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A downturn is ahead, but pinpointing when and where is the real question

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Around this time last year we expected high yield markets to rebound after an August reboot. However, as at the end of October we were looking at our global high yield benchmark losing 15% from the start of 2022. Against this, we did correctly predict that the global yield market would outperform gilts and sterling credit, and that emerging market debt would be a key area of weakness, delivering returns well below the US and European regions.

So, what went wrong? Where could our forecasts have improved? Like the majority of us, we did not foresee Russia invading Ukraine, and the resulting supercharge of inflation. The downstream impacts of inflation on interest rates and the increased risk of recession have been painful.

While outlook pieces stay etched in stone, fund managers have the advantage of revisiting assumptions as new information emerges – but do stay within a clear and consistent investment philosophy and process.

Russia's move into Ukraine forced us into a firmly defensive position. The US Federal Reserve's unwavering commitment to dampen inflation with aggressive rate hikes – at a faster rate than previously indicated – became immediately apparent. However, what was still up in the air, was how the double whammy of the inflationary impact and sanctions on Russian oil, gas and other commodity prices would ultimately leave markets.

We kept that more defensive stance for the rest of 2022. Despite sharp falls in underlying government bonds, and far wider high yield credit spreads, leading to particularly attractive yields, we felt there was no need to be more bullish. Given the asymmetry of risks in credit investing, it doesn't pay to take excessive risks when heading into periods of more negative sentiment.

Looking ahead, should we continue this defensive stance? Yields are now materially higher than this time 12 months ago, but are the prospects for the asset class more bullish? In my view, the answer is generally quite straightforward: in 2023, the high yield market will be all about the recession and the shape of the default cycle.

The fears around the size of the impending recession and subsequent defaults have calmed somewhat after the market panic in the autumn. Since then markets have priced in a more benign environment – one that suggested that the peak of the rate cycle was near and that the recession would be relatively mild. The double-digit default forecasts we saw in September had turned into more modest 4-5% default predictions by December.

As markets have calmed, one aspect we will continue to keep a close eye on is the risk-free rate. Until recently, around two-thirds of the total yield of the market was driven by the spreads on high yield bonds, with the risk-free element representing around one-third. As government yields moved significantly higher, the ratio is now more of a 50:50. While this isn't terrible in itself, it does mean that government bond yield volatility will have a greater impact on the high yield market. And most investors, ourselves included, are predicting more volatility in government bonds next year.

Another factor we will be watching closely is the upcoming moves from central banks. I have a slight concern that there is a general belief the peak of the moves is within sight as their medium-term inflation targets remain difficult to achieve. Perhaps they are able to dissolve the large uptick in prices seen this year, but I'm not so sure. Inflation looks to have reached, or is certainly nearing, its peak in Europe and the US, leading to central banks to pick up the hawkish commentary. However, I feel there is a material chance that we only see inflation back at the 2% targets because of more hikes and / or a deeper recession than is currently priced into markets.

This sounds a rather downbeat assessment, but I continue to see opportunities for high yield investors. The market was quite resolute in 2022, and many of drivers behind that resoluteness remain in place as we move into 2023. The composition of the market is in a better place than it was 20 years ago, with around 9% of the market CCC rated, compared with double that a little over a decade ago while the proportion of higher quality BB bonds has increased materially. More importantly, however, is the yield on the market is now 8%, which provides a nice buffer against further drawdowns and an attractive return if the market doesn't do what we want it to and trades sideways over the next year.

As always, we find ourselves facing higher and lower risk paths depending on what exposure we seek. Given our prediction that interest rates may not be on smooth a tightening path in 2023, many are still looking at short duration strategies to try to mitigate these effects. We may also have to contend with a rather large recession, but unlike in the Great Financial Crisis, or even the pandemic, we expect negative effects to be much more issuer-specific instead of large swathes of certain sectors getting hit. Therefore, my view is that whether focusing on shorter or longer maturity issues, fully understanding that issuer and the quality of their financials, rather than relying on third-party ratings or research, will be the determining factor in investor success in 2023.

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