PUBLIC FIXED INCOME

High Yield

Market Review and Outlook

June 30, 2022

Bloomberg US HY Index	2Q 2022 Return	YTD 2022 Return	OAS 6/30/2022 (bps)	QTD OAS Change (bps)	YTD OAS Change (bps)	YTW 6/30/2022	YTD Yield Change (bps)	YTD Yield Change (bps)
High Yield	-9.83%	-14.19%	569	244	286	8.89%	288	468
BB	-8.43%	-13.86%	404	172	210	7.24%	224	394
B	-10.76%	-13.91%	631	289	318	9.53%	326	496
CCC	-12.98%	-16.35%	1043	418	494	13.6%	457	681

Bloomberg LP, Barclays

HY Market Review:

During the second quarter of the year, volatility and uncertainty remained high as investors continued to manage through a challenging macro environment. Inflation persisted at elevated levels, with year-over-year CPI reaching a high of 8.6% in May. The Fed maintained its hawkish stance and raised their target rate 50 basis points in May and an additional 75 basis during the June FOMC meeting. The 10-year Treasury yield started the quarter at 2.34%, reached a high of 3.47% prior to the June meeting, then rallied to end the month at 3.01%.

US High Yield ("HY") suffered its worst first half performance on record, with the Bloomberg US High Yield Index generating a total rate of return of -14.19%. June was the second worst month of performance since March of 2020 (-6.74%)[1].

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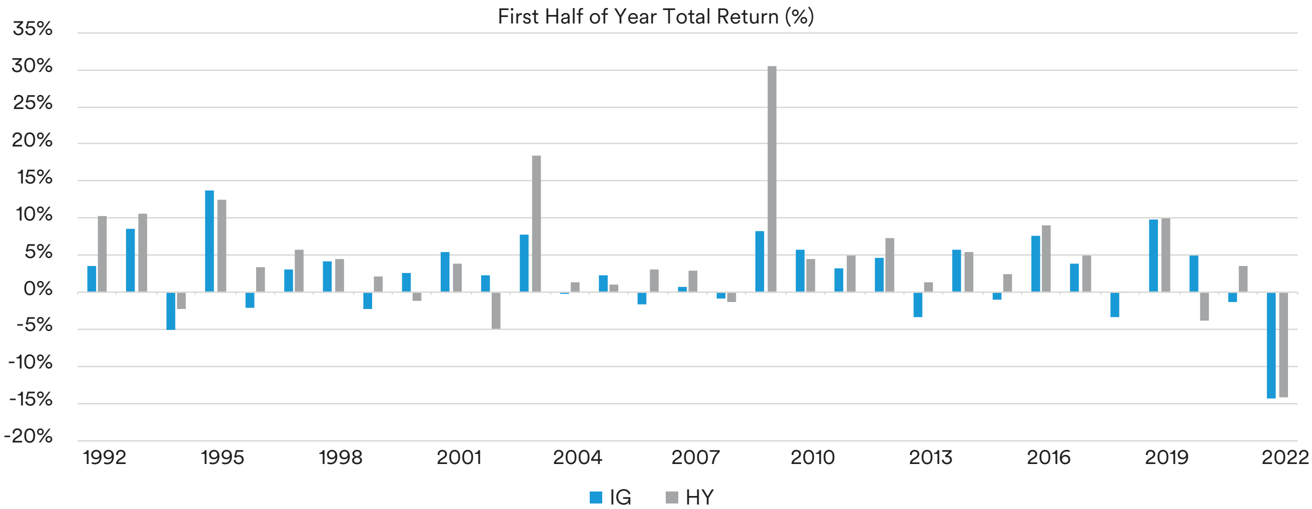
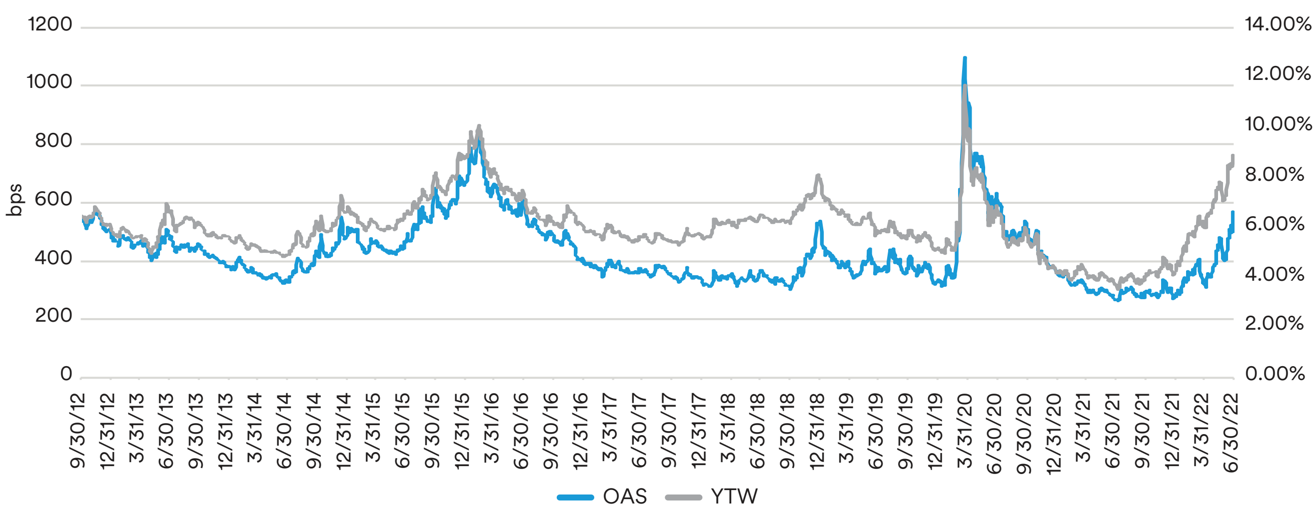
Figure 1 | High Yield vs Investment Grade First Half of Year Total Returns



Source: Barclays

After modest spread widening in the first quarter, HY spreads widened 244 basis points in the second quarter to end at 569 basis points. HY spreads are 286 basis points wider on the year and in line with their long-term historical average. HY yields have also experienced a meaningful adjustment this year. Yields increased 288 basis points in the quarter to end June at 8.89%. As of Q2, HY yields are 468 basis points wider on the year, and about 100 basis points cheap to their long-term historical average.[2]

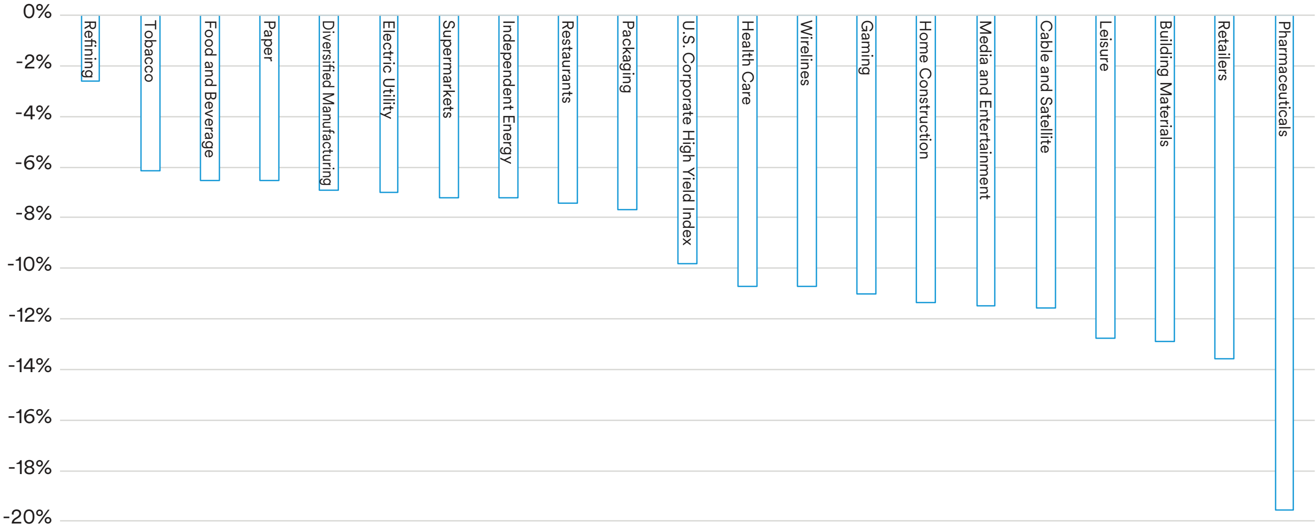
Figure 2 | Bloomberg US HY Historical Spread and Yield



Source: Barclays

Higher quality bonds outperformed during the quarter as investor concern shifted more to credit risk in a potentially slowing economy. The BB index declined -8.43%, the B index was down -10.76%, and the CCC index returned -12.98%. All sectors had negative returns for the quarter. Cyclical sectors underperformed in the quarter as recession fears escalated. Retailers (-13%), Building Materials (-12.9%), and Leisure (-12.8%) were the worst performing cyclical sectors[3].

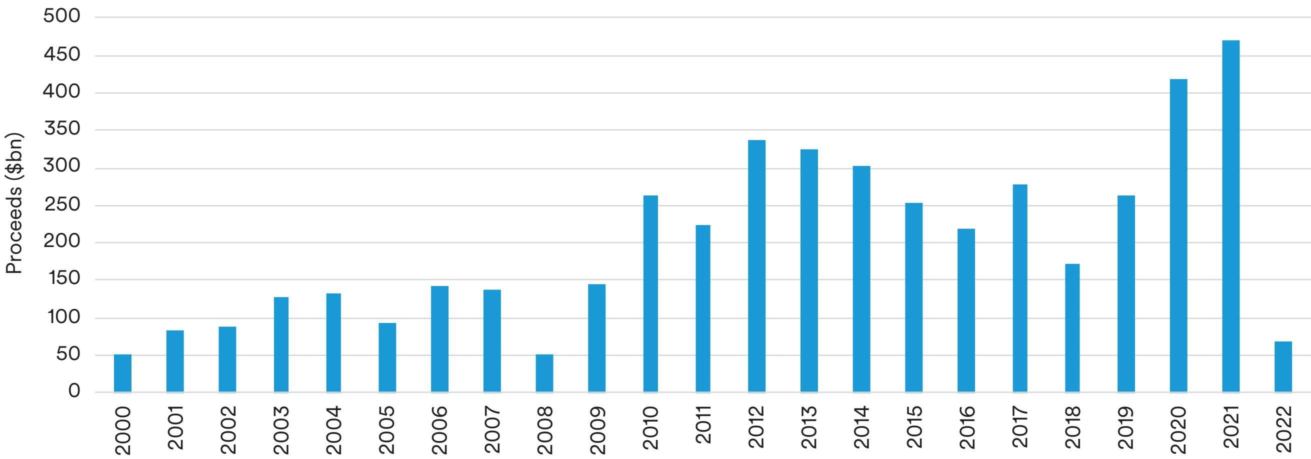
Figure 3 | 2Q22 Top/Bottom Performing Sectors



Source: Barclays

HY issuance remained extremely light again this quarter amid higher yields and increased market volatility. The last five month's activity represents the lightest stretch of issuance since August 2011. Year-to-date issuance of $71 billion is down 76% from first half 2021 levels. We saw private debt step in and take down deals that otherwise would have come through the public universe[4].

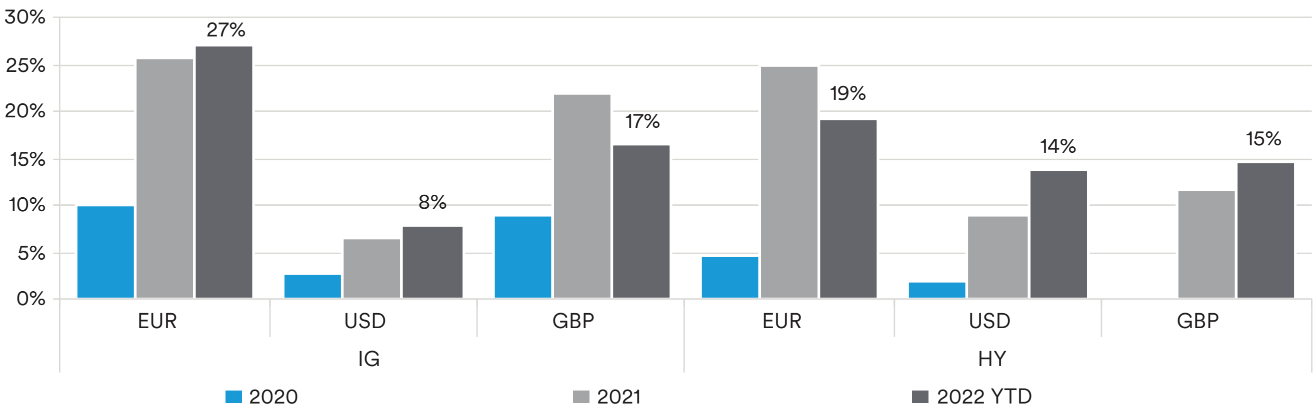
Figure 4 | US High Yield Annual Supply



Source: Bloomberg Indices, Barclays Research

In conjunction with the slowdown in generic primary market activity, global ESG bond supply cooled during the second quarter with $86 billion of new volume vs $126 billion in the first quarter. This decline was largely driven by the slowdown in total corporate issuance. The percentage of all new deals with an ESG label actually increased vs 2021. In the US HY market specifically, the amount of ESG-labelled issuance as a percentage of total corporate supply increased from roughly 9% in 2021 to 14% year-to-date in 2022.

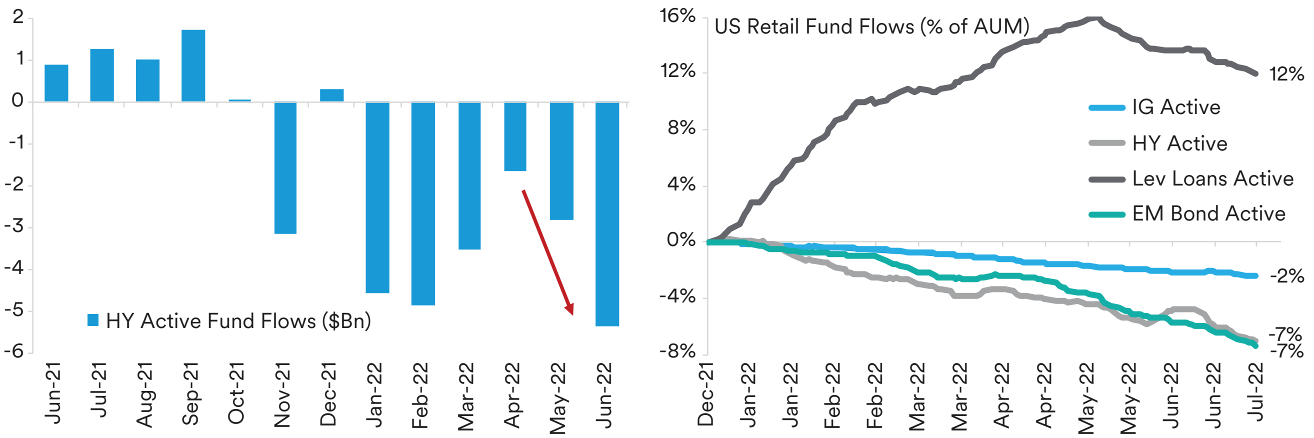
Figure 5 | ESG Labelled Issuance



Source: Dealogic, Bloomberg LP, Barclays Research

HY flows remained negative in the second quarter and outflows reaccelerated in June. Year-to-date outflows have reached -$42.1 billion with outflows representing 7% of HY retail active funds AUM[6].

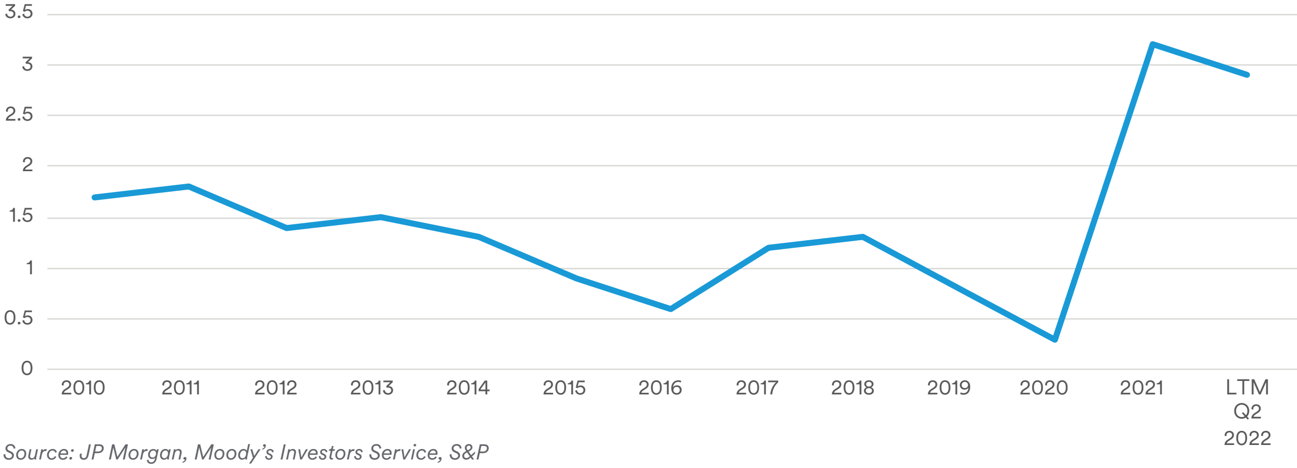
Figure 6 | HY Flows



Source: Credit Suisse

The upgrade trend and rising star momentum that the HY market experienced post Covid remains healthy but is showing signs of slowing. Upgrades continue to outpace downgrades by a ratio of almost 3x on a dollar basis but is showing signs of slowing. Rising stars continue at a healthy pace but in June we saw the largest volume of fallen angels since 2020.

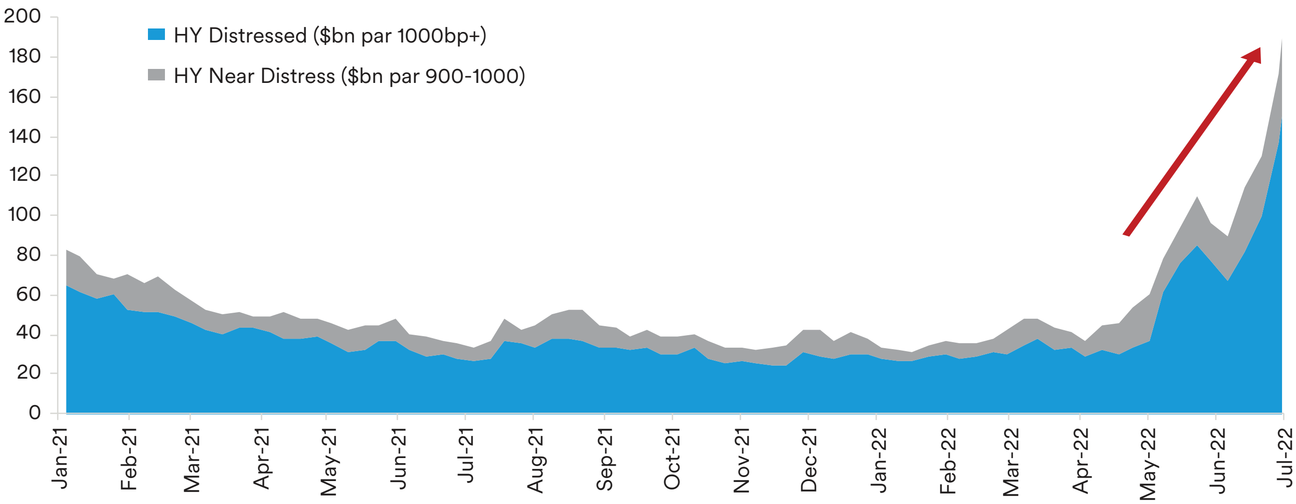
Figure 7 | HY Upgrade/Downgrade Ratio



Source: JP Morgan, Moody's Investors Service, S&P

HY markets are seeing a rise in distressed debt (bonds trading at a spread greater than 1000 basis points). At the end of the second quarter, $150 billion in debt was trading at distressed level compared to $30 billion at the start of the year[6].

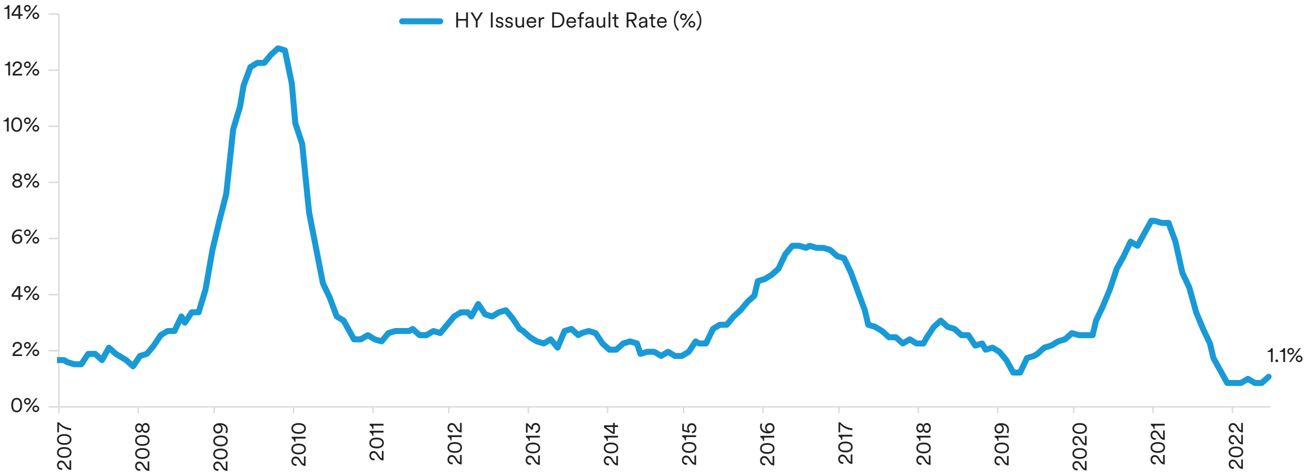
Figure 8 | HY Distressed Levels



Source: Credit Suisse

Distressed debt tends to be a leading indicator of default experience. The current default rate remains well below trend at around 1%[7], but we did see defaults pick up in June which, coupled with a rise in the distress ratio, may suggest a potential uptick in the default rate.

Figure 9 | HY Default Rates



Source: Credit Suisse

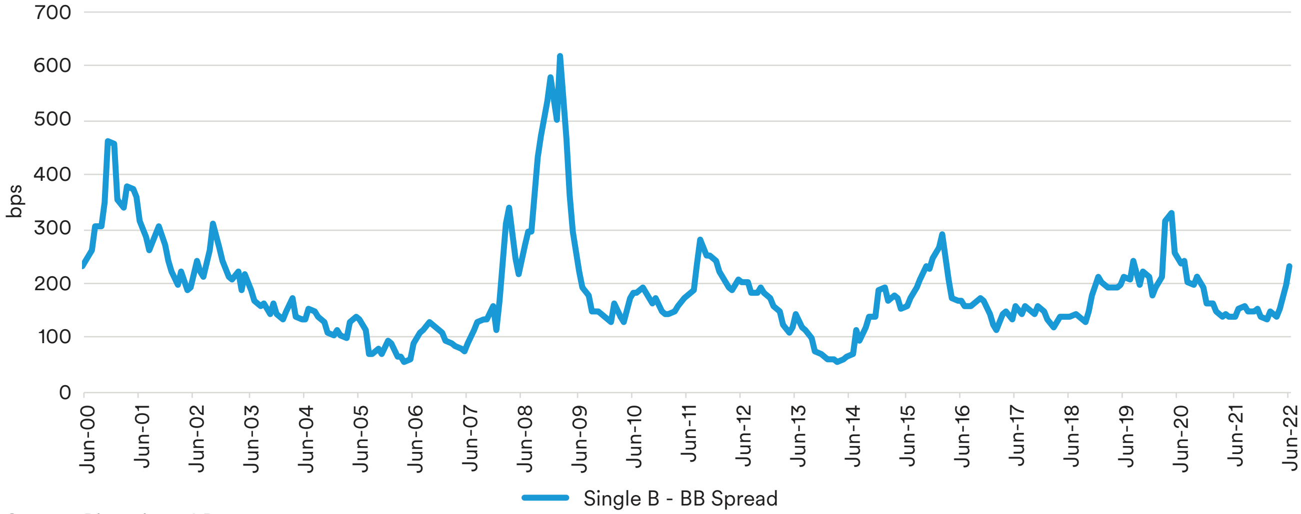
Outlook:

We expect macro factors to continue to drive the direction of the HY market and credit spreads over the near term. As a result, we remain cautious going into the third quarter and cognizant of increasing growth concerns and lingering inflation consequences. The Q2 earnings season will prove telling to how fundamentals are holding up in the current market environment. Corporate earnings are still expected to show year-over-year growth, but the outlook for the balance of the year may prove challenging. We expect earnings guidance and forecasts to likely be revised lower this quarter, and it will be difficult for risk to rally against this backdrop. We believe that earnings expectations are still slightly too elevated, and we will look to use the weakness from this scenario as an opportunity to add risk in the portfolio within names where we remain comfortable.

The uncertainty around the Fed's upcoming actions may leave investors fearful in the near term, until they gain a better sense of market stability. We need to see tangible evidence that inflation is cooling before we think the Fed can pivot to a more moderate policy. If we begin to see data that suggests the Fed will be less aggressive than markets are anticipating, investors could respond positively and support higher beta assets. Based on backward looking data, there have been some indications that inflation has peaked; however, there is a possibility for the Fed to overtighten in this situation and cause additional volatility.

Recently in this technically driven market, even the strong companies have been penalized given the overall sell-off and rate move. Lower quality names suffered through spread widening, while higher quality names were punished with the rate selloff. However, in the second half of the year we expect to see a dispersion between issuers. As the market digests Fed actions, inflation comes down, and slower growth impacts the economy, we will likely see the higher quality names remain resilient, while the very low quality names will feel pain from the macro environment. With this bifurcation in the market, we can expect to see downgrades accelerate, along with a tick up in default rates.

Figure 10 | Single B - BB Spread Differential



Source: Bloomberg LP

We believe that the significant decline in dollar price across corporate credit during a period of broadly healthy credit fundamentals provides some attractive opportunities within the high yield market. With GDP and corporate earnings slowing, we expect higher quality credit to outperform and security selection to be a critical driver of performance over the near term. Valuations have adjusted to reflect these rising risks and are trading in line with long-term historical averages, but have not fully priced in a recession. We like opportunities within the BB portion of the market, especially the less cyclical sectors and issuers with pricing power. We will also look for opportunities within the primary market, where stronger issuers have access to the market despite volatility, and additionally are paying new issue concessions to get deals done.

Endnotes

[1] Bloomberg L.P.
[2] Bloomberg L.P.
[3] Barclays
[4] Barclays
[5] Barclays
[6] Credit Suisse
[7] Credit Suisse

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