High Yield Market Update

Newfleet ASSET MANAGEMENT
A Virtus Investment Partner

MAY 2024

Performance

The U.S. high yield market had its best performance in 2024, gaining 1.1% due to a supportive macro environment, strong earnings, the largest retail inflows since November, and open capital markets. Moderate inflation data and resilient labor reports provided a favorable economic backdrop, with 5-year and 10-year U.S. Treasuries lower by 21 basis points (bps) and 18 bps, respectively. Meanwhile, the stronger growth environment is having a positive impact on corporate profits, with companies beating expectations and increasing guidance at a high rate. The favorable risk environment contributed to large inflows, which contributed to the strong market performance. Higher-quality credits outperformed in response to the rate move as BB, B, and CCC credits gained 1.21%, 0.97%, and 0.44%, respectively. Spreads widened seven basis points to 308 bps, and excess returns were 0.1%. The yield-to-worst (YTW) decreased from 8.1% at the end of April to 8% at the end of May.

Sectors

The best-performing sectors were healthcare, electric, and chemicals, which returned 2.23%, 2.02%, and 1.81%, respectively. Healthcare outperformed due to strong earnings from hospital issuers. Electric benefitted from strong fundamentals due to increased power demand. Chemicals outperformed with the end of customer destocking and early signs of volume improvement. The worst-performing sectors were media, wirelines, and airlines, which returned -1.22%, -0.39%, and 0.49%, respectively. Media and wirelines underperformed due to secular challenges and balance sheet concerns. Airlines underperformed after a strong rally in the prior month.

Fundamentals

There were no defaults for the first time since December 2022. However, distressed exchange activity continued. There were three distressed bond exchanges for $1.1 billion. This resulted in a drop in the trailing 12-month par value default rate of 34 bps to a 14-month low of 2.02%, or 30 bps lower to 1.25% excluding distressed exchanges. The ratio is 86 bps lower year-to-date. We expect the default rate to remain near the post-Global Financial Crisis average of 2.5%. The default rate also moved 21 bps lower on an issuer basis to at 4.04% (1.90% excluding distressed exchanges). The distress ratio increased from 6.4% to 7.1% as higher for longer continues to negatively impact more stressed credits.

Credit quality continued to improve in May, with upgrades greater than downgrades for the second consecutive month and three of the last four months. Additionally, there continues to be a significantly greater par amount of bonds upgraded versus downgraded. In May, 30 issuers were upgraded for $50 billion and 28 issuers were downgraded for $38 billion. The upgrade-to-downgrade ratio was strong in May at 1.1x by issuer and 1.5x by par, keeping the year-to-date issuer ratio at 1.1x and the par ratio to 1.2x. LTM ratios also increased slightly, with the par ratio at 1.51x and the issuer ratio at 1.07x. There remains a large divergence by rating with the YTD upgrade-to-downgrade ratio by the issuer for BB, B, and CCC issuers at 1.38x, 1.23x, and .76x, respectively. During the month, there were three rising stars for $5 billion and one fallen angel for $100 million.

Technicals

Market technicals were strong due to the favorable environment for risk in May as fund flows reversed sharply with positive inflows and market access improved. Fund inflows amounted to $6.9 billion in May, more than reversing the prior month's outflows and increasing the year-to-date inflow to $7.8 billion. New issuance was the most since September 21 with 54 bonds pricing for $34 billion. In May, 83% of issuance went toward refinancings, with the $28 billion representing the most since May 2021 as issuers remained focused on extending maturities. Less than 3% of new issuance was from CCC companies.

Outlook

The market environment remains volatile with growth and inflation data in focus as the market focuses in on the inflation path and labor market environment and what that means for the path of interest rate cuts and economic growth. We continue to expect a bumpy landing as the Fed attempts to bring inflation to target while also allowing the labor market and the economy to remain strong enough. However, the impact of inflation and rates on economic growth remain potential sources of credit volatility. The positive impact from stronger growth has been solid earnings as demand begins to improve and destocking is largely finished. However, the shift to "higher for longer" has had more negative impacts on certain companies, especially distressed credits with near-term maturities. Risks remain around the future path of monetary policy, tighter lending conditions, availability of credit, slowing growth, inflationary pressures, and geopolitical events.

For information about Newfleet's retail fixed income strategies, please visit www.Virtus.com.

The **Bloomberg U.S. High-Yield 2% Issuer Capped Bond Index** is a market capitalization-weighted index that measures fixed rate non-investment grade debt securities of U.S. and non-U.S. corporations. No single issuer accounts for more than 2% of market cap.

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