NCRAM US High Yield Outlook

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MARKETING MATERIAL

NCRAM's 2025 US High Yield Bond Outlook

2024 was a turbulent year across markets and economies, but high yield's competitive carry helped the asset class deliver a strong annual return in excess of 8%. Volatility may continue in 2025, heightened by political and economic uncertainty and stretched risk asset valuations. Nonetheless, NCRAM maintains a constructive outlook for high yield, driven by the following factors:

- Resilient fundamentals underpinned by continued earnings growth
- Supportive technicals, with robust demand subsuming incrementally higher supply
- Attractive carry and all-in yields

High Yield – 2024 Year in Review

High yield bonds posted solid returns in 2024, despite broad instability in the fixed income markets. The ICE BofA US High Yield Constrained Index (HUC0) gained 8.2% for the year. 10-year US Treasury yields jumped 69 bps vs. the level on January 1, ending 2024 at 4.57%, with the yield closing as high as 4.71% in April and as low as 3.62% in September. Treasury volatility was driven by evolving expectations for growth, inflation, and Fed policy. In August, following the release of exceptionally weak US employment data, the Fed Funds futures market priced in nine 25 bps rate cuts by the end of 2025. The market now expects a total of five or six (one or two additional cuts in 2025 after 100 bps of easing in the final four months of 2024). High yield spreads mostly ground tighter in 2024, starting the year with a 339 bps OAS and dropping to 292 bps at the end of December. Spreads' gradual decline over the course of the year was interrupted by periodic risk-off spikes, most notably in August following the employment data scare.

US Economic Outlook

NCRAM expects US economic activity to slow modestly in 2025, from near 3% real GDP growth in both 2023 and 2024, to the mid-2% range in the coming year, with some risk to the upside. The cumulative dampening effect of tighter monetary policy since 2022 is impacting consumer balance sheets and increasing volatility in payrolls data. Heretofore ineffective stimulus efforts in China and political challenges stretching from Brazil to Canada, through France and Germany, and east to South Korea, further cloud the global growth outlook. However, in our view, a US recession is highly unlikely as strong pockets of growth persist, including utility output, energy production, and demand for IT equipment and artificial intelligence capabilities. Business confidence indicators also remain buoyant. One example is Teneo's recent survey of 300 public company CEOs, where 77% of respondents expect the global economy to improve in 1H25.

The most pressing known unknowns facing the economy are the policy priorities of the incoming Trump administration. Deregulation, extending the 2017 tax cuts, and further initiatives to reduce the tax burden on companies and individuals could foster stronger growth and higher profits. Lighter touch regulation would also create a more favorable environment for mergers and acquisitions, supporting asset prices. Successful efforts from the proposed US Department of Government Efficiency (DOGE), led by entrepreneurs Elon Musk and Vivek Ramaswamy, to trim federal spending could help offset budget deficits and bolster private sector activity. Conversely, the DOGE could constrain sectors like defense and healthcare that are buoyed by government expenditures. More pessimistically, Trump's mooted agenda also generates economic risk. Before assuming office, President-elect Trump has already threatened tariff wars with Canada, Mexico, and the BRICs nations (in aggregate, roughly one third of the global economy) and raised other geopolitical questions. Protectionist trade policy and amplified diplomatic tensions are anti-growth and inflationary. For better or worse, the Trump administration must act expeditiously. He enters office a second term president, and thus effectively has two years to execute priorities before his influence wanes after 2026 midterm elections mark the beginning of his "lame duck" period (the final two years of a two-term presidency).

Outlook for High Yield

NCRAM's base case forecast of modestly slower but positive US economic growth in 2025 is a constructive environment for the high yield market. Issuers would continue to generate earnings and cash flow, while weaker activity would likely constrain inflation and enable the Fed to incrementally ease monetary conditions, even if rate cuts do not approach the volume the market anticipated as recently as 3Q24.

NCRAM also believes 2025 will offer a fruitful environment for adding alpha through active management. In a slowing economy, we would expect to see some issuers experience credit challenges, creating an opportunity to deliver alpha by avoiding problems. Furthermore, the average dollar price of a high yield bond as of early January is 95.5, engendering potential to add value on the upside by identifying improving credits with low dollar price bonds that have high positive convexity and room for prices to run.

Three key drivers continue to underpin NCRAM's upbeat outlook for the high yield market:

- **Resilient Fundamentals:** Third quarter earnings season surprised to the upside, with high yield issuers' operating earnings rising 3.0% q/q and 1.2% y/y (JP Morgan data). Leverage and interest coverage remain favorable relative to historical ranges, and the 12-month default rate slid to 0.4% in December. While more issuers are undertaking distressed exchanges, the default rate including such exchanges is 1.5%, still a moderate level.
- **Supportive Supply/Demand Dynamics:** The high yield market's par value expanded modestly in 2024, but increased supply was easily absorbed by solid demand from both dedicated and crossover investors. US high yield mutual funds and ETFs saw full-year net inflows greater than 5% of NAV. New issues and secondary trading were further supported by interest from yield-seeking buyers beyond dedicated high yield investors, including flexible fixed income portfolios, pension funds, insurance companies, sovereign wealth funds, and semi-liquid private credit offerings using high yield bonds as a liquidity buffer.
- **Attractive Yields:** High yield spreads close to 300 bps are historically tight, but NCRAM believes the market's all-in yield of 7.5% offers a sound entry point. We do not expect much near term spread tightening from current levels. Interest rate risk is more or less symmetrical, given the mixed outlook for growth and persistent inflation above the Fed's 2% target according to most price change metrics. Therefore, capital gains are unlikely to drive high yield performance in 2025. However, we believe the asset class can deliver attractive risk-adjusted returns over the next 12 months thanks to the market's favorable 7.5% yield and low default rate expectations.

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