December 2022

HIGH YIELD 2023 OUTLOOK: OPPORTUNITIES AMID UNCERTAINTY

Key Takeaways:

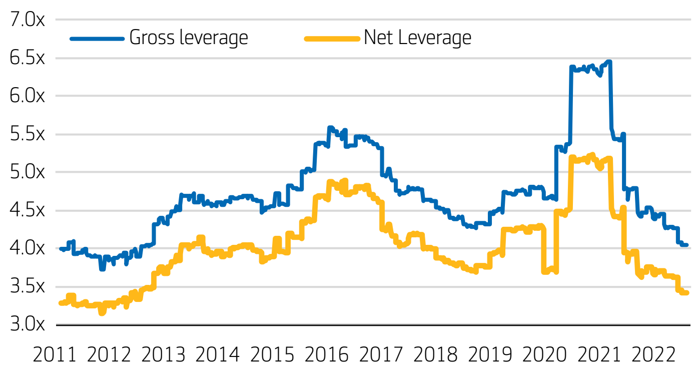
- Caution is warranted entering 2023, however volatility could present intriguing buying opportunities
- Although headwinds persist, the solid fundamental starting point should help most companies weather a slowdown and result in a persistently low default rate
- Spreads could widen if a recession becomes more imminent. However, elevated yields and discounted bond prices look attractive and we believe high yield could surprise to the upside and generate coupon-plus returns

Challenging economic conditions are setting the stage for an interesting year ahead in the high yield market. As the economy slows and the cycle matures, we believe caution is warranted. However, we expect dislocations to expose intriguing buying opportunities and attractive entry points.

Healthy fundamental starting point

From a fundamental perspective, most high yield companies are entering 2023 in a healthy state. Companies have diligently improved their balance sheets, resulting in low leverage ratios (Exhibit 1) and high interest coverage.

Exhibit 1: Low leverage and healthy fundamentals entering 2023



Source: BofA Research as of September 2022. Reflects Gross and net leverage for US high yield companies (as tracked by BofA).

Although corporate earnings were resilient amid rampant inflation in 2022, we believe fundamental improvement has peaked and margins may contract into next year. This could erode credit metrics, especially for the companies that are more levered and reliant on growth. That said, given many issuers are starting in solid financial condition, we believe most high yield companies can weather an economic slowdown. In addition, while the outlook is cloudy, slowing economic growth can bring relief for high yield companies as inflationary cost pressures fade and companies gain more clarity on the economic path forward.

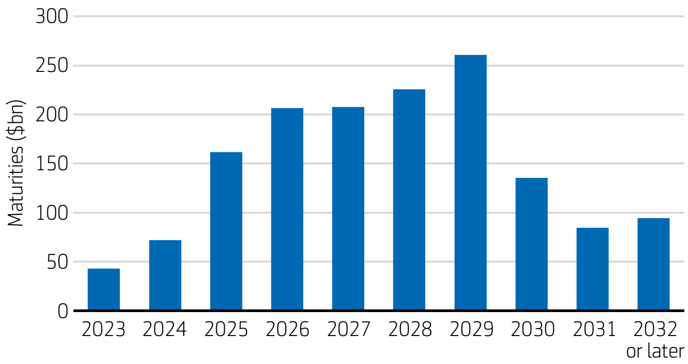
Muted default outlook

As recession odds increase, investors typically grow concerned about defaults. While defaults trend upward during recessions, we expect defaults in the next downturn to be more muted. This view is based on various factors including the healthy fundamental starting point, a higher-quality high yield market, and few near-term maturity concerns.

First, the strong fundamental starting point should help limit distress and defaults compared to prior downturns. Second, the current high yield market has the highest credit quality composition in decades with low levels of CCCs and below, and a higher percentage of BBs. Notably, the high yield market has been cleansed of the more challenged credits during the various downturns or crises in recent years, such as the global pandemic and the 2015-2016 energy situation. In addition, most high yield companies have very few near-term maturities, which reduces refinancing risk (Exhibit 2). And discounted bond prices should help limit the actual loss in the event of default.

Although headwinds will likely persist in 2023 and defaults are expected to increase off current lows, we anticipate more subdued default rates during the next recession relative to prior downturns.

Exhibit 2: Few near-term maturity concerns support a muted default outlook



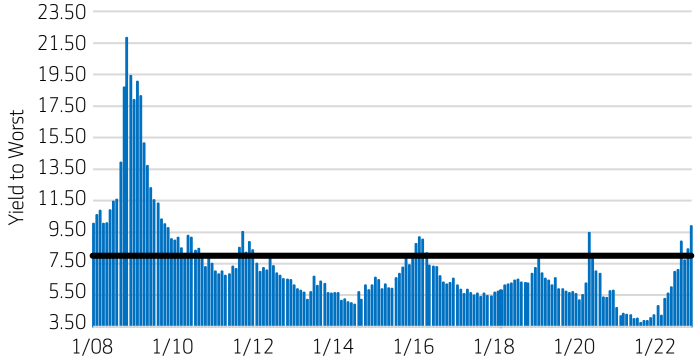
Source: JP Morgan. US high yield bond maturity schedule ($bn) as of November 4, 2022.

Compelling entry points ahead

After many years of low rates, the high yield market currently offers high all-in yields potentially above 8%.[1] Although each cycle is different, and the current yield is primarily the result of higher rates, yields above 8% have been relatively rare and have historically provided attractive long-term return potential. Additionally, bond prices that are well below par should also provide positive convexity and price appreciation potential.

Prior to 2022, there have only been eight months during the last 10 years that offered a starting yield above 8% (Exhibit 3). Historically, investing when yields were above 8% resulted in roughly 8% to10% average annualized returns over a one-, three- and five-year basis (Exhibit 4). Extending this analysis back to the financial crisis in 2008, there were more periods with yields above 8% amid the global financial crisis. While these environments were fraught with economic weakness and macro headwinds, the high yield market generated strong rallies that provided opportunities for investors to generate above-average forward returns. Since 2008, the average forward returns ranged from about 11% to 18% over a one-, three- and five-year basis for the Bloomberg US High Yield index.[1]

Exhibit 3: Starting yields above 8% have been relatively rare[1]



Past performance is not indicative of future results. Source: Aegon AM and Bloomberg. Based on month-end Bloomberg US Corporate High Yield Index data from January 31, 2008 – September 30, 2022. Reflects the forward annualized returns for periods when investing at yields above 8%.

Exhibit 4: Yields above 8% have historically provided compelling entry points and above-average forward returns[1]

Average forward returns from starting yields above 8%	Annualized index returns (Sept 2012 – Sept 2022)	Annualized index returns (Jan 2008 – Sept 2022)
One-year return	18.04%	18.60%
Three-year return	8.38%	13.46%
Five-year return	8.18%	11.16%

Past performance is not indicative of future results. Source: Aegon AM and Bloomberg. Based on month-end Bloomberg US Corporate High Yield Index data from January 31, 2008 – September 30, 2022. Reflects the forward annualized returns for periods when investing at yields above 8%.

While high yields and low bond prices are attractive, current high yield spreads are around historical averages. With spreads below 600 basis points, spreads are not yet reflective of an imminent recession. Given the elevated expectations for a recession in 2023, it is likely that the high yield market could be biased toward bouts of spread widening in 2023.

If the recession is relatively short and shallow, elevated spreads could prove short-lived and be followed by a sharp snapback. These environments have historically created compelling entry points and provided outsized forward returns for investors with a longer time horizon. While there are risks ahead, we think high yield bonds will provide solid relative value versus many other asset classes. Absent a prolonged and deep recession, we maintain a positive outlook on high yield valuations and expect high yield could generate coupon-like or coupon-plus returns in 2023.

[1]All investments contain risk and may lose value. Indices do not reflect the performance of an actual investment. It is not possible to invest directly in an index, which also does not take into account trading commissions and costs.

Uncovering opportunities amid uncertainty

Volatility will likely remain elevated in 2023 as the high yield market grapples with macro headwinds. Navigating market uncertainty in the year ahead will require a sharp focus on balancing risk and reward. Idiosyncratic situations are likely to continue to create dispersion and credit problems, requiring an ongoing emphasis on rigorous bottom-up research and credit selection. Similar to 2022, avoidance of credit problems and mitigating downside risk will likely be key return drivers.

As the year unfolds, we expect opportunities will arise to add risk and to capitalize on dislocations. In this environment, we remain cautious and ready to take advantage of dislocations to lock in higher yields. In 2023, we believe it will be essential to balance patience and discipline with an ability to aggressively pursue potential once-in-a-cycle opportunities.

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