BARINGS

2024 OUTLOOK

COMING INTO FOCUS

GLOBAL HIGH YIELD

CONVERSATIONS

With heightened uncertainty and widespread risks blurring the outlook, our investment professional explores the future prospect for the global high yield asset class.

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MATT LIVAS: There is a lot of uncertainty in the world today—are we are headed into a recession, and how long or severe might it be? What will interest rates do going forward? Against this backdrop, what has the high yield market surprised you most over the past year and how do you see those dynamics playing out in the next 12 months?

BRIAN PACHECO: Looking at the high yield markets, one of the biggest surprises this year has been the performance across loans and bonds. 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. Part of that answer lies in the levels of current yield and return. Looking at the U.S. high yield markets, loans have returned approximately 10% year-to-date and are currently yielding around 9.5%.[1] U.S. high yield bonds are up almost 5% year-to-date, with yields around 9.5%.[2] Yields at these levels may offer a substantial cushion in the event of a meaningful economic slowdown.

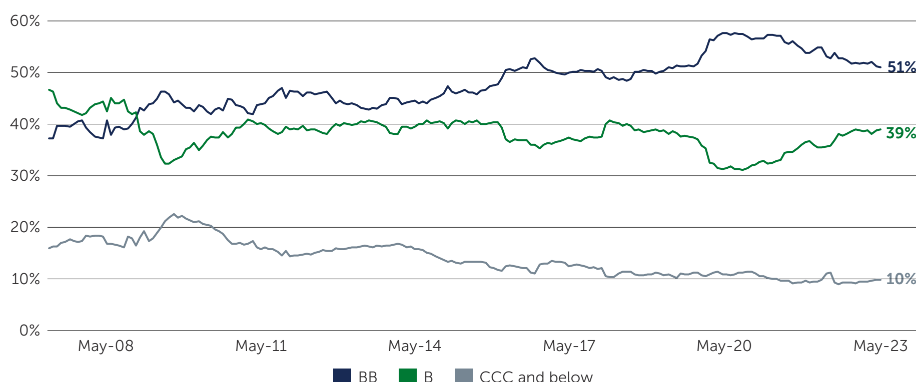
MATT LIVAS: Brian, what is your view of credit quality in high yield bonds and loans? Do you expect to see a big wave of defaults going forward, or are forecasts too negative?

BRIAN PACHECO: With 2023 having been a relatively benign year for defaults, some analysts in the market 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 probably are already trading at steep discounts to par—and the high yields currently on offer would help absorb any defaults that do materialize.**

At the same time, the quality of the high yield market has improved over the last decade, another reason we believe widespread defaults may be unlikely. BBs-rated bonds, for example, now represent around half of the market, up from 40% a decade ago (Figure 1). CCCs-rated bonds, which have the relatively higher risk of default, now account for only 10% of the market versus more than 20% after the financial crisis in 2008. What's more, there is now a broader mix of industries and sectors in the high yield universe, with no single sector comprising more than 11% of the Global High Yield bond market.[3] 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.

1. Source: Credit Suisse. As of October 31, 2023.
2. Source: Bank of America. As of October 31, 2023.
3. Source: ICE BofA. As of October 31, 2023.

Figure 1: A Higher-Quality Market



Source: Bank of America, please note the above data refers to global market. As of September 30, 2023.

MATT LIVAS: Where does the current rising star/fallen angel dynamic fit into that picture?

BRIAN PACHECO: During Covid, more than US$200 billion of investment grade credits fell into high yield.[4] Since then, the high yield market has contracted by around US$350 billion, of which US$230 billion was attributable to rising stars, creating a positive technical backdrop. The recent S&P Global Ratings upgrade of Ford in November 2023*—which represents US$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 less significant than it has been over the last 18 months.

MATT LIVAS: Looking ahead over the next year, what areas look relatively more attractive and where do you expect to see opportunities in high yield market?

BRIAN PACHECO: BB-rated bonds in U.S. market are yielding 7% to 8%,[5] which given the contractual nature of coupons and principal repayment is relatively compelling in comparison to equity markets such as the S&P 500, which has returned around 9.7% over the past 30 years.[6] 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.

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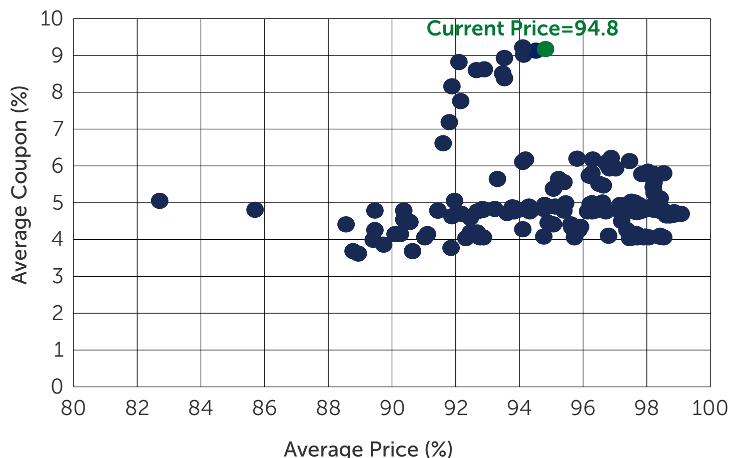
4. Source: J.P. Morgan, Bank of America. As of October 31, 2023.
5. Source: Bank of America.As of October 31, 2023.
6. Source: Bloomberg. As of October 31, 2023.

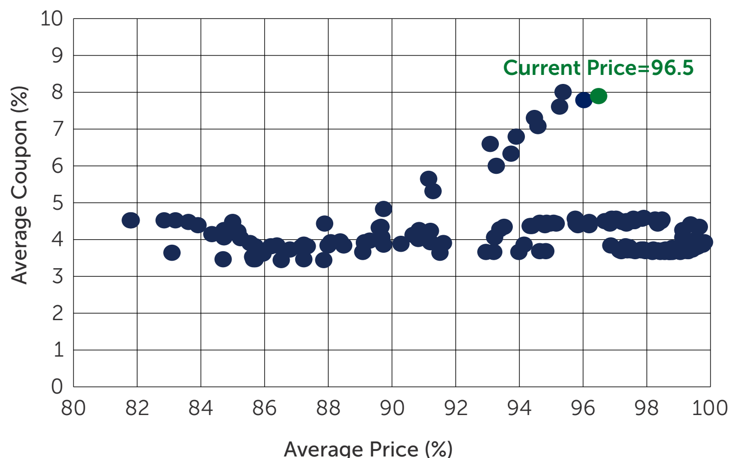
Figure 2: Income for Loan Market is at Peak Levels & Expected to Remain Elevated

U.S. Loan Market Coupon Relative to Price



Source: Barings and Credit Suisse Leveraged Loan Index.
As of September 30, 2023.

European Loan Market Coupon Relative to Price



Source: Barings, Bloomberg and
Credit Suisse Western European Leveraged Loan Index (non-USD).
As of September 30, 2023.

For illustrative purposes only. This analysis is intended to demonstrate only the specific elements discussed. This analysis does not represent all the elements and variables that could be factored into the potential outcome. PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS.

In the loan market, 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.[7] There also are opportunities in other areas of the loan market. For example, you can find the loans that offer yields similar to long-term equity returns,[1, 6] which is rare outside of major adverse macro events such as the financial crisis in 2008 and Covid.

MATT LIVAS: What do you see as the biggest risks to high yield market today and tomorrow?

BRIAN PACHECO: While I'm 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 me, 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. 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 managing additional downside, and identifying issuers that can withstand the challenges ahead.

7. Source: Credit Suisse. As of October 31, 2023.

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