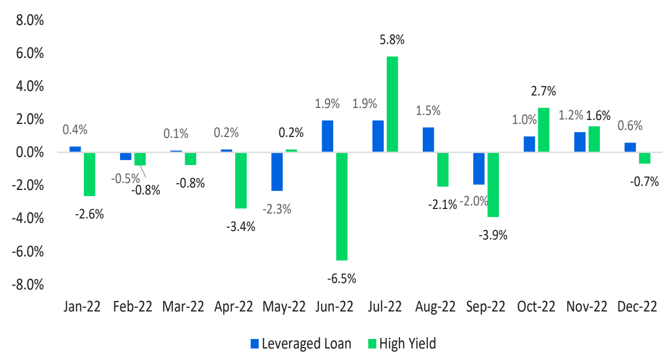
Public Credit

In 2022, high-yield investments were subject to the same economic and geopolitical turmoil impacting other asset classes, as well as specific challenges that included a near-record amount of retail withdrawals from high yield mutual funds and a collapse in capital market activity to a low not seen since 2008. Not surprisingly, these conditions produced a challenging backdrop for returns. US high yield bonds were down -10.6% for the year. Despite the dismal performance, high yield still outperformed other fixed rate asset classes including US Treasuries, investment grade bonds, and emerging market corporate debt, which were down -12.5%, -15.4% and -13.8% respectively. Despite its relative outperformance, it was the second worst calendar year performance for the asset class on record and only the fifth year that investors suffered a negative return in the last 28 years.

Meanwhile, US leveraged loans posted modest gains (+0.1%) and handily outperformed all other fixed income asset classes around the globe, primarily thanks to its limited interest rate sensitivity. In fact, the outperformance of loans versus bonds was the largest on record.

Figure 9. Leveraged Loans Significantly Outperforms High Yield in 2022



Source: J.P. Morgan

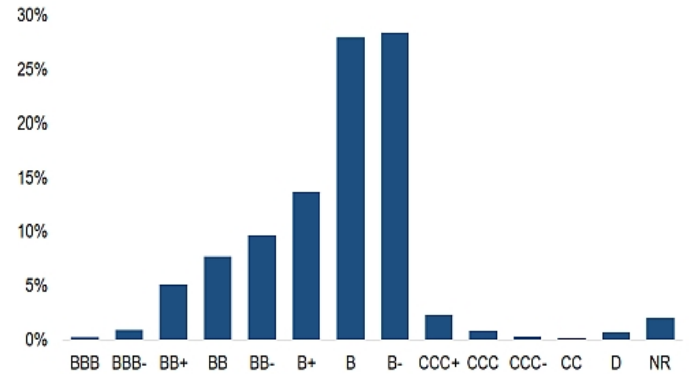
While the loan market was one of the few better spots for investors in 2022, the worsening macro environment does not bode well for continued relative outperformance. Because of the near-zero interest rate environment that encouraged yield-starved investors to load up on low-rated debt, B-minus rated companies took advantage of this demand and now account for a record 28.4% of the leveraged loan market, up from just under 17% in 2017. In fact, B- rated debt now accounts for the largest share of the $1.425 trillion US leveraged loan asset class, the first time in the 25-year history of the Morningstar LSTA US Leveraged Loan Index. These issuers have already begun to feel the liquidity strain: free cash flow has dropped as growth has slowed and debt interest payments have increased substantially with base rates expanding. The expectation is that many of these companies should experience downgrades over the next 12 to 18 months making it increasingly difficult to tap the market to refinance their debt.

We believe default risk is concentrated in lower quality leverage loan issuers with high leverage and in issuers of CCC-rated high yield bonds that are facing looming maturities in the next two years. While the quality of the leveraged loan universe has deteriorated, relatively the high yield bond market has improved given the percentage of BB-rated debt is now near the highest level in the last decade.

Emerging Markets Debt: An Opportunity in 2023?

Emerging market credit spreads in both sovereign and corporate debt have widened alongside other fixed income assets, and after several months of underperformance following Russia's invasion of Ukraine, they have reached levels that may suggest current valuations more than compensate for the negative shock. These lower valuations could provide opportunities for deep country-by-country analysis and relative value security election to capitalize accordingly. For example, fundamentals for many emerging market

Figure 10. Breakdown of the Morningstar LSTA US LL Index by Issuer Rating



Source: PitchBook

corporate issuers look particularly strong within the oil & gas, telecom, utilities, and infrastructure sectors.

Moreover, most emerging market central banks were well ahead of their developed market peers, having collectively raised interest rates significantly, thereby helping to lift emerging market local-market yields to attractive levels. The rate-hiking cycle has been unexpectedly extended by the inflationary impact of the Russia/Ukraine conflict. Country differentiation remains important here, as monetary policy responses have varied, with some emerging market countries, such as those in Latin America, nearing the end of their hiking cycles. As global economic activity begins to normalize, fiscal stimulus measures fade, and central banks withdraw liquidity, inflationary pressures should begin to subside. This would allow emerging market policymakers greater latitude to stabilize rates before shifting to an outright easing cycle, particularly considering the economic slack present in many of these economies.

The technical picture is also showing nascent signs of recovery. Emerging market debt has begun to see net inflows return after record outflows of $87 billion from the asset class over the first 10 months of 2022. We anticipate stronger net flows in 2023 and specifically we expect tactical credit managers, who drastically cut exposure to the asset class in 2022, to increase allocations as the outlook improves, providing further support for spread tightening.