CANDRIAM
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The Big Shrink

Navigating High Yield Markets

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Marketing communication

About the author.

Nicolas Jullien, CFA

Head of High Yield & Credit Arbitrage

Nicolas Jullien has been Head of High Yield & Credit Arbitrage since 2020. He joined Candriam as a Junior Portfolio Manager in 2007, just before the onset of The Great Financial Crisis. In 2011, he was named Portfolio Manager of Candriam's flagship Euro High Yield strategy, and co-manager of other absolute return strategies. In 2017, he added the role of Deputy Head of High Yield & Credit Arbitrage. In 2021, Nicolas introduced an innovative alternative strategy, Credit Alpha, with the ambitious goal of delivering attractive returns in all market conditions.

Nicolas holds a masters degree in actuarial and financial sciences from Université Claude Bernard in Lyon (2007). He graduated from l'Institut des Sciences Financières et d'Assurances (ISFA) and has been a CFA Charterholder since 2010.

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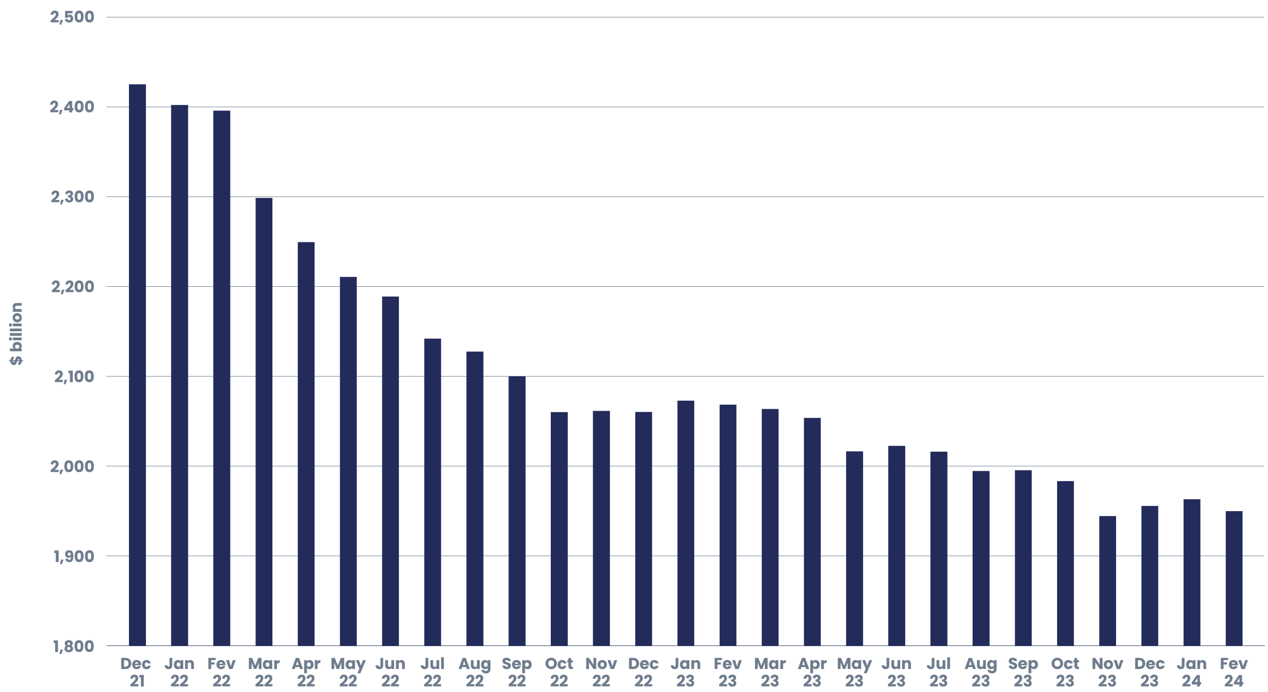
Since the end of 2021 and as a result of structural shifts in the economy, from decarbonization to relocation of supply chains and higher geopolitical risks, interest rates entered a new regime. After two years of rates considerably higher than the previous decade, what are the implications for High Yield markets?

High Yield markets are shrinking.

Stepping back to examine the trajectory of High Yield markets over the past two years, one trend emerges: they are experiencing their most rapid contraction to date.

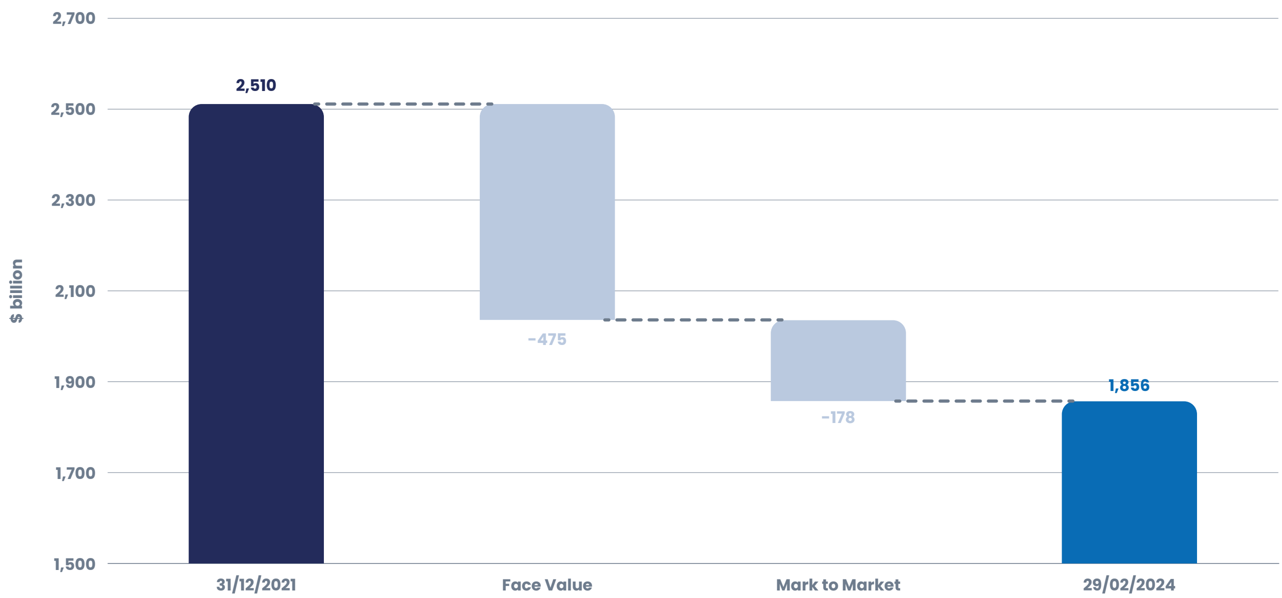
Figure 1:
ICE BofA BB-B Global High Yield Index - Market size (Face Value)



Source: ICE, February 2024

If we take into account market values, High Yield markets have contracted even further, as most bonds are currently trading at a discount. Since the end of 2021, the ICE BofA BB-B Global High Yield Index has lost $654 billion, representing more than a quarter of its size. The size of the market is down from 2.51trn$ to 1.86trn$[1].

Figure 2:
ICE BofA BB-B Global High Yield Index - Market size



Source: ICE, February 2024

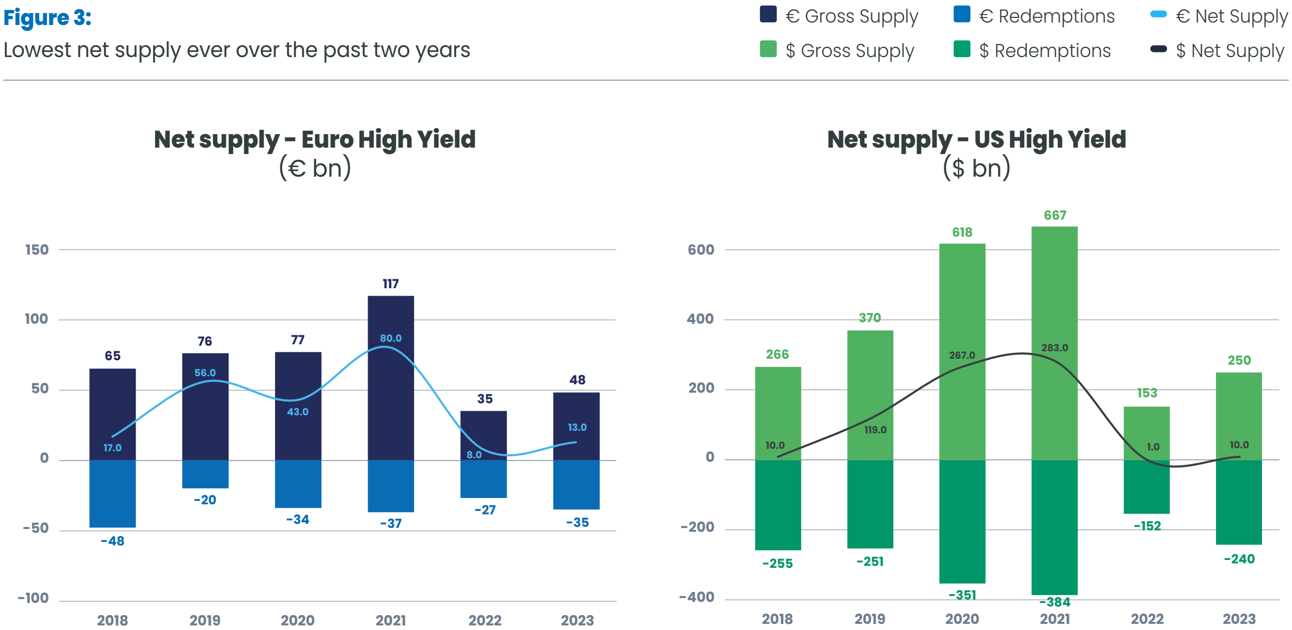
1 - Source: Bloomberg©, ICEBofA BB-B Global High Yield Index (HW40) in USD currency. Data compared between end of 2021 and February 2024.

We believe this contraction is supported by 3 main factors.

- **Corporate behaviour**

Because of higher interest rate and therefore higher costs of debt, many corporates changed their priorities in terms of capital allocation, from M&A and share buybacks to debt reduction. As a result, some bonds maturing are not refinanced with a new issuance but repaid with the free cash flow generated by the issuers, resulting in negative supply for the market.

Figure 3:
Lowest net supply ever over the past two years



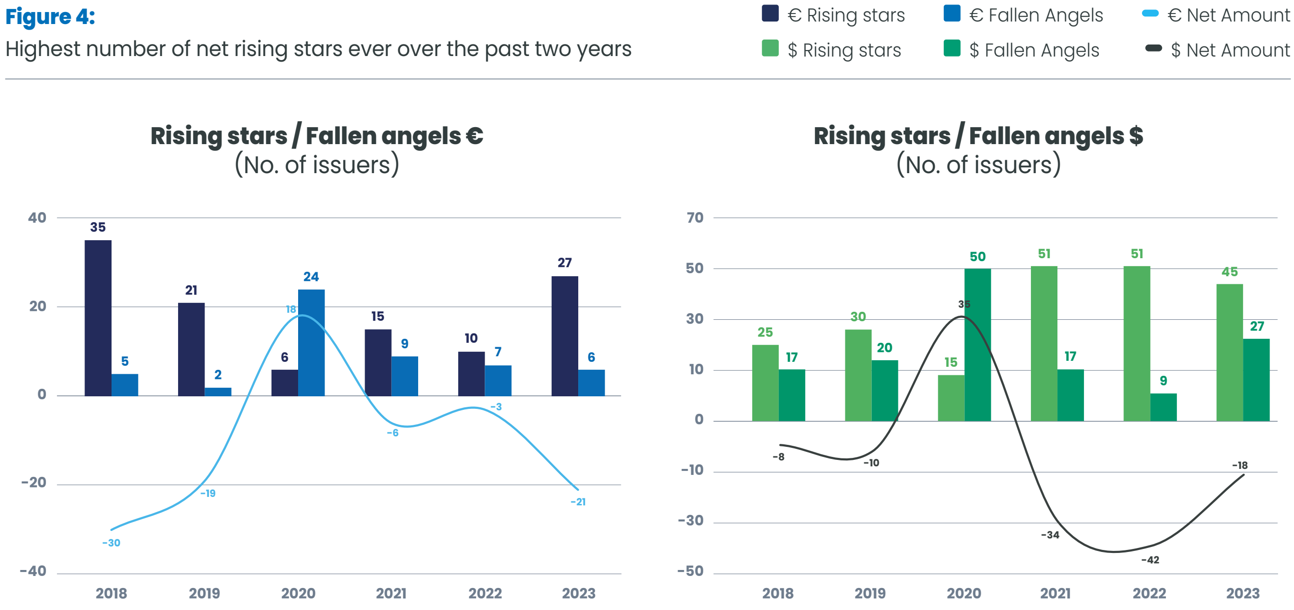
Source: JP Morgan

Source: JP Morgan

- **More rising stars than fallen angels**

Over the past two years, rising stars outpaced fallen angels[2] significantly, as shown in both graphs below for euro and dollar issuers. If many companies decided to shift their priorities toward debt reduction, most of the high BBs – the highest rated within High Yield markets – went a bit further and even committed to bring their rating into Investment Grade territories to benefit from cheaper costs of debt going forward.

Figure 4:
Highest number of net rising stars ever over the past two years



Source: Moody's Investors Service

Source: Moody's Investors Service

- **Higher default rates**

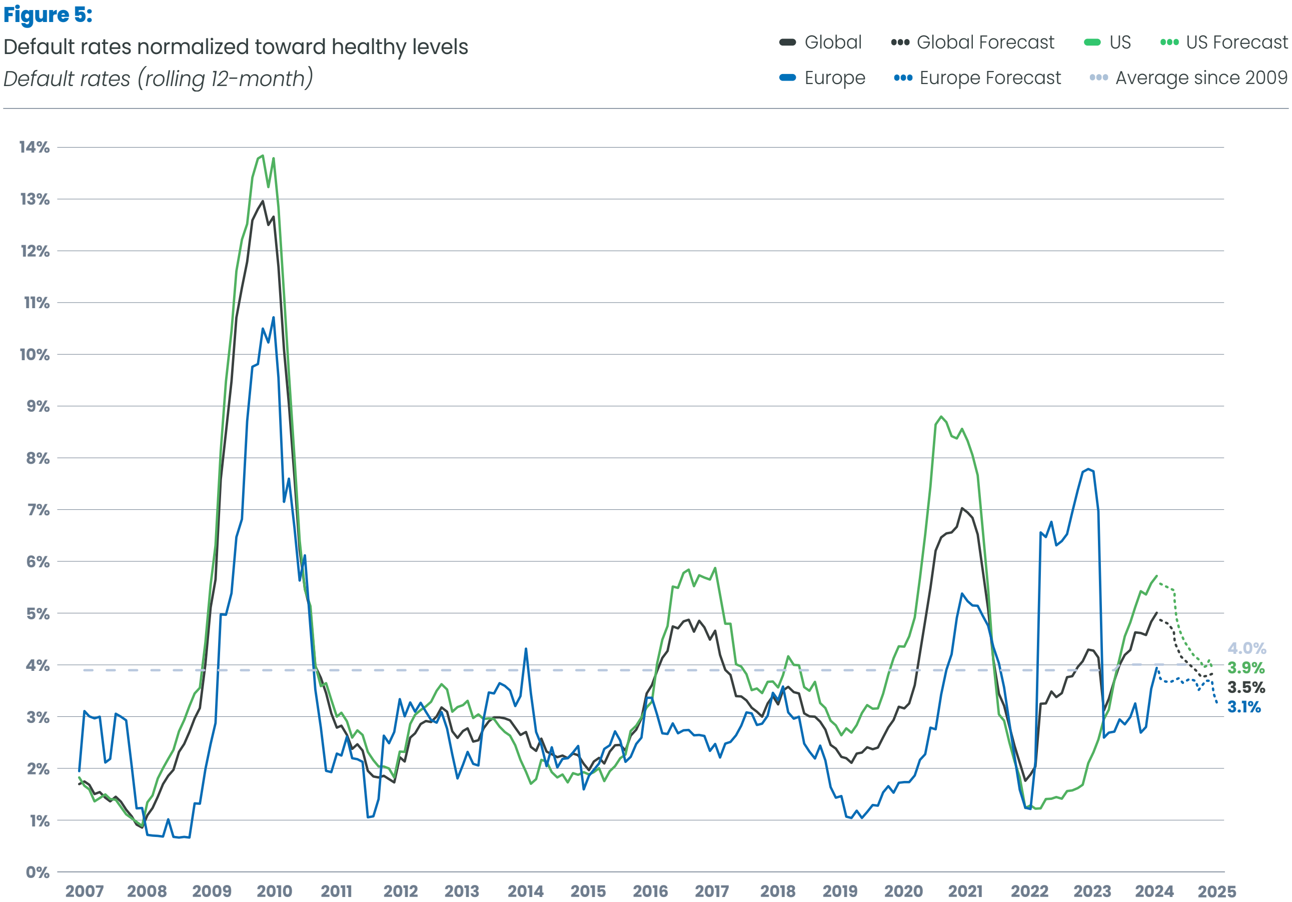
Another consequence of higher rates is higher default rates. After a decade long of free money, some capital structures accumulated too much debt and are no longer sustainable in the current environment. As a result, default rates as well as distressed situations increased materially from very low levels.

2 - Within the High Yield space, rising stars are bonds that were considered speculation grade when issued, but have since improved their financials, reducing the risk of default. On the other hand, bonds described as fallen angels are those that at one time in the past were considered to be investment grade and are now categorized as "junk" bonds due to a reduction in the issuer's credit rating.

Figure 5:

Default rates normalized toward healthy levels

Default rates (rolling 12-month)



Source: Moody's Investors Service

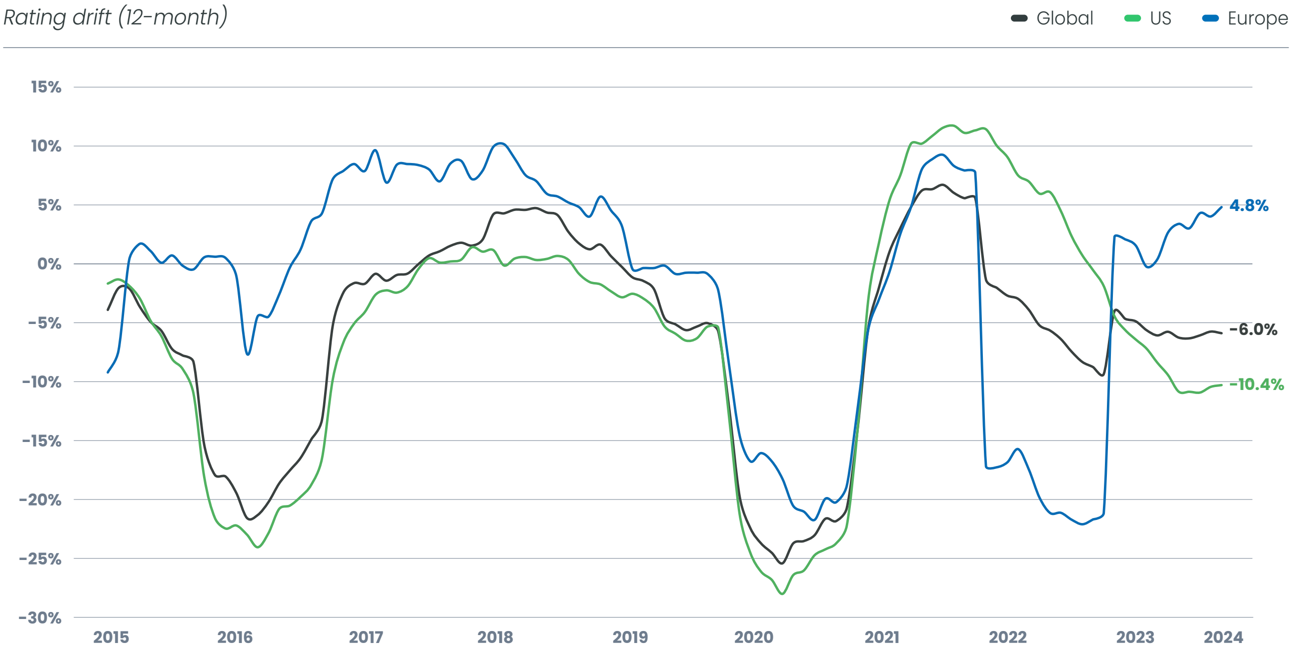
Going forward we expect this trend to continue, although at a slower pace.

- **Corporate behaviours are less credit friendly** – After the very strong rally in credit spreads toward multi decade tights in the US, we start to see some changes in corporate behaviours (M&A, share buybacks and dividend deals from PE owned credits). This should bring positive net supply.
- **Private credit is a new alternative to High Yield** – Thanks to higher rates, private credit attracted significant capital from investors and can be seen as an alternative to the HY market for issuers, which can result in further negative net supply.
- **Large rising star candidates remain in Europe but evaporated in the US** – We believe rising stars will continue to support technicals materially in Europe while it should be more balanced in the US, a contrasted situation that calls for selectivity.

Figure 6:

Fundamentals continue to improve in Europe while they are deteriorating in the US

Rating drift (12-month)



Source: Moody's Investors Service

- **Default rates will remain higher than in the previous decade** – We expect a slow but prolonged default cycle as the most indebted companies will gradually have to incur higher costs of debt as they try to refinance their maturity wall in the coming years. Some capital structures in the low single B and CCC are no longer sustainable in the new environment and will have to be addressed in the coming years.

How can investors navigate in this challenging environment?

This trend created a very strong technical background in High Yield markets, that has been exacerbated by the pivot of central banks at the end of last year and the resulting strong demand from investors for credit and High Yield.

1. Don’t fight the technicals

Though the backdrop of strong technicals does provide support to the market, it is important to keep a close watch on fundamentals for when the tide goes out. While demand for credit is very strong as evidenced by fund flows since the end of October 2023, the macro environment remains uncertain and the technicals could turn again in the next months. While credit dispersion remains temporarily low, we think it is very important to remain focused on fundamentals, as we remain prepared for the return of a higher dispersion regime.

2. From Beta to Alpha

With credit spreads at multi decades tights, we think it is time to shift focus from beta to alpha i.e. from passive to active strategies.

3. Go Global

In a shrinking market, it is essential for investors to broaden their investment universe and go global to leverage on stronger diversification, additional relative value opportunities and tactical allocation between regional markets.

Broaden your opportunity set with high yield experts!

In this environment, we are focused on detecting any promising opportunity, relying on a rigorous fundamental research approach that integrates ESG factors. The smooth collaboration between our portfolio managers, ESG analysts and credit analysts has been key to our success since we started managing high yield bond strategies over twenty years ago.

Risks.

All investments involve risks, including the risk of loss of capital.

The most significant risks of High Yield bond strategies are:

- **Risk of capital loss**
- **Interest rate risk**
- **Credit risk**
- **High yield risk**
- **Counterparty risk**
- **ESG investment risk**

This list is not exhaustive and more details on risks associated with investing in high yield bond strategies are available in the related strategies' regulatory documents.

€145 B

AUM at end December 2023*

+600

Experienced and committed professionals

+ 25 years

Leading the way in sustainable investing

*As of 31/12/2022, Candriam changed the Assets Under Management (AUM) calculation methodology, and AUM now includes certain assets, such as non-discretionary AUM, external fund selection, overlay services, including ESG screening services, [advisory consulting] services, white labeling services, and model portfolio delivery services that do not qualify as Regulatory Assets Under Management, as defined in the SEC's Form ADV. AUM is reported in USD. AUM not denominated in USD is converted at the spot rate as of 31/12/2023.

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