We therefore preferred Bs over CCC as we thought the compression in CCC had already been very substantial.

Reaction: We were correct in expecting spreads to tighten in 2021 as risks in general declined. We were partially correct in assuming that investors would reach for lower-rated credits, but CCCs did in fact outperform, and B-rated credits underperformed as a whole, but that underperformance was mainly driven by Chinese property, which was a sector comprised of companies that largely had B-ratings.

Impact: Due to our belief that spread tightening would occur, we increased the risk in our portfolio, including increasing our CCC-weighting, although we generally stayed at a neutral or slightly below-average risk level and retained an aggregate underweight to CCCs throughout. That positioning cost us some performance, but security selection in the B and CCC categories helped to minimize or completely offset those negative effects.

Figure 1: Development of high yield credit spreads across major regions (basis points)



Source BAML; November 2021

- **European vs. US high yield:** We had a slight preference for European high yield going into 2021. In our opinion, European high yield had slightly more room in terms of spread compression after the pandemic compared to the US.

Reaction: US high yield modestly outperformed its European peers on the back of outperformance in CCCs and energy, which have much higher weightings in the US.

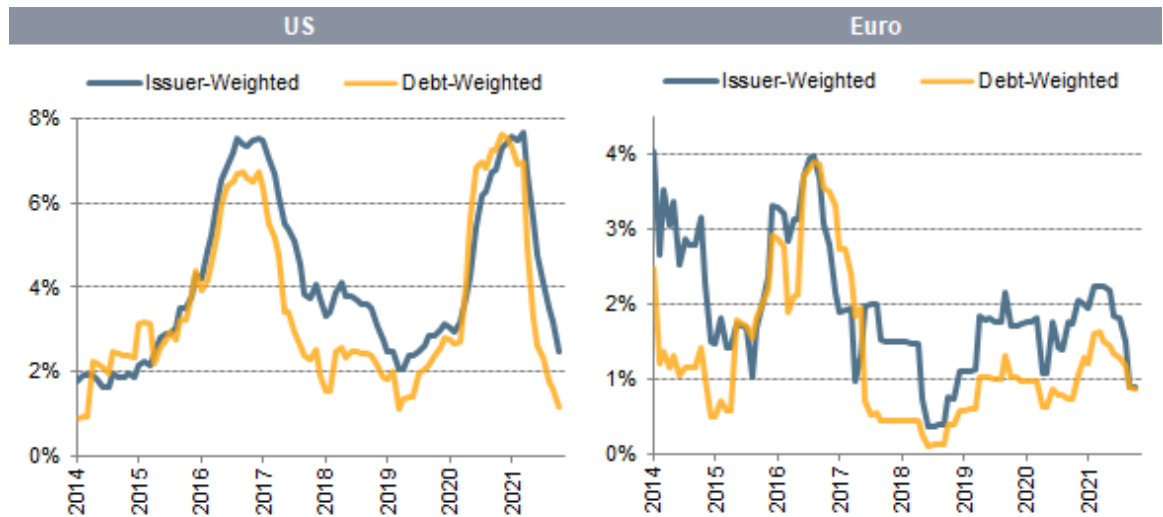
Impact: We increased our weighting throughout the year to US high yield so the effect on our strategy was quite limited.

- **Default rates:** We expected default rates to decrease relative to the high level caused by the pandemic and move closer to their long-term average of around 4%. However, we believed they would not decline meaningfully below long-term averages for some time, as companies could struggle with their capital structures coming out of the pandemic. This was especially true for the energy sector, which had suffered from persistent low energy prices.

Reaction: Default rates did decline, but much more quickly and substantially than we expected, and will end 2021 under 1%, which will be close to all-time lows.

Impact: The record-low default rate and the outlook for a continued low default rate supported the move toward lower spreads as already described.

Figure 2: High yield LTM default rates



Source CreditSights, ICE BofA HY Indices

- **Technical:** Our expectation was that both gross and net supply would be lower. Nonetheless, although lower than 2020, we expected supply to remain robust in 2021.

Reaction: Supply hit record highs on all levels in 2021 as government bond yields and spreads stayed low. The market also experienced outflows, which in theory should have put some pressure on valuations.

Impact: The high yield market shrugged off this technical factor, confirming again that supply and flows are generally not good predictors of performance for the asset class. More importantly, the record supply was helpful for issuers to refinance their debts at low interest rates, which helped support low default rates.

We expect 2022 to again return low single digits (for non-USD investors), but volatility to be much higher than 2021.

- **Global pandemic:** We expect the global pandemic to have less impact in 2022 as vaccination rates are high, booster shots are rolled out, and further treatment options are approved. Nonetheless, new mutations could at times cause disruptions, especially to the travel industry, and potentially affect supply chains. We also expect, as the situation normalizes, that investors will focus on the changes that have become permanent to determine winners and losers as a result of changed behavior.
- **Inflation:** We published a paper (*“High yield bonds and inflation: Certainly not a deal-breaker”*) earlier in 2021, where we outlined that higher inflation is generally not a concern for the high yield market. Although we continue to believe that inflation will be higher than average versus the recent path (although declining versus H2 2021), we do not view it as a major impediment for our asset class. The risk from high inflation remains that central banks are forced to become much more aggressive with monetary policy, slowing the economy too much, and that would be a catalyst for wider spreads. This, along with the risk of higher interest rates, could weigh on returns in the high yield market.
- **Energy:** Energy remains a major topic for our strategy due to the weighting of the sector. Energy prices, both oil and natural gas, have exceeded our expectations in 2021, but the outlook remains

favorable for both. We can though envision natural gas prices moving lower in 2022, but still averaging healthy levels, while oil prices could prove more volatile. Nevertheless, we would expect average oil prices to remain significantly above USD 60/barrel. Anything above that level should provide more than adequate support to the energy sector. ESG is another driver for the sector, and we expect there to be a greater focus from investors on issuers in segments such as arctic drilling, oil sands, or issuers that do not reduce methane emissions. The ratings upgrades we anticipate provide a further element of our positive view on the energy sector for 2022, but clearly valuations are not as attractive as they were a year ago.

- **Default rates:** We would expect default rates to increase slightly in developed markets from historically low levels in 2021 of under 1%. However, we would be surprised if they increased to meaningfully more than the 1% level as issuers have strong earnings, moderate leverage, and favorable maturity profiles. Emerging markets, especially Asia, will have higher default rates than developed markets, but the overall default picture remains generally supportive for the high yield market.
- **Valuations:** Spreads in developed markets are in the low 300 basis points range, which, while not leaving much room for spread compression, reflect the low default rate environment as well as leverage that is, for most issuers, toward historic lows. We expect spreads to end next year modestly wider, stripping out the impact from a large cohort of 'Rising Stars'. Emerging markets have more compelling valuations after underperforming in 2021 due to the Chinese real estate sector as well as reflecting country-specific problems, such as those in Turkey and Argentina. While we believe emerging markets will provide attractive opportunities in 2022, timing will be key. In terms of European high yield versus US high yield, we are broadly indifferent.
- **Technical:** Our belief is that the supply of new issuance will be smaller than the record year we experienced in 2021. Nonetheless, we would expect supply to remain at a relatively high level. Demand for high yield should remain relatively strong as the fundamental outlook remains favorable, and, due to low yields, investors are forced to add credit risk in order to meet return targets. For especially USD BB-credits, a recent change by the insurance regulator in terms of more favorable capital treatment for investments in that category should also prove a tailwind. More importantly, we would expect the high yield market to shrink in 2022 as, following the wave of Fallen Angels in 2020, we expect a record volume of Rising Stars in 2022 (some forecasts are for up to a 10% decline in the size of the high yield market.) That trend began to materialize in late 2021 and should provide a meaningful positive impact on the asset class in 2022.

Conclusion

We expect high yield to again generate a positive, low single-digit return for non-USD investors in 2022. The fundamental backdrop is extremely supportive with low defaults, but valuations do not really leave room for much further narrowing in spreads. In fact, we forecast a modest widening in spreads as the fundamental outlook becomes slightly more challenging, even if it remains broadly favorable. We can see a few risks, but do not foresee those risks having a major impact on the high yield market in 2022.

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