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Global High Yield: A Fortunate Year for Income

Fixed Income Boutique

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High yield bonds outlook

1. Central Banks will be less aggressive with their rate hikes in 2023. This should lead to reduced interest rate volatility and increased credit spread stability

2. Inflation continues to turn the corner on both sides of the Atlantic and we note that gas prices in Europe have resumed their decline and are now at pre-Ukraine invasion levels. Low gas prices through 2023 will be extremely supportive to the European Area (EA) economy and is a key determinant of inflation overall

3. A soft landing of the developed market economies is achievable given the “cooling” labor market, resilient consumer, and hopefully data dependent central banks combined with still solid credit fundamentals and manageable maturity wall for high yield issuers

4. A yield-to-worst starting at just over 8% is an attractive entry point for investors
   – In the past, a down year was typically followed by double digit returns the year after
   – Historically, 12-month forward looking returns tend to be positive from this starting point due to the power of high carry

5. The overall mix of the global high yield market constituents is high quality in terms of credit rating, collateral, and sector exposure

6. In all, we think that it is possible for high yield investors to earn a solid total return in 2023 from a combination of carry and capital appreciation

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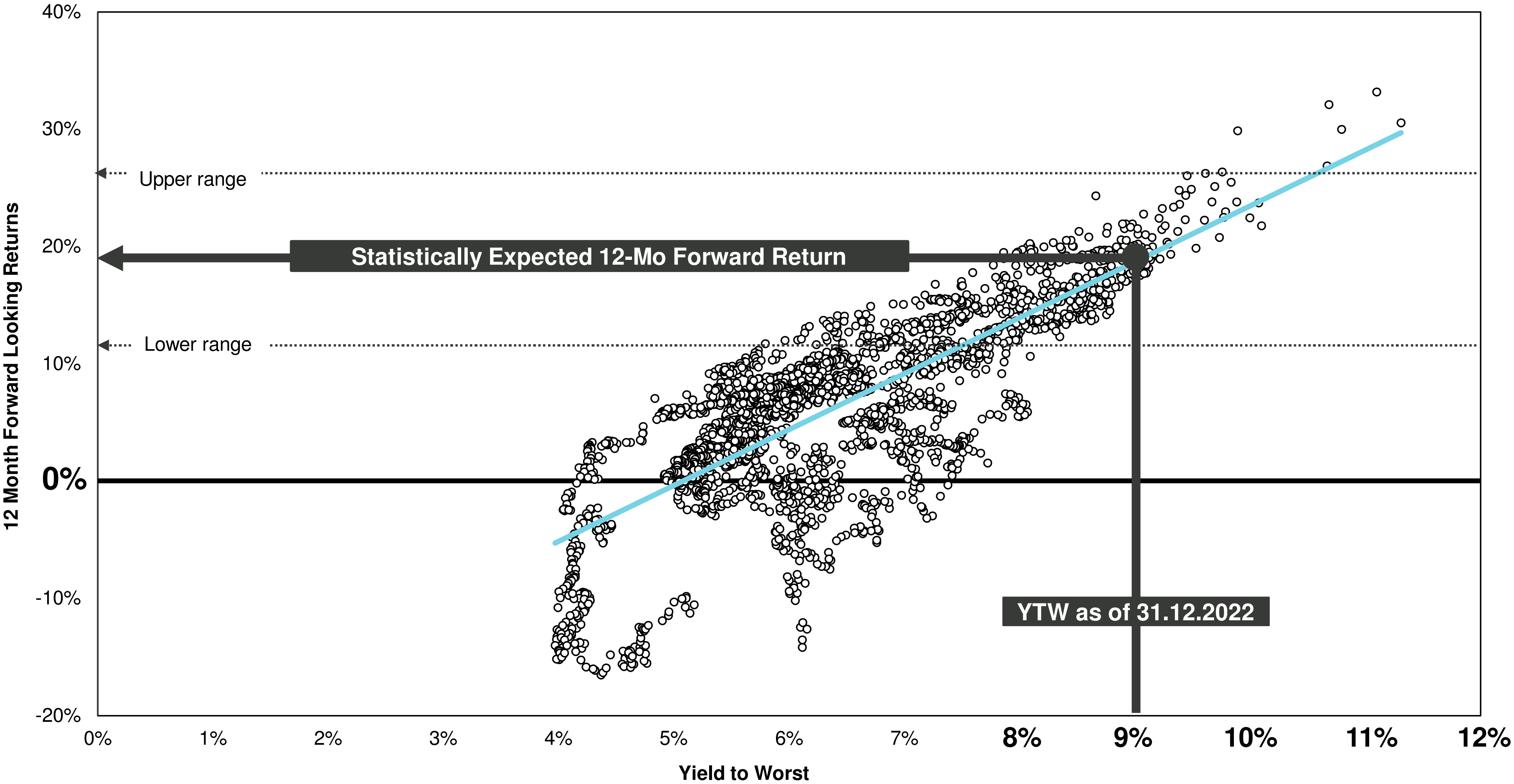
Forward-looking returns have been strong when the starting yield is at 8% or higher

Regression of 12-month forward-looking returns on yield



Past performance is not a reliable indicator of current or future performance.

Forecasts based on internal / external analysis; not guaranteed; and actual results may differ materially.

Source: ICE BofA Global Markets High Yield Constrained Index (HW0C Index). Daily data range from 1.1.2010 to 31.12.2022.

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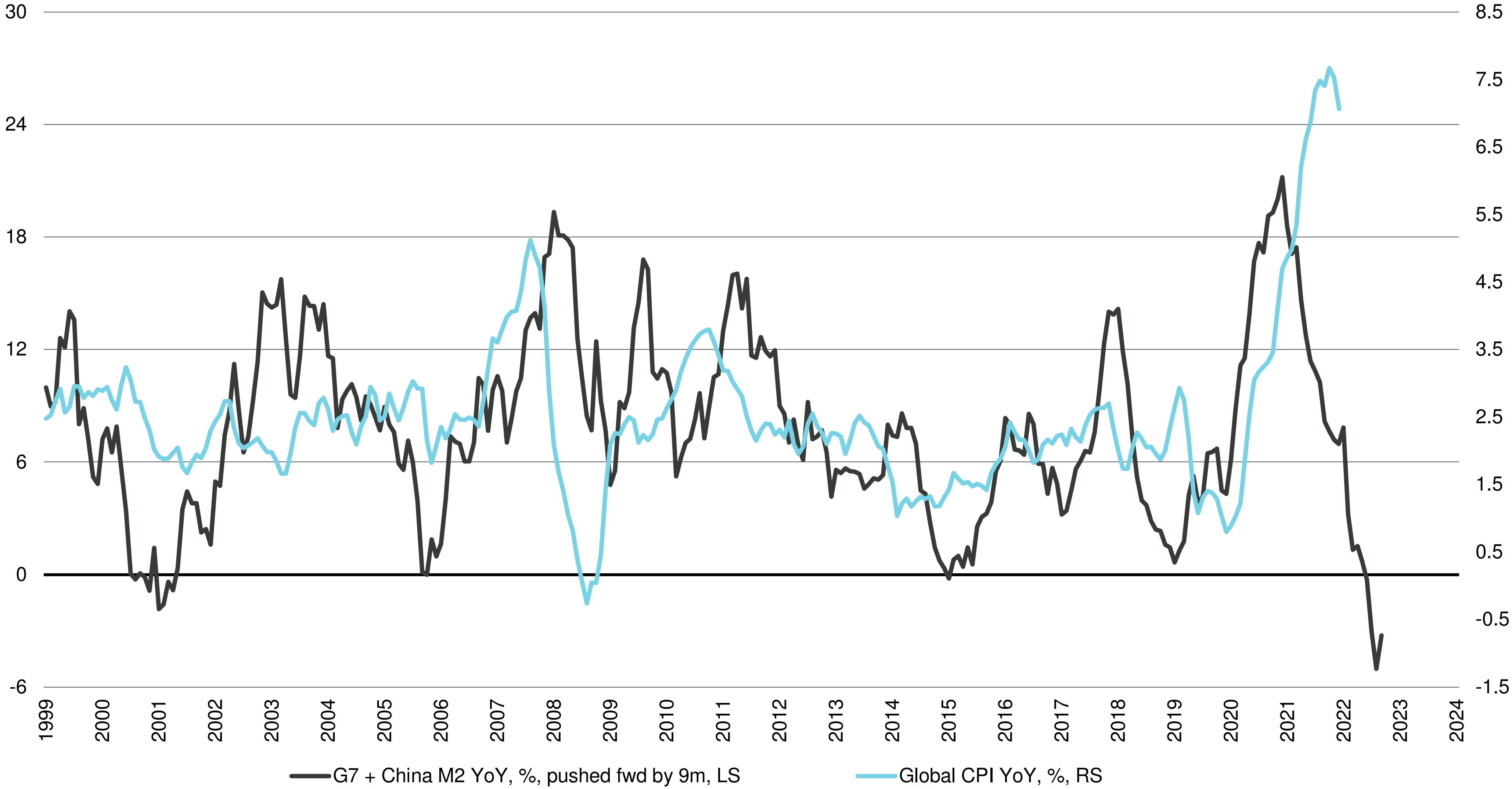
The meteoric rise in M2 money supply since the onset of the pandemic resulted in elevated price pressures…

M2 growth has since collapsed and inflation should start to fade too



Source: BofA Research, as of December 2022.

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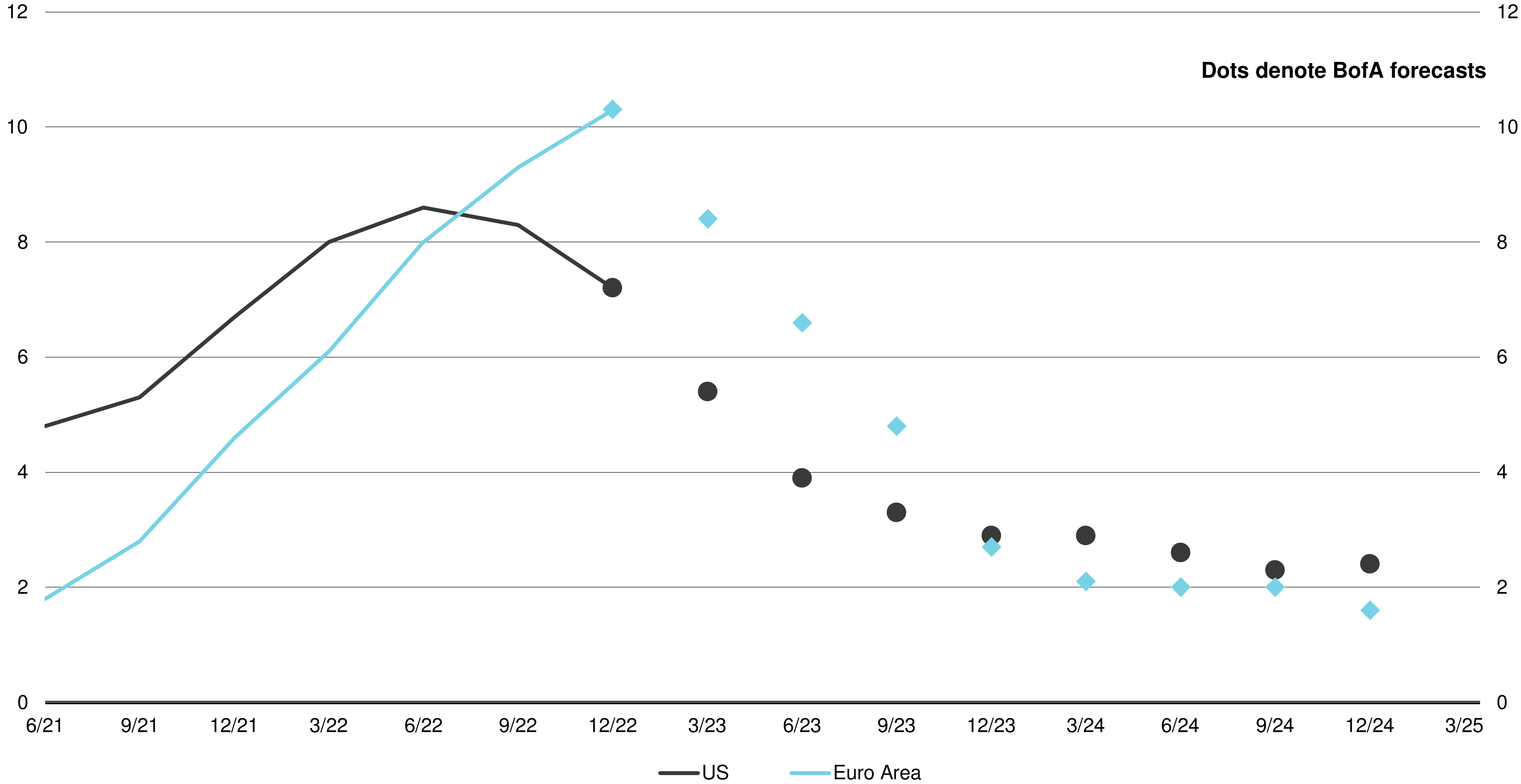
Inflation has started moderating given a usual turnaround lag of 18 months after M2 money supply growth peaked in Feb 2021

CPI YoY % (2Q21–4Q23E)



Source: BofA Research, as of December 2022.

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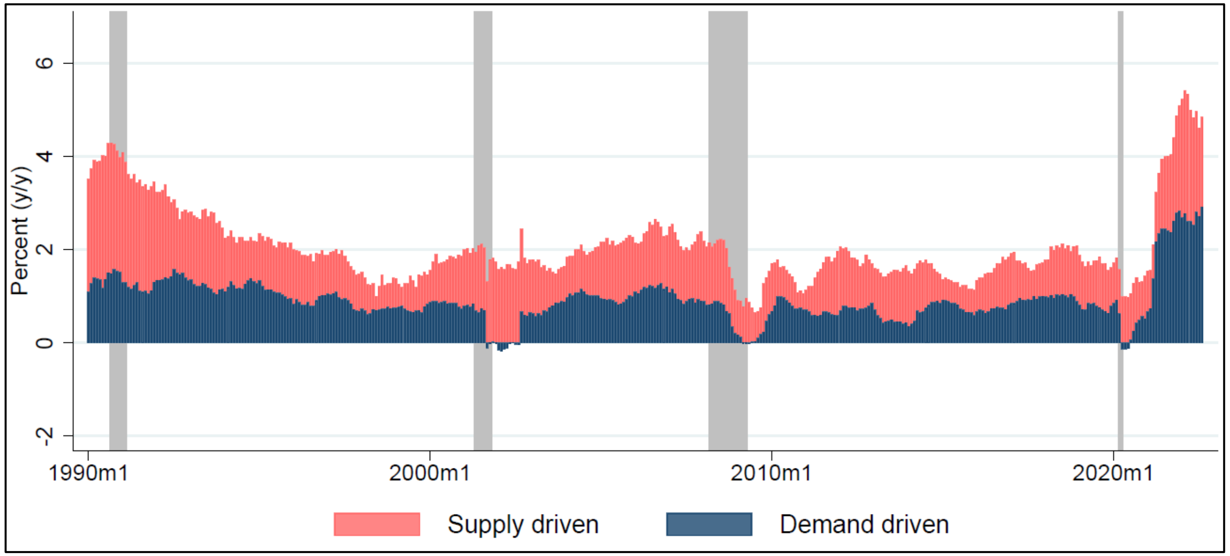
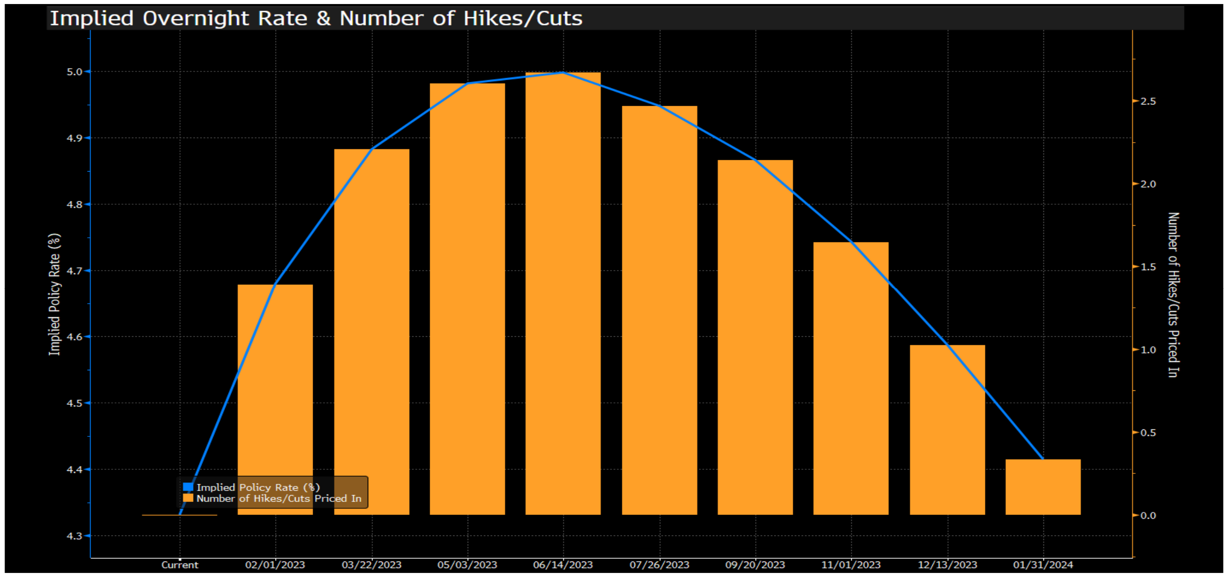
Half of the US Core PCE is supply driven, and this contribution is receding as supply chain disruptions have eased…

The demand-driven contribution to Core PCE should also decline as the Fed Funds rate is now almost double the size of it, with Fed tightening typically impacting only this side of PCE.

Further, the Feds Fund rate is now forecast to track inflation or exceed it, with Chair Jay Powell indicating that real borrowing rates for people are now meaningfully positive.





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Real Borrowing Rates are meaningfully positive and restrictive as people do not borrow at the Fed Funds rates, but at much higher bank rates

Key quotes from Chair Powell's November 2022 Q&A:

- **Nick Timiraos**

"Nick Timiraos of the Wall Street Journal. Chair Powell, core PCE inflation on a 3 or 6-month annualized basis and on a 12-month basis has been running in the high 4's, close to 5 percent. Is there any reason to think you won't have to raise rates at least above that level to be confident that you are imparting enough restraint to bring inflation down?"

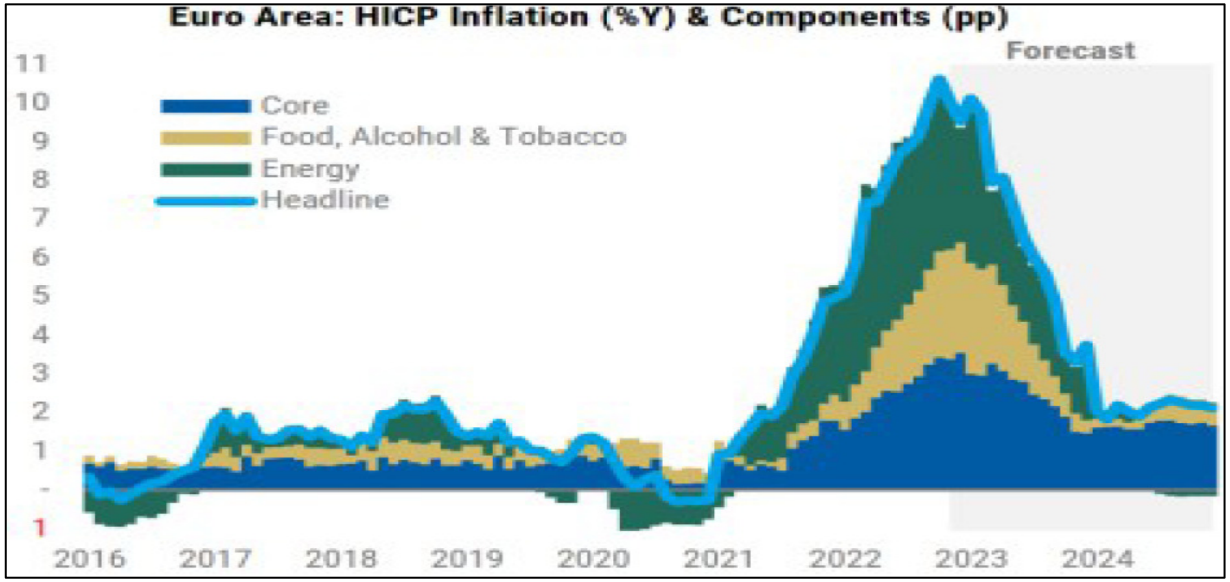
- **Chair Powell**

"So, this is the question of *[inaudible]* does the policy rate need to get above the inflation rate? And I would say, there are a range of view on it. That's the classic Taylor principle view. **But I would think you'd look more at a forward, a forward-looking measure of inflation to look at that**. But, I think the answer is, we'll want to get the policy rate to a level where it is, where the real interest rate is positive. We will want to do that. I do not think of it as the single and only touchstone though. I think you put some weight on that, you also put some weight on rates across the curve. **Very few people borrow at the short end, at the federal funds rate for example, so households and businesses, if they're very meaningfully positive interest rates all across the curve for them, credit spreads are larger so borrowing rates are significantly higher and I think financial conditions have tightened quite a bit.** So, I would look at that as an important feature. I'd put some weight on it but I wouldn't say it's something that is the single dominant thing to look at."

Gas prices are a key determinant of the way forward for EA inflation, and consequently the ECB policy response rate. The one year forward curve sees much lower prices

About 70% of inflation in the EA is supply or non-core i.e. Food and Energy.

With these components easing, especially Gas prices, the ECB policy response rate should be milder and the odds of a mild recession have increased.



Source: Bloomberg Netherlands Nat Gas 1 year forward index; Morgan Stanley HICP decomposition.

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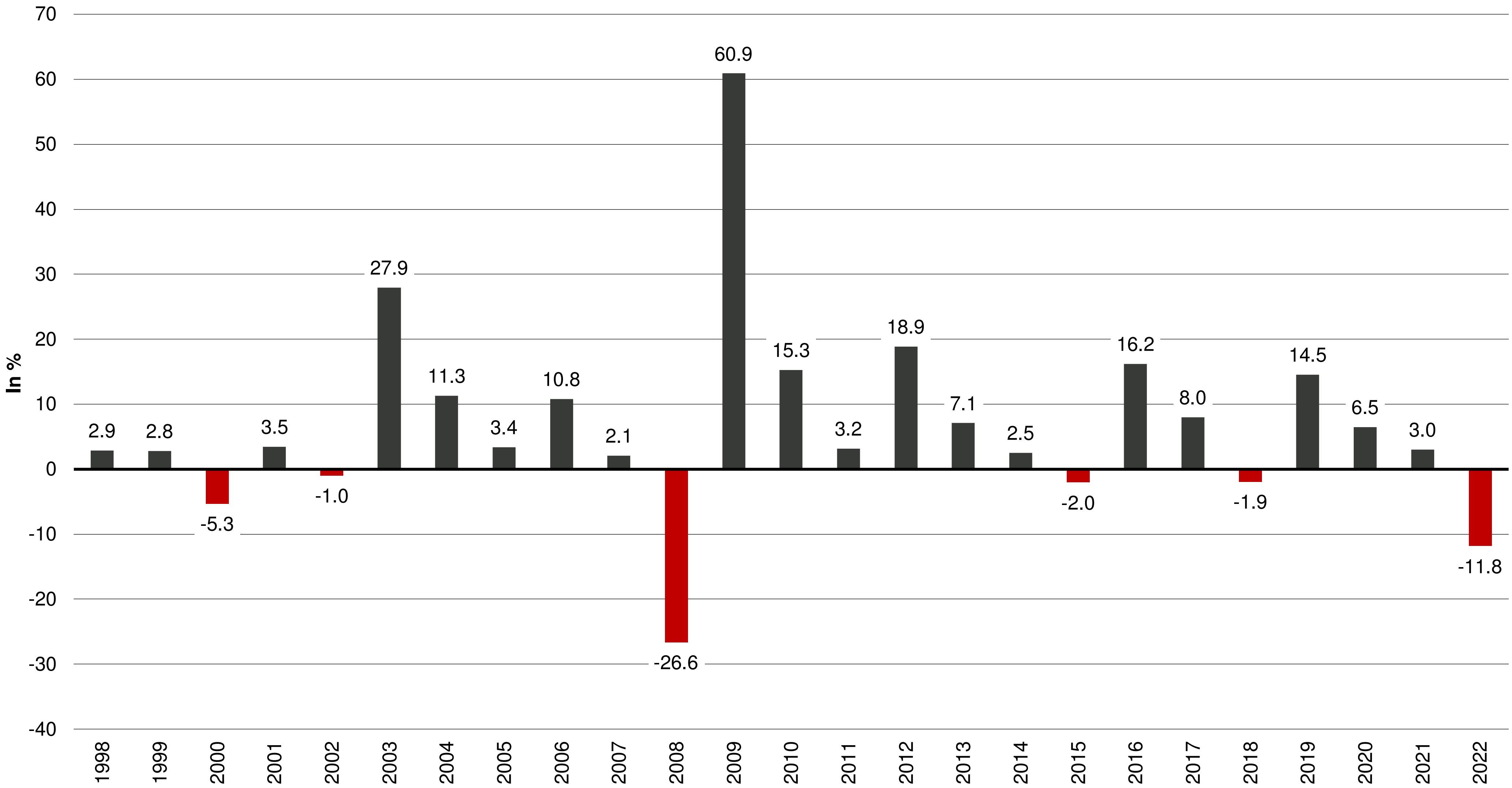
Total returns have typically rebounded after negative years

Global High Yield Index annual performance, in USD



Past performance is not a guarantee of future results.

Source: Vontobel Asset Management, ICE BofAML Index, as of 31.12.2022.

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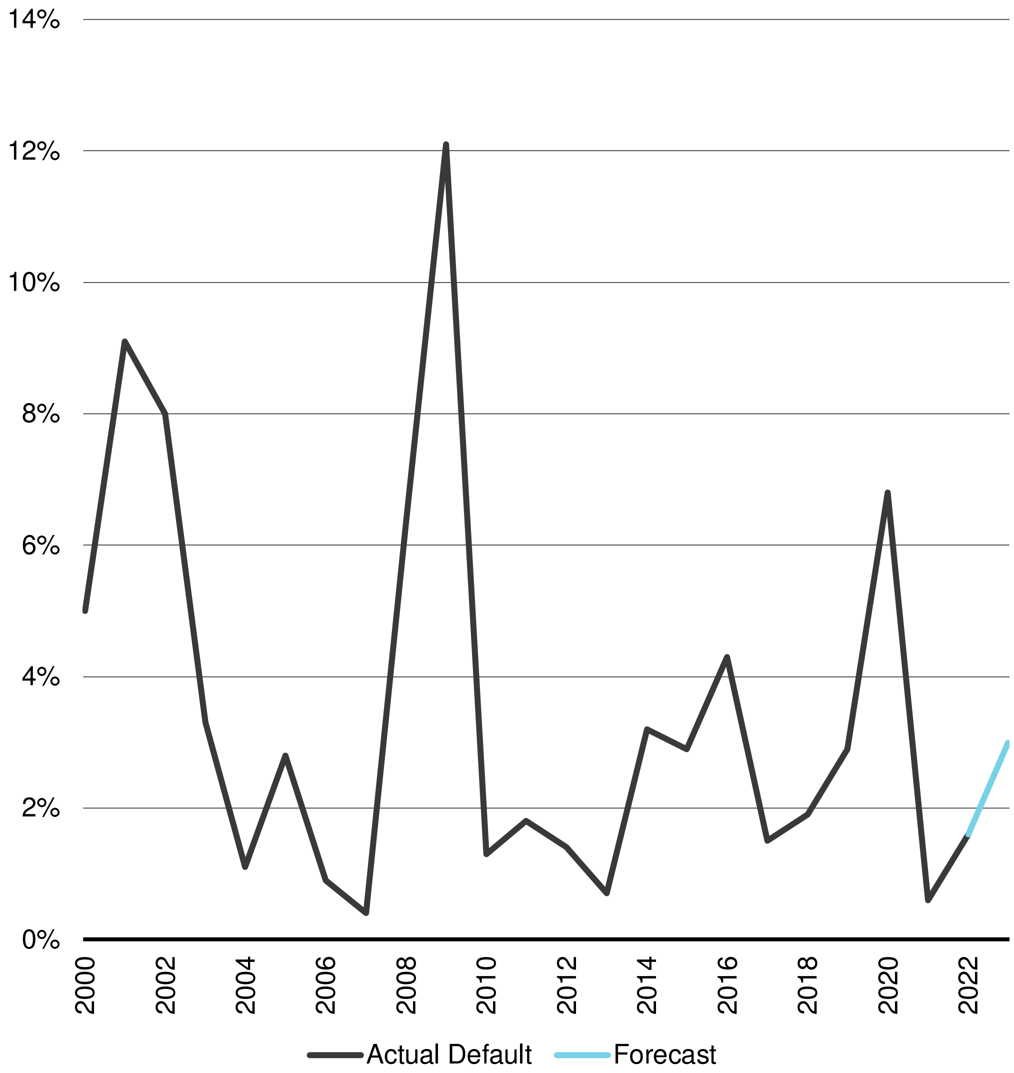
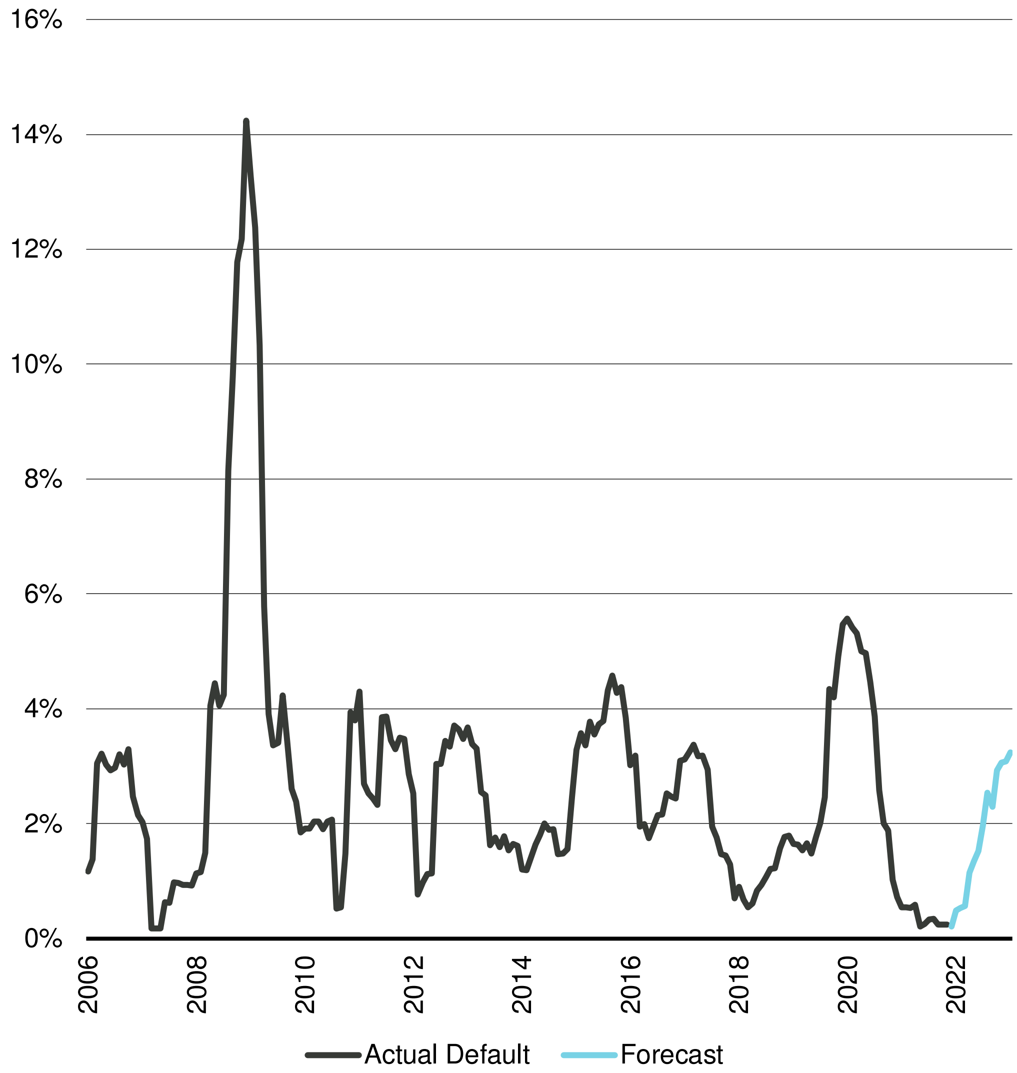
Default rates are projected to increase but should remain well contained

US issuer weighted default rate (%)



EU issuer weighted default rate (%)



Source: Barclays Research, as of December 2022.

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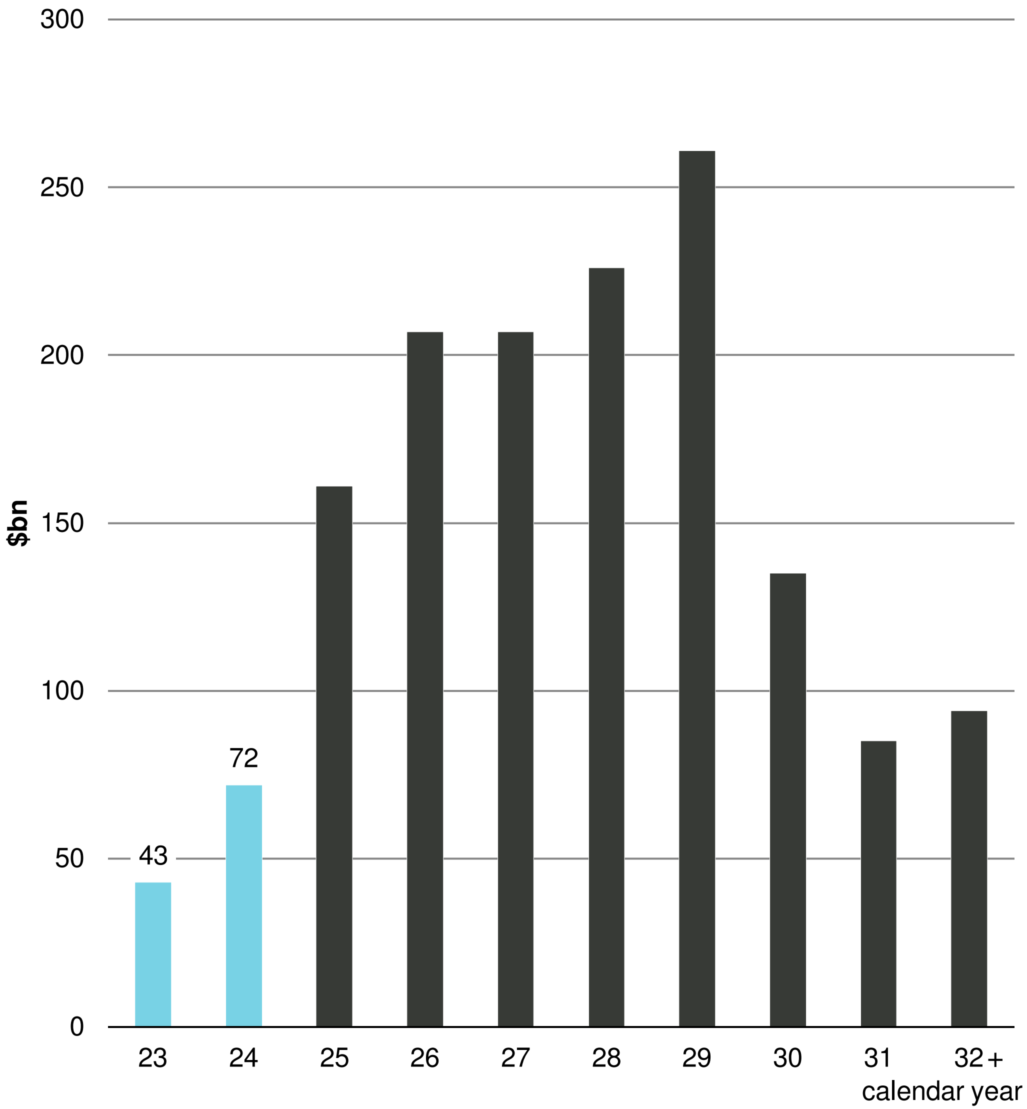
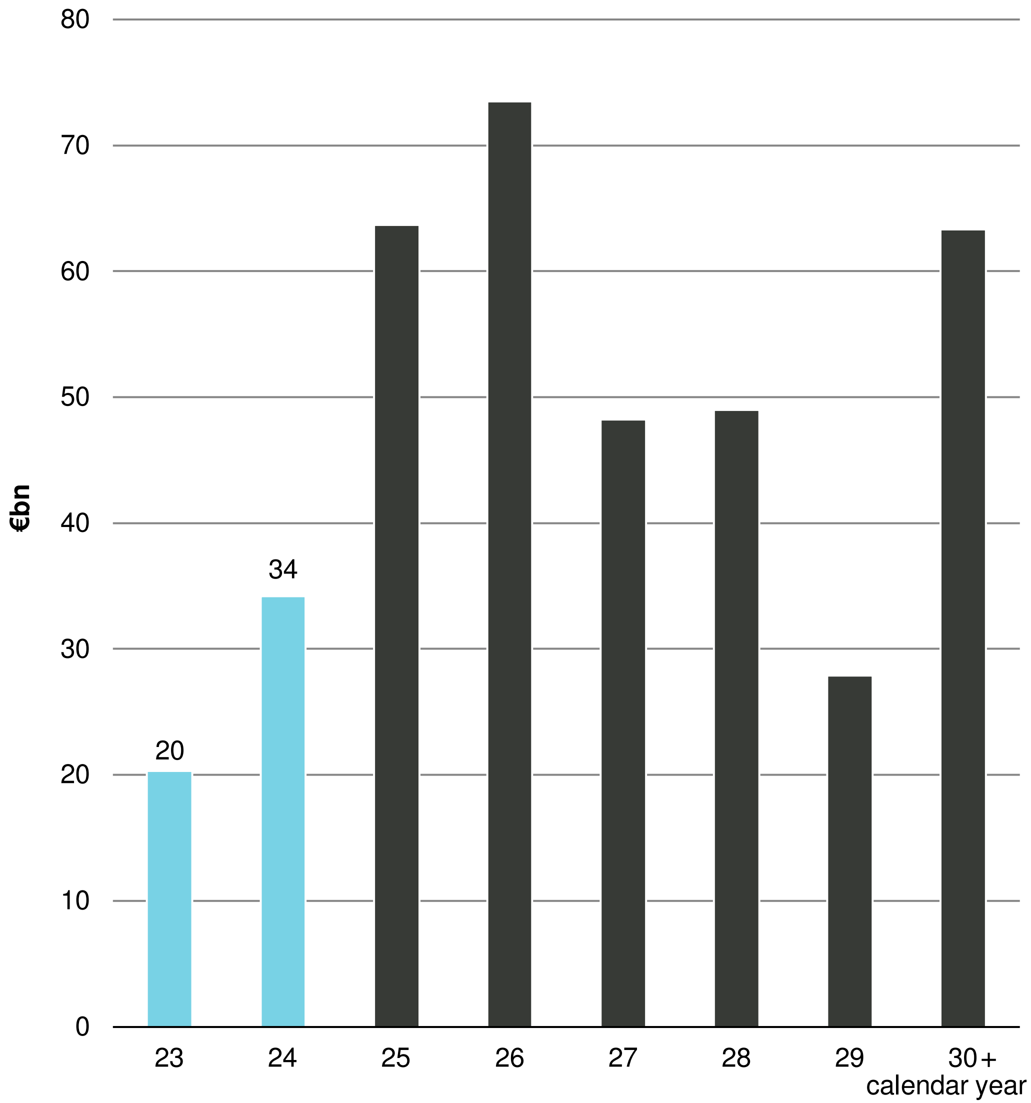
Debt maturity wall has been pushed out – low refinancing needs in 2023

USD HY bond maturity wall[1]



EUR HY bond maturity wall[2]



Source: [1]JPMorgan, as of 29.11.2022; [2]Barclays, as of 1.12.2022.

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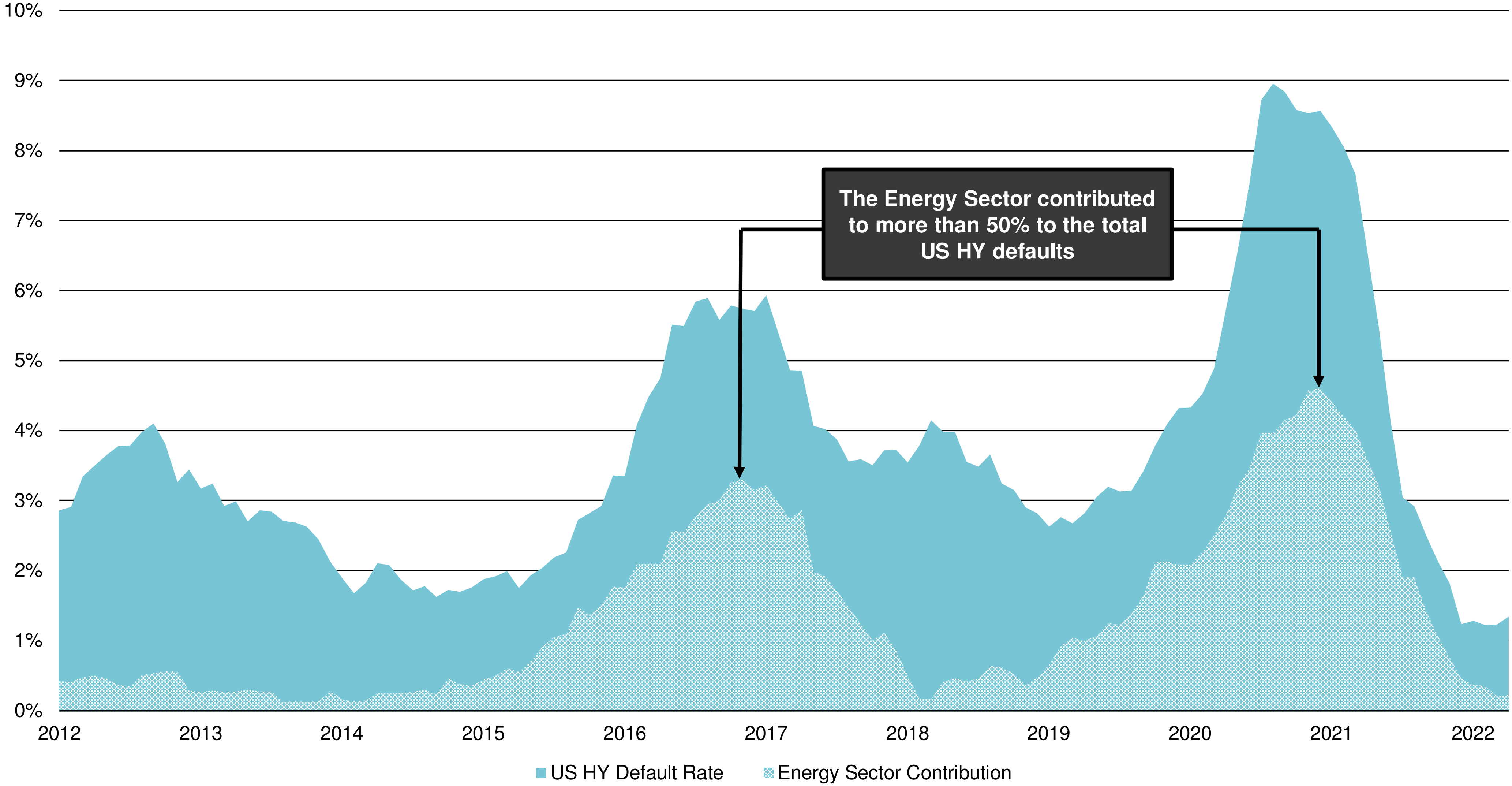
Strong energy markets should keep defaults low in the Energy sector

US Energy Sector was a major contributor in US HY defaults



Source: Moody's, BofA Research, Vontobel, as of 31.3.2022.

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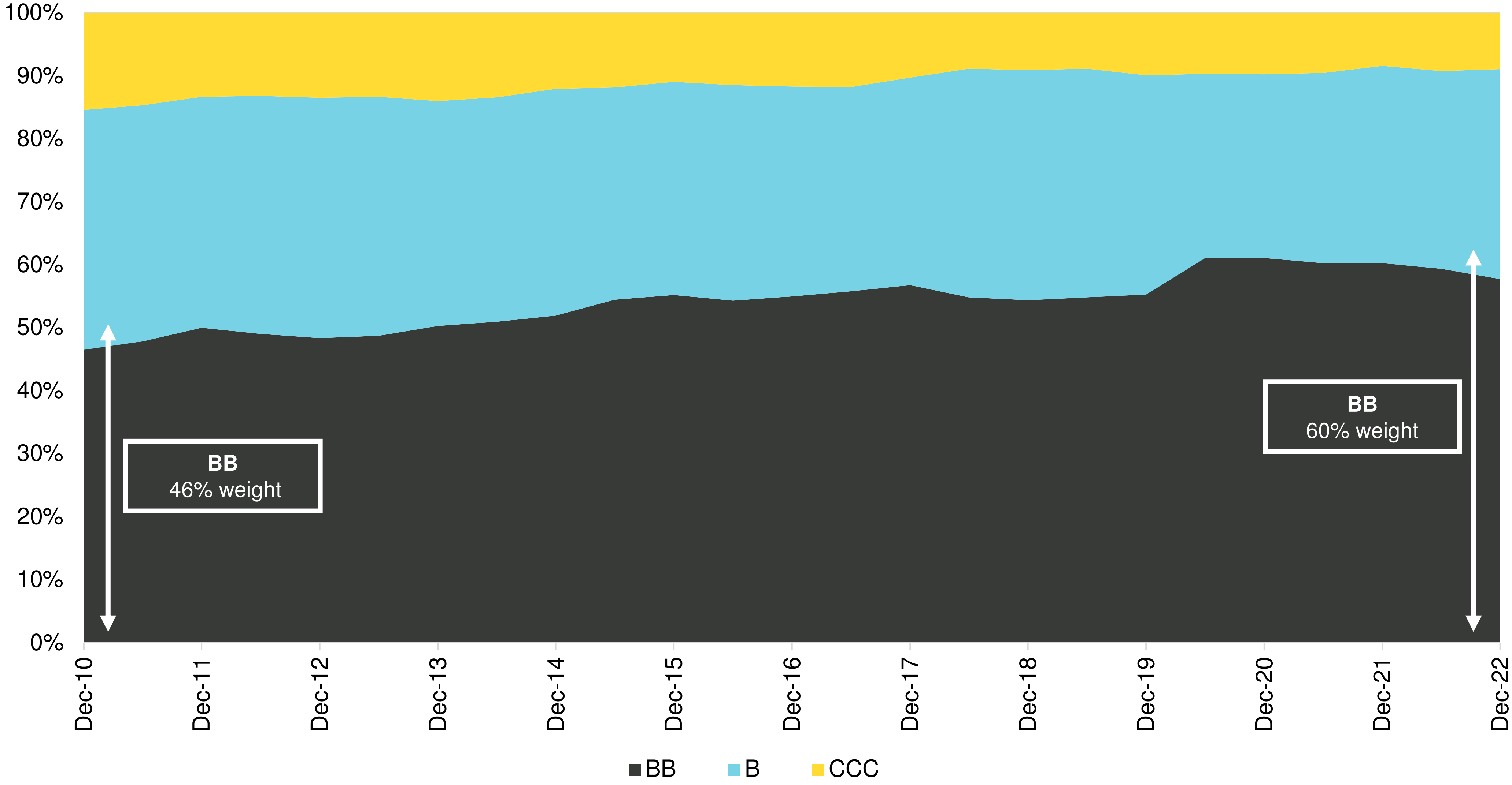
Credit quality of the HY universe has improved due to relative increase in the BB universe

HY benchmark rating composition



Source: ICE BofA Global High Yield Index (HW00 Index); Vontobel, as of 31.12.2022.

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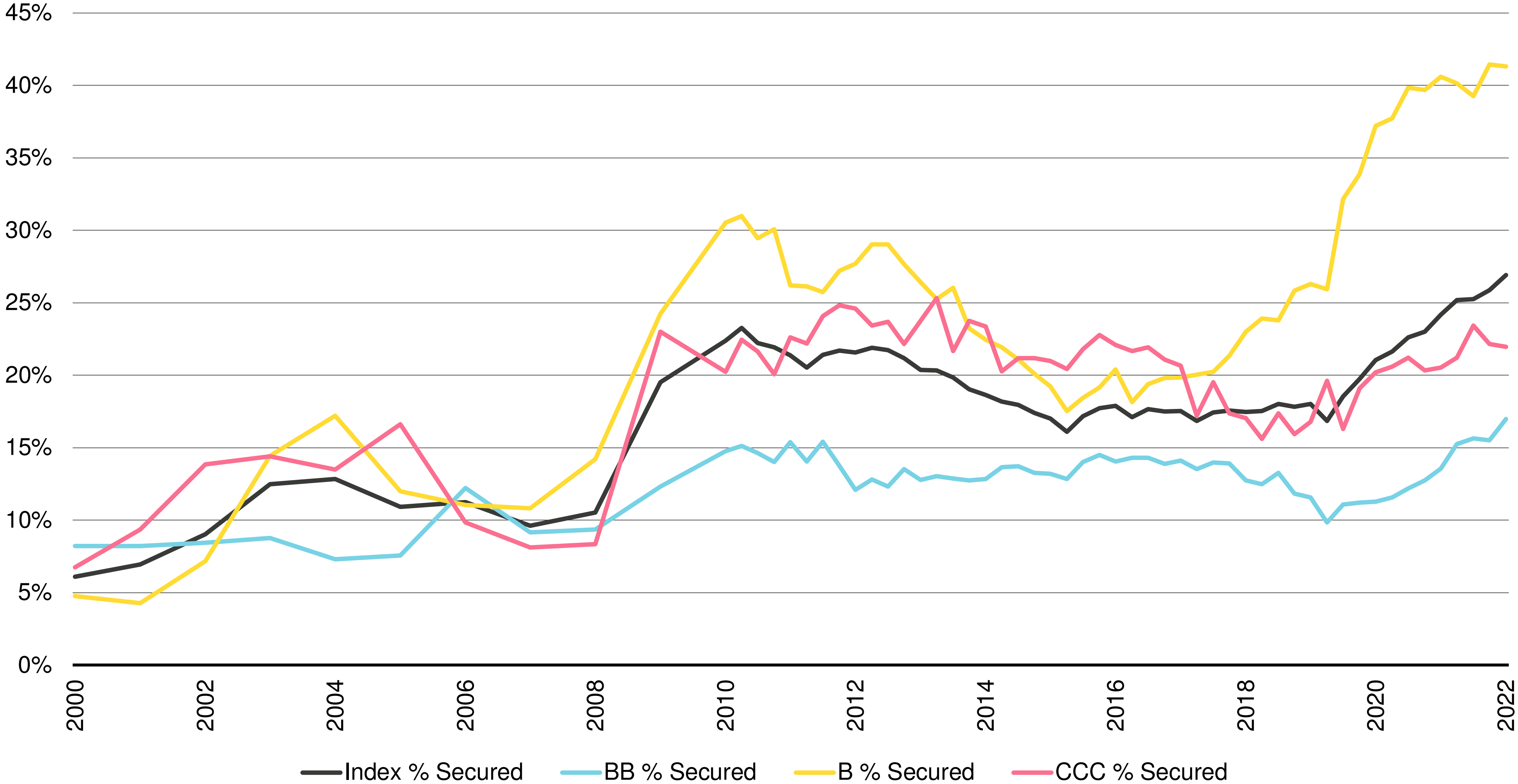
Credit quality has improved further by a record portion of secured single Bs

US High Yield (% secured)



Source: Barclays Research, as of December 2022.

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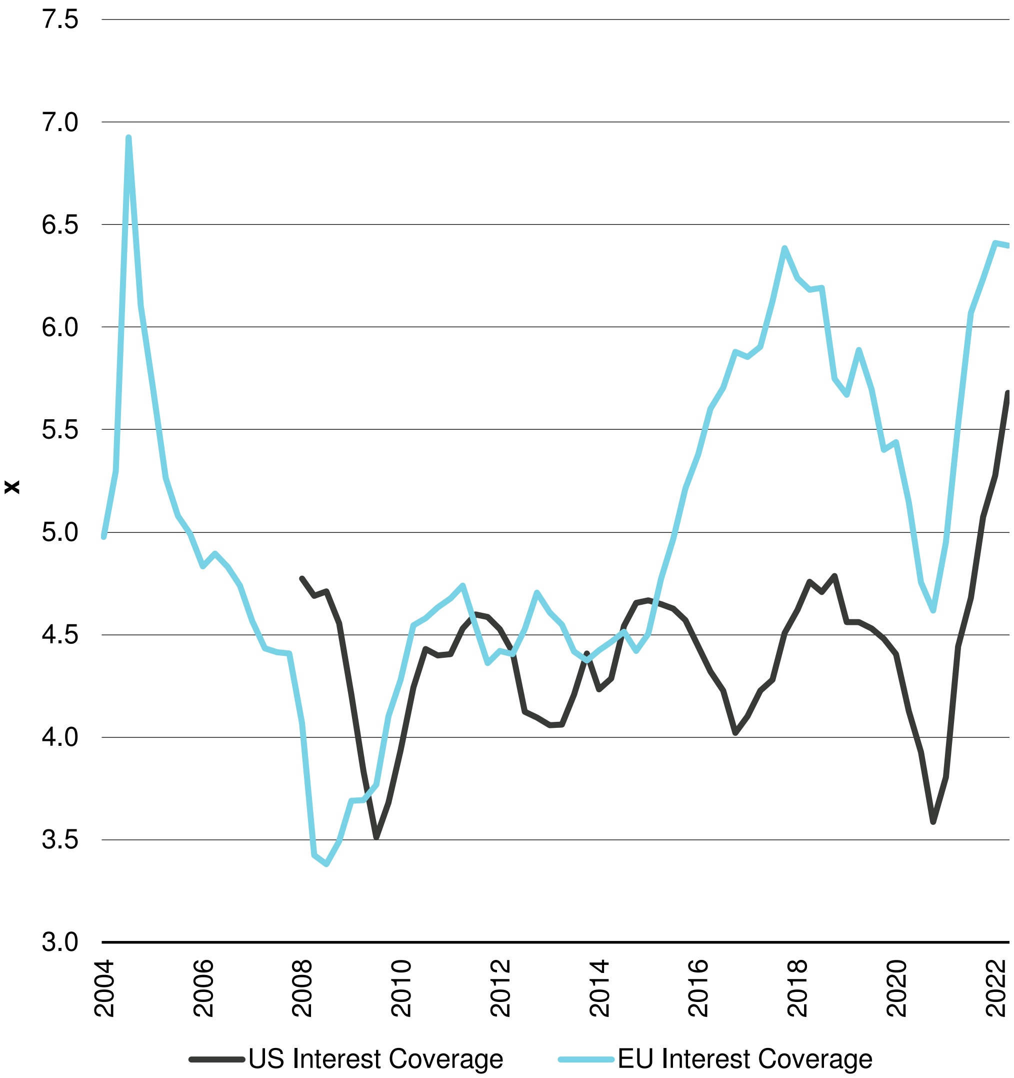
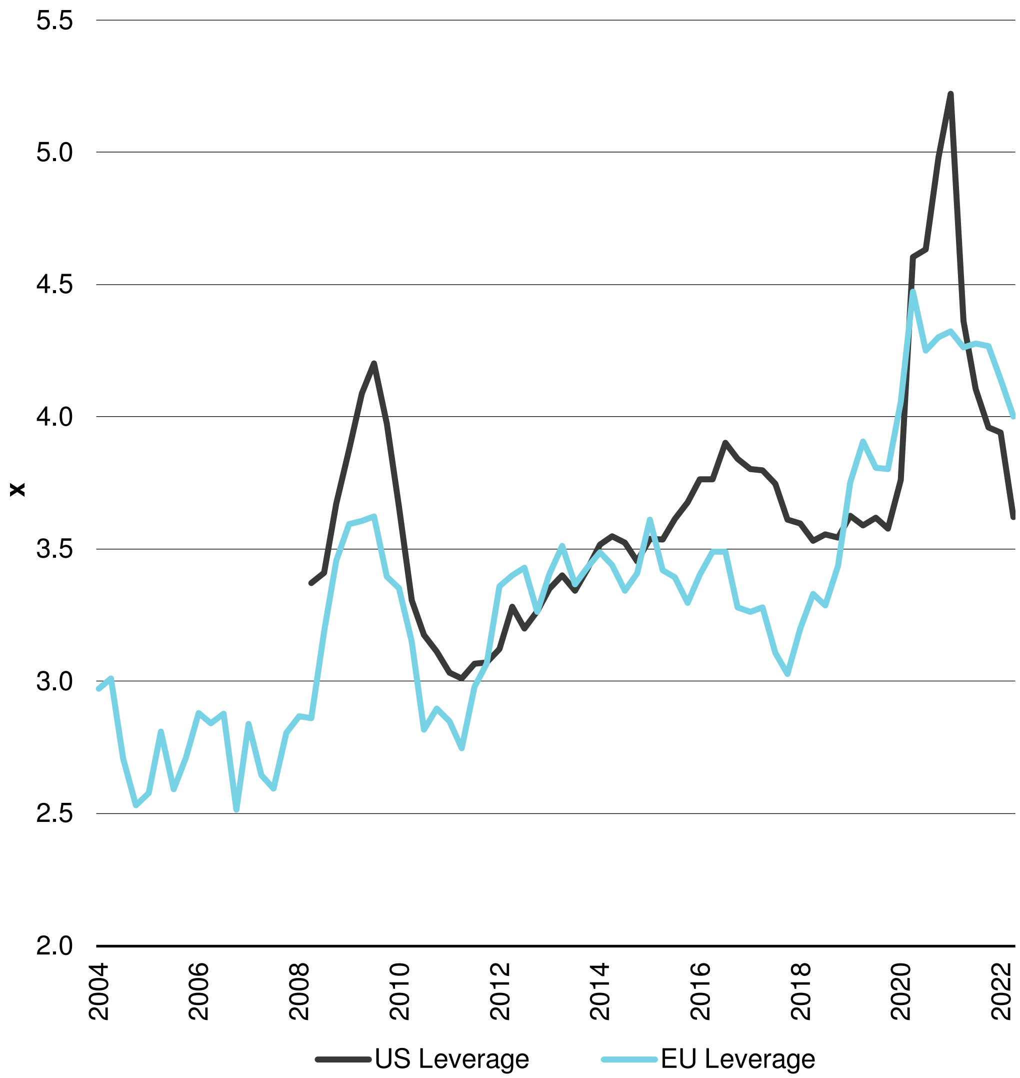
HY companies entered the current market downturn with good credit metrics

Interest coverage



Net leverage



Source: JPM Research, as of December 2022.

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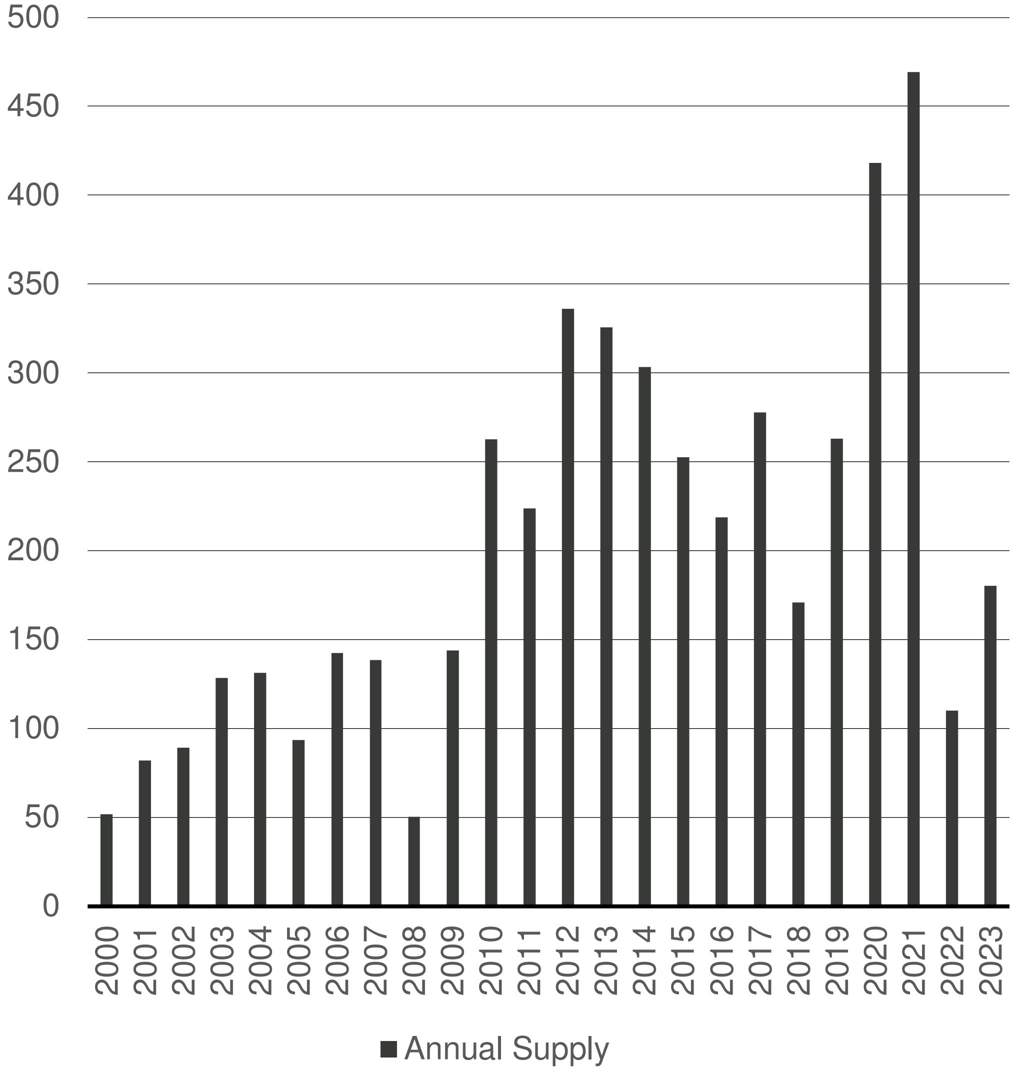
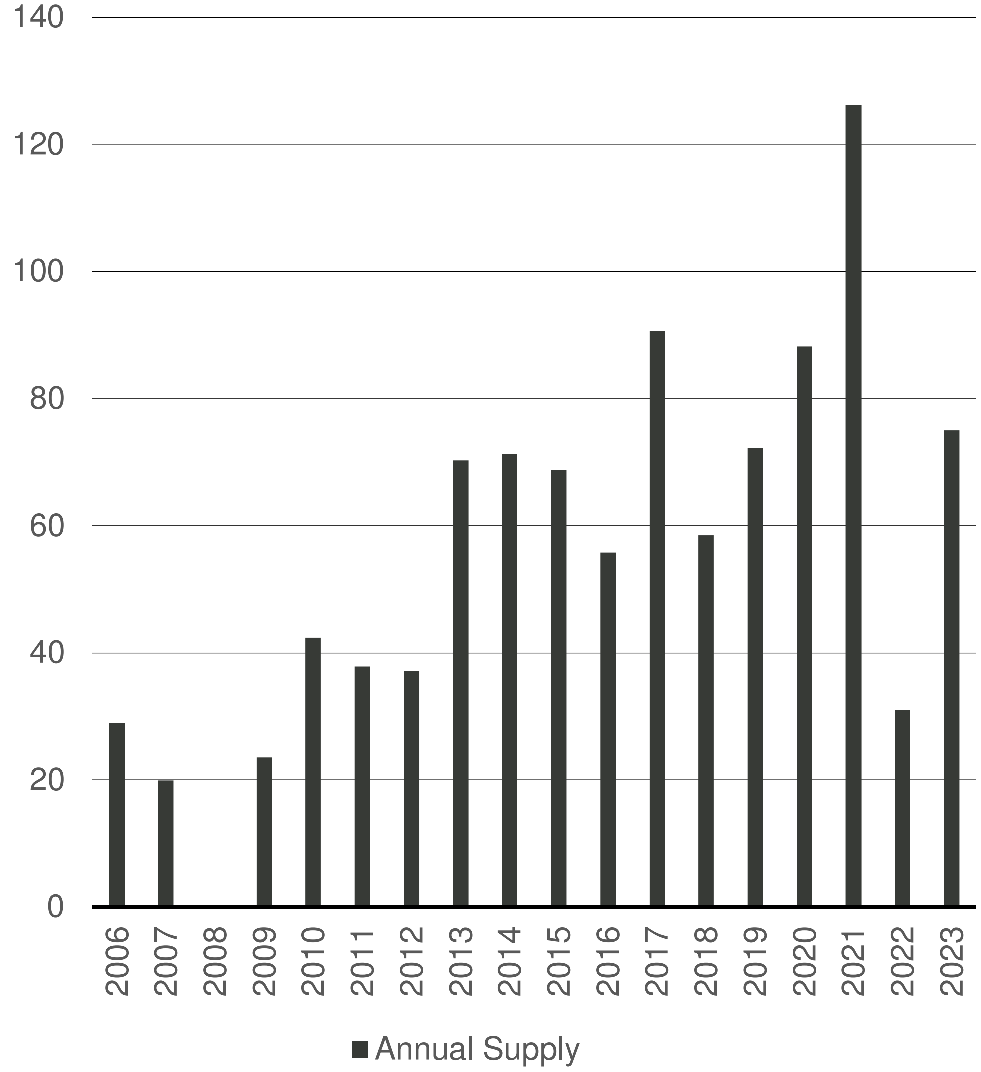
New issue likely to improve but still remain muted

US HY New Issue Supply ($ bn)



EU HY New Issue Supply (€ bn)



Source: Barclays Research, as of December 2022.

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