Payden&Rygel

A World of Opportunity in Global High Yield Bonds

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Higher yields are attracting more demand from investors. Also, given that equities had a strong year last year, big funds have taken some chips off the table in equities and put them into fixed income. There's a lot of demand that's supporting the market. We think government bond yields have the potential to be volatile this year and will dictate the total returns for fixed income broadly.

However, global high yield is a lower duration asset class and will be less impacted by what happens with government bond yields and more impacted by credit quality and how strong the economy is. These things are positive for the market.

Global Economy

We expect strong growth in 2024, especially in the US because business activity is picking up and is being supported by a strong labor market. The expectation is that central banks, especially the Fed, will start to ease monetary conditions, which will be another tailwind for the economy in 2024.

Outside the US, it's less clear, but should be positive, just not as robust as the US. There are areas globally like China that are slowing down and Chinese activity has ripple effects through other parts of the global economy, especially Europe. But we still expect there to be growth.

Rate expectations

We expect to see the Fed cut rates at some point in 2024. The question is when and how many get pushed into 2025? We did have hotter-than-expected inflation data early this year that has pushed some into thinking the Fed will hold out and move later than originally expected. We think that some of the early year inflation numbers showed higher readings because of seasonal factors more than showing a change in trend. Once that trend resumes and shows a downward trajectory for inflation, the Fed will begin cutting rates because rates right now are restrictive and they know it.

In Europe, the markets are pricing in a similar number of rate cuts by the European Central Bank (ECB) and the Bank of England to the US. If we were to bet on a market that's more likely to cut first, we would say it's over here in Europe.

For example, growth is more lackluster here. But also, especially in the UK, higher interest rates feed more quickly into the economy because mortgage terms are mostly shorter than five years. We think the Bank of England is wary of that, and that it's a matter of time before the force of all the rate hikes of the last few years starts to weigh more heavily on the consumer.

A good environment

For global high yield, we saw close to 13% return for 2023. 2024 is going to be harder because the potential for capital appreciation is limited. That leaves the carry component and the coupon as the main driver of returns. We think it's going to be a supportive environment for investors to capture that carry and will result in a 7% to 8% type of return for global high yield, which is very good.

Furthermore, default expectations remain low. Expectations are about 2% in Europe and closer to 3% in the US, but also, recovery rates have been robust.

At this point from a valuation perspective it's much more about being issuer specific than sector specific for us. We've also been finding value in other high-yielding markets: some high yield emerging market sovereign debt and some BBB CLO exposure, though not overriding the main thesis of the strategy which is high yield corporates.

New issuance should be higher this year. Last year in the European market, we had just under $50bn in new issues. The US market was just under $200bn. We think that number has upside potential given the refinancing needs, due to the maturity walls that we have in 2025. The high yield market likes to refinance at least a year in advance. Investors like to see that issuers can term out their upcoming maturities a bit earlier than in other markets which that creates more investment opportunities.

Investment Grade vs High Yield

One of the things that high yield has over investment grade is it's not as sensitive to interest rates. Interest rates are such a big driver of volatility in the fixed income market currently. That's something that tends to weigh more on investment grade returns than it does high yield.

If your biggest fear this year is that inflation could pick up and weigh heavily on fixed income markets, that's really going to be a government yield issue. And given the fact that high yield is a 3-year duration versus investment grade at an 8-year duration, a 100 basis point increase in rates is only going to cause the high yield market to sell off 3% and the coupon of 7 ½% will more than make up for that. Whereas investment grade would sell off by 8% and the coupon is 4% or 5%. That's not going to make up for that move, so there's a better buffer with high yield.