NCRAM

Monthly Update

January 2, 2024

US High Yield

The US high yield market returned 3.69% in December, bringing the calendar year total return to 13.47%, as measured by the ICE BofA US High Yield Constrained Index (HUC0). When looking across November and December together, the high yield market returned 8.42%, and for Q4 as a whole, the market returned 7.07%.

After a sell-off in September and October driven by fears of “higher for longer,” the rally began in November as the employment report and CPI provided evidence for moderating growth and inflation, and a potential case for easier monetary policy in 2024 began to emerge. On December 13, Fed Chair Powell embraced this case for easier policy more explicitly than expected, turbocharging the rally into year end. After a year of focusing primarily on reducing inflation, Powell indicated a pivot in the Fed outlook to give equal weight to unemployment and inflation. He acknowledged that the current Fed Funds rate of 5.25% to 5.5% will look very high in real terms if inflation heads towards 2%, and that rate cuts are being discussed. This was a significant dovish shift, and the futures market is now pricing in six 25 bps cuts by the end of 2024.

Easier monetary policy in turn raises the odds for a soft landing, and high yield spreads tightened even as rates fell. With soft landing hopes, CCC bonds had the best performance. The Telecom, Cable, and Banking indices performed the best, while Gaming, Leisure and Transportation lagged. In December, the yield on the US high yield market fell from 8.50% to 7.69%, and spreads tightened from 384 to 339 bps.

Looking forward, a soft landing – including stable growth, moderating inflation, and Fed rate cuts – has become the market's base case, so 2024 market performance will depend on the path of those key factors. In addition, the US election in November may or may not influence the market's returns in 2024. With regard to growth, continuing fiscal stimulus and a strong stock market create a positive backdrop, though some drags from higher rates and slower growth overseas should be expected. Generally, we think business, consumer, and government spending will support a slow growth environment. With respect to inflation, goods deflation and manageable energy prices are helpful. Beyond these factors, we believe the labor market has been rebalancing, which should help control inflation in services, and a massive boom in apartment construction should help control inflation in rents. For these reasons, we believe inflation will probably continue to moderate, but how far it falls remains a key question. Clearly, the Fed would like to engineer a soft landing if possible, and progress on inflation has given them room to contemplate cuts. A cut in March and a few beyond that point are a reasonable base case, though the Fed will want to avoid prematurely declaring a full victory on inflation, so they may move somewhat carefully. Overall, we believe high yield can generate an attractive risk-adjusted return in 2024, given stable growth and Fed cuts, but some ebb and flow on valuations can be expected after the recent rally.

European High Yield

The European high yield market returned 2.83% in December, resulting in a 12.69% total return for 2023, as measured by the ICE BofA European Currency High Yield Constrained Index (HPC0, EUR, unhedged). Spreads tightened 31 bps during the month as the market looked forward to central bank rate cuts in 2024. Flows into European high yield continued for both ETF and dedicated high yield funds, and, combined with thin liquidity over the holiday period, led to a strong technical for the entire market. We continue to have a positive outlook on the next twelve months, as we see the European economy being able to weather a mild recession, while the lower rate environment should allow companies to refinance shorter term maturities and keep the default rate in a historically low range.

Emerging Markets

Emerging markets hard currency sovereign bonds posted a 4.81% gain in December, accumulating a 10.45% annual return in 2023, as measured by the JPMorgan Emerging Markets Bond Index Global (EMBIG). High yield sovereign credits outperformed with a 15.42% return for the year, while the turnaround in US yields in late 2023 brought the return of investment grade sovereigns back to positive territory with a 7.08% return. The EMBIG index tightened 55 bps in 2023 to 319 bps over US Treasuries, ending with a 7.2% yield.

Emerging markets corporate bonds gained 3.07% in December, bringing the annual return to 9.08% in 2023, as measured by the JPMorgan Corporate Emerging Markets Bond Index Broad Diversified (CEMBI BD). Similar to US high yield credit and EM sovereigns, EM high yield corporate credit outperformed the most with an 11.17% return in the year, led by some names in the Transportation, Oil & Gas, and Consumer sectors. The CEMBI BD index tightened 41 bps in the year to 281 bps over US Treasuries, ending with a 6.8% yield. Our main two flagship EM strategies (corporate and sovereign) outperformed their benchmarks in 2023.

Multi-Asset Credit

NCRAM's Responsible Multi-Asset Credit Strategy posted solid performance in December, similar to its customized blended reference index. Our overweight to investment grade credit and long duration posture were positive contributors, while our tactical low credit risk posture was a negative contributor. After the strong rally, we further reduced our credit risk and duration posture in December. Looking forward, a soft landing is now the base case for 2024 with a dovish Fed, economic slowdown, and cooling inflation. However, with uncertainty about the pace of easing, we remain cautious for now, and we continue to favor higher quality assets with a long duration bias in this strategy.

David Crall, CFA
NCRAM CEO and CIO

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