NCRAM

Monthly Update

February 1, 2024

US High Yield

The US high yield market returned 0.02% in January, essentially flat, as measured by the ICE BofA US High Yield Constrained Index (HUC0). During the month, economic data indicated that growth has firmed up recently, contrary to many expectations. Real GDP growth was reported to be an annualized 3.3% in Q4, and data in January such as the PMIs and unemployment claims indicate that this momentum has continued into 2024.

At the same time, inflation has continued its steady decline, and Core PCE has been at 2.0% for the past six months. Putting the two themes of growth and disinflation together, the soft landing outlook remains intact. The Fed, while pleased by the inflation progress, recognizes that stronger growth gives them no reason to cut rates quickly, so they have discouraged hopes for a March cut and led the market to expect a first cut in May.

With the overall economic backdrop relatively steady, US high yield had a quiet month. US Treasury yields ended the month roughly unchanged, while spreads widened marginally due to modest profit taking after the strong market in late 2023. Coupons offset the price depreciation and the market delivered a flat return. The spread widening was greatest in CCCs, leading CCCs to perform the worst among the ratings segments. Among industry sub-indices, Banks, Non-Food Retail, and Transportation performed the best, while Cable TV, Entertainment, and Telecom performed the worst. The US high yield market ended the month with a yield of 7.84% and spread of 359 bps.

Looking forward, we are currently expecting Fed cuts to begin in May. We believe inflation is still moderating, as slower rent increases will flow through the inflation data over the course of the year. As inflation continues to head towards 2% on a sustained basis, the current Fed Funds rate of 5.25% to 5.5% will look very high in real terms. We also think the Fed will want to avoid cutting very close to the November election, which supports getting started sooner. Meanwhile, business, consumer, and government spending is expected to support a slow growth environment. Overall, we continue to believe high yield can generate an attractive risk-adjusted return in 2024, given Fed cuts and stable growth.

European High Yield

The European high yield market returned 1.09% (EUR, unhedged) in January, as measured by the ICE BofA European Currency High Yield Constrained Index (HPC0). Spreads tightened 17 bps during the month, which outperformed the US high yield market. Demand continued to be strong during the month as inflows into the asset class were driven by expected central bank rate cuts in 2024. New issue activity picked up as issuers took advantage of market conditions to refinance their 2025 and 2026 maturities, and this supply was easily absorbed by the market. Our view on 2024 is positive, as Eurozone economic growth has come down, which should help move inflation towards the long term target and support rate cuts. Capital markets remain open, underpinning our view that default rates will remain low, leading to another year of positive returns in the European high yield market.

Emerging Markets

EM bonds had mixed performance in January, with EM sovereigns lagging on the back of US rates and supply, while EM corporates remained more resilient and posted a positive return. EM sovereigns declined -1.18% in January, as measured by the JPMorgan Emerging Markets Bond Index Global (EMBIG), mostly driven by investment grade credits that were more sensitive to higher US yields. The spread at the index level widened about 17 bps.

Meanwhile, EM corporates started the year with a 0.59% gain, as measured by the JPMorgan Corporate Emerging Markets Bond Index Broad Diversified (CEMBI BD), and high yield credits in the index outperformed with a 1.37% return and 21 bps tighter spreads. We remain constructive on the asset class, given attractive yields in the high yield portion of EM corporate and sovereign bonds, prospects of Fed easing during the year, supportive technical factors, and a potential return of inflows into EM.

Multi-Asset Credit

NCRAM's Multi-Asset Credit Strategy posted a small gain in January, outperforming its customized blended reference index. Our tactical risk and duration increase into the mid-month sell-off was a positive contributor. A soft landing is our base case for 2024 with a potential "growth phase" coming later, supported by the upcoming easing cycle, cooling inflation, and resilient economy. Despite the increasing odds of a soft landing, credit markets seem to largely price in this scenario, and given uncertainty about the speed of easing, we plan to keep risk at a modest level until valuations improve.

David Crall, CFA
NCRAM CEO and CIO

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