PUBLIC FIXED INCOME

High Yield

Market Review and Outlook

December 31, 2022

Bloomberg US HY Index	4Q 2022 Return	YTD 2022 Return	OAS 12/31/2022 (bps)	QTD OAS Change (bps)	YTD OAS Change (bps)	YTW 12/31/2022	QTD Yield Change (bps)	YTD Yield Change (bps)
High Yield	4.17%	-11.19%	469	-83	186	8.96%	-72	475
BB/B	4.56%	-10.57%	385	-81	143	8.10%	-71	427
BB	4.31%	-10.80%	295	-59	101	7.21%	-56	391
B	4.93%	-10.26%	489	-130	176	9.21%	-102	464
CCC	0.51%	-16.29%	1008	-96	459	14.26%	-96	744

Source: Bloomberg LP, Barclays Research

Market Review:

Risk-on appetite during the fourth quarter led to an aggressive rally across the broad Fixed Income market. Easing inflation concerns, limited supply, better than feared earnings, and the largest stretch of retail inflows on record aside from the stretch surrounding the pandemic helped support High Yield (HY) assets in the fourth quarter. Despite year-over-year inflation prints continuing to come down from the peak in July, consumer demand remained robust in the face of rising interest rates and persistent inflation. The Fed's comments remained hawkish as inflation would likely remain above target levels until demand weakened. For the most part, the markets seemed to shrug off this tone until the end of December, when a combination of hawkish surprises from the Fed and European Central Bank, weak global economic data, and the Bank of Japan's surprise monetary

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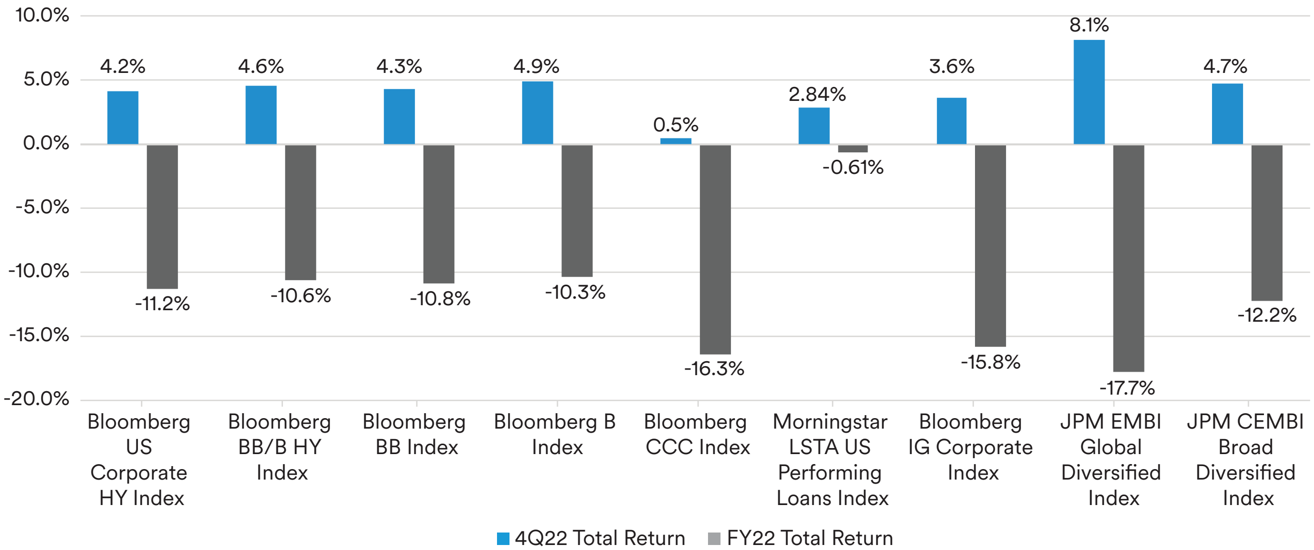
policy normalization reintroduced some weakness. Aside from floating rate Bank Loans, HY was the best performing fixed income asset class during the year. HY assets remained less impacted by the aggressive treasury yield rise than Investment Grade securities and more sheltered from geopolitical tensions than Emerging Markets.

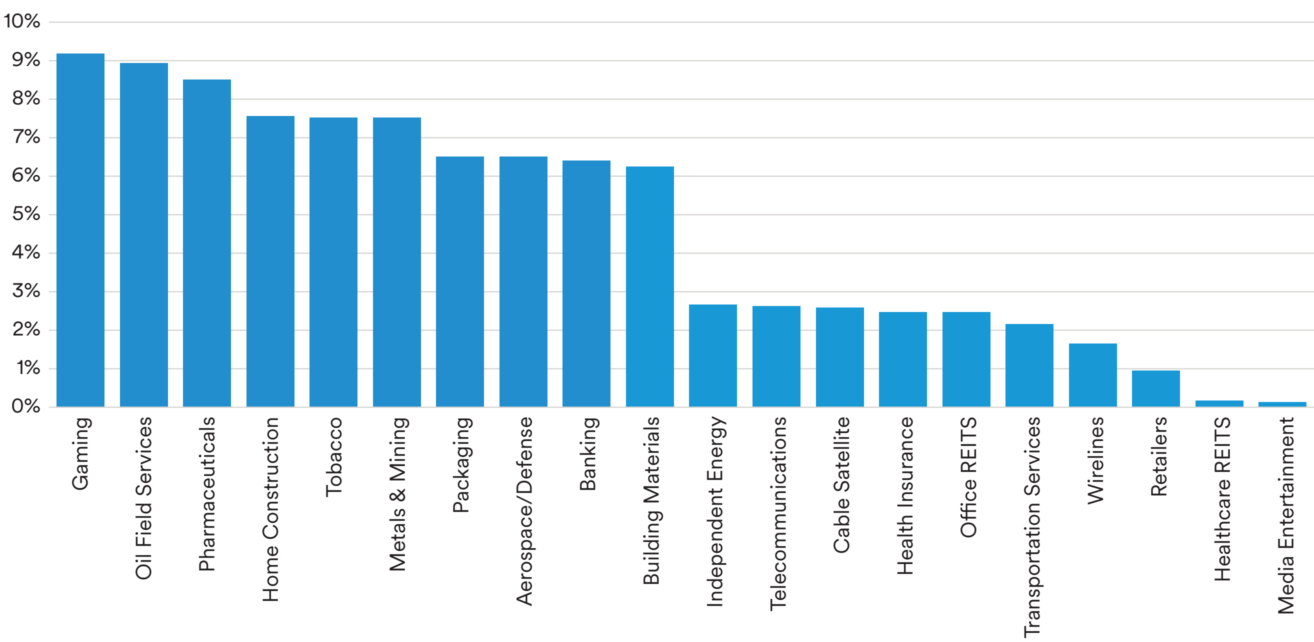
Figure 1 | Total Returns



Source: Bloomberg LP, JP Morgan

HY bonds closed out the year with October and November posting the strongest two-month rally since 2020. The Bloomberg US HY Index returned 4.17% in the fourth quarter to put 2022 returns at -11.2% after hitting a low of -14.9% at the end of Q3[1]. Gaming was the top performing sector as China witnessed significant easing of the country's Zero-COVID policy, supporting Macau gaming issuers within the index[2].

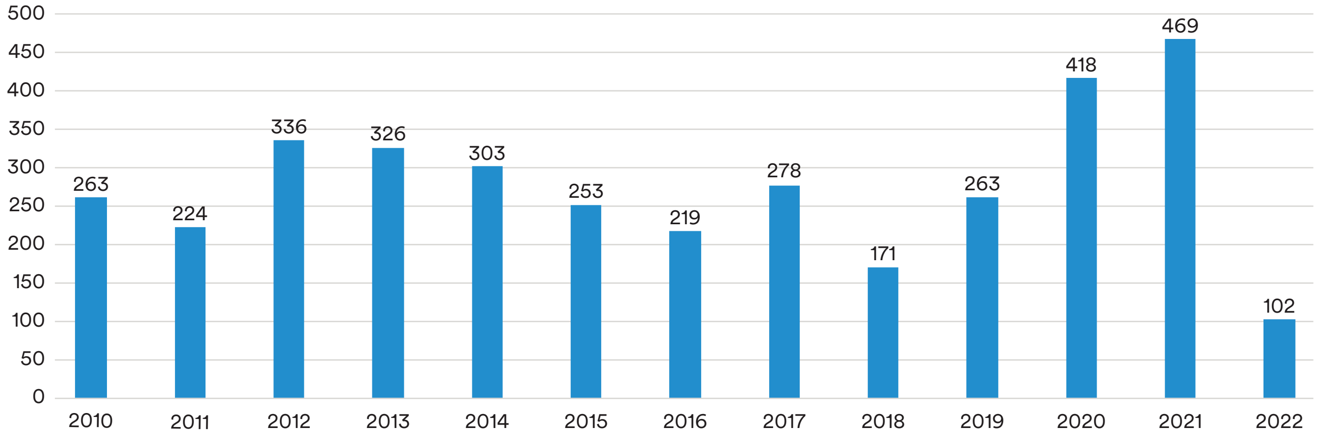
Figure 2 | High Yield Returns by Sector



Source: Bloomberg LP, Barclays Research

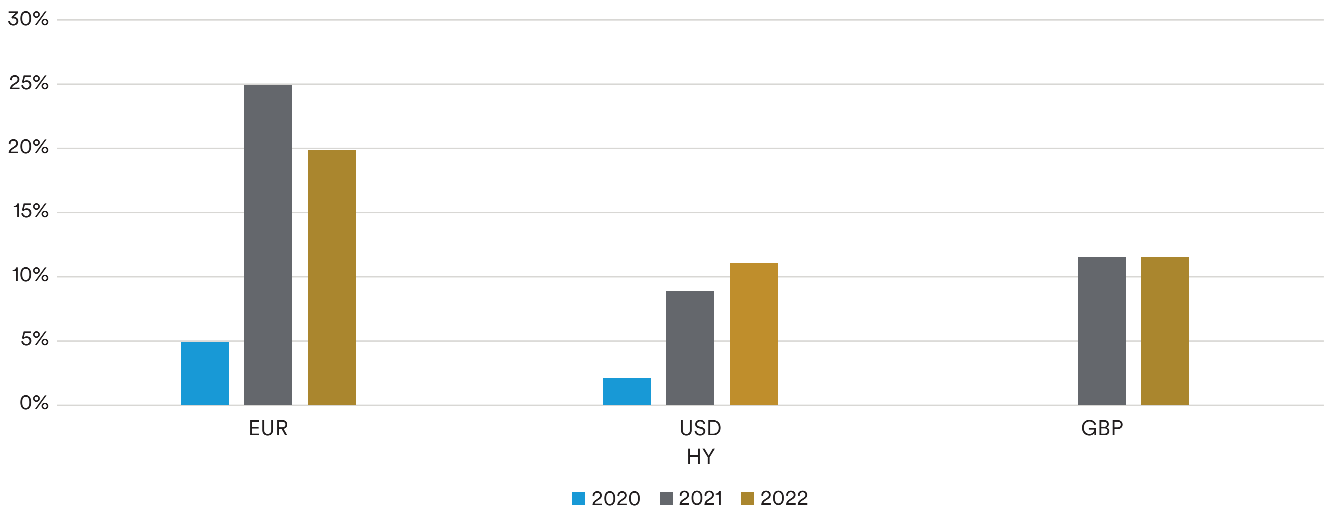
HY bond issuance for 2022 of $102 billion was down over 75% from 2021, as rising yields and market volatility froze primary activity. Q4 issuance of $16.5 billion was the lowest quarter of issuance since Q1 2009[3]. Although 2022 was a down year for primary activity across credit markets, ESG issuance as a percentage of total corporate supply continued to rise. Notably, green bonds expanded their market share in the labeled issuance space year-over-year, while sustainability-linked bonds make up a smaller proportion of the market than they did last year. Green bond issuance should continue to dominate the labeled market in 2023 as issuers may look to avoid additional interest expense in an elevated rate environment.

Figure 3 | High Yield Annual Issuance ($bn)



Source: Barclays Research

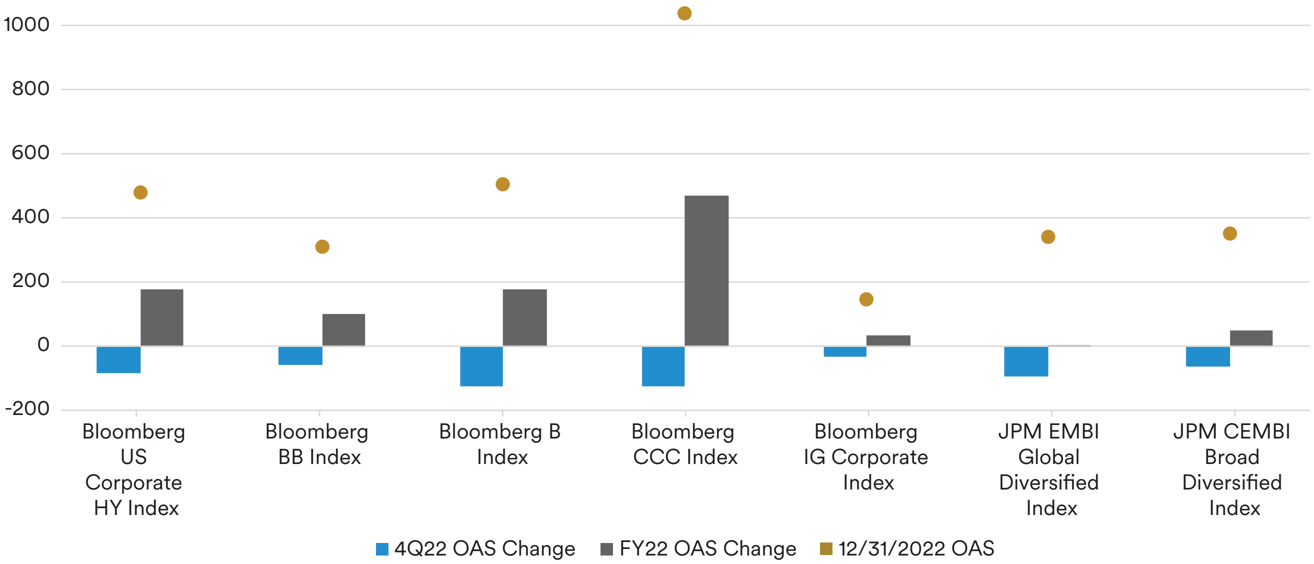
Figure 4 | HY ESG Issuance as % of Total Supply



Source: Barclays Research

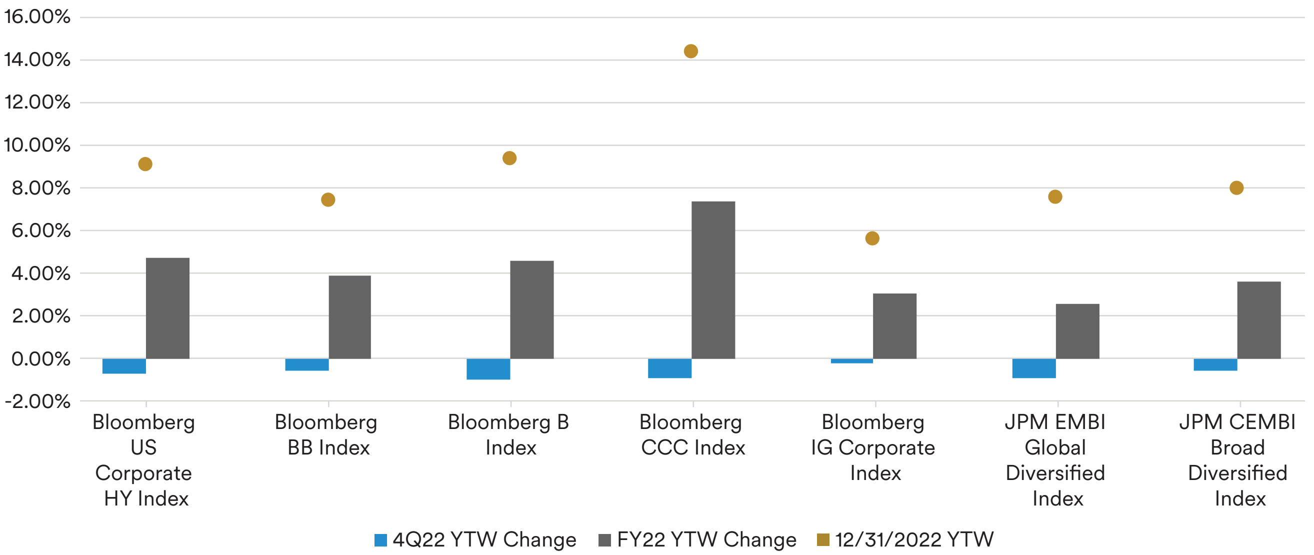
In Q4, spreads tightened across all credit quality with single-B credit experiencing the most tightening in the quarter. However, for the year, spreads widened 101bps for BBs, 176bps for Bs, and 459bps for CCCs. The increase in yield was even more dramatic with yields increasing almost 400bps for BBs, 464bps for Bs, and 744bps for CCCs[4]. The increase in yield was even more dramatic with yields increasing almost 400bps for BBs, 464bps for Bs, and 744bps for CCCs . Given the combination of wider spreads and higher Treasury yields, yields across High Yield ended the year cheap to their 20yr long-term average.

Figure 5 | Option Adjusted Spread (OAS) Changes (bps)



Source: Bloomberg LP, JP Morgan

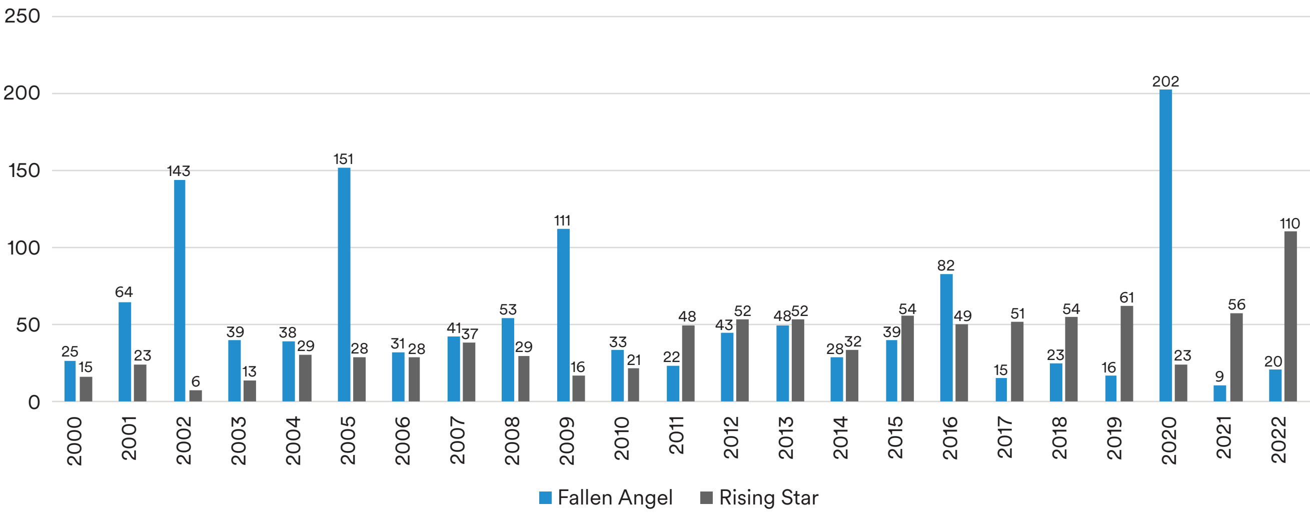
Figure 6 | Yield to Worst Changes (bps)



Source: Bloomberg LP, JP Morgan

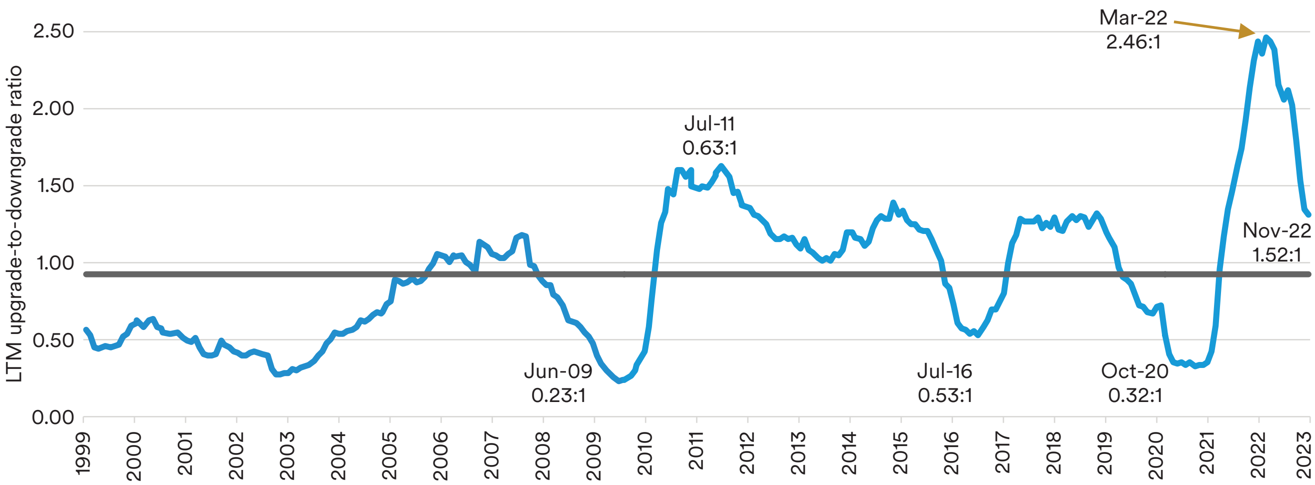
Fallen angels remain at extremely low levels while the index recorded a record amount of rising stars as companies focused on improving credit metrics. Despite this, we have seen an uptick in downgrades, as the upgrade/downgrade ratio has peaked and is projected to decline as the cycle progresses.

Figure 7 | Rising Stars and Fallen Angels ($bn)



Source: Barclays Research

Figure 8 | HY Upgrade/Downgrade Ratio



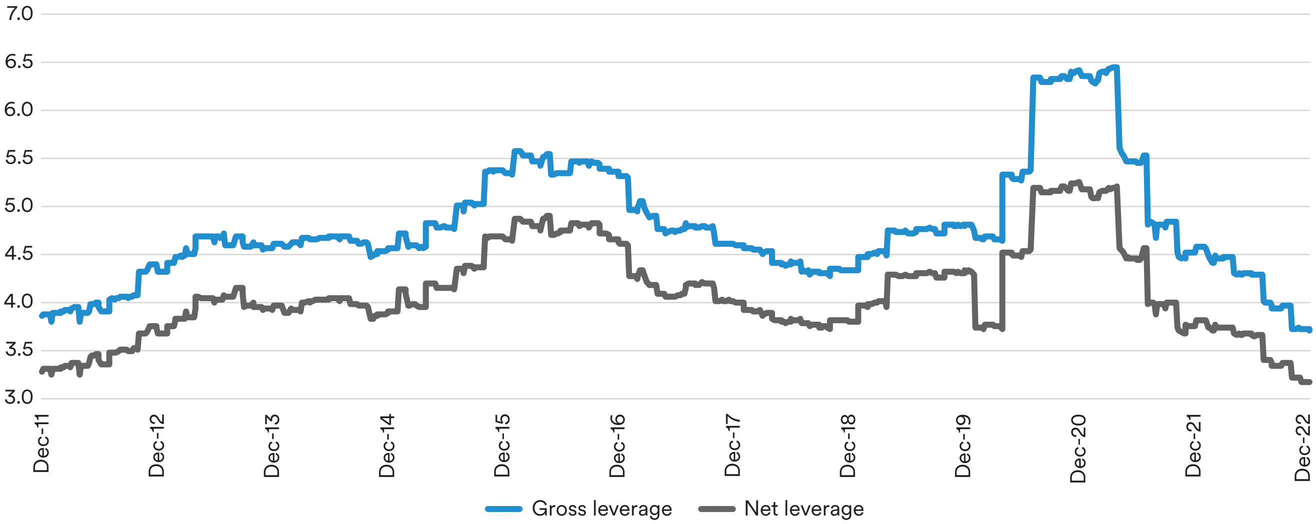
Source: JP Morgan

Outlook:

We maintain a cautious risk appetite heading into 2023 as spreads remain tight amid an uncertain macroeconomic environment, where there is potential for further spread widening. Uncertainty around economic data continues, and Q4 earnings reports will prove critical; however, as the possibility of a soft-landing recession gains increased traction, there is opportunity for high yield to outperform. With spreads almost 100 basis points through long term averages, valuations do not appropriately reflect the current macro headwinds. Yet this more challenging fundamental backdrop will likely translate into increased sectoral dispersion, ratings decompression, and wider spreads in 2023, opening the door to opportunities within HY. Following a historically low year of issuance in the high yield primary market, we expect issuance to modestly rebound in the new year, providing opportunities to capitalize on new issue concessions as investors begin seeking market access once again.

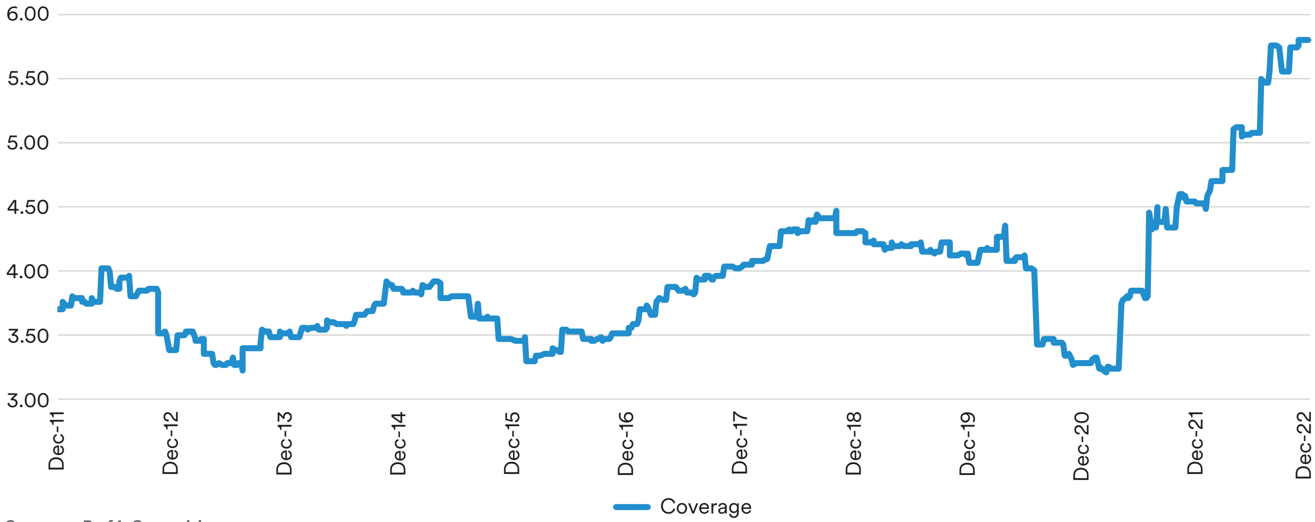
Despite concerns of a recession on the horizon, the HY market has data indicating that issuers are better prepared than historically to weather the storm. As such, we remain comfortable with issuers' abilities to continue servicing debt even in the face of challenging macro headwinds. While we feel corporate fundamentals remain strong, we do expect a lag in tighter financial conditions to weigh on high yield credits in 2023 and are positioned accordingly, with security selection remaining essential.

Figure 9 | High Yield Leverage



Source: BofA Securities

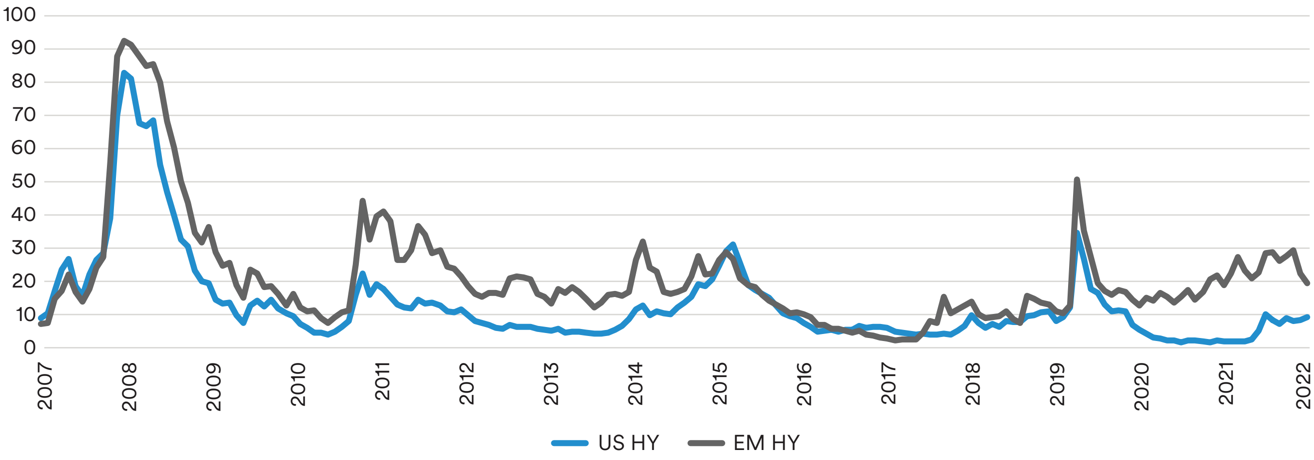
Figure 10 | High Yield Coverage



Source: BofA Securities

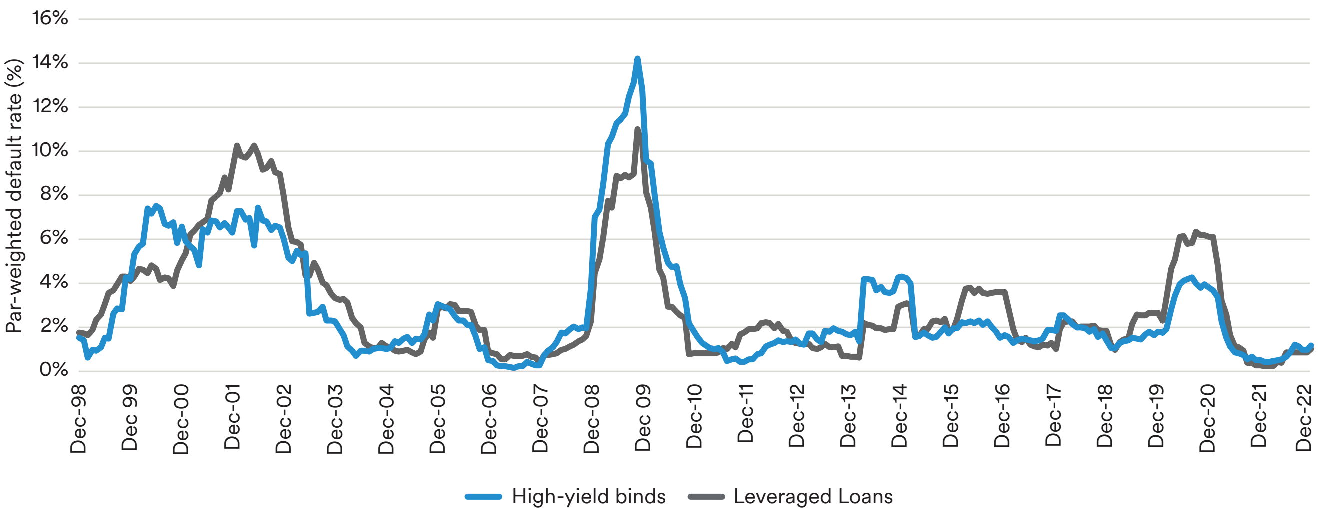
While we do expect to see an uptick in defaults as recession risk increases, the current distressed ratio remains below 10% of US HY issuers. In addition to supportive fundamentals, manageable near-term maturities should help keep the default rate below traditional recessionary periods. We believe the maturity wall for 2023 and 2024 is manageable, providing flexibility for issuers to weather the near-term outlook.

Figure 11 | Distressed Ratio (% of Issuers)



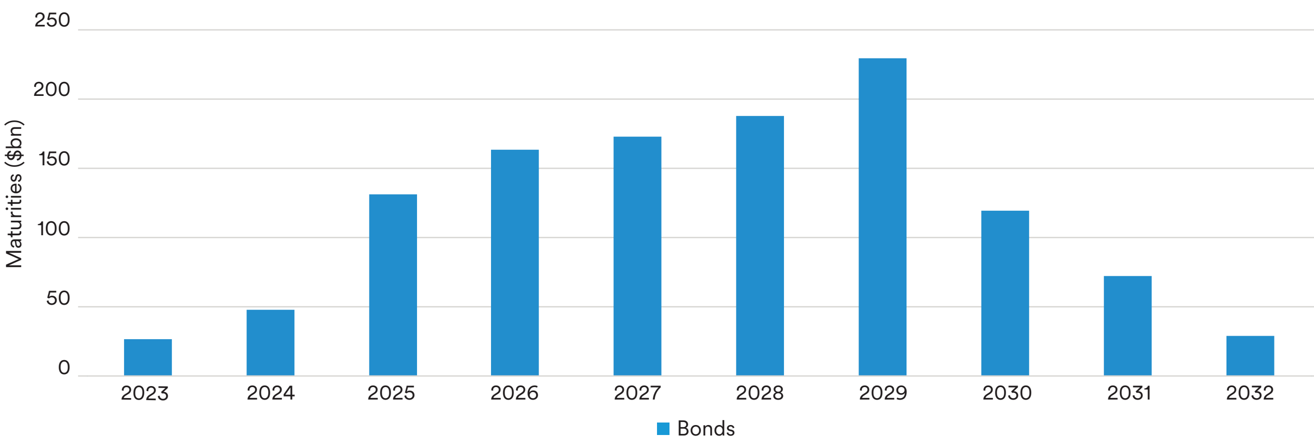
Source: BofA Securities

Figure 12 | HY and Loan Default Rates



Source: JP Morgan

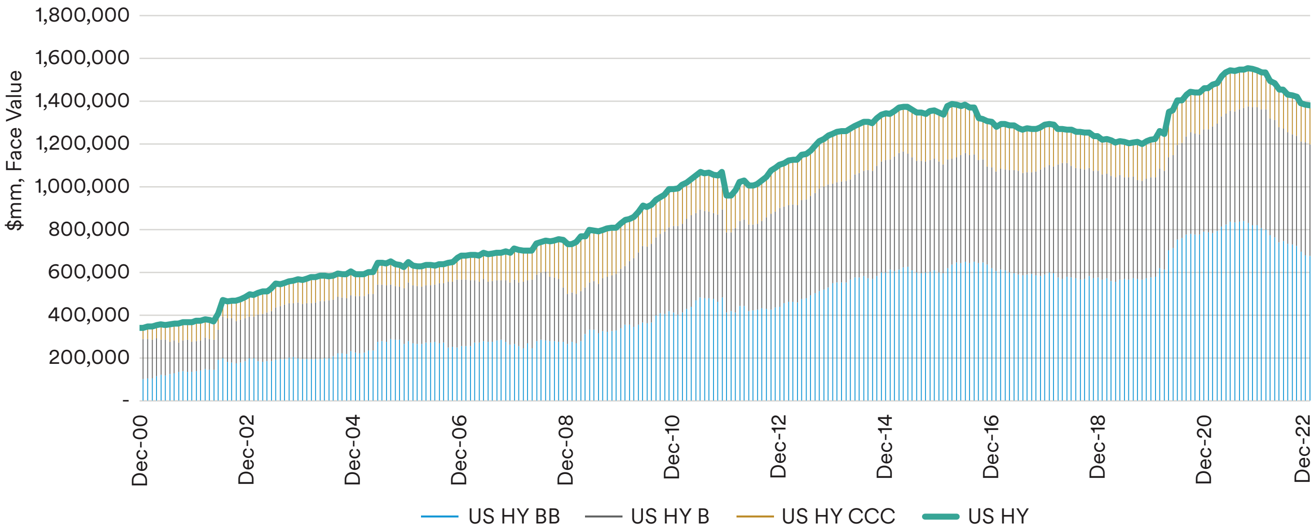
Figure 13 | HY Maturity Wall



Source: BofA Securities

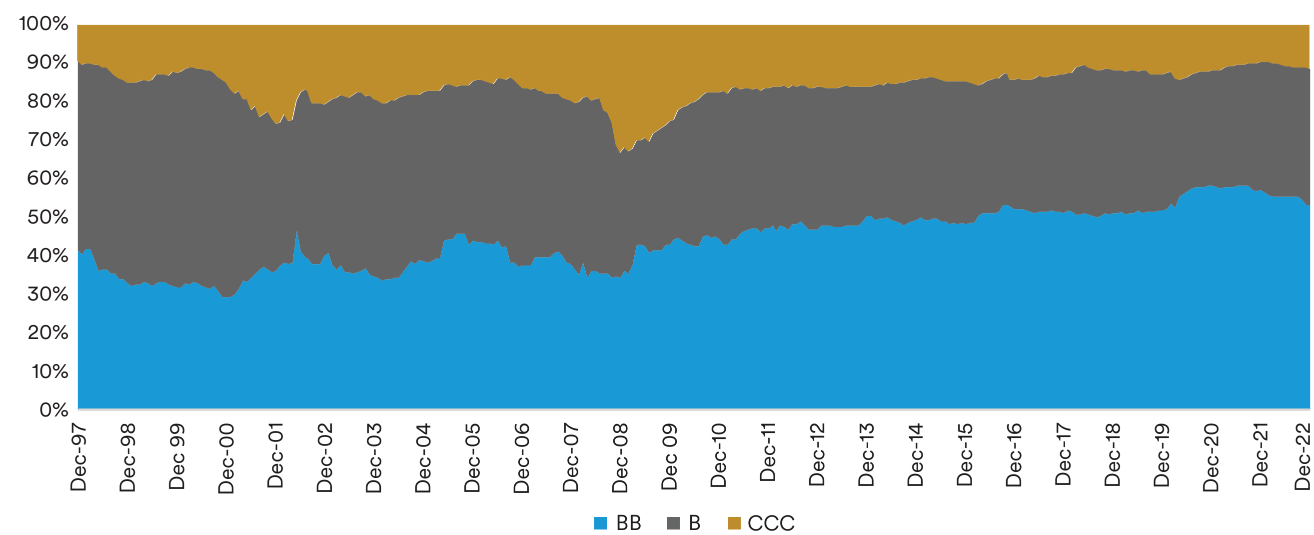
Given the lack of new issuance in the HY market as investors turn to alternative funding sources as maturities come due, the size of the market has been decreasing. Riskier issuers such as LBOs have utilized the bank loan and private credit markets opportunistically over the last few years. As a result, the HY market has not taken on those additional risks as it has in other sustained market rallies. Additionally, lower quality investors have been shut out of the market due to volatility and higher costs of funding. As a result, the overall credit quality of the market has gone up, with the CCC space decreasing. We believe this additional technical will continue to support a lower default rate in the face of a recession.

Figure 14 | Size of HY Universe



Source: BofA Securities

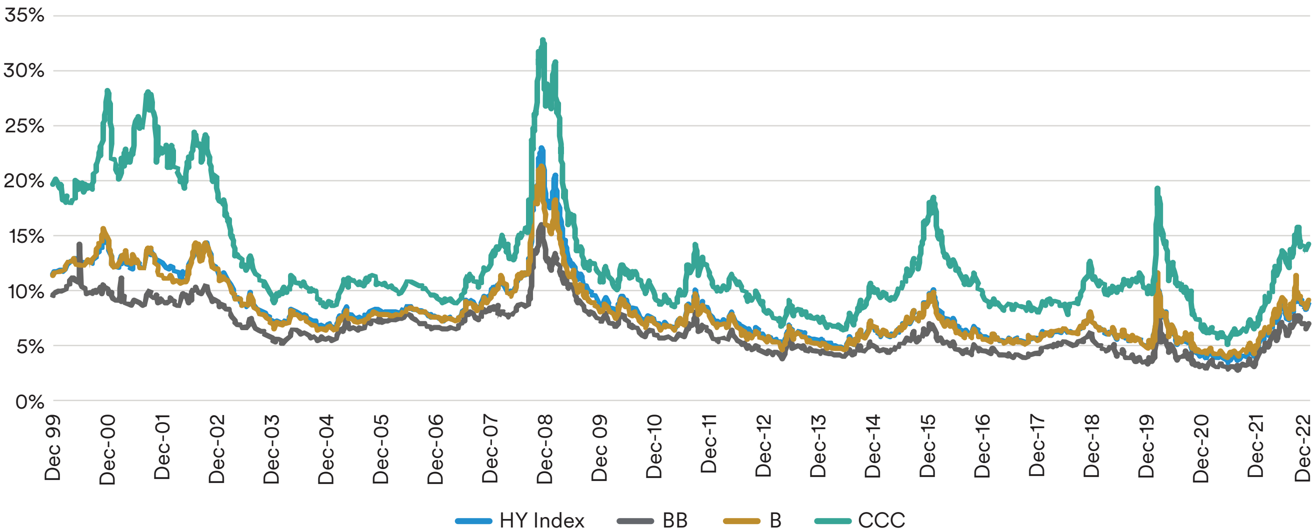
Figure 15 | HY Distribution by Rating



Source: BofA Securities

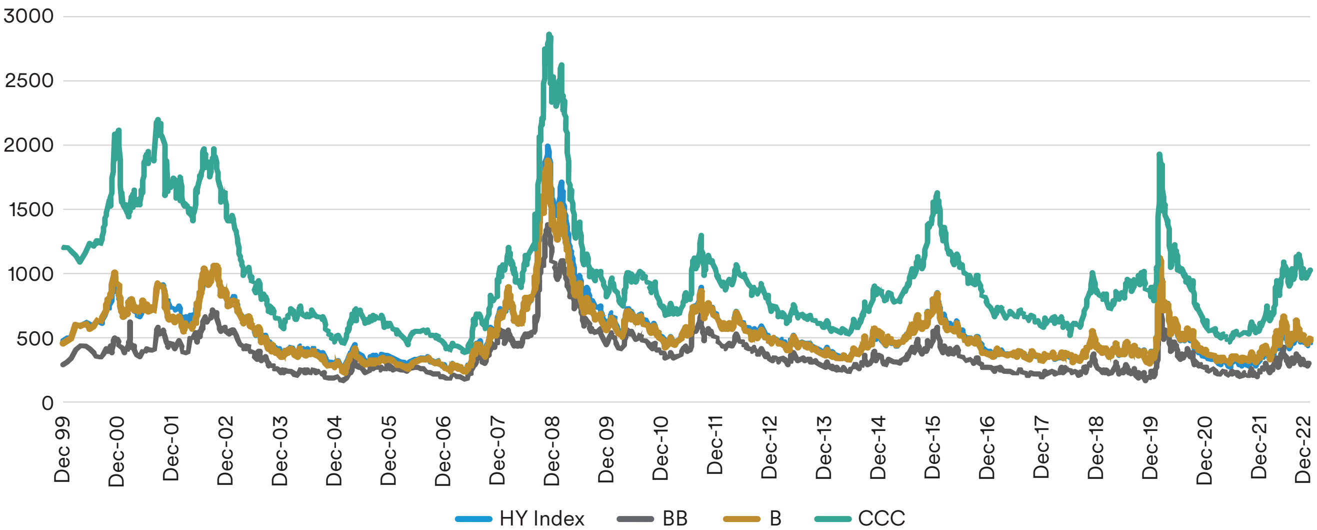
From an absolute yield perspective, the HY market looks enticing with the current index level near 9%. We believe even within the high-quality space, which is well positioned in a recession scenario, a yield above 7% provides attractive opportunities to investors.

Figure 16 | Historical Yield To Worst



Source: Bloomberg LP

Figure 17 | Historical OAS (bps)



Source: Bloomberg LP

Endnotes

[1] Bloomberg LP
[2] Barclays Research
[3] Barclays Research
[4] Bloomberg LP

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