AXA Investment Managers

US High Yield Market Outlook

The U.S. high yield market underwent a tumultuous 2022 with multiple drivers: the first-order impact of higher benchmark Treasury and Fed Fund rates resetting corporate bond prices lower; recessionary concerns negatively impacting revenue expectations; labor and price inflation pressuring corporate profit margins; and higher cost of debt and equity driving management teams to reassess capital spending and deployment.

While the US HY market's absolute return YTD is one of the worst annual returns on record, the asset class did exhibit outperformance relative to longer duration fixed income asset classes and equities.

Source: ICE BofAML, S&P Dow Jones Indices, FTSE Russel as of 12/31/22.

* 12M Gross Dividend Yield

USD (H) Currency

Ice Indices Total Return	2022 Total Return	2022 4Q Total Return	YTW	OAS
Credit Suisse Lev Loan Index	-1.18	2.33	9.88	369
Euro High Yield Index (H USD)	-9.33	5.71	7.89	515
US Corporates 1-10yrs	-9.63	2.70	5.43	127
US High Yield BB Rated	-10.57	4.33	7.26	308
US High Yield B Rated	-10.58	4.33	9.34	515
US High Yield Index	**-11.22**	**3.98**	**8.98**	**481**
Euro Corporate Index (H USD)	-11.92	2.10	4.17	167
US Corporate Index	-15.44	3.53	5.51	138
US Corporates BBB Rated	-15.86	4.06	5.83	172
US Treasury 10 year	-16.28	0.65	3.83	1
US High Yield CCC and lower	-16.32	1.12	15.69	1170
S&P 500 Index	-18.11	7.56	1.76*	N/A
Russel 2000 Index	-20.44	6.23	1.63*	N/A

As we look forward to 2023, key areas of focus include:

1 Central banks and their ability to fight inflation

Similar to 2022, this will once again be the biggest driver of performance for most asset classes in 2023.

2 Default expectations and the severity of an economic downturn

We expect that should the US enter a recession, it will be mild relative to events such as the 2008/09 Global Financial Crisis and the sudden COVID driven economic shutdown in 2020. In addition, many issuers in the high yield market improved their balance sheets since early 2020, in particular boosting liquidity and terming out debt maturities in the favorable market conditions of 2020 through 2021. With manageable near-term maturities for most of the market, our bottom-up 2023 default rate is in a 2-4% range, largely consistent with historical levels. Top-down driven default expectation models indicate higher default rate projections, as key indicators such as % of market trading at distressed prices or credit lending standards suggest a more dire default outlook. Either way, the key to credit spreads in 2023 will be the market's change in expectations for the default rate, i.e. the default rate for 2023-2025 in addition to the default rate for 2023. We expect a fundamental, bottom-up approach to default rate expectations to be more helpful forecasts for investors than top-down macro default models.

3 Floating rate debt exposure

High yield bonds have nearly uniform fixed rate coupons, leaving our market well positioned to weather increases in short-term funding rates. Even among high yield issuers with bank debt exposure, many have business models and/or sufficient cushion in their free cash flow generation to sustain a higher interest burden without material credit degradation. Some recent LBOs were structured with substantial levels of floating rate bank debt, and with relatively low ratios of free cash flow to debt at lower rates, these businesses could face liquidity pressures.

4 Credit rating downgrades at senior levels of capital structures

The leverage loan market has experienced seven consecutive months where downgrades outpaced upgrades, and the recent upgrade wave in the HY market (more upgrades than downgrades for 21 consecutive months) has stalled recently. As we have noted for over a year, there is a significant amount of debt at the mid to low single B level in the leverage loan universe. A risk (but not our base case) is that a multi-notched downgrade wave creates technical selling pressure in the loan market which in turn has a negative impact on the HY bond market, notably the lower-rated portion of the market. CLO's have been a large buyer of bank debt within leveraged structures; however, many of these investment vehicles have ratings constraints. Should senior levels of capital structures see credit rating downgrades, forced selling could lead to price drops, which would in turn force subordinated layers in the structure to reprice.

5 Returns across credit quality – the potential for dispersion and decompression

The consensus view in the market shows a preference for higher quality securities within the high yield market, mainly due to reasons mentioned above. In the near term, and at a top-down view only, we wouldn't disagree. Near term rallies could very well be led by higher quality securities, but we would point out that this has already begun, as shown by 2022's fourth quarter performance. There is a strong case to be made for select triple C securities, particularly issuers that continue to experience fair to positive results and have enough free cash flow cushion to manage through a higher interest rate environment. We see the potential for BB and B-rated securities to outperform in the near term, but also see the potential for select triple C-rated securities to be the top performers in 2023.

6 Volatility and liquidity pressures in other fixed income and risk asset classes

We believe many of the risks associated with the potential for wider spreads are indirect risks within the financial system that occur outside the US High Yield bond market. That said, the potential for investors to look to the more liquid high yield market to reduce overall credit exposure is a tail risk that could drive spreads wider in the short term. However, if this were to occur, we believe this improvement in valuation would be an opportunity that would not last long, as the majority of investors are already defensively positioned towards risk asset classes including High Yield.

7 Higher carry produces higher returns

It's a simple concept, but it's the main reason why the US High Yield market has not experienced a negative return in two consecutive years. Improved income generation after any sell-off improves the forward outlook, and we believe that will be the case again for the US High Yield market in 2023.

In AXA IM's US High Yield team, our focus continues to be on actively managing our exposure at individual company and sector levels, with macroeconomic views informing our approach at analysing each credit. Corporate fundamentals are likely to see a dispersion in earnings and credit quality trends in 2023 depending on each individual issuer and industry exposures. Particularly in volatile market conditions, credit selection can mitigate defaults, significant losses and negative credit ratings migration. In the section below, we highlight different fundamental trends at the sector level.

	Returns		12/31/22		
	2022	2022 4Q	% Weight in Index	OAS	YTW
US HIGH YIELD INDEX	**-11.22**	**3.98**		**481**	**8.98**
Energy	-5.48	4.22	12.23	377	8.02
Transportation	-6.16	3.91	2.27	436	8.60
Capital Goods	-6.59	5.93	6.56	391	8.24
Insurance	-8.02	4.56	1.58	439	8.62
Services	-8.25	4.49	6.63	488	9.09
Utility	-8.67	3.78	3.05	292	7.10
Leisure	-8.91	4.06	7.80	498	9.21
Basic Industry	-9.88	6.84	7.83	443	8.59
Automotive	-11.11	4.38	4.45	367	7.82
Financial Services	-11.19	5.00	5.08	566	9.85
Real Estate	-11.86	3.61	4.01	524	9.40
Consumer Goods	-12.33	5.23	3.81	418	8.36
Technology & Electronics	-12.94	2.76	5.22	490	9.06
Telecommunications	-13.69	3.38	6.51	526	9.29
Banking	-14.71	6.34	0.87	362	7.93
Media	-15.84	1.13	9.02	593	9.97
Healthcare	-16.27	3.96	7.69	612	10.21
Retail	-17.19	1.74	5.38	601	9.99

Source: ICE BofAML as of 12/31/22.

Sector Commentary:

Automotive

The automotive industry continues to be challenged by supply chain constraints, resulting in production and sales volumes at near recessionary levels. We expect the supply chain issues — which have only partially improved — to linger into at least the first half of 2023 and possibly into 2024. Auto pricing growth was strong in 2021 and 2022 driving higher margins, but we expect pricing to be pressured in 2022, creating an additional headwind for the sector. The anticipated pricing pressure (new vehicle prices were flat m/m in November) is primarily a function of the significantly higher interest rate environment, which has flowed through to auto loans and leases, decreasing affordability. Auto consumer health has already begun to show signs of weakening, particularly in sub-prime borrowers, and we expect further deterioration in 2023 as economic growth slows. That said, there is a degree of pent-up demand following two years of low dealer inventories and elevated used car prices. Automakers have also been slow to ramp production in the face of macroeconomic uncertainty, narrowing the range of outcomes for the upcoming year.

Building products

Building product companies that are exposed to single-family new construction are starting to see slow or declining order rates, while the non-residential construction end market continues to see solid demand. Infrastructure end markets are also very solid with additional tailwinds expected to come from the Infrastructure bill. As such, we expect companies more exposed to R&R and infrastructure, and non-residential markets, to fare better than those exposed primarily to single-family new construction markets. Until recently, building product companies have been able to at least partially offset inflation with substantially higher pricing. Going forward, as demand wanes and inflation remains elevated, companies less exposed to commoditized products will likely find it easier to maintain margin stability. We attribute the slowdown in new home purchases to affordability issues and a volatile mortgage rate market and expect the industry to start recovering once the rate environment stabilizes and buyers adjust to the “new normal” of higher rates.

Cable & satellite television

Cable operators consistently demonstrated positive operating leverage on growing broadband subscriptions until 2022. The sticky, high-margin revenues that came on with each incremental subscriber saw regular price increases and had significant conversion to free cash flow. 2022 saw headwinds emerge, with new competition ranging from fixed wireless access from the national wireless networks to fiber builders in the traditional wireline space that previously were unable to offer competitive broadband speeds. The emergence of competitive offerings, in an industry that had historically low marks by customers for quality of service and network reliability, drove share loss. In 2023 and beyond, we expect subscriber share capture by fixed wireless to moderate given the technology’s limited capacity, which should drive stabilizing KPIs for the cable industry. In addition, most large operators in the space are also engaged in large scale investments into their physical plant, which drive higher levels of capital expenditures. Even as top line trends and profit margins stabilize for the sector in 2023, free cash flow likely will be pressured. For higher quality cable operators, near term pressure on free cash flow is likely to reduce returns to shareholders, while leverage profiles and credit ratings remain stable.

Chemicals

Most chemical issuers experienced strong performance in the first half of 2022 on top of solid results in 2021, despite rising energy, feedstock, and supply chain costs as companies were able took aggressive pricing actions. By late summer, we saw some management teams adjust their forecasts lower as demand started to falter. Results in the third quarter verified concerns about growth as weakness in Europe and lockdowns in China were being cited as key drivers for earnings misses. Still, while year-over-year comparisons showed declines in earnings, we believe third quarter results were reflective of chemical companies reverting to more "normalized" performance after six quarters of above-cycle earnings. We expect the weakening demand trend to continue into 2023 as global GDP growth decelerates. However, most high yield chemical companies strengthened their balance sheets in the last eighteen months and are in good financial position to weather any coming downturn. We expect basic chemical producers to experience greater downside in their results compared to specialty chemical names as higher-value-added players are more likely to hold onto recent price increases.

Consumer products

Consumer goods companies continue to be pressured from inflation including labor. Some tailwinds on costs should help in 2023, especially freight, which has seen container spot rates fall to $2,300 per container from peaks over $20k per container. Retailers increased inventory in anticipation of supply disruptions and now are destocking which is eating into consumer products sales. 2023 will likely be weak for many consumer goods companies but the reduction in elevated inventory should lead to increased free cash flow in 2023 after working capital builds impacted 2022.

In food, commodity prices have moderated and should be at least flat in 2023 if not a modest tailwind. Demand remains strong in most categories, but trade down to private label remains a risk. A historically acquisitive sector, we expect food names to continually acquire new products despite the higher cost of capital.

Energy

Despite the recent sell off in oil and natural gas prices we believe the credit outlook should remain positive — current bond pricing reflects as much. The 2023 WTI strip is above $70/bbl reflecting concerns around a recession hurting demand. Natural gas remains elevated at $5.59/mmbtu as demand for LNG exports remains at peak levels. At the current strip prices, and despite expected capital expenditure inflation of 10-20%, we believe exploration and production companies should continue to generate significant free cash flow. During 2022, energy companies concentrated on fixing balance sheets and repaying debt. While we expect that to continue, shareholder friendly capital allocation will likely increase limiting upside from here. We see the potential for a few large capital structures within the Energy sector to be upgraded to Investment Grade in 2023, reducing Energy's size in the High Yield market.

Gaming/leisure

Leisure companies have benefitted from robust demand coming out of the COVID-19 pandemic as consumers were eager to leave their homes and engage in travel and "experiences". The gaming industry, which did particularly well during COVID due to regional casinos' "drive-to" locations, has improved margins significantly compared to 2019 and has continued to maintain elevated margins post-COVID as costs were permanently taken out. Pricing at hotels and theme parks are considerably higher than 2019 levels driven by the strong leisure demand. While leisure companies are not yet seeing weakness in consumer demand, we believe COVID has shown how quickly these companies can react to lower demand levels and most balance sheets have recovered sufficiently to withstand another downturn.

Homebuilders

Homebuilders are seeing orders decline significantly as buyers hesitate to purchase homes due to affordability issues and the volatile rate market. We expect buyers to remain on the side-lines until home prices come down (materially), the rate environment stabilizes, or both. In the meantime, builders continue to look for ways to ease affordability, either on the financing end or by including additional home amenities in the sale price. Despite the expectation for lower year-over-year revenue in 2023, homebuilder margins have increased considerably since 2019 as companies were able to increase home prices more rapidly than input costs. Additionally, most homebuilders have de-risked their balance sheets since the last downturn by adopting more land option strategies, and debt/cap levels are in good shape heading into a potential downturn.

Mortgage originators and servicers

Mortgage originators saw a material slowdown in 2022 volumes due to rising underlying interest rates. Fannie Mae now estimates originations in 2023 will be down over 60% from 2021's record levels. Mortgage lenders have recently noted that since benchmark mortgage rates more than doubled in the past year, a negligible amount of homeowners have an economic incentive to refinance. Furthermore, the cost of financing a new home purchase is such that current homeowners are likely to stay put rather than moving. Lower home buying due to higher cost of financing will likely impact the broader economy, given that homebuyers generally buy durable goods when moving into a new home (e.g., appliances, furniture and cars), and turnover in the housing stock is associated with renovations, which are a driver for both commodities and labor. We expect mortgage companies that retained servicing rights associated with their originations during the peak volume years of 2020 and 2021 will continue to benefit from a longer expected duration on the income stream of these assets, allowing these companies to service and reduce their debt loads.

Packaging

During the third quarter of 2022, packaging companies reported that demand for their products declined as inflationary pressures significantly impacted consumers. Looking ahead to 2023, this trend will continue through the first half of the year. However, most packaging companies have significant exposure to noncyclical food, beverage, and healthcare end markets, which will keep them more insulated from the effects of a recession. Additionally, most of the packaging companies in the HY universe have contractual pass-through mechanisms for rising input costs, which helps to stabilize margins and will be a tailwind to earnings when input costs begin to fall due to the cost/price lag. In light of the uncertainty ahead, a large number of growth capex initiatives (ie building of additional capacity) have been postponed as many issuers focus on capital preservation and firming up the balance sheet, which remains strong with ample liquidity. Along with the expectation of working capital to be a source of cash in 2023 and the sustainability tailwinds for metal and glass packaging we believe this sector will be stable over the next 12 months and return to a GDP-like growth rate.

Pharmaceuticals

High yield pharmaceuticals are a fairly idiosyncratic group, and the sector's underperformance in 2022 was tied to poor performance in some of the larger structures due to litigation and other company specific issues. Contract research organizations saw the roll-off of COVID-related projects and lower VC funding levels somewhat constrain growth in 2022, but on the whole, performance and balance sheets remain healthy. We expect they will continue to perform well in 2023 despite some lingering headwinds. Contract drug manufacturers have faced similar headwinds from lower COVID vaccine/treatment volumes and labor and supply cost inflation issues, which we expect to continue in the first half of 2023.

Providers (Health facilities/health services)

High yield facilities and providers spent most of 2022 battling labor cost pressures, particularly for nurses and low skilled healthcare workers. Hospitals and physician groups in urban and suburban settings fared better than rural operators and post-acute/home health providers. Hospital and ER physician providers are also seeing an impact from aggressive payer actions, particularly after the implementation of the No Surprises Act, which bans balance billing (i.e. billing a patient for out-of-network ER charges) and, in most cases, only requires an insurer to pay the in-network median rate for services provided. Going into 2023, labor cost pressures have showed signs of easing, but we expect further impact, particularly for more exposed rural providers and in lower-skilled settings. We also expect aggressive payer actions to continue to pressure reimbursement in 2023.

Retail

Retail will likely remain weak in 2023 as stores struggle with too much inventory and weakening consumer demand. Most retailers are decreasing inventory dramatically as higher prices have limited consumer buying. While some inflation has eased, especially freight, margins will continue to be pressured by higher labor costs and rising interest rates. Auto dealerships should see some deterioration in margins as new and used car prices fall, but margins should remain higher than normal for new cars as inventory levels remains relatively low. There are likely to be some bankruptcies in the retail sector, but these will largely remain idiosyncratic.

Software/services

High yield software companies saw demand trends hold up fairly well during 2022, although we saw some softening toward the end of the year. Margins have also been impacted by a tight labor force for both sales and engineering personnel. We expect the weaker macroeconomic environment will continue to impact demand going into 2023, but B2B providers with mission-critical solutions should be fairly well insulated compared to B2C software companies and IT consulting/services players.

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