Bellerive 241 | P.O. box
CH-8034 Zurich
info@fam.ch | www.fam.ch
T +41 44 284 24 24

»Outlook 2023
High Yield Bonds

December 2022

Marketing material

Kyle Kloc
Head Developed Markets

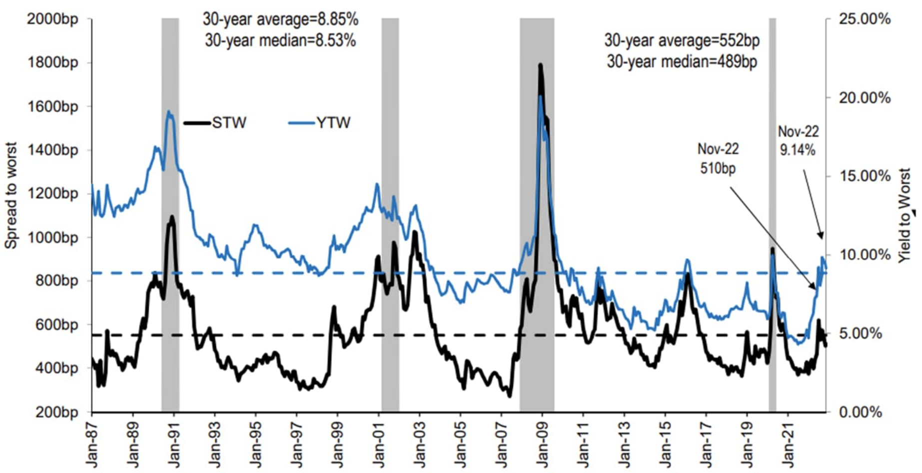
Executive Summary

- High yield bonds suffered their second-worst year on record in 2022, despite the continued low default rates as higher interest rates, the Russian invasion of Ukraine and substantially wider spreads took their toll as the limited carry could only provide a modest offset to those losses
- Spreads should move toward 700 bps in the coming months due to a likely recession, and default rates will continue to move higher and closer to their long-term averages before potentially falling in the second half of 2023
- After a year with extremely limited refinancing activity, new issuance is likely to pick up substantially, but riskier credits will continue to struggle to obtain new financing
- The normalisation of monetary policy (i.e. more normal interest rates) should lead to a high yield market over time more similar to the period from prior to the GFC than in the past 15 years

Review of 2022

High yield has seen by far the worst calendar year of all time in 2022, with the exception of the financial crisis in 2008. Returns have been influenced predominately by significantly higher yields on government bonds as central banks raised interest rates extremely quickly, by spreads widening from 300 bps to 550 bps, and default rates moving up from their rock-bottom levels (with the exception of emerging markets, where default rates already began increasing in 2021 and continued their march higher in 2022).

Chart 1: Development of high yield spreads and yields



Source J.P. Morgan

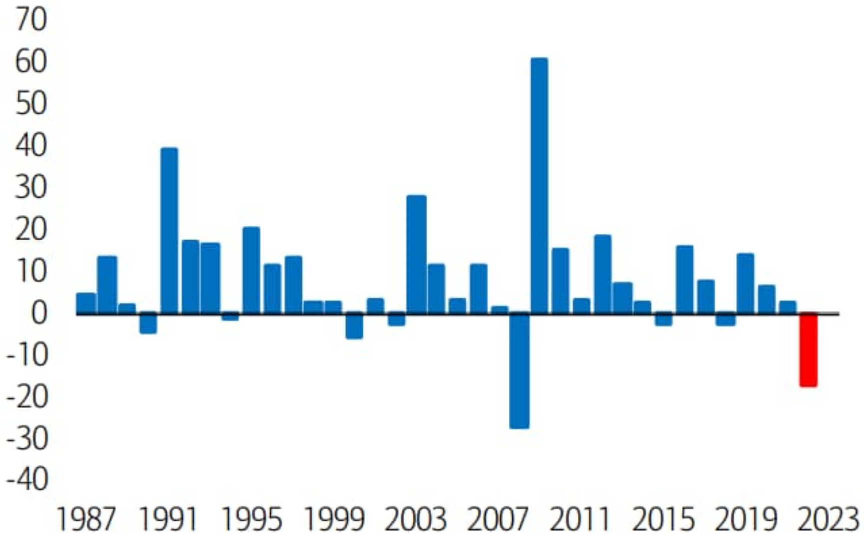
» Strong macro calls and security selection were the main drivers of outperformance.

Our Global High Yield strategy performed substantially better than the market (200 bps+) in 2022 due to certain strong macro calls and supported by strong security selection. First, the strategy avoided any direct exposure in Russia and Ukraine due to unattractive risk-reward profiles and in addition maintained a sizeable overweight to the energy sector, which was the strongest sector due to the disruptions in energy markets from the invasion. The strategy also maintained its sizeable underweight in Chinese property developers, another very weak segment, and reduced over the course of 2022 its positions in CCC-rated bonds, which also underperformed significantly, especially as the year wore on. At the same time, recession fears, rising interest rates, and substantial outflows from the asset class led to a more difficult environment for issuers to secure new financing so that new issuance volumes dropped precipitously. In light of that environment, we looked to take advantage of various idiosyncratic stories, which ended up supporting performance. Another bright spot was the record amount in 2022 of Rising Stars, whose identification is a consistent focus for the strategy and also buttressed performance.

Outlook 2023

We expect 2023 returns in high yield to be in the mid-single digit positive range (in EUR hedged). Negative returns in consecutive years would be a first, although not completely out of the question, considering the cause of negative returns in 2022 being predominately driven by higher rates.

Chart 2: 2023 shaping up to be a lot better for HY returns (%)

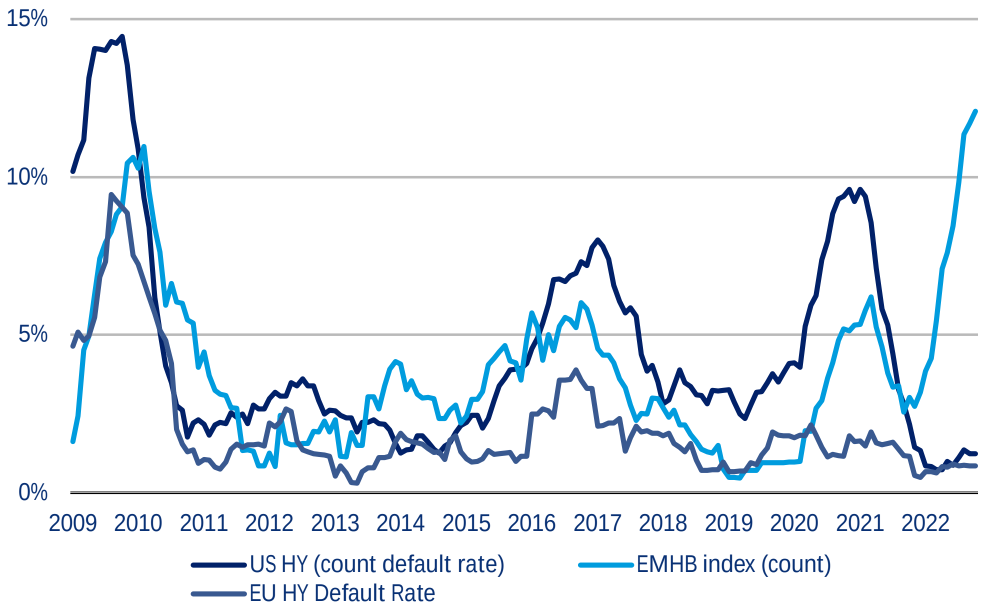


Source ICE Data Indices, BofA Global Research

We expect the first half of 2023 to be a more challenging one from the perspective that many issuers will face falling earnings due to weak (or negative) economic growth and inflationary pressures. This effect will lead to weakening fundamentals to at least start the year and likely be reflected through increased downgrades.

The second half of the year should prove better on the earnings front, but default rates will likely continue to increase over the course of 2023. US and European default rates will likely increase to around 4%, whereas EM default rates are expected to remain around 10% due primarily to further defaults in Chinese property.

Chart 3: Development of US, EU and EM high yield default rates



Source ICE Data Indices, BofA Global Research

One reason we expect default rates to not increase rapidly is that issuers still have a relatively benign maturity schedule in 2023, and the inability to pay off or refinance maturities remains one of the leading causes of default.

After a dreadful year in new issuance in 2022, we expect activity to pick up in 2023 as despite significantly higher coupons versus existing debt, many issuers will want to refinance debts as 2024 gets closer and will be forced to return to the market, if available. We believe, however, that the riskiest issuers (e.g. many CCC-rated issuers) will nonetheless face difficulties obtaining financing in the market, and even if theoretically available, many issuers could not afford to pay those high interest rates.

» We expect further Rising Stars, mainly in the energy sector.

We also believe that the volume of both Rising Stars and Fallen Angels will also increase or remain at high levels in 2023. That may seem like a contradiction, but it is driven by two separate factors so that helps to square the circle. 2020 saw a record amount of Fallen Angels and although many of them were upgraded again in 2022, we expect further significant upgrades in 2023, especially in the energy sector, but also a large issuer from the automotive sector. On a side note, these changes will likely reduce the weight of energy from the index, although due to the large gap between energy and the second-largest sector, we still expect energy to remain the largest sector. Fallen Angels will likely increase as a result of falling earnings in light of the weaker economic outlook and higher interest costs as a result of increased interest rates and spreads.

Overall, this leads us to expect that the market will experience much lower volatility in 2023 than 2022; however, on an individual security level dispersion will increase as is usually the case when the fundamental outlook between credits diverges. We believe this is an optimal environment for credit selection but will also require the need to reposition portfolios as the year progresses. We think investors will return to the high yield market in 2023 after the market suffered significant outflows in the last two years.

» We prefer a defensive bias to start the year.

In our opinion, it makes sense to be somewhat defensively positioned to start the year from an overall risk standpoint, but also by limiting exposure to volatile, high-risk cyclical sectors like retail and real estate, as well as to CCC-rated issuers. Instead, we prefer to start the year with a bias towards defensive sectors like energy, telecom, and healthcare and towards higher-rated credits, but expect to need to change that positioning as the year progresses to reflect a more attractive environment. Regionally, we do not have a strong preference for Europe or the US but start the year still a bit more cautious on EM, predominately due to China. Timing is of course always very difficult so that remains one of the greatest risks to our forecast. If inflation remains high, however, we could envision a scenario where economic weakness lasts longer, which could prevent the rebound in the market which we expect later in the year.

Conclusion

Overall, we believe we are in the beginning of a return to a more normal credit environment, which means default rates are higher and spreads are not ultra-low, especially as central banks need to expunge the scourge of inflation. For investors though, this is not a bad environment as decent returns are available, but security selection becomes more important. Returns will be primarily driven by carry ultimately, with the latter half of the year likely proving more attractive than the first half.

Disclaimer