What's all the fuss about?

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High yield

When looking forward, it's always important to look back first. Heading into 2024, we were keen to note that we expected a continuation of trends seen at the time: maturity wall concerns being overplayed; companies holding high liquidity; private debt markets eating the bottom cohort of public markets; and public markets remaining open, with solid issuance levels.

While we don't want to pat ourselves on the back too much, the year did play out quite close to the above scenario. And, going forward, we see much of the same. As long as public markets stay open, any remaining maturity wall concerns will be swept away. And, as long as private markets are continuing to provide liquidity to the weakest parts of public markets, defaults will stay low.

> This evolution underpins the performance of the market: better corporate technicals have resulted in lower defaults, which lends itself to lower volatility.

In 2024, spreads tightened significantly. This offset the risk-free rate moving higher as the government curve has also steepened – providing a healthy single-digit positive return in high yield markets.

For the next year, we see a similar return profile from high yield markets but we expect the inverse: spreads to be a touch wider and the risk free a touch tighter to leave yields at similar levels. Defaults levels look set to remain low, allowing for a high single-digit return from high yield markets but with slightly more assurance shorter on the curve.

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Not your parents' high yield asset class

The high yield market is much more established, deeper in liquidity, diversified and higher in quality than in decades past. This evolution underpins the performance of the market: better corporate technicals have resulted in lower defaults, which lends itself to lower volatility.

This institutionalisation of the high yield market has seen quality improve – with a reduction in lower rated names allowing a considerably higher rating than in decades past. This is clearly seen in the dramatically lower number of CCC rated bonds in the market compared to BBs. In 2003 CCCs were 17% of the market and BBs were 36%; by October 2024 CCCs were just 9% and BBs had grown to 60%. As a result, we see risk-adjusted spreads at fair value.

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 results in public markets being left in a structurally stronger place.

As the CCC portion of the market continues to diminish, taking the most stressed part of the market out of public hands, we can see clear signs of why default rates remain so low. There are no indications of private markets closing up: as closed ended vehicles these have already raised a substantial amount of funding and still have much dry powder: we don't see where else they can use it.

As well as improved credit ratings, we have seen issue sizes grow, with bond issues now on average three times higher – leading to greater liquidity.

The correction in yields seen in 2022 was the worst since the Global Financial Crisis. As a result, valuations look extremely attractive given the yields on offer, especially when you consider credit fundamentals remain robust. Broadly, companies have used stable revenues to prudently build healthy liquidity runways, leading to little additional pressure to refinance in the near term. This has been borne out by relatively low core default rates in the asset class. This is all despite a backdrop of an inflationary environment and higher refinancing costs.

Spreads are tight, will they get tighter?

Spreads are uncomfortably tight but yields are generous. It is sometimes overlooked that high yield is an asset class bought on yield rather than spread so we believe technicals should remain supportive.

Most high yield issuers are domestically focused – so Trump's tariffs may not hurt the asset class the way it might for others. We may only see this as a marginal issue. High yield sectors are now defensive in nature when compared to the past – for example, the energy sector has had two default waves in the last decade, and as a whole the high yield market has far less cyclicals exposure compared to the past.

Central banks usually take the escalator up and the elevator down. Rate hikes are slow and measured but rate cuts tend to be quick and come in bunches. This cycle is the exact opposite. While we expect we've hit the ceiling for rates in this cycle and that these are unlikely to rise from here, they are also unlikely to fall much – so carry matters even more than before.

We expect public markets to remain active. Fresh leveraged buyouts are likely to provide supply and widen the high yield market but only if credit spreads are range bound, whilst private credit issuers may return to public markets – which we see as an interesting trend to keep an eye on.

Where does the risk lie?

As spreads tighten, there is a perception that the high yield market is risky for investors, but we feel this does not tell the full story. The fundamentals in the market are considerably better than previously with the quality of names improving. We believe that the combination of attractive valuations and robust fundamentals provides a constructive environment for 2025.

The main catalyst for volatility on the horizon – as with other asset classes – is a Trump presidency. Until there is greater clarity on what policy path he takes forward, and what policies he decides to focus on, high yield spreads could trade sideways – as the risk is politically driven, not market driven.

The election has been decisive, with the Republicans sweeping the swing states, comfortably winning the Senate, and on track for a 'red sweep'. After the diversion of an election cycle, markets are back to focusing on policy and the macro environment. And the macro outlook is still attractive. As we move further away from the election, however, there is scope for spreads to widen as we expect to see the high pace of issuance continue.

How to navigate these choppy waters

We have seen the global economy survive a year of intense geopolitical risk in the Middle East and the heightened uncertainty that comes from a US presidential election. It has weathered the quickest hiking cycles in decades, and jobless rates are still low. Further afield, China seems serious about putting a floor under the economy, even if growth upside is limited.

In our view, the best pathway through markets is to focus on those risks that you can control and forecast with a higher degree of precision. We will focus on moderating spread duration and, as always, 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. Under our investment approach, 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.

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