PICTET WEALTH MANAGEMENT

2024 Outlook - corporate bonds

Attractive high-quality bond yields: a call to extend duration

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FLASH NOTE

SUMMARY

- US and euro corporate bonds have posted positive performance year-to-date thanks to spread tightening and elevated carry. Against a backdrop of rising government bond yields and bullish equity markets, US and euro high-yield (HY) bonds have generally outperformed investment-grade (IG) bonds. However, cracks have been appearing in the riskiest credit segments, such as the lowest-rated HY bonds and leveraged loans.
- We still prefer the highest-quality bonds as we believe HY bonds are not adequately rewarding investors for the level of risk they involve. With refinancing costs high and default rates rising, we only expect low-single-digit returns for HY in 2024, but mid-to high-single-digit returns for IG. We expect US and euro HY spreads to widen towards 600bp in the first half of next year as economic growth decelerates, but they could tighten again below 500 bps in the second half.
- We favour locking in the high yields offered currently by companies of quality. As cash becomes less attractive in anticipation of central bank rate cuts next year, we are ready to lengthen our duration exposure IG credit. As we believe 10-year US Treasury yields have more limited downside than 10-year German Bund yields, we favour US IG corporate bonds of up to five years maturity, but up to seven years in euro IG.

2023 HAS REWARDED THE RISK TAKERS

US and euro corporate bonds have posted positive performances year-to-date thanks to spread tightening and elevated carry. Against a backdrop of rising government bond yields and bullish equity markets, US and euro HY bonds have generally outperformed IG issues. Both US and euro HY bonds have been extremely resilient in the face of this year's rise in interest rates thanks to their lower effective duration and much higher coupons than IG bonds. The ICE Bank of America Merrill Lynch

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(ICE BofA) US HY corporate bond index was up 8.5% year-to-date as of 27 November, while its IG counterpart was only up 3.5%. It has been the same story for euro credit, with euro IG credit rising by 4.4%, underperforming high yield's gain of 7.3%.

However, cracks have been appearing in the riskiest credit segments, such as the lowest-rated HY bonds and leveraged loans. Default rates are rising fast in these areas due to prohibitive financing costs – especially for leveraged loans, which are subject to floating rates. High financing costs have resulted in lower HY credit net issuance than in previous years, with companies choosing to postpone refinancing or to use cash for other sources of funding instead. We can see the consequence of this in the steep declines in the weighted effective duration of ICE BofA HY bond indexes so far this year – down from 4.0 to 3.5 years for the US HY index and from 3.1 to 2.8 years for the euro HY index.

WE FAVOUR QUALITY

The cost of financing has been on the rise for companies, especially those with an IG rating. The ICE BofA euro investment grade index's coupon has risen from 1.7% to 2.1% so far this year as of 27 November. Despite this increase, financing costs remain at historically low levels for IG and HY issuers alike. Looking ahead, the total amount of HY debt and leveraged loans that will mature over the next two years appears manageable. While the maturity wall (the date when debts fall due) for IG bonds in the US is more challenging than f for US HY companies, IG issuers tend to have easier access to capital. This can help them navigate any potential refinancing concerns, whereas HY issuers may face greater difficulties, although they are in less urgent need of refinancing. As a result, issuance by CCC rated companies has been scarce since the summer, while secured issuance (debts secured against company assets) has gained momentum. This shift in issuance quality reflects companies' cautious approach, as elevated refinancing costs have made it less attractive for lower-rated issuers to tap the unsecured bond market.

Higher refinancing costs have impacted HY companies, as the rise in default rates this year shows. While the default rate increased to 3.8% for US HY bonds, the default rate for leveraged loans rose to 5.4% in October. Meanwhile, the distress ratio (the proportion of companies with credit spreads trading above 1000 bps) has increased in both the US and euro HY universes in recent months (*see chart 1*). In 2024, we expect US HY default rates to rise to an average of 5.5%, peaking at 6.0%, while for euro HY we forecast an increase to an average of 4.0% with a peak of 4.5%.

Rising default rates are the main reason for our projected increase in HY credit spreads next year. With an economic slowdown anticipated in H1, we expect US and euro HY corporate spreads to widen towards 600 bps by the middle of 2024. However, we expect US HY spreads to tighten back to 450 bps and euro HY spreads to 480 bps in H2. We expect IG credit spreads to widen towards 200 bps initially, but to end the year at 130 bps for US issues and 140 bps for euro bonds.

We prefer the highest-quality bonds and advise caution on HY issues, at least until the second half of the year, when we expect economic growth in the US and euro area to recover. The difference in spreads between BB-rated and BBB-rated issues in both the US and euro area is below historical median levels (*see chart 2*), which suggests to us that investors are not being adequately rewarded for taking on the level

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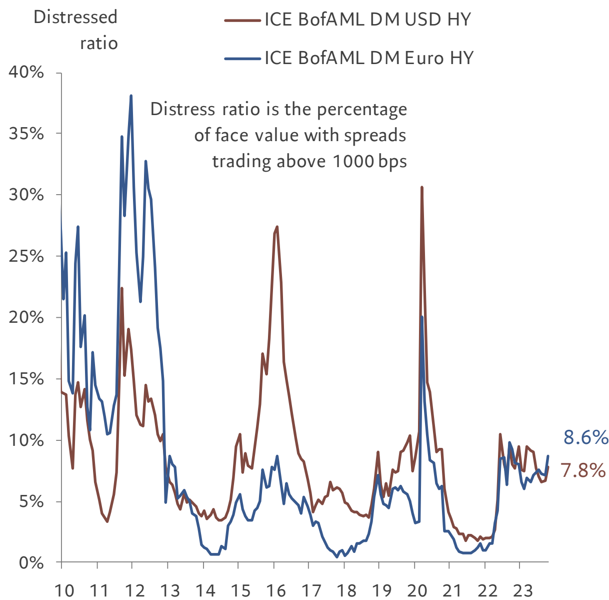
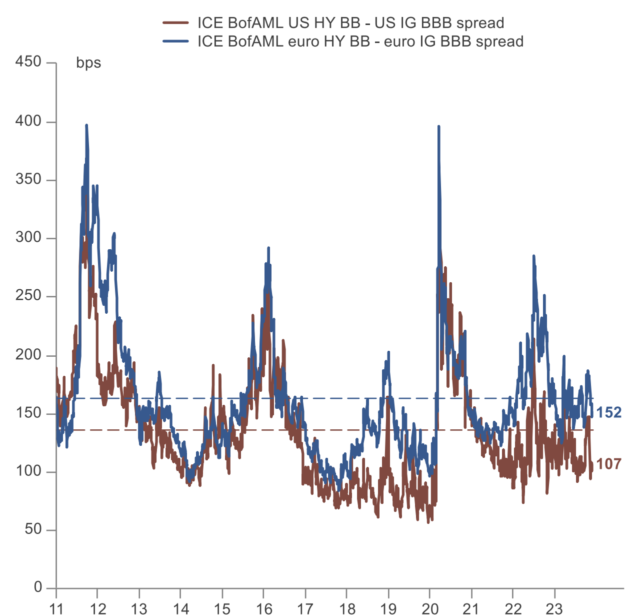
of risk associated with HY relative to IG. Indeed, we expect a default loss (the losses associated with bond defaults after recovery amounts have been taken into account) for US high yield of around 3.85% in 2024 in light of the projected increase in default rates next year. The default loss should reach 2.8% for euro HY in 2024. As such, we only expect a low single-digit total return for US and euro HY next year, whereas we expect a mid-to-high single-digit total return for US and euro IG.

Chart 1: Developed market (DM) high yield distressed ratio



Source: Pictet Wealth Management, FactSet, as of 27.11.2023

Chart 2: US and euro spread differential between BBBs and BBs



Source: Pictet Wealth Management, FactSet, as of 27.11.2023

FROM CASH TO DURATION

With the fast increase in policy rates over the last 18 months threatening growth prospects and pushing up sovereign bond yields, our favourite investment theme in fixed income has been short-term (one-to-three-year maturity) IG corporate bonds. Attractive IG yields in absolute terms and the recent surge in core government bond yields have more recently been pushing us to increase our duration exposure: to five years for US IG credit and to seven years for euro investment grade (*see chart 3*).

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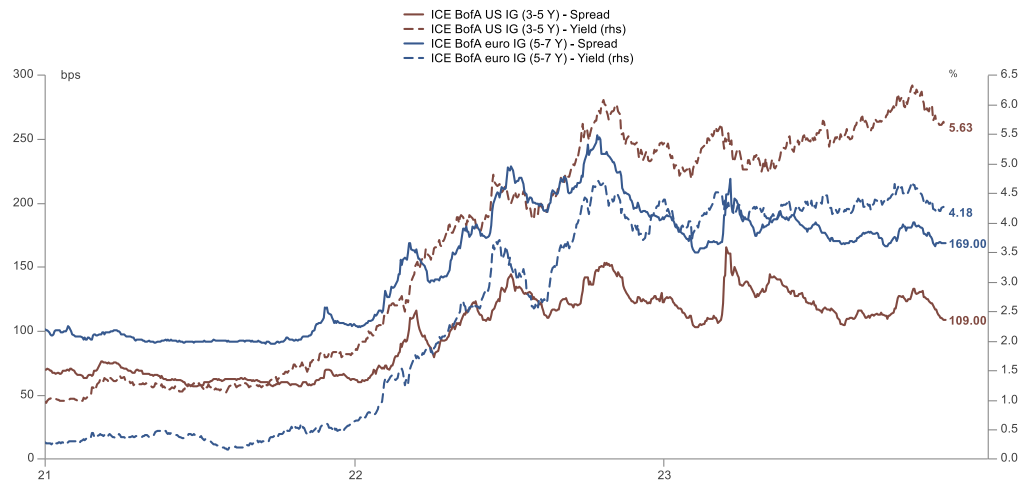
Chart 3: US IG 3-5-year maturity and euro IG 5-7-year spread and yield



Source: Pictet Wealth Management, FactSet, as of 27.11.2023

We continue to expect a shallow recession in the US in the first half of 2024, possibly leading to rate cuts by the US Federal Reserve (Fed), which should bring Treasury yields down. Similarly in Europe, stagnant economic growth coupled with fiscal consolidation and a more rapid transmission of previous rate hikes to the economy may lead the European Central Bank to start cutting rates in June. We see cash as looking less attractive as short-term yields increasingly price in cuts to policy rates over the coming year. As we believe that fixed income overall now offers better risk-adjusted return prospects than equities as yields peak, we have moved to an overweight position in euro IG credit, in line with our overweighting of US IG.

We have been lengthening duration to different extents in the US and euro IG universes. As we set out in our core government bonds 2024 outlook (see Core government bonds: 2024 outlook), we believe the 10-year US Treasury yield has more limited downside than the 10-year German Bund yield. Indeed, there is a risk that growth in Germany is more sluggish than we expect in our central scenario and that growth in the US is higher. Should the US economy prove stronger than expected in 2024, the Fed would be less likely to cut interest rates and could even consider hiking again, leading to a higher Fed funds rate. The risk of such a scenario explains why we limit our duration exposure to US IG bonds to five years. In addition, although the net issuance of US Treasuries should decrease next year, it could still be historically high (*see chart 4*). This diminishes the appeal of US corporate bonds, overshadowed by the increasing size of the US Treasury market. This, plus the greater downside potential for German government bond yields, explains why we like euro IG corporate bonds with longer maturities than in the US.

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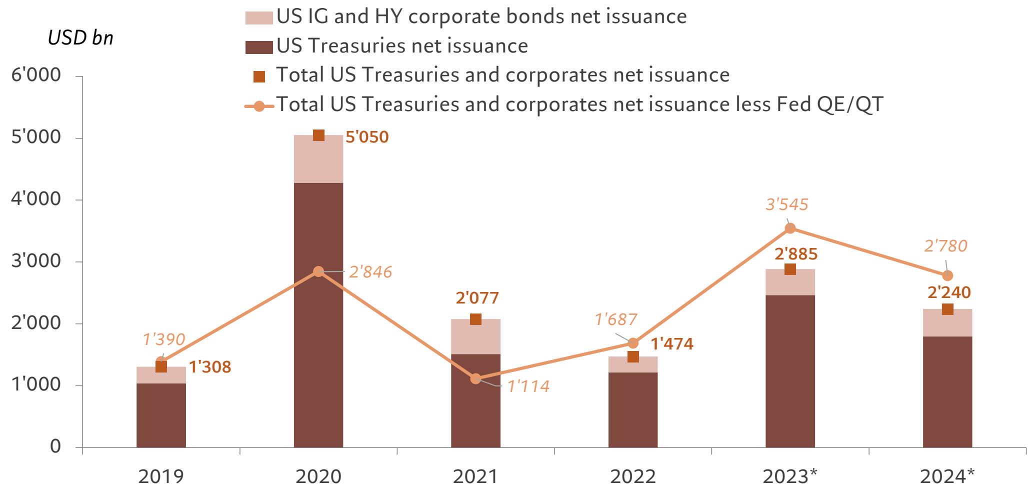
Chart 4: Past and projected* net issuance of US Treasuries and US corporate bonds



Source: Source: Pictet Wealth Management, SIFMA, US Federal Reserve, as of 31.10.2023

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