AEGON Asset Management

Outlook
February 2024

2024 HIGH YIELD OUTLOOK

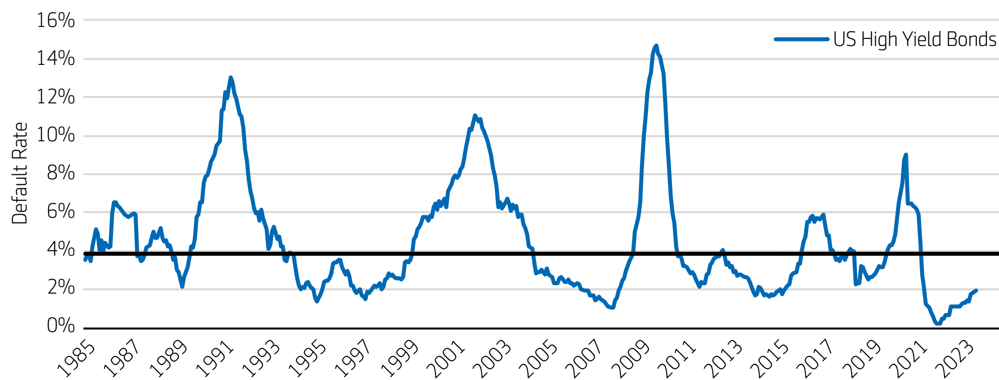
Solid fundamentals, benign default outlook

From rising interest costs to lingering inflation pressures, companies have faced numerous challenges in recent years. While the much-anticipated recession did not materialize in 2023, slowing economic conditions and the lingering macro headwinds will undoubtedly continue to pressure companies in the year ahead.

Despite these macro uncertainties, most high yield issuers have maintained solid fundamentals and are well-positioned to navigate an economic slowdown. Many companies have well-managed balance sheets and have demonstrated discipline, using excess cash to pay down debt and engage in creditor-friendly behaviour. Although credit metrics are moderating from their post-Covid peaks (as illustrated by declining interest coverage and increasing leverage ratios), many companies are starting from a position of strength.

Given the solid state of company fundamentals, our outlook on defaults in 2024 is relatively benign. We expect defaults will continue to increase and migrate toward historical long-term averages. In a low or sub-trend growth scenario, we could see defaults increase gradually toward 3% to 4% but remain below historical recessionary levels. That said, we anticipate that distressed exchange activity will pick up, which could add volatility to the market. However, based on the solid fundamental state of most companies, combined with the higher-quality market composition, we expect defaults will remain relatively contained in 2024.

Exhibit 1: US high yield default rate remains below long-term average



Source: Moody's as of September 30, 2023. Reflects the trailing 12-month US high yield bond dollar-weighted default rate.

Key takeaways

- After posting double-digit returns in 2023,[1] we expect high yield to continue to present interesting opportunities in the year ahead based on solid fundamentals and elevated yields.
- Despite macro headwinds, many high yield companies have maintained healthy balance sheets and are well-positioned to navigate an economic slowdown.
- We continue to believe that high yield offers reasonable yields given the solid company fundamentals. However, spreads could be subject to short-term volatility.
- Increasing dispersion and periods of volatility require a focus on selection, creating a ripe environment for active managers.
- Although slowing economic conditions warrant caution, high yield bonds could generate coupon-like returns in 2024.

For Professional and Institutional Investors.
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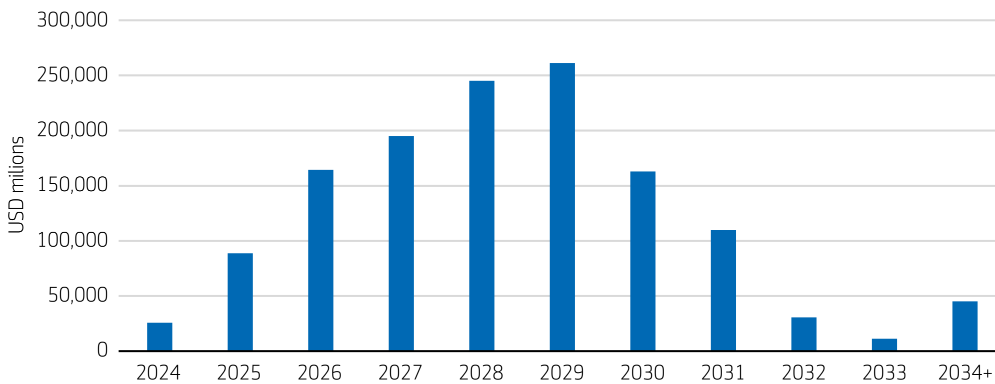
[1]Based on the 2023 return of the Bloomberg High Yield Corporate - 2% Cap Index, which was 13.44%.

Addressing the looming maturity wall

After many high yield issuers delayed refinancing their bonds in 2023 amid the higher interest-rate environment, we expect companies to become increasingly focused on addressing upcoming maturities in coming years. The maturity wall is not a significant concern in 2024, but the refinancing runway is shortening. As shown in Exhibit 2, the amount of debt coming due in 2025 and 2026 will become a greater concern for companies and investors alike.

As we approach 2025, we expect that the more challenged companies in the lower tier of the market will have to make tough decisions about how to address their upcoming maturities. Some of the more stressed companies may have difficulty accessing capital markets and refinancing upcoming maturities. As a result, we remain focused on scrutinizing companies' ability to address upcoming maturities and believe this will play a larger part of the market narrative in the year ahead.

Exhibit 2: USD high yield bond maturity wall



Source: BofA Research as of December 31, 2023

Increasing dispersion, emphasis on selection

Although fundamentals are starting from a position of strength and defaults are expected to remain relatively low, bifurcation is continuing to increase across the high yield market. This dispersion is becoming more apparent in the lower-quality part of the market as the weaker companies continue to face idiosyncratic challenges.

In this environment, selection is key. There are opportunities to hedge against an economic slowdown and help minimize downside risk by focusing on higher-quality companies with well-managed balance sheets. Valuations also support up-in-quality positioning as current spreads offer little incentive to stretch for unnecessary risk. While CCCs led the rally in 2023, we believe that momentum will fade and expect the lower-quality part of the market to be more prone to increasing dispersion and spread widening. In these situations, we believe it is important to position ahead of the market and capitalize on anticipated turning points in the months ahead. In addition, opportunities to add risk may arise as the cycle turns and valuations in lower-quality bonds become more attractive.

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Elevated yields present long-term return potential

From a valuations perspective, yields remain elevated while spreads are around long-term averages. The US Federal Reserve Open Market Committee's pivot in December changed the sentiment of many market participants and spurred further spread tightening in the fourth quarter of 2023, which pulled forward some of the return potential from 2024. While it is unlikely that spreads will tighten significantly in the near term, the asset class continues to look reasonably attractive from a yield perspective, especially given the solid fundamentals.

Additionally, it is important to not lose sight of the bigger picture. Yields in the 7% to 8% have been relatively rare and can provide solid total returns for long-term investors. Historically the starting yield to worst of the index has been a reasonable estimate of the forward 5-year returns. Given current index yield to worst[2] is hovering around 7.80% as of January 31, 2024, we believe high yield bonds look relatively interesting for long-term investors who can tolerate some short-term volatility.

Volatility creates opportunities

Currently, the high yield market appears to be pricing in Goldilocks or soft-landing scenario with spreads inside long-term averages. While the US economic outlook has improved modestly with the Fed seemingly ready to cut rates, we are not convinced the path will be as smooth as the market expects and valuations may suggest. We agree that the probability of a recession has decreased, but we expect that slowing US economic conditions will create volatility in 2024.

With the current option-adjusted spread inside of 400 basis points, there is little room for substantial tightening. Additionally, high yield spreads rarely stay at these low levels for long. As a result, we believe spreads are likely biased toward widening in the short term as volatility resurfaces. And this environment could present intriguing entry points for high yield investors.

Historically a starting option-adjusted spread of 500 to 800 basis points has resulted in an average total return of 9% or more over the following five years.[3] We expect wider spread levels will present intriguing entry points for more tactical investors. That said, wider spread environments have historically been short-lived, requiring investors to act quickly. Overall, we expect 2024 will expose intriguing buying opportunities and attractive entry points within the high yield market.

[2]As of January 31, 2024, the yield to worst on the Bloomberg US High Yield Corporate Index was 7.80%.Data is provided for illustrative purposes only. Indices do not reflect the performance of an actual investment. It is not possible to invest directly in an index, which also does not take into account trading commissions and costs. All investments contain risk and may lose value.

[3]Based on monthly Bloomberg US Corporate High Yield Index data from January 31, 1994 to September 30, 2023. The five-year annualized return for the index ranged from 9.02% to 13.63% in periods in months where the starting OAS was at 500, 600, 700 and 800 basis points.

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