

Overview

Positive Returns Continued in 2Q Despite Modest Spread Widening

The US High-yield bond market posted another quarter of positive gains during the second quarter of 2024, as spread widening was minimal due to continued market faith in a decent macro environment. As we look ahead to the back half of 2024, we believe the US High Yield market remains poised to deliver “coupon plus” returns at year end, as solid corporate earnings keep spreads relatively low, while fixed coupon bonds start to benefit from the initial round of Fed rate cuts that we expect will occur near the end of the year.

Quality Outperforms in The Second Quarter

The US High Yield bond market provided gains of 1.23% during the second quarter of 2024 due in large part to strong returns in June, according to JP Morgan data. During the quarter, spreads inched up slightly by 8bps while yields also crept higher to end the quarter at 8.03%. Despite this small tick higher, current spread levels of 351bps are still significantly tighter than historic averages for the US High-yield market. Spreads even reached post Great Financial Crisis tightness temporarily in the beginning of May before widening slightly by quarter’s end. Helping drive this tightness of spreads was a decent earnings season, benign inflation data and hope that late year end Fed rate cuts help the US economy nail a soft landing. By rating, higher quality BB companies were the top performing high yield bonds in 2Q24 with returns hitting 1.44%. That being said, CCC bonds remain the top performing credits by rating for the year-to-date due to their strong 1Q returns and still positive, albeit small 2Q gains of 0.70%. By sector, Healthcare was the best performing industry in the second quarter with gains reaching 3.12%, while Broadcasting was the worst performer with losses totaling 2.91% during this same time-period. Year-to-date, Automotive remains the best performing industry with gains reaching 7.06% while Broadcasting takes the title as the worst performing industry with losses hitting 4.26%. Market credit quality, as measured by ratings, improved on a dollar weighted basis in the second quarter as the Upgrade/Downgrade ratio climbed to 2.4x. This breaks the recent trend of consecutive quarterly negative readings for the Upgrade/Downgrade ratio and suggests market credit risk is likely not increasing for the time being. The US HY default rate ended the quarter at 1.79%, down 109bps from the end of 2023. These default levels are still well below the historical average default rate of 3.4% as calculated by JP Morgan.

Capital Market Indicators

The US High Yield primary market remained solid in the second quarter of 2024 as ~\$78bn of gross issuance was placed during the

quarter, according to JP Morgan. Refinancing activity remained the main driver of issuance in 2Q once again with refinancing deals representing ~79% of new volume in the quarter. By ratings, issuance remained focused on higher rated BB credits in the quarter. In total, BB and Split BB-rated deals represented ~54% of the new bonds issued during 2Q. CCC issuance, at ~3% of new volume remains relatively subdued verse the recent past and shows a decline in issuance volume from the first quarter. At year end BB and split-BB bonds still represented the majority of the high yield market value.

Defensive Short Duration High Income

The Defensive Short Duration High Income strategy holds mainly BB/B rated bonds with an average portfolio maturity of 3 years or less and outperformed the ICE BofA 1-3 Year BB/B Rated US Cash Pay HY Index on a gross basis. The Telecom and Media industries outperformed through strong security selection identifying credit improvement situations with a handful of competitors lagging during the period. The Transportation sector outperformed as a private aviation company reported increased subscribers and flight time within their customer base. The Healthcare sector lagged due to weak cash flows for two companies that are investing in inventory and backlog for future customer orders during the period. Additionally, a lower quality Healthcare index name outperformed despite significant patent risk. We focused the credit rating toward BB-/B+ reducing exposure to BBB/BB+ and B/B- exposure during the quarter.

Defensive High Yield

The Defensive HY strategy performed in line with the ICE BofA BB-B US Non-Distressed HY on a gross basis during 2Q. The Media industry outperformed through strong security selection identifying credit improvement situations with a handful of competitors lagging during the period. Additionally, we outperformed in the Real Estate and Retail sectors through conservative underweights concentrated away from the most challenged areas. The Healthcare sector lagged due to weak cash flows for two companies that are investing in inventory and backlog for future customer orders during the period. Additionally, a lower quality Healthcare index name outperformed despite significant patent risk. In the Transportation sector, a logistics company struggled with integrating a vertical acquisition during the quarter. Incrementally, we reduced BB exposure due to compressed spreads finding more opportunity in higher quality B credits. Duration remains slightly higher than the benchmark through a higher participation in new issuance at higher coupons but also modestly longer maturities.

Opportunistic High Yield

The Opportunistic HY strategy underperformed the ICE BofA US HY Constrained Index during 2Q. The Telecom industry outperformed through strong security selection identifying credit improvement

situations with a handful of competitors lagging during the period. We outperformed in the Real Estate sector through a conservative underweight that concentrated away from the most challenged areas. We lagged in the Media sector as concerns grew that 2024 political spending would be muted after a short Presidential primary campaign and weak advertising market. The Healthcare sector lagged due to weak cash flows for two companies that are investing in inventory and backlog for future customer orders during the period. Additionally, a lower quality Healthcare index name outperformed despite significant patent risk. Incrementally, we added to BB bonds while reducing exposure to lower quality B/B- bonds. Duration remains slightly higher than the benchmark through a higher participation in new issuance at higher coupons but also modestly longer maturities.

Outlook

Higher Market Yields Constructive for Returns

The Federal Reserve signaled in December that the interest rate hiking cycle has ended providing projections of cuts coming in 2024. Interest rates have been a significant headwind to the high yield market over the past three years and this signal is welcome. In the short term, the expected timing of these cuts have been deferred from starting in the 1H 2024 to late 2024, providing slightly less than coupon returns over the past six months. High yield coupons have risen to 6.27% (at a 92.98 dollar price for a 8.03% yield to worst) providing a stronger return environment for the asset class going forward. The pace of rate cuts will be a second factor for prospective returns in future months with a modified duration of 3.53 providing the prospect of high single to double digit returns based on the Fed rate guidance.

The current environment calls for focusing on strong credits that can weather economic slowdown due to higher rates for longer. In many areas, the credit market is not differentiating well between the strongest companies and weaker competitors, so we are upgrading the portfolio by reducing risk with little loss of return today. New issuance has been muted but we have found a “buyer’s market” with high coupons and strong covenants providing an attractive risk-return paradigm. We are focused on new issuance with higher coupons to seek to drive a higher significantly higher current yield as compared to the index in the current environment.

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