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High Yield and Multi Asset Credit strategies

Quarterly Overview

31 March 2024

ROYAL LONDON
ASSET MANAGEMENT

Overview

Market overview

A key theme to emerge during the quarter was indication of a more favourable global macro backdrop. Despite some mixed signals, the US economy remains resilient, while Europe and the UK show signs of gradually exiting their recessions. Activity in China also seems to be stabilising. At the same time, core central banks are still confident that the disinflation trend remains intact, despite some recent setbacks in inflation prints. Policymakers have often highlighted that they are in no rush to cut rates – with markets now generally pricing the start of the easing cycles to begin this summer. The Federal Reserve, European Central Bank and Bank of England all left interest rates unchanged over the quarter.

One major development over the quarter is that markets have aggressively recalibrated their pricing for expected central bank cuts over this year. At the end of last year, markets were pricing in an aggressive rate cutting cycle, but then swiftly move to temper those forecasts. This re-pricing contributed to negative returns for global government bond markets over the quarter. Despite the belief of many that it was the anticipation of a 'Fed-pivot' that contributed to the rally in equity markets in late 2023, equity markets proved to be immune to this bond market sell-off as global growth and business confidence showed signs of resilience and investors focused on the potential offered by AI.

Government yields rose in all the major markets. In the US, 10-year treasury yields rose from 3.88% to 4.21%, while German 10-year bunds similarly saw yields rise from 2.01% to 2.30%. Mirroring this backdrop of rising yields, UK government bonds produced a return of -1.62% (FTSE Actuaries) over the first quarter, with the benchmark 10-year gilt yield rising from 3.54% to 3.94%. The bulk of this move occurred in the first two weeks of January, before largely trading in a range between 4% and 4.2% for the rest of the quarter. The rising yield environment helped short-dated bonds to outperform their longer-dated equivalents.

Global corporate bonds saw mixed effects during the quarter. In the US, euro zone and UK, the negative impact of rising underlying government bonds was offset by credit spread tightening and positive carry, to leave returns roughly flat (local terms).

In the high yield market, the ICE BofAML (BB-B) Global Non-Financial High Yield Index (sterling hedged) benchmark returned 1.77% in the quarter as spreads hit 290bps. At the end of the period, the index's yield-to-worst stood at 6.95%, having fallen 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 7.65%. Over the course of 2023, Global high yield new issuance has totalled $285bn up from $170bn in 2022.

Portfolio commentary

RL Global High Yield:

The fund underperformed its benchmark in the quarter. The year started with many of 2023's themes playing through – spread resilience and some rate volatility ultimately leading to an environment where carry dominated. Spreads continued to tighten during the quarter – hitting levels we haven't seen since the inflation environment worsened, perversely where the economic data made people pause on the belief that rates will get back to low levels quickly.

It was a nice environment for issuers in the quarter, with BB and single B rated issuers enjoying an open market, but we did see some idiosyncratic factors further down the rating scale start to cause some investor panic.

We have seen the cost of capital rise over the past 24 months but companies are now adjusting to this environment instead of sitting on their hands and waiting for interest rates to come down. As such, we have seen well behaved markets and companies now holding high liquidity. It is worth noting, however, that equity valuations seem high and don't match the high costs of capital.

As a result of this, later in the quarter, we seen some investor panic. Which led to companies further down the credit ratings scale give back much of the gains made from the rally seen at the start of the year. In turn, this hurt the fund's performance as the market took fright. The majority of the market, however, has been even keeled, with default rates remaining low – especially in the BB and B space.

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.

With the attractive yields on offer for strong, liquid BB and B credits, there is more than sufficient incentive to soak up natural public market demand. That means that the CCCs and those smaller issuers are far more exposed to a higher rate environment. Some of those capital structures really aren't sustainable at current yield levels and certainly won't be funded by public markets.

We are happy with the positioning of the fund and have looked to participate in new issues in an attempt to seek out yield as spreads in the secondary market have tightened. The fund holds

Overview

Altice France and Intrum but we are comfortable with where we sit in the debt stack and feel well placed holding the investment.

As credit spreads have been squeezed, we moved out of some investment grade names, looking for value where spreads are wider. In a benign default environment, we were happy to move down the credit rating scale to pick up additional spread and yield.

Short Duration Global High Yield:

The fund underperformed its benchmark in the quarter. As mentioned earlier, companies further down the credit ratings scale gave back much of the gains made from the rally seen at the start of the year. In turn, this hurt the fund's performance as the market took fright. The majority of the market, however, has been even keeled, with default rates remaining low – especially in the BB and B space. There was some high profile volatility in the period, most notably from Irish packaging firm Ardagh and telecoms and media group Altice France, as well as debt specialist Intrum – which affected the wider market.

Early in the quarter, cash was spent on existing positions and new positions in Power Solutions, Royal Caribbean Cruises, SM Energy, United Group and Walgreens. Following the high amount of new issuance in the market in January, several companies used those proceeds to redeem outstanding debt. As a result, the fund's holdings in Ball, Caesars, Cirsa, Ineos, and Transdigm were redeemed during February, while Q-Park was redeemed earlier in the quarter.

Multi Asset Credit:

The fund broadly tracked its benchmark index in the quarter. As mentioned earlier, companies further down the credit ratings scale gave back much of the gains made from the rally seen at the start of the year. In turn, this hurt the fund's performance as the market took fright. The majority of the market, however, has been even keeled, with default rates remaining low – especially in the BB and B space.

We have looked to add CLO tranches during the period, increasing our CLO exposure through new issues, as we are seeing high yields on offer, especially in the investment grade market. The benefit of the loan book in the portfolio includes the high carry, the short interest rate duration risk and convexity (as most high quality loans trade below par) so there is optionality on a refinancing in a defensive instrument.

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 at around 2-3%, with global defaults not much higher, and we expect this to track to 3%-5% over the course of next year. We expect that most high yield issuers will wait for interest rates to recede from their relatively high levels before returning to the tap markets. They 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.

With a dovish update in March, companies are becoming less focused on the US Federal Reserve as they adapt to the 'higher for longer' environment. With monetary policy lags appearing longer than they used to be there is some recognition by central banks that policy tightening needs time to work and that the impacts of policy tightening are still feeding through. This is causing spreads to tighten as investors are now convinced the fallout won't be coming until late 2024 or early 2025.

In our view, the way through difficult 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.

Further Information

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