BARINGS

2024 OUTLOOK

COMING INTO FOCUS

PUBLIC FIXED INCOME

CONVERSATIONS

With heightened uncertainty and widespread risks blurring the outlook, our credit market experts explore the future prospects for asset classes ranging from high yield and IG credit to EM and securitized debt.

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MATT LIVAS (MODERATOR): There is a lot of uncertainty in the world today—are we are headed into a recession, and how long or severe might it be? What will interest rates do going forward? Against this backdrop, what has surprised you most about your markets over the past year and how do you see those dynamics playing out in the next 12 months?

RICARDO ADROGUÉ: The magnitude of the U.S. Federal Reserve's (Fed) rate-hiking cycle was clearly surprising this year, but perhaps an even bigger surprise was that the U.S. economy continued to accelerate through those hikes—especially against a backdrop of a rising 10-year Treasury yield, a stronger U.S. dollar, and slowing growth across most of the world. What is arguably even more significant is that the inflation-adjusted interest rate has moved up by 300 basis points (bps) in the past 18 months.[1] And that may suggest that the global economy, and the U.S. economy in particular, may be headed for a longer period of strong growth.

BRIAN PACHECO: Looking at the high yield markets, one of the biggest surprises this year has been the strong performance across loans and bonds. While that was partly due to high yield's shorter duration/lower interest rate sensitivity, it was also a result of the lack of negative catalysts. **As we expected, the wave of defaults that some were expecting at the start of the year have not transpired, and the 'higher-for-longer' reality has been a tailwind for loans in particular, which are floating-rate.** At the same time, downgrades have been manageable.

The big question, of course, is whether the strength can continue if the macro picture starts to worsen. Part of that answer lies in the levels of current yield and return. Looking at the high yield markets, loans have returned approximately 10% year-to-date and are currently yielding around 9.5%.[2] U.S. high yield bonds are up almost 5% year-to-date, with yields around 9.5%.[3] Yields at these levels should offer a substantial cushion in the event of a meaningful economic slowdown.

YULIA ALEKSEEVA: Arguably, one of the biggest surprises of 2023 was the strength of the U.S. consumer. However, that strength may be starting to wane.

In particular, the sub-prime part of the market is beginning to show signs of stress. In addition to the depletion of physical stimulus savings, auto loan and consumer loan delinquencies spiked over the last year, while credit card debt surpassed $1 trillion for the first time in history.[4] Last month we also saw the largest post-Covid increase in sub-prime delinquencies and modifications for non-qualifying mortgages. A final wrinkle is the resumption of payments for student loans, the impact of which also will be felt more disproportionately by consumers with lower incomes. These data points suggest that risks to U.S. consumers skew to the downside.

1. Source: Federal Reserve. As of October 31, 2023.
2. Source: Credit Suisse. As of October 31, 2023.
3. Source: Bank of America. As of October 31, 2023.
4. Source: Federal Reserve Bank of New York. As of October 31, 2023.

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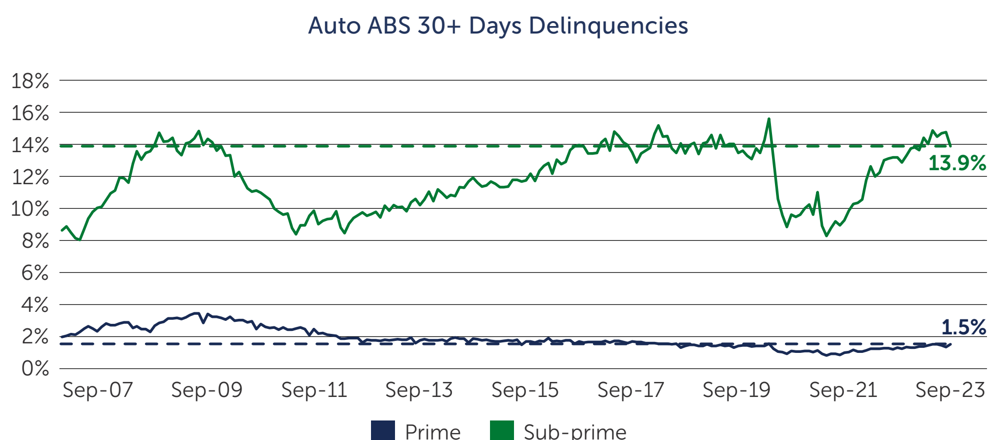
"Overall, corporates have managed their balance sheets very conservatively and have termed out much of their debt, locking in historically low financing costs."

Figure 1: U.S. Consumer Deterioration: Sub-prime Auto Performance



Source: Barings, Bank of America. October 31, 2023.

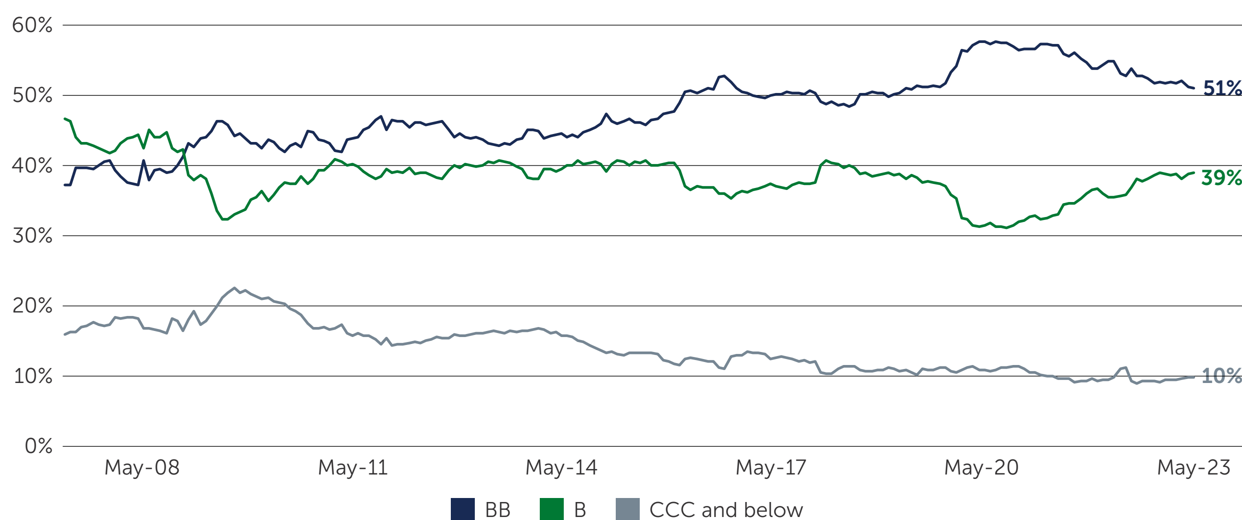
From a corporate standpoint, we may also begin to see some deterioration over the next year, however, fundamentals are starting from a position of strength. For instance, leverage has increased but remains reasonable. Higher rates will be a headwind for interest coverage, but its onset will be gradual. Overall, corporates have managed their balance sheets very conservatively and have termed out much of their debt, locking in historically low financing costs. Along with their excess cash, most have considerable financial flexibility and are well-positioned should the economy head into a recession.

MATT LIVAS: Brian, what is your view of credit quality in high yield bonds and loans? Do you expect to see a big wave of defaults going forward, or are forecasts too negative?

BRIAN PACHECO: With 2023 having been a relatively benign year for defaults, some analysts are still predicting draconian default rates and widespread investor losses in the next 12 to 18 months. However, that's not our base case scenario for a few key reasons. First, if a recession or a sharp slowdown were to occur, it would be one of the most anticipated downturns in history. **Since markets are forward-looking, they have already priced in a downturn such that most credits likely to default over the next 12 to 18 months are already trading at steep discounts to par—and the high yields currently on offer should help absorb any defaults that do materialize.**

At the same time, the quality of the high yield market has improved significantly over the last decade, another reason we believe widespread defaults are unlikely. BBs, for example, now represent around half of the market, up from 40% a decade ago (Figure 2). CCCs, which have the highest risk of default, now account for only 10% of the market versus more than 20% after the financial crisis. What's more, there is now a broader mix of industries and sectors in the high yield universe, with no one sector or industry exhibiting signs of significant stress, as was the case historically in previous default cycles. For these reasons, defaults that occur are likely to be idiosyncratic and particular to a specific credit. So, to sum up, while defaults are likely to move higher from current low levels, the high yield market appears healthy overall.

Figure 2: A Higher-Quality Market



Source: Bank of America. As of September 30, 2023.

MATT LIVAS: Where does the current rising star/fallen angel dynamic fit into that picture?

BRIAN PACHECO: During Covid, more than $200 billion of investment grade credits fell into high yield.[5] Since then, the high yield market has contracted by around $350 billion, of which $230 billion was attributable to rising stars, creating a positive technical backdrop. The recent upgrade of Ford—which represents $40 billion in debt—is significant, and we expect rising stars continuing to exceed fallen angels in 2024, although the technical tailwind will likely be less significant than it has been over the last 18 months.

MATT LIVAS: Ricardo, while emerging markets (EM) debt as an asset class certainly is not homogenous, are there any overall themes or trends that investors should consider?

RICARDO ADROGUÉ: As we look across the EM debt landscape, countries with strong domestic financing markets and flexible exchange rates are likely to fare much better than those that rely more heavily on foreign financing. Of the countries that lack strong domestic financing capabilities—many of which are frontier markets—most also have fixed exchange rates, which will continue to pose challenges.

5. Source: J.P. Morgan, Bank of America. As of October 31, 2023.

> “After more than 10 years of remaining very low, yields in developed markets have finally increased to attractive levels.”

However, while we may see an increase in defaults going forward, much of that risk is already priced in, with many of these countries trading at significantly distressed levels. It’s also important to note that these countries make up only about 10% of the EM sovereign hard currency index.[6]

At the same time, there are indications that some of these countries may still be able to receive the external financing they need to avoid a default. Post-Covid, a number of EM countries were encouraged to seek financial assistance under the IMF’s Common Framework—and in some cases, as a condition of receiving financing, countries were being encouraged to restructure their debt or default even if they were capable of meeting their obligations. Now, that stance seems to have changed, with suggestions that solutions other than default are being encouraged. This is positive for investors and presents potential opportunities in some of these distressed countries.

MATT LIVAS: Looking ahead over the next year, what areas look most attractive and where do you expect to see opportunities in your markets?

RICARDO ADROGUÉ: After more than 10 years of remaining very low, yields in developed markets have finally increased to attractive levels. **In particular, an opportunity has emerged in developed market interest rates, which we believe will persist going forward if the “higher-for-longer” rate environment plays out—as many expect it will—and real rates also remain high.** While a weaker U.S. consumer and indications of Fed rate cuts would impact our outlook, we don’t expect these scenarios to unfold in the near term, and believe 2024 should be a good year, overall, for developed market interest rates.

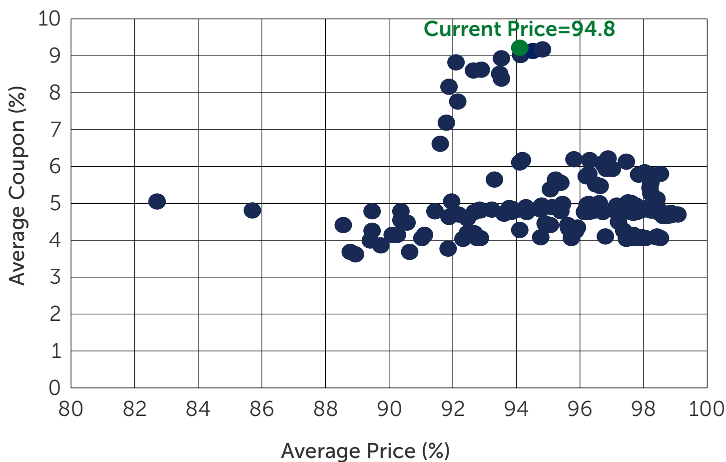
In EM, I see two kinds of opportunity. The first, as mentioned, involves distressed situations. Some distressed names are offering prices of 20 or 30 cents. Many of these should be worth maybe 60 cents, so you can double or more than double your money if you pick correctly. Second, EM rates and developed market rates are on different cycles. Many EM countries did not engage in quantitative easing in the past, so they are not engaging in quantitative tightening in the present, and they did not massively expand fiscal spending. As a result, local interest rates in EM look particularly attractive. Those countries that can borrow from their own domestic markets and that have broad inflation under control, which most of them do, offer select opportunities for investors in local rates.

6. Source: Barings. As of October 31, 2023.

BRIAN PACHECO: There is a similar theme in high yield today. BB bonds, for example, are yielding 7% to 8%, which given the contractual nature of coupons and principal repayment is extraordinary in comparison to equity markets such as the S&P 500, which has returned around 10% or 11% over the very long term.[7] **With yields at these levels, there is no need to "stretch for yield" by taking on additional credit risk.** We see particular opportunities in high-spread, yield-to-takeout trades, in which there are near- to medium-term maturities and where the borrower has liquidity levers or secured capacity—essentially, multiple ways to refinance. In BBs and high-quality single Bs, we look for catalysts for spread tightening. That could be earnings momentum or upgrade potential due to improving fundamentals.

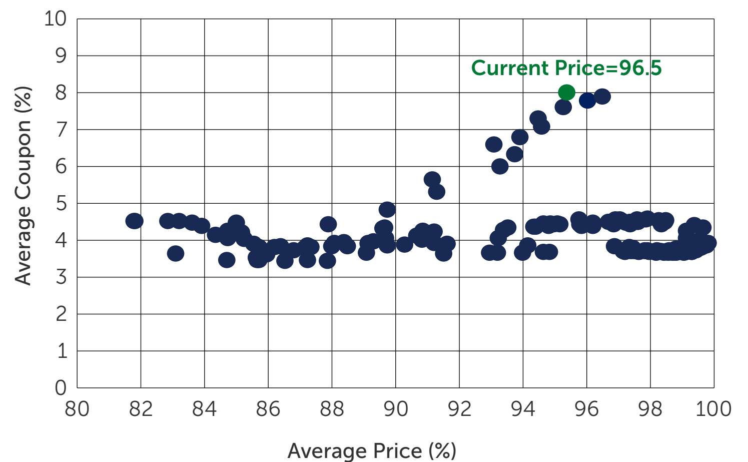
Figure 3: Income for Loan Market is at Peak Levels & Expected to Remain Elevated

U.S. Loan Market Coupon Relative to Price



Source: Barings, Credit Suisse Leveraged Loan Index and Credit Suisse Western European Leveraged Loan Index (non-USD). As of September 30, 2023.

European Loan Market Coupon Relative to Price



Source: Barings and Bloomberg. As of September 30, 2023.

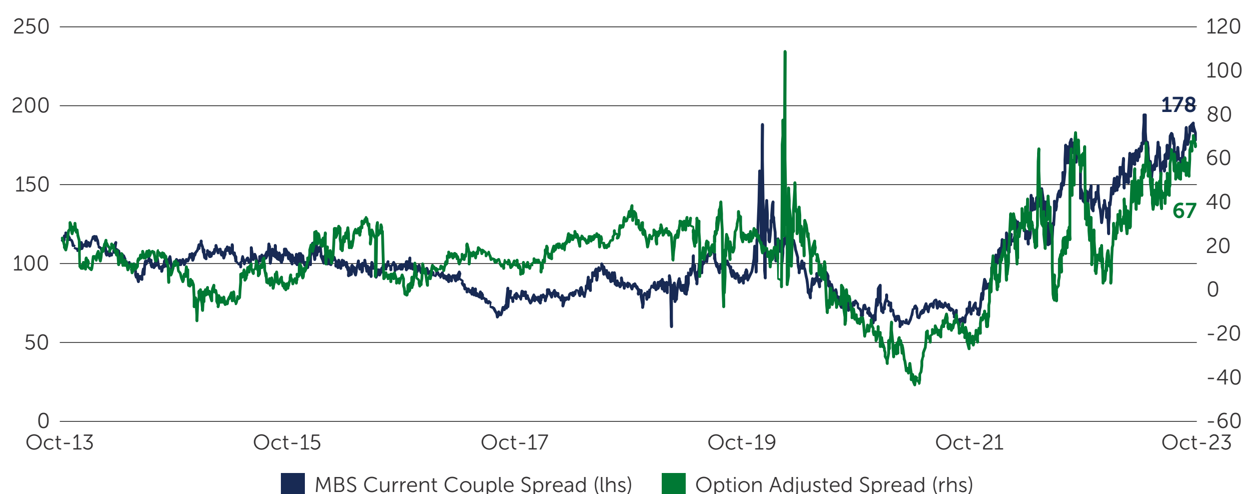
For illustrative purposes only. This analysis is intended to demonstrate only the specific elements discussed. This analysis does not represent all the elements and variables that could be factored into the potential outcome. PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS.

In the loan market, there is considerable carry. BB-rated loans are offering coupons of approximately 7.5% to 8%, and this is a part of the market where default rates have historically been very low.[8] There also are opportunities in other areas of the loan market. For example, you can find first-lien loans that offer equity-like returns, which is rare outside of major adverse macro events such as the financial crisis and Covid.

7. Source: Bank of America. As of October 31, 2023.
8. Source: Credit Suisse. As of October 31, 2023.

YULIA ALEKSEEVA: In the securitized space, we're currently seeing an opportunity in agency mortgage-backed securities (MBS), which have become attractive for the first time in more than a decade. Valuations are compelling on an absolute basis, with both nominal spreads and option-adjusted spreads in the 99th percentile for the past 10 years (Figure 4). On a relative basis, MBS also look compelling versus IG corporates. Since there is no credit risk with mortgages given the government guarantee, the key risk is negative convexity. But over the last couple of years, amid the low interest rate environment, many borrowers have refinanced their mortgages at historically low rates, which suggests low prepayment risk today—in fact, less than 1% of the current mortgage universe is refinanceable.[9] As a result, we think the market has a lot of upside potential. **This is why we believe today represents an attractive entry point into mortgages for those investors who have been sitting on the sidelines.**

Figure 4: Agency MBS Spreads Look Attractive versus History



Source: Morgan Stanley. As of October 31, 2023.

Specifically, investors can benefit from the inversion on the front end of the curve, earning a roughly 7% coupon while being fairly well insulated from credit risk.[10] And by investing in a pool of naturally deleveraging assets, investors are essentially de-risking their basis if we are nearing a recession.

Finally, I think 2024 will be a good year for investment grade (IG) credit. Although spreads on IG corporates are pretty tight, the all-in yields are at their highest level since 2009. This is a good time to be prudent and move to higher ground across sectors and geographies until there is more clarity.

9. Source: Bank of America. As of October 31, 2023.
10. Source: Barings. As of October 31, 2023.

“This is a good time to be prudent and move to higher ground across sectors and geographies until there is more clarity.“

MATT LIVAS: What do each of you see as the biggest risks to your markets today and tomorrow?

RICARDO ADROGUE: The biggest risk we are focusing on today is the direction of China’s economy, which seems to be on a downward path—and this has broad implications for the global economy generally and for EM in particular. We also are concerned about geopolitics, which makes country-specific analysis so important. We tend to favor countries that have a clear path forward, either due to domestic financing or because their restructurings appear to be headed the right direction.

YULIA ALEKSEEVA: On a more micro level, my concern is the U.S. commercial real estate market, where valuations across property types have dislocated as a result of the new rate regime and in sympathy with the distress in the office sector. This has led to a price dislocation in collateralized mortgage-backed securities (CMBS). We have been focusing on continuous re-underwriting to find pockets of strength in the CMBS market while others are running for the exit.

BRIAN PACHECO: While I’m not too concerned about the high yield and loan markets overall given the default rate math and high current yields, what’s different about this cycle is the poor creditor protection in recent-vintage loans and how companies and sponsors are finding creative ways to exploit gaps. Being caught on the wrong side of liability management worries me, and while there are ways to mitigate the risks—by being a top lender, having a seat at the negotiating table, and being well-connected with sponsors, peers, and advisors, for example—none is foolproof.

At the same time, there is a risk in sitting on the sidelines and trying to time things perfectly. There is simply too much income available right now to wait because buying opportunities like this don’t typically last very long. But given the potential for a more challenging scenario to unfold, we believe that a bottom-up approach to investing—issuer by issuer, deal by deal, and credit by credit—is crucial to both avoiding additional downside, and identifying issuers that can withstand the challenges ahead.

This piece has been adapted from our 2024 Public Fixed Income Outlook Roundtable. Watch the full webinar here.

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