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Aegon Asset Management

HIGH YIELD UPDATE: HEADWINDS VS. TAILWINDS

On the heels of a turbulent 2022, the high yield market is showing signs of bouncing back in early 2023. Demand returned to the asset class as moderating inflation and positive economic data temporarily eased recession fears. While positive news has provided tailwinds for the high yield market, investors continue to grapple with one key question—is this rally sustainable in 2023?

In our view, the three key tailwinds and headwinds that will shape the high yield market in the months ahead include:

Key tailwinds

- **High yields, attractive long-term return potential:** After years of low rates, high yield is now living up to its name. With yields running around 7% to 8%, high yield securities currently provide attractive opportunities to generate income and above-average long-term total return potential compared to other fixed income assest classes. Historically these entry points have provided double-digit returns over the subsequent one, three and five-year periods.[1]
- **Solid fundamentals, muted defaults:** High yield companies are entering 2023 with relatively healthy balance sheets, historically low leverage and few near-term maturity concerns. Although fundamental improvement has likely peaked, this solid fundamental starting point should help most high yield companies weather a slowdown and help limit distress and defaults compared to prior downturns.
- **Supportive market technicals:** After significant outflows from high yield funds last year, we expect demand to return to the asset class as investors rebalance their portfolios and allocate to higher-yielding fixed income investments. As we've seen so far this year, this technical can result in swift spread tightening. We expect most bouts of spread widening to be met with a strong risk appetite.

[1]All investments contain risk and may lose value. 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.

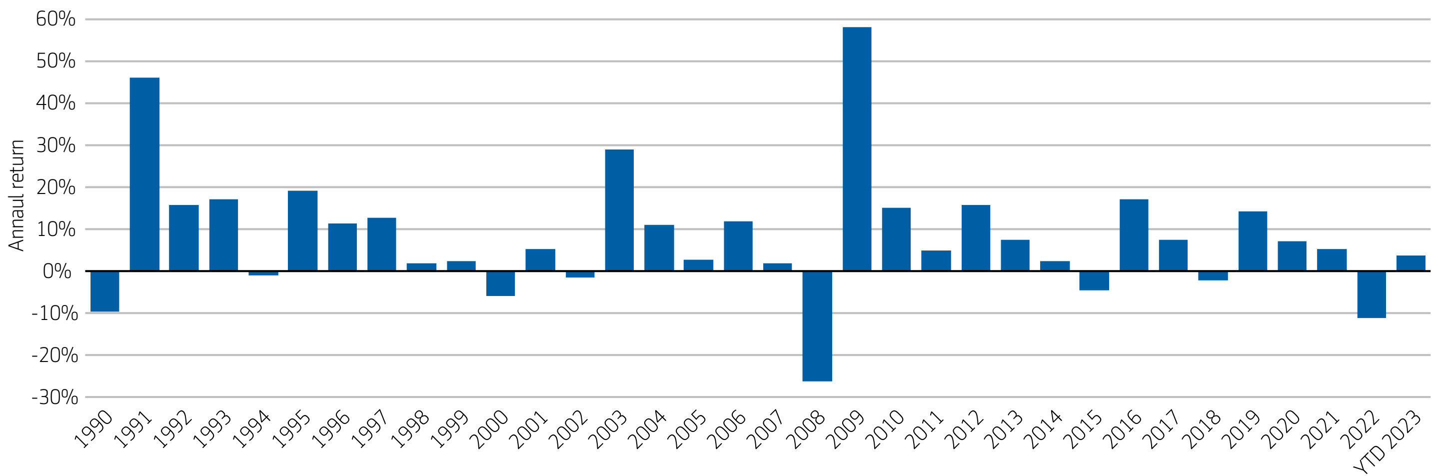
Key headwinds

- **Monetary policy tightening:** Despite moderating inflation, we don't expect central banks to pivot quickly from tightening to easing policies. While we think rate hikes will slow as inflation moderates, it seems that the market overestimated the likelihood of a 2023 pivot and we believe elevated rates will persist. While rising rates continue to create headwinds, short-duration high yield bonds can help dampen the effects of rising rates and help mitigate interest rate risk relative to longer-duration fixed income securities.
- **Slowing economic conditions:** We anticipate a shallow recessionary environment, as central banks raise rates to combat inflation. That said, there is still a possibility of a soft landing if inflation can moderate quickly, but the path is not easy. Despite the looming recession risk, we believe most high yield companies are well-positioned to weather a downturn given the solid fundamental starting point.
- **Potential spread widening:** Although current yields are attractive, spreads are not currently reflective of recessionary levels and could be biased toward widening in the short term given the macro uncertainty and economic slowdown. Heading into this year, spread expectations generally ranged from 400 to 600 basis points absent an imminent recession. With high yield now at the tighter end of that range, we believe the market could be prone to bouts of widening. However, spread widening could be more contained than in prior downturns given the higher-quality composition of the market. In addition, in light of the amount of cash sitting on the sidelines and the potential resurgence in high yield demand, it is possible we may see a rapid snapback as investors seek to capitalize on wider spread levels.

Overall, challenging economic conditions are setting the stage for an interesting year ahead. Despite the positive momentum, we expect elevated volatility and bearish sentiment to resurface in 2023. After all, markets do not follow a straight line. That said, we believe tailwinds will eventually trump headwinds during 2023. As illustrated below, historically, negative return years have been followed by strong positive snapbacks (Exhibit 1). Additionally, the high yield index has generated positive returns in 76% of the years from 1990 to 2022, with an average annualized return of 8.55%.[1]

Although caution is warranted and we expect a bumpy ride ahead, we believe the high yield market will provide attractive opportunities to generate solid coupon-like returns in 2023.

Exhibit 1: Annual high yield index returns[1]



Source: Based on the Bloomberg US Corporate High Yield Index. Includes annual returns from 1990-2022 and year-to-date returns for 2023 through January 31. [1]All investments contain risk and may lose value. 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.

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