

High Yield Outlook and Positioning



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- **A Slightly Positive Quarter for Global High Yield, While a Good Quarter for the US:** The ICE BofA Merrill Lynch (BAML) US High Yield Index gained 0.94% while the ICE BAML Global High Yield Index was up 0.21%, restrained by EM High Yield's - 2.68% return.¹
- **Sovereign Yields Were Volatile, but Ended the Quarter Almost Flat:** Treasury and Bund yields fell in July, yet rebounded to close the quarter near June 30th levels.²
- **Ratings Performance Was Clustered:** Within US high yield, the largest regional market, returns were led by BBs at 1.08%, followed by CCCs at 1.01% and Bs at 0.69%.¹
- **Spreads Widened:** Although BB spreads in the US and Europe were flat, B and CCC spreads widened modestly.¹
- **Focus Moves to Chinese Property Companies:** Evergrande, the second largest Chinese residential property developer, captured investors' attention as the company encountered difficulties servicing its \$300 billion in debt.³ The weakness in the sector was a major factor in the underperformance of Emerging Markets for the quarter.
- **Defaults Continued to Fall:** The trailing twelve-month default rate declined further as more 2020 defaulting companies rolled off and the 2021 default run-rate fell to a post-Global Financial Crisis low.⁴
- **"COVID" Sector Performance Normalized:** Air Transportation and Leisure performed in line with the market; Energy outperformed as oil prices remained near \$70 and US production discipline was maintained.¹

Third Quarter 2021 Market Conditions

The US and global economies continued to expand during the third quarter, yet more slowly than the very high rates predicted earlier in the year as labor shortages, supply chain problems and the Delta variant impeded growth. Equity prices ascended to record highs in early September, then faded into quarter end. Spread performance was mixed, with BB spreads mostly flat and spreads for lower quality bonds moving wider.

Economic conditions continued to improve, particularly in the US. The US unemployment and weekly initial jobless claims rates fell and job openings increased. However, very high economic growth expectations were dialed down as investors realized that the economic expansion would be capped by the inability of employers to hire workers. Goods shortages, partly due to the inability to transport and distribute imports, reduced retail activity. Outside the US, the Chinese government's attempt to constrain debt-funded growth intersected with Evergrande's need to roll its debt; current assumptions are that the Chinese government will be able to reduce the systemic effects of this troubled borrower. However, the problems at Evergrande and other Chinese real estate developers caused very weak performance for Emerging Market High Yield.

1. ICE BofA, as of 9/30/21
2. Bloomberg, as of 9/30/21
3. Reuters, 10/12/21. For illustrative purposes only. Not intended to represent an investment in any Amundi US portfolio.
4. JP Morgan as of 9/30/21

New issuance was busy during the quarter, with new issue supply at record levels. The new issue slate showed some evidence of more aggressive issuance, with acquisition finance growing as a use of proceeds; however, these deals will have minimal impact on the stock of high yield bonds as a whole.

Key Themes for 4Q 2021 and 2022

“Bullish-ish”: Little has changed since the end of the second quarter. However, our analysts have become less positive on their issuers’ prospects, even though financial performances have been strong and bond spreads are relatively unchanged. We think this downshift in confidence may be rooted in the labor and supply chain difficulties so many management teams are communicating. Although many companies have been able to raise prices, at some point higher costs associated with goods, transportation and labor may seriously challenge their profitability. A comment from an Amundi portfolio manager may sum it up: longer term, markets “can’t be an environment in which everyone wins.”

Has Inflation Become Structural?: Although underemployment and unemployment remain elevated compared to pre-COVID, we are concerned that tight labor conditions will begin a cycle of rising wages. Even with increasing automation, there are certain functions that can only be performed by a person, so technology will provide only limited relief. We believe most market participants assume the inflation currently being experienced is transitory, so solid evidence that inflation has become structural could de-stabilize markets.

The Taper Approaches: Unlike in 2013, the Fed has communicated voluminously about the plans to taper its purchases of US Treasuries and mortgage-backed securities. Fed speakers have also been careful to note that the conclusion of tapering will not be automatically followed by increases to the Federal Funds rate target. However, even considering the strong communication, we are concerned that investors will view the taper as the beginning of the removal of the extraordinary monetary accommodation. While we see little evidence this is currently driving markets, we believe this could increase volatility as some investors decide to exit risky asset classes such as equities and high yield bonds.

The Fed and COVID as Tail Risks: We think investors believe they know the probable path for both the Fed and COVID but are worried about tail outcomes for each. Regarding the Fed, tapering later this year with rate increases sometime in 2023 are our and the market’s assumption. For COVID, a slow transition from pandemic to endemic disease is the central case. In each instance, the tail outcomes – a rapid rate increase response as inflation moves from transitory to structural and variant after variant overwhelming vaccinations – deserve attention.

Bumps in the Energy Demand Transition: We are preparing for and participating in the shift from fossil fuels to carbon free renewables, and we are happy that other investors have been doing the same. Investment in wind and solar, intermittent renewables, has grown quickly and the storage capability needed for robustness is limited. At the same time, investment in the fossil fuel mega projects needed to maintain the current system has plummeted. We believe many investors are projecting that fossil fuel consumption will begin to decline in about five years, so new fossil fuel megaprojects producing for multiple decades may not be needed to satisfy global demand. We are concerned that the transition to renewable generation with sufficient storage will take longer than five years and we fear that supply-demand mismatches such as recently seen in the UK with natural gas may become more frequent.

Emerging Signs of Shareholder-Friendly Actions: After recessions, companies are usually risk adverse for a period, with the new issue market focused on refinancing. However, we are already starting to see new issues funding dividends, acquisitions and leveraged buyouts. Although these transactions are a very small portion of the market, we know they are likely to represent a disproportionate share of future defaults. We will be closely watching

this trend and would likely become more cautious is the preponderance of new issuance shifted from refinancing to LBO/M&A financing.

Winning By ‘Not Losing’: In our view, fixed income returns have traditionally been asymmetric, with the amount that can be gained on a good security selection limited and the amount that can be lost on a bad security selection much greater. This dynamic is exacerbated by today’s tight spreads and low yields. Although we believe the economy will be supportive of high yield issuers in general, we are being very careful regarding idiosyncratic risks.

Outlook: Defaults Continue to Decline and Spreads Grind Modestly Tighter

The default rate has continued to decline, as defaults recorded in the second half of 2020 roll off the trailing twelve month numbers. With the face value of high yield bonds trading at distressed levels near ten-year lows even though outstandings have grown, we suspect default rates will remain low for a while.

Although we do not foresee significant spread tightening and think of the market as range bound for the next few months, we believe spreads are likely to tighten modestly from today’s levels. The BB weight in the ICE BofA BAML US High Yield Index has grown significantly, making the Index higher quality than it has been historically. BB spreads remain attractive when compared to BBB spreads, particularly as BB duration is shorter by more than three years.

Regarding performance, we believe coupon-area performance is likely for the next few months. COVID appears to be having less medical impact, but the impact on the global economy and markets from COVID’s fallout remains high. We are carefully watching inflation developments, as aggressive moves from central banks to restrain higher than projected inflation would upset the current equilibrium. The outlook for 2022 is very dependent on the starting point (i.e. where are spreads at yearend 2021) but assuming spreads end the year as close to current levels 2022 is likely to be a year of modest yet still positive returns. In comparison, the longer duration of most other fixed income asset classes could become a performance headwind for 2022.

Definitions

Indices are unmanaged and, unlike fund returns, do not reflect any fees or expenses. It is not possible to invest in an index.

The ICE BofA Merrill Lynch US High Yield Index tracks the performance of US high yield bonds.

The ICE BofA Merrill Lynch Global High Yield Index tracks the performance of global high yield bonds.

Bond ratings are grades given to a bond by rating services that indicate its credit quality. Ratings take into consideration a bond issuer's financial strength or its ability to pay a bond's principal and interest in a timely fashion. Ratings typically range from "AAA", indicating high quality, down to "CCC", indicating a speculative grade bond. High yield bonds typically range from "BBB" or below, while investment grade bonds have higher ratings. Credit ratings can be as low as "D" (currently in default).

Credit Spread: The difference in yield between a corporate bond and the sovereign issues (US Treasuries, in the case of US dollar corporate bonds).

Spread Tightening: A decline in the relative yield of bonds of similar maturity but different credit quality. In this paper, spread tightening refers to high yield bond yields falling relative to yields of US Treasury bonds of similar duration.

LBO/M&A: Leveraged buyout/ merger and acquisition.

Idiosyncratic Risk: The inherent risk involved in investing in a specific asset, such as a bond or stock.

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Date of first use: October 20, 2021.

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RO 1881268