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# High Yield and Multi Asset Credit strategies

## Quarterly Overview

## 30 June 2024

ROYAL LONDON
ASSET MANAGEMENT

# Overview

## Market overview

Markets have once again been dominated by interest rates during the quarter, despite little or no movement in this area. 2024 started with expectations that central banks would cut early and cut often. However, as the year has progressed, those expectations have changed. Inflation has generally not come down quite as fast as hoped, with services inflation proving sticky, particularly in the UK, while growth has generally not been as weak as feared – particularly in the US. Interest rates were cut just once across the Federal Reserve, European Central Bank and Bank of England, with the ECB cutting rates in June. Most central bank forecasters now only expect one or two cuts from each of these banks over the course of 2024 as a whole.

Ahead of the US Presidential elections in November, snap parliamentary elections were called in the UK and France, providing reminders that voter dissatisfaction with the seeming consensus on economic policy and ongoing lack of consensus on longer-term issues such as climate change create an uncertain backdrop for businesses and consumers alike.

The US Federal Reserve continued to keep rates on hold at 5.25-5.50% over the quarter against a still resilient labour market backdrop, and the relatively strong core CPI inflation seen over January to April. The May data (released in June) was more reassuring both from a CPI and core PCE perspective. As of their June meeting, the median forecast of participants changed from showing 75 basis points of rate cuts for 2024 to only 25bps of cuts.

The ECB lowered rates by 25bps in June, following good inflation progress and previous hints from ECB speakers. Further rate moves after June are less certain and depend on data. The European elections saw incumbent parties suffer a loss of support and prompted President Macron to call an early parliamentary election. This uncertainty saw French government bonds weaken in relation to German government debt.

Data released in the UK in the second quarter confirmed that the country bounced out of technical recession in the Q1 and painted a picture of continued positive economic growth. The Bank of England kept rates at 5.25%, even though headline inflation dropped. This reflected concern about services inflation and pay growth, both of which remain elevated. The calling of UK general election, which has resulted in a change of government, had minor impact on sterling asset prices, reflecting a view that there would be little shift in economic policy.

Government yields generally rose over the quarter, particularly following poor US inflation data released in April with yields largely range-bound through May and June. In the US, 10-year treasury yields rose from 4.21% to 4.40%, while German 10-year bunds similarly saw yields rise from 2.30% to 2.50%. Benchmark 10-year gilt yields rose from 3.94% to 4.18%.

Global corporate bonds saw broadly flat returns over the quarter, with the impact of higher underlying government bond yields and slightly wider credit spreads mitigated by the positive carry on the asset class. In local currency terms, US and euro investment grade markets outperformed sterling equivalents.

In the high yield market, the ICE BofAML (BB-B) Global Non-Financial High Yield Index (sterling hedged) benchmark returned 1.31% in the quarter as spreads hit 282bps. At the end of the period, the index's yield-to-worst stood at 6.97%, in line from 7.05% at the start of the year. In the broader-based high yield index, which includes CCC rated bonds, spreads tightened to 358bps, with a yield-to-worst of 7.74%.

## Portfolio commentary

The RL Global High Yield underperformed its benchmark in the quarter, while the RL Short Duration Global High Yield and RL Multi Asset Credit funds outperformed.High yield markets were fairly benign in the second quarter with the themes seen in the first quarter continuing to play out in the second quarter. Spreads tightened, but not much, while rates behaved themselves with carry offering the return for the fund. A key development through the quarter was the heightened supply seen but the majority of this was companies taking advantage of current market conditions to extend and lock in debt at levels they're happy with as opposed to fresh new issues.

Increased refinancing has come as companies wrestle with current valuation levels versus higher yields. In our view, we are not seeing valuations adjust to the 'higher-for-longer' market environment, where yields are expected to stay at elevated levels as major central banks hold off on an aggressive rate cutting cycles as global economies show modest growth. As companies struggle to attain the value they are hoping for in private markets, they instead chose refinancing debt in public markets. Which has led to the large amount of supply – which in turn is keeping defaults low, which is keeping spreads in line.

Low default rates are also indicative of a high yield market that is more robust than in the past. The CCC portion of the market is now a relatively small portion of the market, with issuers now typically larger and in better financial standing. We are seeing the majority of the market handling the higher cost of capital. Liquidity and flexibility mean that defaults are being deferred and the most recent data also shows how issuers in distress are not defaulting.

With compressed spreads, and high liquidity, companies can seek refinancing at comfortable rates. We will, however, begin to see higher levels of cashflow spent on debt servicing if yields remain this high – which is where we see a disconnect with equity valuations.

# Overview

## Activity

With the benign default environment, we are seeing maturity concerns pushed further out. As such, we see refinancing continuing and new supply remaining fairly low. If spreads were to loosen, new supply could return to the market but if we see continued tight spreads – which is probable in conditions with high liquidity and solid corporate fundamentals – then current mood should continue.

We are happy with the position of the funds as we seek to pick out idiosyncratic factors to spick up spread and yield. We are in a permissive credit climate where covenants are loosening further as the weight of demand is suppressing not only spreads but also protective features.

Leveraged buyouts have been few and far between, which is feeding into spread compression. As new supply is limited, there is excess demand in public markets.

Defaults remain depressed with corporate fundamentals and liquidity at impressive levels. This leaves us happy to lend further down the rating scale. In a benign default environment, we are happy to move down the credit rating scale to pick up additional spread and yield.

The low default rates being seen are indicative of a high yield market that is more robust than in the past. The CCC portion of the market is now a relatively small portion of the market, with issuers now typically larger and in better financial standing. We believe the majority of the market can handle the higher cost of capital and are adjusting to the environment. Liquidity and flexibility mean that defaults are being deferred and the most recent data also shows how issuers in distress are not defaulting.

## Outlook

High yield fundamentals are well supported and that has resulted in a very moderate default climate up to now. Current US high yield default rates are very low, sitting below 2% with global defaults below 3%. While companies are relatively comfortable with the position that credit spreads are not going to be too volatile, and they have a good handle on the strength of their balance sheets, we can see a scenario where current tight spreads tighten further – with not many new issues and yields remaining high.

As spreads tighten, there become a perception that the high yield market is risky for investors, but we feel this does not tell the full story. The fundamentals in the market are considerably better than previously with the quality of names improving. We believe that the combination of attractive valuations, robust fundamentals, and the fact that macro headwinds have abated with the US monetary tightening cycle coming to an end, provides a constructive environment for 2024 and 2025.

In our view, the way through markets is to focus on those risks that you can control and know what you own. We will keep spread duration low and focus on the quality of issuers' financials, rather than relying on third-party ratings: at a sectoral level, cashflows are the key factor, meaning we need to know about on- and off-balance sheet leverage. We prefer not to wait for defaults as the recovery process can take time: however, should they occur, the key is to have an adequate solvency cushion.

We still believe 2024 should play out similarly to 2023: maturity wall concerns being overplayed; companies holding high liquidity; private debt markets eating the bottom cohort of public markets; public markets remaining open, with solid issuance levels. As long as public markets stay open, any maturity wall concerns will be swept away. And, as long as private markets are taking away the weakest parts of public markets, we believe defaults should stay low.

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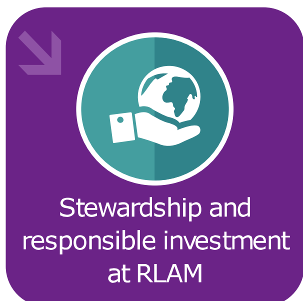


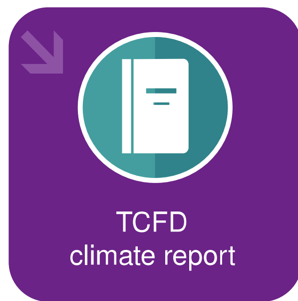


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