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Amundi ASSET MANAGEMENT

June 2021

High Yield Outlook and Positioning

Why We Believe High Yield Spreads May Go Tighter

MARKET OUTLOOK

Summary

- High yield spreads are tighter than average, but are not at all-time records.
- We believe spreads may tighten further due to: 1) the record high percentage of BBs today compared to prior periods, 2) the conservative use of proceeds of new issues, and 3) the attractiveness of BBs compared to BBBs.

With over 100 years of financial markets experience among the three members of our high yield portfolio management team, we long ago learned that the best response when a market prognosticator uses the phrase, "it's different this time", is to run from the room screaming as you warn others of an impending financial catastrophe. Among the 10 timeless rules for investing by Bob Farrell, Merrill Lynch's long-retired, but still revered chief stock market analyst, was the rule "there are no new eras – excesses are never permanent".[1] We will therefore tread carefully as we make predictions about the direction of high yield credit spreads. We will start with a simple declaratory statement: high yield credit spreads are not historically cheap. We will add, however, that we believe they could get tighter.

There are a multitude of fundamental reasons why we believe risk markets in general, and high yield in particular, may continue to perform despite the significance of the rally from the depths of the 2020 COVID-triggered recession. But others have already articulately described the impact on financial markets of accommodative central banks, rapidly recovering Chinese and US economies, increased corporate earnings and falling default rates. As earnings rise and defaults drop, investors expect reduced compensation for credit risk, particularly with the Federal Reserve (Fed) and the European Central Bank (ECB) on hold. We want to focus instead on often-overlooked structural reasons why we believe high yield spreads can get tighter.

A History of Highs and Lows[2]

First, let's look at spread history. The spread-to-worst for the ICE BofA Merrill Lynch (BAML) US High Yield Index reached its all-time low on June 1, 2007 at 252 basis points – and, of course, within 18 months it hit its all-time peak at 2,069 basis points on December 12, 2008, as the financial markets came close to imploding during the 2008/2009 Great Recession. During the period since the end of the 2008/2009 Great Recession, high yield credit spreads hit their pre-COVID lows on October 3, 2018 at 326 basis points and hit a post-COVID low of 329 basis points on June 21, 2021, which was within a few basis points of where they stand today.

[1] Source: https://www.cnbc.com/2020/02/11/this-wall-street-legends-10-rules-for-investing-are-very-applicable-to-this-bull-market.html. [2] Source: Bloomberg. As of 5/28/21.

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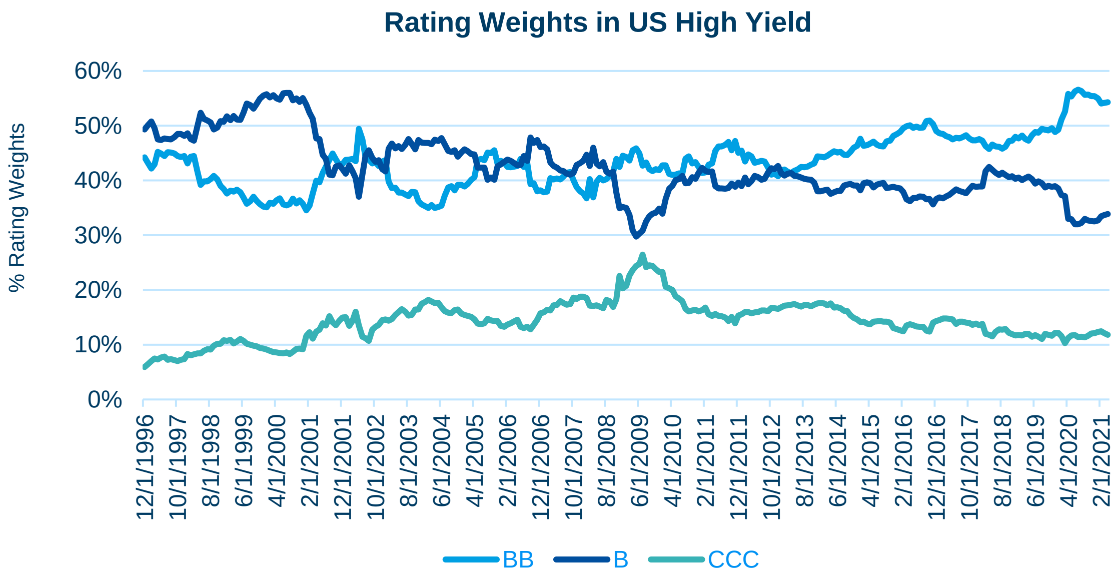
Increasing BB-Tilt to the Market

The index providers began providing rating tier dates in the late 1990s. Initially, B-rated bonds were the largest component of the US high yield benchmark, as seen below.



Source: Bloomberg, ICE BAML. Last data point, 4/30/21. US High Yield is represented by the ICE BAML US High Yield Index, which tracks the performance of US high yield bonds. Indices are unmanaged and, unlike fund returns, do not reflect any fees or expenses. It is not possible to invest in an index.

BB-rated bonds overtook B-rated bonds as the largest rating tier during the Global Financial Crisis and, except for brief periods, have remained in the leadership position. As shown in the graph, the BB share was further boosted by the downgrade wave following COVID-19. According to JP Morgan,[3] $213.8 billion of investment grade bonds were downgraded to high yield in 2020, explaining part of the growth of the overall market, which expanded from $1.242 trillion to $1.407 trillion. New issuance tells a slightly different, yet supporting story, according to Barclays. Barclays data shows higher volume of B-rated new issues, but, after considering redemptions, net new issuance is higher for BBs.[4]

Considering the higher percentage of BBs in the high yield rating mix, we think it makes sense to consider today's high yield spreads on a rating quality-adjusted basis. The record tight spread of 252 basis points for the US high yield index would have been 233 basis points, 19 basis points tighter, if the rating mix then would have been the same as it is now.[5] As today's spreads are in the low 300s, we believe this indicates that the compensation for high yield credit risk is appreciably higher than the prior record tight.

Reduced Level of LBO and Acquisition Finance Activity

Another factor we see behind the expansion of the BB share has been the reduced level of leveraged buyout (LBO) and acquisition finance activity in high yield. The share of issuance to finance acquisitions, including LBOs, peaked at 52.7% in 2007. In contrast, acquisition finance, including LBOs, fell to 20% in 2019, 8% in 2020 and 13% year- to-date. Instead, refinancing has become the largest use-of-proceeds in high yield, at 67% in 2019, 58% in 2020 and 74% year to date.[6] Refinancing is a relatively low risk use of proceeds, as investors can rely on their knowledge of the company to price the risk.

[3] JP Morgan Default Monitor, May 3 2021. [4] Barclays US High Yield Corporate Update, May 3 and Jan 4, 2021. As of 6/22/21. [5] Sources: ICE BofA and Amundi US, as of 6/22/211. [6] JP Morgan Default Monitory, 5/3/21.

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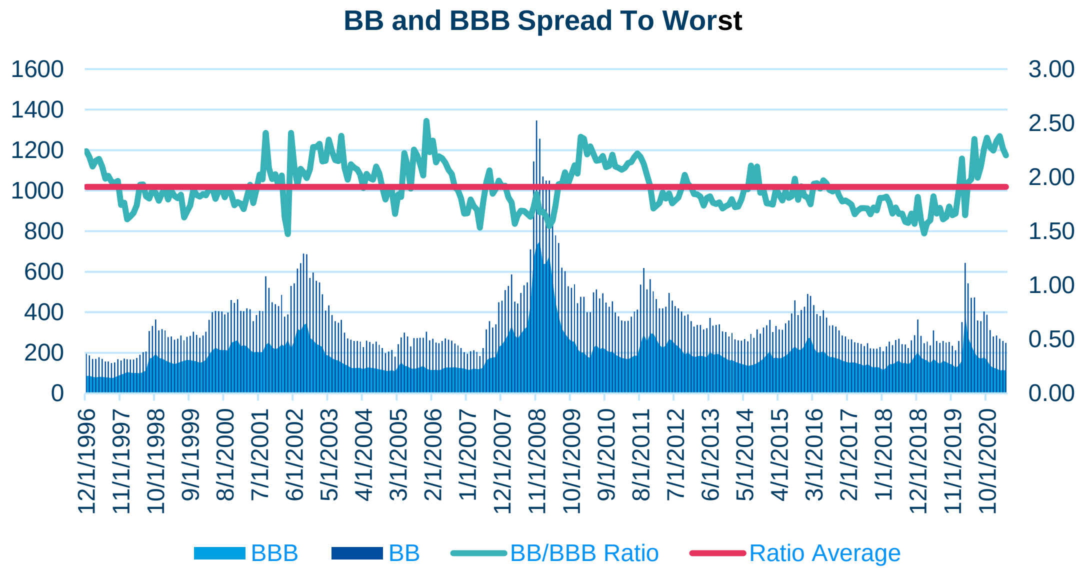
Although the high yield bond market financed many large LBOs prior to the Great Financial Crisis, acquisition finance has shifted to the leveraged loan market, with 39.7% of proceeds during the first quarter of 2021 devoted to financing acquisitions, including LBOs; 43.6% of first quarter 2021 proceeds were for refinancing. Dividends, generally thought of as a low quality use of proceeds as funds, are flowing to the owners, amounting to 11.5% of loan proceeds.[7] The volume of transactions being processed by the loan market is also impressive, with 383 deals with acquisition or LBO use of proceeds coming to market in the year ending March 31, 2021.[8]

The Crossover Buyers' Search for Yield

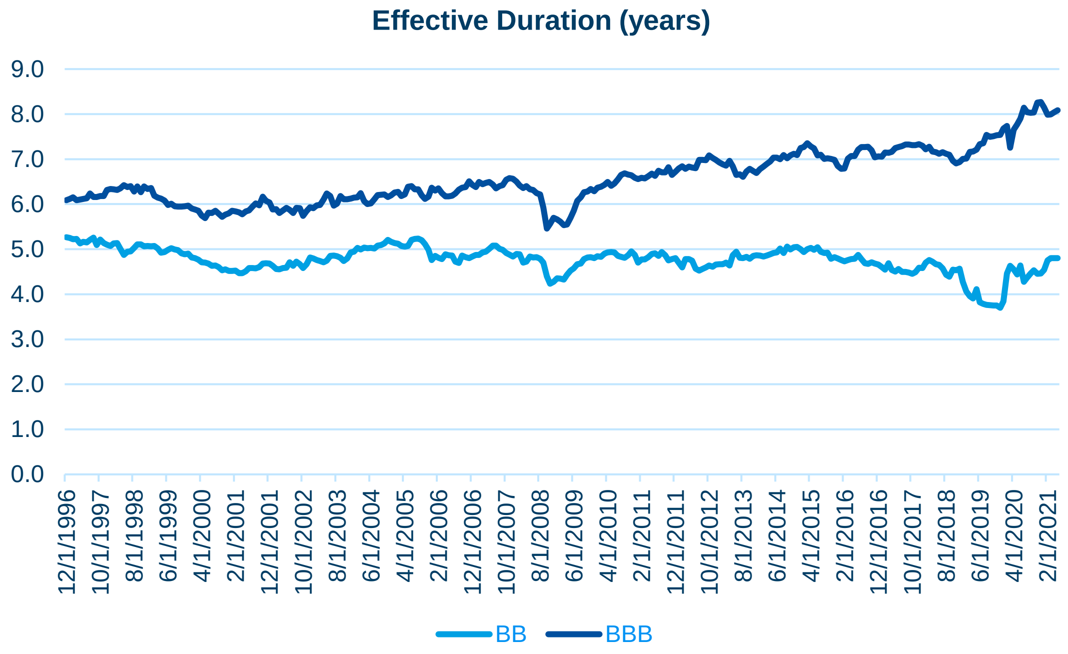
We believe record low bond yields have encouraged investors normally focused on investment grade credit to dip into high yield. These crossover buyers are most likely to focus on BB-rated bonds, as their characteristics are the most similar to investment grade, and they know many of these issuers from when these bonds had investment grade ratings. As can be seen below, the long-term average is for BB spreads to be 1.92 times BB spreads and this ratio has been above the long-term average since the emergence of COVID-19.[9] With BBs being historically inexpensive compared to BBBs, crossover buyers are being attracted to high yield. As this differential is relatively wide today, we think it is likely that crossover buyers will remain interested in BBs until the ratio returns closer to historic averages.



Source: Bloomberg, ICE BAML. Last data point, 4/30/21. US High Yield is represented by the ICE BAML US High Yield Index, which tracks the performance of US high yield bonds. Indices are unmanaged and, unlike fund returns, do not reflect any fees or expenses. It is not possible to invest in an index.

In addition to the relatively high spread BBs offer in historical terms compared to BBBs, the duration of BBs has remained near the long-term average, while BBBs' duration has increased. BBs' duration is less than one month higher than the long-term average, whereas BBBs' duration is one and a half years higher. BBBs' duration has increased as yields have fallen and the stock of BBB bonds has shifted to reflect the low coupons issued in recent years. On the BB side, duration has generally fallen as prices rose, reflecting the call features of most original issue high yield bonds; additionally, only a small percentage of BBs are issued with greater than 10-year maturities. The large downgrade wave in 2020 added a large amount of bonds issued as investment grade, which typically are longer dated on average and tend not to be callable.

[7] Source: S&P Global Market Intelligence, LCD's Quarterly Leveraged Lending Review, Q1 2021. [8.] Source: S&P Global Market Intelligence, LCD's Quarterly Leveraged Lending Review, Q1 2021. [9.] Source: ICE BofA as of 5/31/21.



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Conclusion

As described earlier, although we believe high yield credit spreads are not historically cheap, we believe they could get tighter. However, we see a substantial chance that high yield spreads may move tighter before they move appreciably wider. We believe this is because of the increased BB tilt of the high yield market, high yield's relative attractiveness due to the relatively higher spread and shorter duration of BBs to crossover buyers, and the defensive use-of-proceeds in the issuance mix.

Definitions

- **Basis Point**: A unit of measure used to describe the percentage change in the value or rate of a financial instrument. One basis point is equivalent to 0.01% (1/100th of a percent) or 0.0001 in decimal form. In most cases, it refers to changes in interest rates and bond yields.
- **Beta:** measures an investment's sensitivity to market movements in relation to an index. A beta of 1 indicates that the security's price has moved with the market. A beta of less than 1 means that the security has been less volatile than the market. A beta of greater than 1 indicates that the security's price has been more volatile than the market.
- **Covenant:** A promise in an indenture, or any other formal debt agreement, that certain activities will or will not be carried out or that certain thresholds will be met. Covenants in finance most often relate to terms in a financial contract, such as a loan document or bond issue stating the limits at which the borrower can further lend.
- **Default:** Failure to pay interest or principal as scheduled.
- **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**: High yield bond yields fall while US treasury prices yields rise or stay the same.
- **Spread-to-Worst:** The spread associated with the lowest yielding call date on a bond's call schedule.

Important Information

Date of First Use: June 25, 2021.

Amundi Asset Management US is the US business of the Amundi Asset Management group of companies.

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