NCRAM

Monthly Update

August 2, 2024

US High Yield

US high yield returned 1.96% in July, bringing the YTD return to 4.63%, according to the ICE BofA US High Yield Constrained Index (HUC0). July continued the pattern from June, in which slightly slower growth and inflation is viewed as bullish, because it allows for Fed rate cuts. During the month, hints of slower global growth could be seen in lower commodity prices such as copper. In the US, signs of stress have been emerging among lower income consumers, including higher delinquencies on loans. At the same time, Q2 GDP was reported to be 2.8%, showing the inherent economic momentum in the US, and employment data has been generally stable until the July report in early August. As the Fed has indicated they would like to focus on both parts of their dual mandate (i.e. both inflation and unemployment), a rate cut in September has become nearly assured, and following the July employment report release, the market is pricing four cuts by year end. The prospect of Fed cuts allowed Treasuries to rally, and the yield on the 5-year Treasury fell by 46 bps. Most of US high yield rallied along with Treasuries, and overall spreads remained steady. However, the market views Fed cuts as extending the economic cycle, so smaller cap equities rallied significantly. For a similar reason, CCCs were the best performing ratings category in the market, up 4.0% in July. Stressed sectors like Cable TV and Telecom performed the best, while Paper, Food & Drug Retail, and Airlines lagged. The US high yield market ended the month with a yield of 7.6% and spread of 325.

Looking forward, parts of the economy may continue to soften. The July ISM Manufacturing Index reported on August 1 suggests manufacturing is slowing, and the

July employment report on August 2 was weak. Election uncertainty may modestly depress activity. At the same time, continued strength in key areas such as technology, energy production, and tourism are bolstering growth. In general, slower but positive growth can be a positive environment for credit, as issuers in aggregate are likely to broadly maintain profitability and cash flow, but economic weakness should enable the Fed to take their foot off the brake and pivot to easing later this year. Furthermore, fundamentals remain resilient, with Q2 earnings season off to an encouraging start. In addition, technicals are supportive for prices, as the par amount of bonds outstanding has grown by less than $40 billion YTD, easily absorbed by the positive investor flows observed this year. NCRAM believes that given the yield on offer in the high yield market, spread tightening or lower base rates are not required for high yield to deliver solid returns over the next 12 months. We have increased some defensive aspects of our portfolios, and we also expect increased credit differentiation in the coming year.

European High Yield

The European high yield market returned 1.34% (EUR, unhedged) in July and 4.92% YTD, as measured by the ICE BofA European Currency High Yield Constrained Index (HPC0). The 10-year Bund rallied from 2.5% to 2.3% during the month as central banks continued to signal that the current policy stance was sufficiently restrictive and rate cuts would be appropriate going forward. Inflation remained relatively stable in the Eurozone as June core CPI came in at 2.9%, while preliminary July CPI was 2.8%. Economic growth continued to struggle, however, as manufacturing PMIs were weak and German economic growth dipped into negative territory. Earnings were mixed to begin the month as certain industries such as automakers and luxury consumer goods saw weakness, particularly from their Chinese markets. On the other hand, chemicals have seen sequential improvement as the industry moves past the destocking cycle seen in 2023. Higher quality BB and B issuers outperformed during the month, and duration rallied as well. As we go into the quiet summer months, we expect technicals to remain strong, and accordingly we saw a strong bid for risk going into month end. New issues should be sparse during August, which will also continue to support the market returns.

Emerging Markets

Emerging markets hard currency bond indices posted positive returns in July, aided by stronger US Treasuries, which offset a moderate 10 bps spread widening in EM bonds during the month. EM corporate bonds, as measured by the JPMorgan Corporate Emerging Markets Bond Index Broad Diversified index (CEMBI BD), gained 1.50% in July with similar performance across sectors, except from real estate which outperformed. Meanwhile, EM sovereign bonds, as measured by the JPMorgan Emerging Markets Bond Index Global (EMBIG) gained 1.82% in the month, due to their higher duration relative to EM corporates. Yields ended July at 6.4% for EM corporates and at 7.7% for EM sovereigns.

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