

Q1 2024 High Yield Outlook Snapshot

Transcript

Daniel Niland, CFA, High Yield Product Specialist: Hi. I'm Dan Niland, Product Specialist for PGIM Fixed Income's High Yield Bond Desk, with our 2024 update and outlook. Despite the Fed raising rates a few times this year, lifting yields higher and pressuring bond prices lower, U.S. High Yield Index total returns year-to-date are reasonably strong at around 8%, and excess returns over government bonds are around 6%. High-yield returns were lifted this year by credit spread tightening, as credit fundamentals in high-yield companies remained relatively strong. Defaults moved marginally higher, but from historic low levels. And technical supply and demand factors are helping maintain a firm tone in the market. This year, OAS or option-adjusted spreads, in U.S. high yield traded in the range of roughly 380 to 500 basis points over treasury yields, with the wide end of that range coinciding with U.S. regional banking failures we experienced back in March. Since then, OAS remained in the 400s and is currently trading toward the lower end of the year-to-date range, around 90 basis points tighter on the year. Yields in high yield are high again. This year, yields ranged from the high 7s to the mid 9%. Each time yields moved higher and began to approach double-digit yields, demand from asset allocators would step in, creating a strong technical factor, driving yields lower and prices higher. Although the high-yield market experienced net-negative flows in both passive ETFs and active funds over recent years, when you take into consideration all supply and demand factors, we're on pace to experience another net supply shortfall of over \$100 billion. This follows a record supply shortfall in 2022 of \$232 billion. Positive credit migration is one factor contributing to the supply shortfall, as high yield issuers are upgraded to investment-grade status. Most recently, Ford was upgraded in October, moving almost \$50 billion of debt back to the investment grade market. Although the Fed raised short-term rates significantly, the transmission mechanism of higher rates has been slow to impact the total cost of capital for high yield issuers. During COVID, when rates were at historic lows, high-yield issuers refinanced debt at low coupons, and where possible termed out debt into longer maturities. The average coupon on outstanding high yield fixed rate debt is 5.98%, helping keep interest expenses low and credit fundamentals strong for many high-yield borrowers. Eventually, lower coupon high-yield debt will need to refinance at higher coupons. But of the \$1.4 trillion in U.S. high yield debt outstanding, only 3% is due to mature in 2024 and just 9% in 2025. Debt maturing in the next two years is also skewed toward higher quality BB borrowers, which should have stronger credit fundamentals in place to withstand refinancing debt into higher coupons and resulting in higher interest expense. Looking ahead to 2024, our central economic case is we avoid recession in both the U.S. and in Europe. However, recession is still a possibility. Weaker growth is expected in Europe in the earlier part of 2024 and U.S. recessionary risks are elevated, but in the middle part of next year. In Europe, we believe we're in a weaker growth period, with high rates that are expected to decline over time. Defaults in Europe are expected to remain at near current levels. In the U.S., contract labor wage pressures and higher costs of capital are expected to weigh on corporate margins for certain industries. Consumers continue to draw on excess savings to fuel consumption, challenging consumption growth from households. Defaults in the U.S. may move higher next year but given the level of relative credit strength and the fundamentals, we expect defaults to remain below 5%, even in the event of a U.S. recession. Taking all factors into consideration, should we avoid a recession, we're expecting total returns for both U.S. and European High Yield markets to be strong, potentially rivaling 2023 returns. And that's our outlook for high yield. Thank you.

[Music]

IMPORTANT INFORMATION

Source(s) of data (unless otherwise noted): PGIM Fixed Income, as of September 21, 2023.

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