NCRAM US High Yield Outlook

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MARKETING MATERIAL

NCRAM's 2024 US High Yield Outlook

Looking ahead from high yield's robust year of double-digit performance in 2023, NCRAM maintains a constructive outlook for the asset class. The ICE BofA US High Yield Constrained Index (HUC0) enters 2024 with yields at 7.7% and relatively tight spreads at 339 bps, thus we expect forward returns to be driven by carry and potential rate declines rather than spread tightening. NCRAM believes four key positives support our expectations for a solid year of performance from the asset class:

- Easier monetary policy should encourage lower rates across the curve, bolstering returns
- Issuer fundamentals are softening from very strong levels, but remain resilient
- Light issuance provides a continued technical tail wind
- Yields offer an attractive entry point for investing in high yield

Review and Outlook

2023 was a surprisingly strong year for high yield bonds, as the US economy staved off an expected recession, high yield issuers continued to deliver buoyant operating earnings, and new issuance remained light with elevated interest rates providing little incentive for borrowers to tap the capital markets unnecessarily. The ICE BofA US High Yield Constrained Index was up 13.5% on the year.

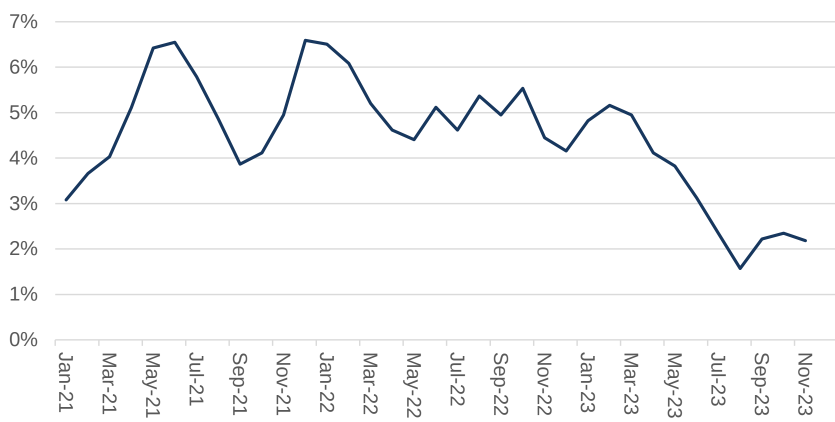
Headed into 2024, NCRAM expects US real GDP growth of at least 1.3% for the full year, and a soft landing is increasingly likely, though we remain cognizant of downside risks to growth. Continuing US fiscal stimulus and a strong stock market create a positive backdrop, though some drags from higher rates and slower growth overseas should be expected. Overall, we think business, consumer, and government spending will support a slow growth environment. High yield spreads have narrowed, but all-in yields remain attractive. Four key factors underpin our outlook for the high yield market to deliver calendar year 2024 total returns close to the 7.7% starting yield.

1. ***Looser Fed policy to support high yield returns***

Tighter financial conditions over the last two years have so far delivered few signs of a slowing US economy, as exemplified by the blowout 4.9% real and 8.3% nominal GDP growth rates in 3Q23. The job market may be less vigorous entering 2024, but the unemployment rate remains comfortably below 4%.

Given the Fed's mandate of balancing full employment and moderate inflation, most investors had anticipated a continued hawkish stance from the central bank until inflation dropped to its 2% target. In December, the FOMC surprised markets by indicating that faster-than-expected disinflation had increased the probability of rate cuts in 2024. The Fed now appears to be more willing to normalize rates as inflation converges on the bullseye – it does not have to wait for unemployment to increase before easing. NCRAM has been closely watching the rolling 3-month annualized Core PCE inflation rate, which sits at 2.2% as of November, not far from the Fed's 2% objective.

Rolling 3-Month Annualized Core PCE Inflation



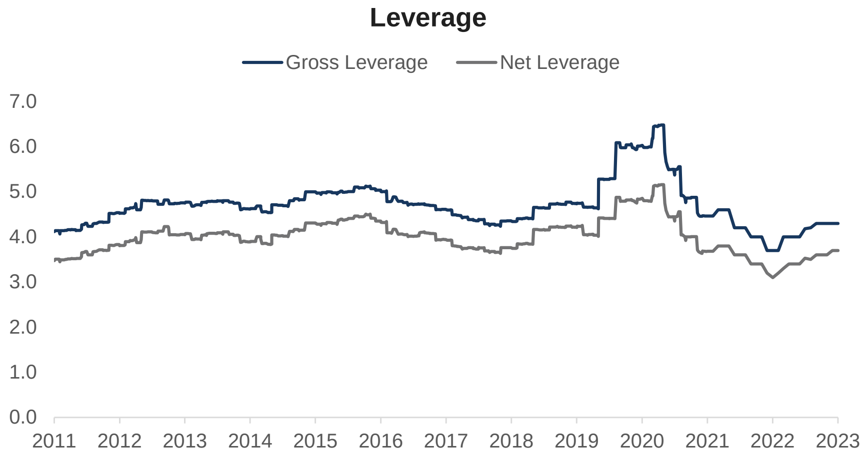
Sources: NCRAM, Bureau of Economic Analysis, via Bloomberg, as of November 2023

The median FOMC member now expects three 25 bps rate cuts this year. Declining Fed Funds rates may support lower US Treasury rates across the curve, creating a positive backdrop for credit and fixed income more broadly.

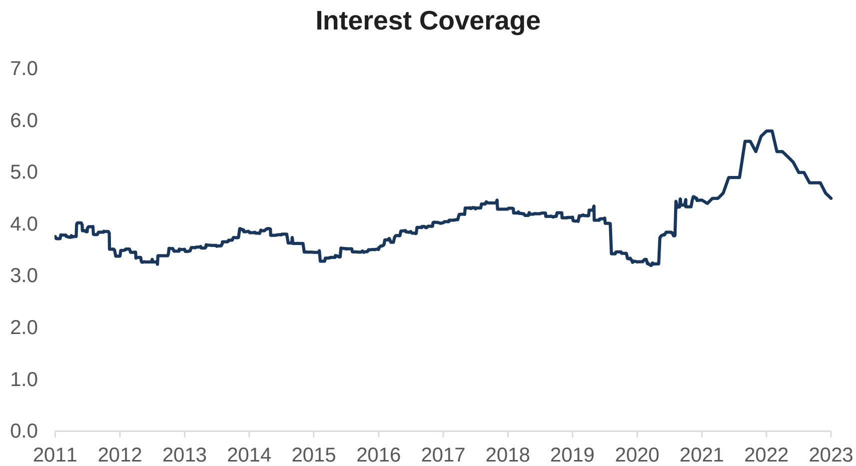
2. High yield fundamentals remain resilient

High yield issuers continue to generate sturdy operating earnings, and the companies are using those resources to prepare for a slower economy. Fundamentals are not quite as robust as observed earlier in 2023, but third quarter earnings did grow modestly both sequentially and year-over-year.

Balance sheet leverage is increasing vs. the cycle nadir; however, the market's 3.7x net leverage remains healthy relative to post-GFC history. Similarly, interest coverage has fallen from its historical peak as earnings growth has decelerated and shorter tenor debt is rolled over at higher rates, but coverage remains at a still-solid 4.5x.



Source: BofA, as of December 31, 2023



Source: BofA, as of December 31, 2023

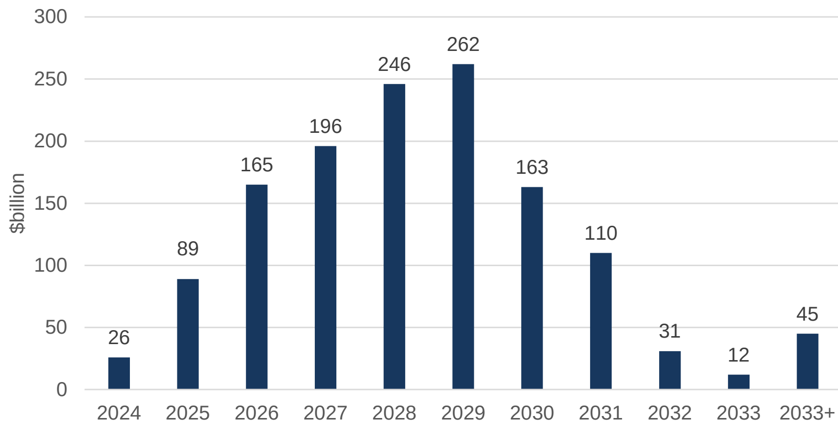
Furthermore, the high yield market's credit risk profile now skews toward higher quality. Close to 50% of the HUC0 index is rated BB, while only 11% is rated CCC or below, near this century's low point. Resilient fundamentals and a higher quality market should result in a manageable default rate, even if US economic growth disappoints in 2024. We expect the default rate to peak below 3% this cycle, below the market's long-term average around 3.4%.

3. Technical tail wind to continue in 2024

The US high yield market contracted by over $90bn in 2023, shrinking the par amount outstanding by more than 5%. Calls, tenders, and maturities were greater than $155bn, while rising star upgrades into investment grade were nearly $125bn. Fallen angel downgrades were less than $15bn, and total new issuance was about $175bn. This supply environment has created a favorable demand dynamic that is supportive for bond prices.

Moving into 2024, we do not expect the positive gap to persist between rising stars and fallen angels. The large issuers on the cusp of an upgrade were lifted out of the high yield market in 2023, notably Ford ($40bn of debt) and Occidental Petroleum ($20bn). However, we do expect issuance to remain light. As of January 1, only $26bn of high yield debt comes due in 2024 and $89bn in 2025. More than 90% of issuers have no debt maturing before 2025 and looking out three years, more than 55% have no maturities prior to 2027. Thus, there is little urgency for most issuers to tap the high yield market until rates decline to more borrower-friendly levels.

US High Yield Bond Maturities



Source: BofA, as of December 31, 2023

4. An attractive entry point

Despite the strong rally over the last two months of 2023, the asset class' yield to worst remains in the cheapest yield quintile based on the last ten years of data. Spreads inside of 350 bps are tight relative to the post-GFC average. However, investors are focused on high yield's resilient fundamentals, supportive technicals, relatively low average dollar price, and the ample all-in yield, pushing down the option-adjusted spread.

NCRAM believes yields are attractive at current levels, as the income offered by the asset class, the pull to par effect driven by average bond prices in the low 90s, and the potential for declining US Treasury yields create an environment conducive to favorable high yield performance in 2024. For the full year, we expect the high yield market to generate returns close to the 7.7% starting yield.

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