RBC Global Asset Management

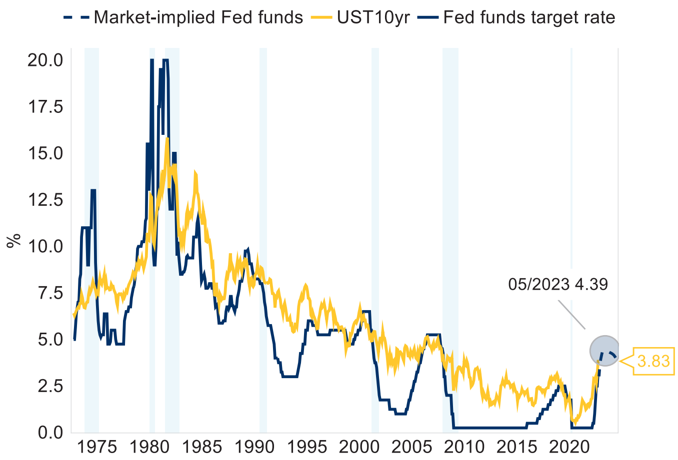
In a rising-rate environment, high yield bonds look well-positioned

August 2022

After a decade of zero, if not negative rates, the scenario has drastically changed: what are the general consequences for the bond market?

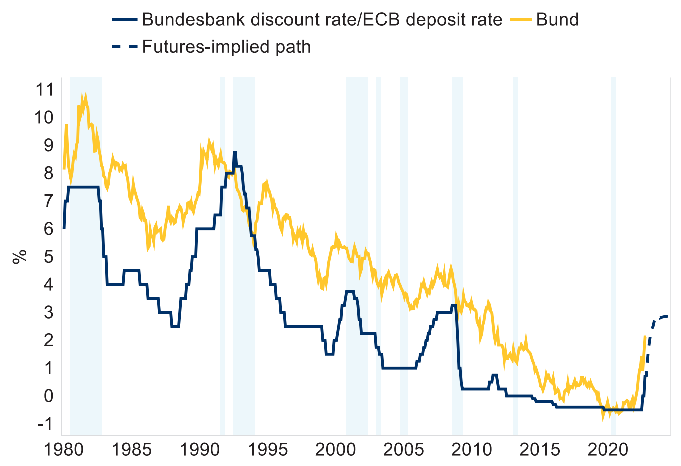
In a word - pain. The move higher in interest rates across major global central banks (including the Federal Reserve and ECB) occurred at a time when duration, or the sensitivity of bond prices to interest rate moves, was near its all-time high. This has driven bond prices dramatically lower as rates have risen. The negative impact on total returns was substantial – many segments of the global fixed income universe experienced declines of more than 15% year-to-date. On a more positive note, bond prices are now at levels where yields are much more compelling and could well offer sufficient income to insulate from further upward interest rate moves.

Higher Rates, Negative Returns, More Yield
Fed funds and UST10yr yield[1]



1 Source: Macrobond; latest data at 3 October 2022

ECB deposit rate and bund yield[2]

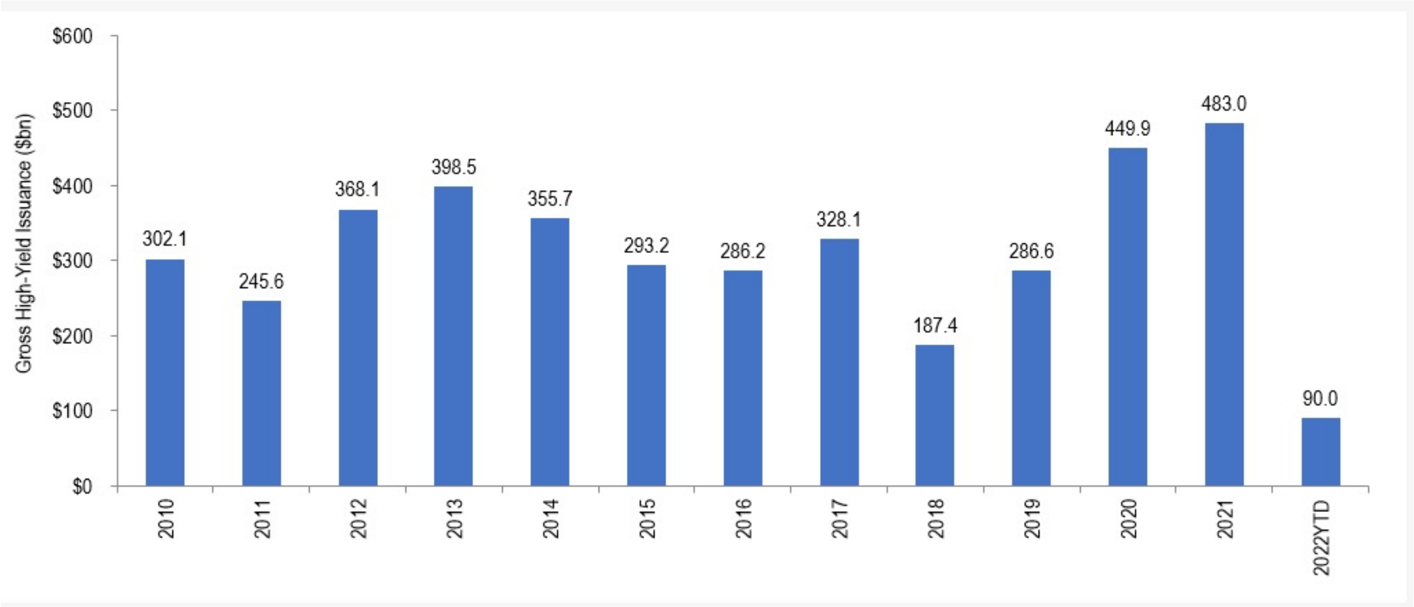


2 Source: Macrobond; latest data at 3 October 2022

What is the impact on debt refinancing operations by governments and private companies, especially with regard to investments in sustainability?

High yield new issuance has slowed dramatically in 2022 for two reasons. First and foremost, 2020 and 2021 saw sequential record new issue supply. Over half of that supply was used to refinance existing debt. As a result, there is very little corporate debt needs to be refinanced over the next two years. Looking at the wider fixed income universe, we note that there was over $1 trillion of ESG related financings in 2021 across sovereigns and corporates, with sustainability-related supply matching green debt issuance for the first time.

Figure 2: US High Yield New Issuance Over Time



The new government in Italy and British fiscal policy are two new factors in Europe: how will the two scenarios evolve, and what impact will they have on investments?

In the UK, the impact of the new prime minister's economic agenda has sent shockwaves in domestic markets. Investors judged the recent 'mini—budget', which included £45 billion of tax cuts, as ill-advised in a cost-of-living crisis and reckless given its unfunded nature and the already large intervention in capping energy prices. Despite some moderate policy U-turns, we think investors will continue to be skeptical of UK assets - e.g., the pound and gilts - until fundamental policy or political change is enacted. The government will reveal its longer-term fiscal plans at the end of October, providing investors the opportunity to evaluate the plans in detail. However, we think the UK government will have a difficult time convincing markets that their longer terms fiscal plans are both credible and deliverable, and therefore will continue to attach a substantial 'risk premium' in UK assets in the months ahead.

In Italy, incoming prime minister Meloni faces the same challenges on the energy front as much of Europe - which will dominate fiscal policy over the coming quarters. Domestically, driving the tax and pension reform will be high on the list of post-election promises. While there is scope for some turbulence internally heading into the budget season, particularly from Lega and regarding the flat tax reform, we think senior coalition members, the Brothers of Italy, will opt for a more responsible, targeted approach. There is little to gain in the short-term in being confrontational with EU rules, and more to lose through Next Gen EU grants and the ECB TPI backstop. Overall, we think the communication on the fiscal front will be gradual and typically conservative, allowing the focus to switch to the growth part of the agenda.

The alternative between an inflation under control and an economy in recession is now clear. What to expect?

It will be incredibly difficult to tame inflation without slowing the economy to the point of a recession. The Fed has an explicit goal of tightening financial conditions. Their monetary policy will increase the cost of capital for corporates and individuals alike. Eventually unemployment rates will increase, and growth will slow to the point of recession. We believe the US will see a relatively benign recession compared to Europe, where fiscal policy support will be necessary to prevent a truly bleak scenario. That said, in our opinion, default rates will not reach levels seen in previous recessions. High Yield leverage and interest coverage ratios are strong by historical measures, which demonstrates that the asset class is well prepared to weather the storm ahead.

Which sectors and geographical areas offer the best investment opportunities in this context?

We are overweight non-cyclical issuers and have a regional preference for corporates in the United States. The American consumer will remain strong while unemployment is low. The world shares in the pain of inflation, but energy costs are far more severe in Europe than in the US. That said, there are pockets of value in each sector across High Yield. We prefer shorter duration, senior secured, single

B-rated bonds, while remain underweight CCC-rated bonds that are most vulnerable to an economic slowdown. We prefer investments in larger issuers whose debt trades often and is considered liquid. That allows us to remain nimble in volatile and uncertain markets.

Could you indicate 4/5 interesting issuances, explaining why they are interesting?

Our benchmark is the ICE BofA Global High Yield Investment Grade Country Constrained corporate bond index (HWIC.) It consists of 1,429 different companies (issuers) domiciled in investment grade rated countries, who have issued 3,320 bonds that total nearly $2.2 trillion in debt. Our benchmark has grown by as much as 22% in the last three years. It is simply too large for investors to ignore. We typically have exposure to approximately 150 issuers at any point in time. Our ability to actively search for and invest in multiple segments of a large and liquid market is one of the keys to our success. None of the below are investment recommendations. Instead, just observations.

The single largest bond issue in the benchmark is Industrial and Commerical Bank of China (ICBCAS). We do not have exposure to any Chinese banks including ICBCAS, despite their weight in the benchmark.

Transdigm (TDG) designs, produces, and supplies aircraft components in the US and internationally. The second largest bond issue in the benchmark is TDG 6 1/4 03/26, which is a first lien senior secured bond and offers an attractive yield in short-dated risk, but lacks material upside.

The sixth largest individual bond in the benchmark is from Tibco Software (TIBX). TIBX bond came on the back of a leveraged buyout of Citrix that priced in September 2022. As market conditions worsened considerably since the financing package underwriting the transaction was announced, banks were forced to issue TIBX senior secured bonds at a discount of 83.56 cents on the dollar.

Centene (CNC) is a high-quality US health insurance provider with strong fundamentals but offers too little yield to warrant a position currently.

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