High yield outlook for 2024: What's the carry-on in high yield markets?

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Default climate remains benign

At the start of the year, we were forecasting a higher default rate than the trend we have ultimately seen play out, with defaults set to end the year around 3% to 4% – and we see 2024 playing out similarly. We see defaults sitting around 3% to 5%, with our most pessimistic case seeing 7%.

Even if defaults do end up breaching 5% and creeping towards 7%, we don't see this as particularly worrying as it won't change the fundamentals of the high yield market and will only come about from US Federal Reserve monetary policy, which has been priced into corporate valuations, instead of, as of yet, unknown increased economic hardship.

With this in mind, we 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, defaults will stay low.

Increasingly, private markets are slowly but surely reducing the CCC bucket of public markets – which improves the quality of names in which we choose to invest.

Economic trouble ahead not that concerning

In our view, the downward trending economic cycle is not much to fret about for the high yield market – with default rates coming between 3% to 5%, this isn't particularly worrying. The main difference, however, is how the 'higher-for-longer' environment will lead to a shift in the make-up of yields – which is currently about half spread and half underlying government bond yield.

Even in this higher-for-longer world, we still see the default cycle being extended into 2025, leading us to believe spreads will fall in a range of 340 to 450 for next year. So, if defaults and spreads are in a relatively benign state, the key for us then becomes income.

Finding yield in a high yield market

We are targeting a yield of 8% to 9% in this market, which, should, barring a material increase in interest rates, lead to a positive return in 2024. We are confident in finding insulation to protect ourselves from the structurally weakest parts of the market.

There is potential trouble, however, in the form of determining when the Fed begins cutting interest rates. This is not unique for us, though. The lagged impact of the sharp rise in rates over the past 12 months will eventually feed through the economic system. But this risk is not as bad as the downside risk of the Fed staying where it is. In trying to predict rate cuts, it is a case of positioning our portfolio appropriately but if the Fed doesn't bring rates down, we could see increased economic fallout and heightened defaults, as higher rates for longer begins to hurt when companies feel the increased cost of capital.

Higher for only-so-much-longer

Rate cuts from the Fed, and most other major central banks, are priced in for the next couple of years – which we have seen baked into corporate valuations. Again, this makes us think the biggest danger to the high yield market is the Fed staying where it is as corporate valuations are tied to interest rate expectations, so any change in rates will change valuations, which will then impact credit markets by reducing the margin of safety in terms of equity cushions and would mean higher spreads.

> “The lagged impact of the sharp rise in rates over the past 12 months will eventually feed through.”

We think the tailwind risks of a much harsher recession than the shallow one currently predicted is hard to foresee as the credit market will be reacting to the recession, unlike its role in 2008 where it was a leading indicator as the root of the crisis.

While we are comfortable with what we feel is a benign economic environment, we do accept there is increased idiosyncratic risk now than there was 12 months ago. There is uncertainty around the Middle East and the upcoming US elections, while rising government deficits also offer a technical risk that is flying under the radar.

Where does that put our strategies?

With the main uncertainty next year coming from rates, we are high on short duration bonds and carry – income matters in this yield environment.

Although we have mentioned increased idiosyncratic credit risk, we do not see these risks sneaking up on investors. As a result, we will maintain our preference for liquid capital structures, staying away from smaller capital stacks, and a preference for larger names which have established routes to capital.

An ever-increasing important aspect of high yield markets is the role of private debt. We are seeing private debt markets grow in size, hoovering up lower rated companies. This focus on lower quality companies results in public markets being left in a structurally stronger place.

As the CCC portion of the market continues to diminish, taking out of public hands the most stressed part of our market, we can see clear signs of why default rates remain so low. If private markets dry up, will this then have a knock-on for us? It could, but we see no signs of private markets closing up: they have their dry powder, and we don't see where else they can use it.

With this lower than anticipated defaults, we believe you are not incurring the usual risks in the high yield markets – which is why we keep our focus on carry and income.

> “The credit risks are not going to sneak up on you.”

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