2024 outlook: what's next for high yield?

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Against a backdrop of heightened uncertainty, what has surprised you most about high yield over the past year? And how do you see those dynamics playing out in the next 12 months?

One of the biggest surprises this year has been the strong performance across the high yield bond and loan markets. While that was partly due to high yield's shorter duration/lower interest rate sensitivity, it was also a result of the lack of negative catalysts. As we expected, the wave of defaults that some were expecting at the start of the year have not transpired, and the 'higher-for-longer' reality has been a tailwind for loans in particular, which are floating-rate. At the same time, downgrades have been manageable.

The big question, of course, is whether the strength can continue if the macro picture starts to worsen. A big part of the answer lies in the levels of current yield and return. Looking at the high yield markets, global loans have returned approximately 10% year-to-date and are currently yielding around 10%, while global high yield bond yields are up about 6% year-to-date, with yields around 9%.[1] Yields at these levels should offer a substantial cushion in the event of a meaningful economic slowdown.

What is your view of the credit quality in high yield bonds and loans?

With 2023 having been a relatively benign year for defaults, some analysts are still predicting draconian default rates and widespread investor losses in the next 12 to 18 months. However, that's not our base case scenario for a few key reasons. First, if a recession or a sharp slowdown were to occur, it would be one of the most anticipated downturns in history. Since markets are forward-looking, they have already priced in a downturn such that most credits likely to default over the next 12 to 18 months are already trading at steep discounts to par—and the high yields currently on offer should help absorb any defaults that do materialise.

At the same time, the quality of the high yield market has improved significantly over the last decade—another reason we believe widespread defaults are unlikely. BBs, for example, now represent around half of the market, up from 40% a decade ago.[2] CCCs, which have the highest risk of default, now account for only 10% of the market versus more than 20% after the financial crisis. What's more, there is now a broader mix of industries and sectors in the high yield universe, with no one sector or industry exhibiting signs of significant stress, as was the case historically in previous default cycles. For these reasons, defaults that occur are likely to be idiosyncratic and particular to a specific credit. So, to sum up, while defaults are likely to move higher from current low levels, the high yield market appears healthy overall.

Where does the current rising star/fallen angel dynamic fit into the high yield picture?

During Covid, more than $200 billion of IG credits fell into high yield.[3] Since then, the high yield market has contracted by around $350 billion, of which $230 billion was attributable to rising stars, creating a positive technical backdrop. The recent upgrade of Ford—which represents $40 billion in debt—is significant, and we expect rising stars continuing to exceed fallen angels in 2024, although the technical tailwind will likely be much less significant than it has been over the last 18 months.

Looking ahead over the next year, what areas look most attractive?

With current yields at elevated levels, there is no need to "stretch for yield" by taking on additional credit risk. BB bonds, for example, are yielding 7% to 8%—which, given the contractual nature of coupons and principal repayment, is extraordinary in comparison to equity markets such as the S&P 500, which has returned around 10% or 11% over the very long term.[4] We see particular opportunities in high-spread, yield-to-takeout trades, in which there are near- to medium-term maturities and where the borrower has liquidity levers or secured capacity—essentially, multiple ways to refinance. In BBs and high-quality single Bs, we look for catalysts for spread tightening. That could be earnings momentum or upgrade potential due to improving fundamentals.

In the loan market, there is considerable carry. BB-rated loans are offering coupons of approximately 7.5% to 8%, and this is a part of the market where default rates have historically been very low.[5] There also are opportunities in other areas of the loan market. For example, you can find first-lien loans that offer equity-like returns, which is rare outside of major adverse macro events such as the financial crisis or Covid.

What do you see as the biggest risks to high yield today and tomorrow?

While we're not too concerned about the high yield and loan markets overall given the default rate math and high current yields, what's different about this cycle is the poor creditor protection in recent-vintage loans and how companies and sponsors are finding creative ways to exploit gaps. Being caught on the wrong side of liability management worries us, and while there are ways to mitigate the risks—by being a top lender, having a seat at the negotiating table, and being well-connected with sponsors, peers, and advisors, for example—none is foolproof.

At the same time, there is a risk in sitting on the sidelines and trying to time things perfectly. There is simply too much income available right now to wait because buying opportunities like this don't typically last very long. But given the potential for a more challenging scenario to unfold, we believe that a bottom-up approach to investing—issuer by issuer, deal by deal, and credit by credit—is crucial to both avoiding additional downside, and identifying issuers that can withstand the challenges ahead.

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FOOTNOTES

1 Source: Credit Suisse, Bank of America. As of October 31, 2023.
2 Source: Bank of America. As of September 29, 2023.
3 Source: J.P. Morgan, Bank of America. As of October 31, 2023.
4 Source: J.P. Morgan. As of October 31, 2023.
5 Source: Credit Suisse. As of October 31, 2023.

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