RBC Global Asset Management

Global high yield set to repeat its strong rebound pattern

March, 2023

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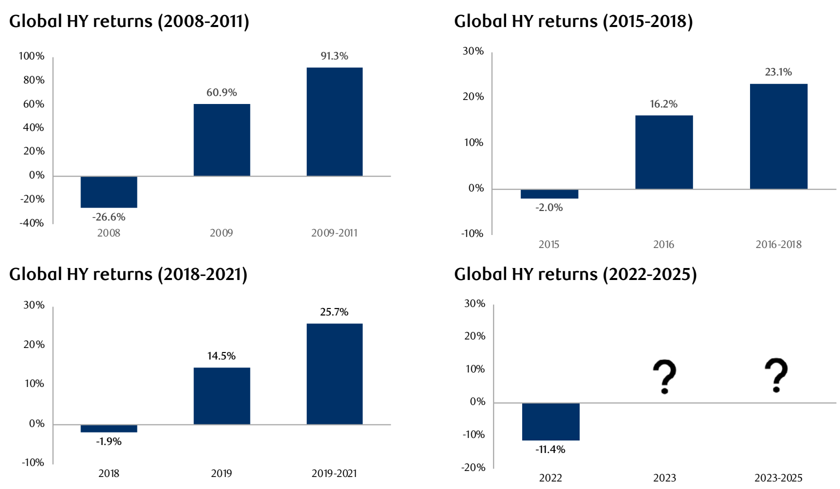
It has been an encouraging start to 2023 in terms of returns, engagement, and activity for high yield (HY). A drawdown of -11.38%[1] in 2022 has set the stage for better returns over the next 1-2 years in this strongly mean reverting asset class. The sharp repricing of government bond yields has taken the Global HY yield to nearly 8.75%[2] which has historically proven good entry points for longer term investor.

The challenge for allocators is that greater opportunity is not without risk. Higher interest rates over several quarters tend to lead to defaults due to pressure on corporate earnings and profit margins. The challenge to cash flows from a regime change on funding costs is that they will take a long time to play out - with limited maturities and largely fixed coupon debt this is a multi-quarter or even multi-year process.

However, it can also be costly to sit on the sidelines waiting for lagged quarterly data to confirm that most HY companies have weathered the storm. Global HY is among the most resilient asset classes and tends to rebound quickly after a drawdown, thanks to its consistent, high income.

Exhibit 1: Global HY 1-and 3-year returns historically rebound strongly after rare down years



Calendar Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Return (%)	-26.6	60.9	15.3	3.2	18.9	7.1	2.5	-2.0	16.2	8.0	-1.9	14.5	6.5	3.0	-11.4

Source: RBC BlueBay Asset Management and Bloomberg, as at 31 December 2022.
Global High Yield represented by the ICE BofA Global High Yield Constrained Index USD Hedged; 3-year returns are cumulative.

[1] Global HY market represented by the ICE BofA Global High Yield Constrained Index. Index returns are USD Hedged. Returns over 2022 were -11.38%.

[2] Yield of the ICE BofA Global High Yield Constrained Index as at 22/02/2023.

Why is global high yield resilient?

- Since total returns are the price moves of a bond plus coupon payments, then the higher the coupon, the more able the bond is to absorb any decline in dollar price caused by a rate or spread hike.
- When high-yield issuers call their bonds before they mature, they pay bondholders a premium for the privilege.
- Bonds do not typically default – if they can be refinanced.
  - At higher yields there is more incentive for capital to be provided to management companies to refinance their bonds.
  - Aside from public bond markets – management companies can also refinance global high yield bonds in the private credit, leveraged loan, convertible bond or equity markets.

Fundamentals - Strong starting point eases concern on expected challenges ahead

The underlying credit ratings for the asset class has been on an improving trajectory. Around 58% of the Global HY index is now in top rated BB cohort.

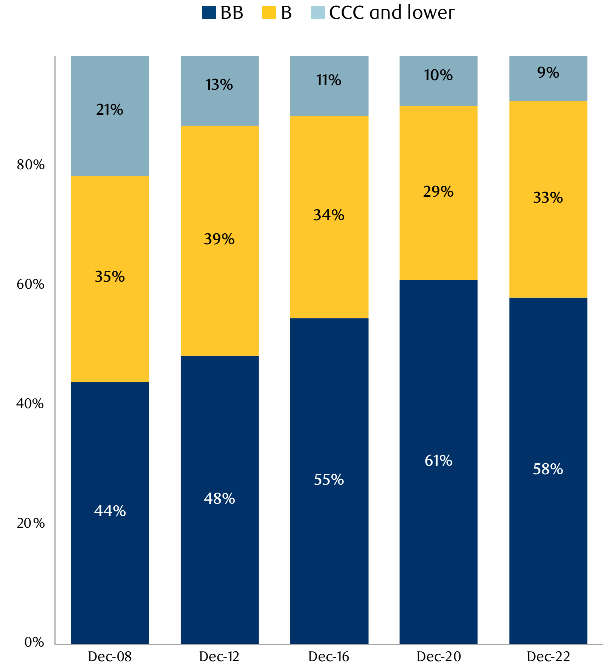
Trailing credit metrics reflect that balance sheets and fundamentals are near record strength. Exhibit 3, shows that US HY bond net leverage is back to pre-Global Financial Crisis (GFC) lows. For some industries, the inflation shock has been a credit positive, enabling them to pay their fixed rateobligations with inflated assets and cash flows.

> **"The most indebted segments of the investment universe offer higher spread but with additional risk on how their upcoming maturities will be refinanced."**

The energy and metals and mining sectors have seen the most impressive credit metric improvements over past few quarters. The most indebted segments of the investment universe offer higher spread but with additional risk on how their upcoming maturities will be refinanced. As underwriting standards tighten, industries in secular decline will also warrant careful due diligence to identify the survivor balance sheets and avoid the capital structures heading towards stress and a potential default or restructuring.

While we expect defaults to rise, companies do have more breathing room than in prior recessions. We expect the default rate to remain below 5% which is meaningfully lower than the previous cycle peak. The Covid era provided a long period for companies to refinance and extend their capital structures; this is a tailwind today. With continued moderation in inflation data there is the possibility that the Federal Reserve could switch to more accommodative policy in late 2023 or early 2024. This will further support the functioning of capital markets to refinance obligations.

Exhibit 2: Global HY Index rating composition



Source: Bloomberg and ICE BofA as of December 31, 2022. Global HY Index composition represented by ICE BofA Global High Yield Index.

Exhibit 3: Q322 US HY net leverage and coverage metrics

	Q3 2022	Q2 2022	Q3 2021	Q1 2008	Q/Q	Y/Y	Pre-GFC
Leverage	3.06x	3.11x	3.07x	3.06x	-0.05x	-0.02x	0.00x
Coverage	6.19x	5.92x	5.24x	4.43x	0.26x	0.95x	1.76x

Source: Morgan Stanley Research, Bloomberg, S&P Capital IQ Q322 results, as at 2 February 2023. Net leverage defined as net debt / trailing 12-month EBITDA; Coverage defined as EBITDA/Net Interest Expense.

Exhibit 4: US HY par-weighted default rates

Source: JPMorgan as at 1 February 2023.

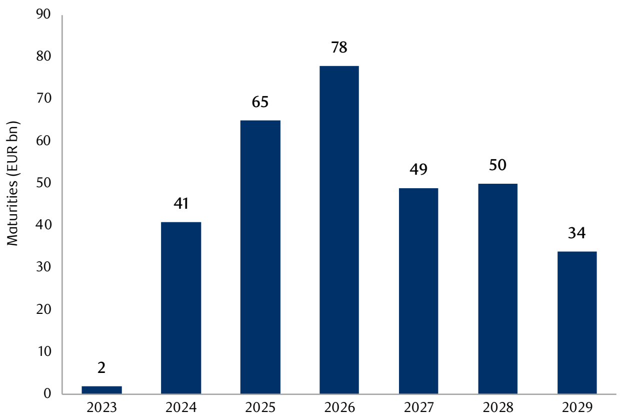
A further favourable trend is that the pace of upgrades from HY (rising stars) continue to exceed the downgrades into HY (fallen angels). In European HY, there are expectations that 2023 rising star volumes could surpass EUR 25bn, while in US HY some of the largest disruptive fallen angels from 2020 could be upgraded this year. Ford and Occidental Petroleum by themselves could remove around USD 70bn of bonds from HY indices.

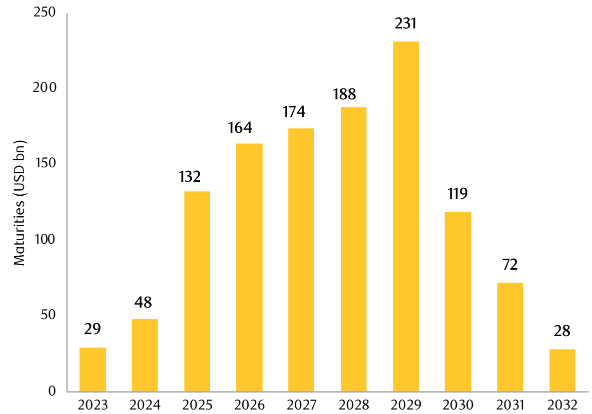
> **"In European HY, there are expectations that 2023 rising star volumes could surpass EUR 25bn, while in US HY some of the largest disruptive fallen angels from 2020 could be upgraded this year."**

Technical factors remain supportive

High yield supply has been exceptionally low; exhibit 7 shows this dramatic drop. As the supply of US high yield was only USD 115bn last year this is significantly below the average for the decade, at an 80% drop. Given the reset in yields there is very strong demand when the modest number of new, clean stories come to market. Primary market issuance is only expected to be slightly higher in 2023 and represents an attractive channel to re-position portfolios. It is the same story in Europe. This meagre supply means that credit spreads have been pushed tighter pushing high-yield bond prices higher.

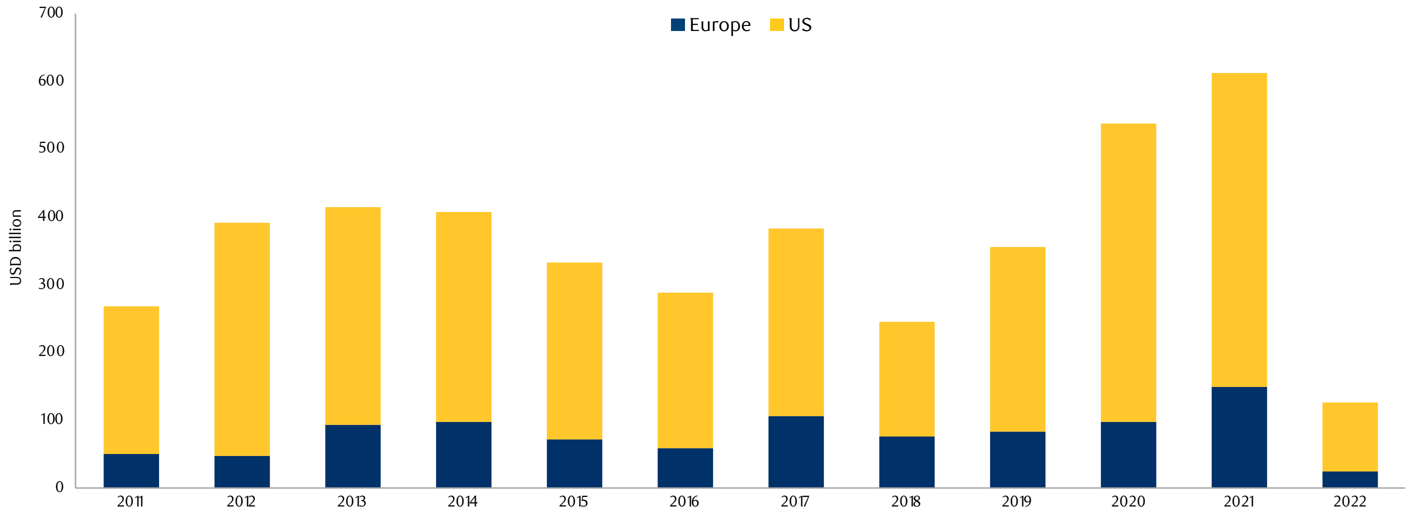
Exhibit 5 and 6: European and US HY maturity wall





Source: Top chart: Bloomberg Indices, UBS for Euro HY and Leveraged Commentary & Data (LCD) as at 31 December 2022; Bottom chart: BoA, as at 30 November 2022.

Exhibit 7: New issue volume



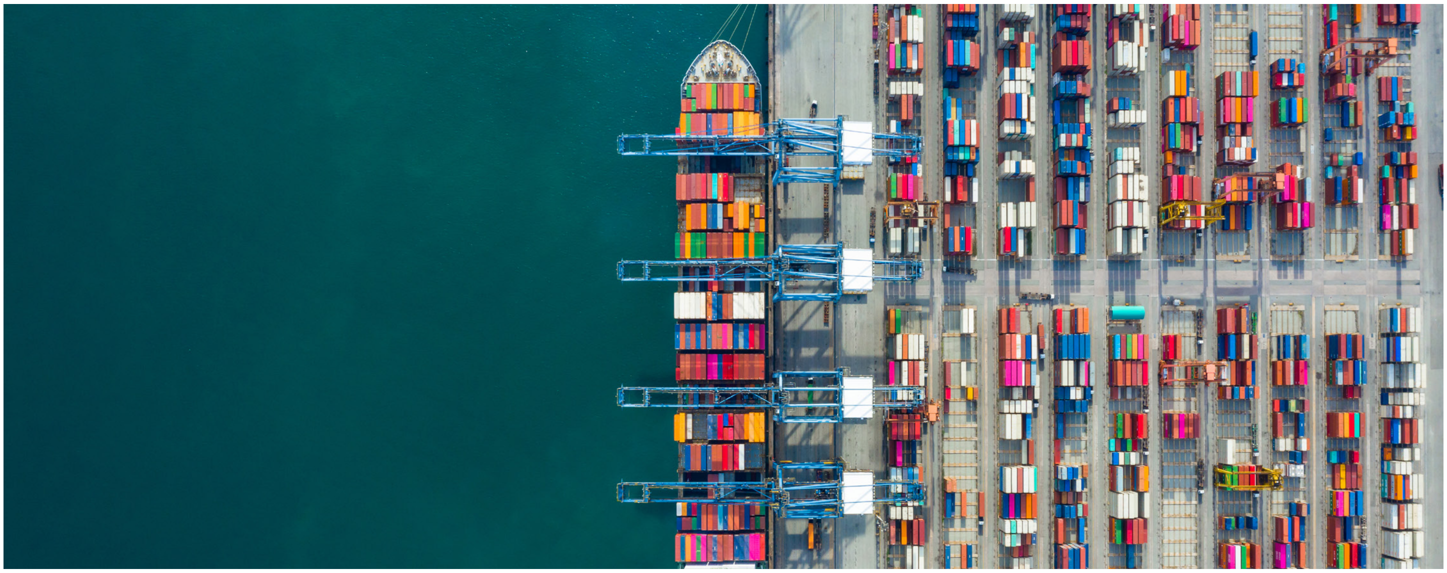
Source: Leveraged Commentary & Data (LCD), as at 31 December 2022.

"We have been highlighting how the wider asset class feels under-owned, but that trend is beginning to turn."

Last year there were sizable outflows from the asset class. 2022's USD 49bn outflow from US HY mutual funds and ETFs set a record with a further EUR 12bn pulled from European HY funds. We have been highlighting how the wider asset class feels under-owned, but that trend is beginning to turn. As we get more clarity on the future path of inflation and the earnings outlook, we only expect the trend of investors re-engaging with the asset class to accelerate.

Final remarks

While it may be premature to say we have reached the peak yields in this Global HY cycle until we have a few more quarters of earnings releases – we believe the yields at nearly 8.75% - are sufficient to compensate investors for foreseen and unforeseen risks. In past cycles, Global HY has delivered positive returns despite rising credit stress and weakening growth rates. The starting quality of fundamentals and strong technical factors give us conviction that the asset class can continue its mean reverting pattern, after a rare down year.



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