Executive Summary

Economic repercussions from the deepening Russia/Ukraine conflict as well as a more hawkish Federal Reserve ("Fed") helped propel negative high yield ("HY") returns in 1Q 2022 ("1Q").

1Q in Review

US HY spreads widened in 1Q as late March tightening could not offset early quarter weakness. Investor concerns regarding the economic impact of Russia's invasion of Ukraine as well as an increasingly hawkish Fed commentary regarding inflation were both major drivers of bond weakness and investor outflows in the quarter. Unlike bonds, leveraged loans benefitted from increasing investor inflows in 1Q as the floating rate nature of the asset class became more attractive to investors given the backdrop of higher interest rates.

The bank loan market was still unable to post positive gains for the first quarter. As we look ahead into 2022, we expect a sustained commitment from the Fed to try and thread the needle between fighting high inflation and not tipping the economy into a recession by raising rates too far too fast. We also believe that supply chains snarled by lingering impacts of Covid-19 and the Russian invasion of Ukraine will begin to ease and that spending on services can continue to recover on the backdrop of fading pandemic related restrictions.

Barring any further geopolitical tensions, we believe the overall US economic backdrop should provide for a low default environment that will keep credit spreads range-bound. Though not our base case, we are cognizant that risks of a double-dip recession are higher now than they were at the start of the year.

"March"ing Back From Early Quarter Lows

US HY bond spreads and yields started off the year widening significantly on the back of growing inflation fears, sporadic Covid-19 variant outbreaks and growing geopolitical risks for the global economy related to a worsening conflict between Russia and Ukraine. By mid-March, spreads quickly began to tighten as worst-case scenarios related to rate hikes, war expansion and Covid-19 shut-downs failed to materialize. Despite this late quarter spread rally, US HY bonds still fell 4.15% during 1Q with spreads up 24 bps and yields up 160 bps from the start of the year.

By rating, split-B & single-B bonds were the top performing HY bonds in 1Q with losses limited to -2.91%, and -3.23%, respectively. Duration sensitive BB-rated bonds were the worst performers for the quarter given their -4.92% return. By sector, Energy was the best performing industry in 1Q on the back of rising natural gas and oil prices with losses of only -1.89%. Metals & Mining was the second-best performing sector during the quarter with losses limited to -2.43%. The worst performing sector during 1Q was the interest rate sensitive Housing sector which fell -6.28%.

Leveraged loan returns held up much better than those of HY bonds in 1Q as their floating rate nature benefited from rising short-term rates. Leveraged loans only lost 1 bps in the quarter besting returns of HY bonds by 414 bps. By ratings, B-rated loans provided the highest relative returns in the quarter by squeaking out a 0.09% gain. Riskier split-B/CCC loans on the other hand were the worst performers by rating for the first quarter given their -1.62% return. By industry, the largest loan sector outperformer in 1Q was Energy which provided a +1.11% return. Telecommunications was the biggest underperformer in the quarter with losses totaling -0.61%. (Source: JP Morgan).

Capital Market Indicators

The US HY primary market calendar in 1Q was very light as investors and issuers dealt with growing geopolitical and interest rate uncertainties. Only $47b of new issuance priced in the first quarter of 2022. This marks an issuance level over 70% lower than the first quarter a year ago. Refinancing activity remained the main driver of the limited issuance seen this quarter by representing ~47% of new volume in 1Q. By ratings, issuance became more focused on single-B quality credits instead of the BB-rated quality focus we experienced last year. In total, single-B rated deals represented ~44% of the new bonds issued during the quarter.

In the leveraged loan market, we also saw a significant decline in new issuance year-over-year ("YoY") with only $121b of loans pricing in 1Q. This issuance level represents about 60% less volume than we saw during the same time-period last year. Driving these volume declines was a significant fall-off in refinancing/re-pricing deals as net new issuance was up 10% YoY in 1Q as volumes hit $84b. As was the case with bonds, B-rated loans represented the largest amount of issuance by rating in the first quarter. At 80% of new issuance in 1Q vs ~74% of issuance in 2021, the term loan primary market is also showing greater growth in slightly lower quality credits than in the recent past. (Source: JP Morgan).

Ultra Short Duration Corporate Income

Our Ultra Short Duration Corporate Income strategy, which owns mainly BBB-B rated corporate bonds maturing in only three years or less, outperformed ICE BofA 1-3 Year US Corporate / Government Index. Strong security selection within Covid-recovery industries such as Gaming, Recreation & Travel and REITS led the way. Selection within Steel and Homebuilding also added value, whereas Forestry/Paper and Auto Loans detracted.

Off-index yield curve positioning added value, as the 0-1 year maturity bucket outperformed. The bank loan allocation outperformed, as did the portfolio's allocation to B-rated bonds. Capital market activities slowed versus the very active calendar year 2021; approximately 6% of the portfolio was refinanced during the quarter, the majority of which were tender offers.

Defensive Short Duration High Income

During 1Q, our Defensive Short Duration High Income strategy, which holds mainly BB/B rated bonds with an average portfolio maturity of three years or less, outperformed both the ICE BofA 1-3 Year BB Rated US Cash Pay HY Index and the BB/B version of the index. Strong security selection within Chemicals and Gaming sectors led the way, as did an underweighting to Banking and Auto Loans. Security selection within Energy and Telecommunications sectors detracted, however. Credit quality allocation was not a major factor, but accounts with bank loans benefitted from rising short-term rates. Off-index yield curve positioning detracted value, as the 3+ year maturity bucket underperformed the 0-1 year maturity bucket. Capital market activities slowed versus the very active calendar year 2021; approximately 8% of the portfolio was refinanced during the quarter, the majority of which were tender offers.

Defensive High Yield

During the quarter, our Defensive HY strategy slightly underperformed its benchmark, the FTSE BB-B Capped HY Index. Selection within Food, Technology, Telecommunications, Pharmaceuticals and Financials more than offset Omicron-related weakness in "re-opening" credits within Rental Cars and Retail. An overweight to Automakers, which helped last quarter, detracted this quarter as did rate-related weakness in Homebuilding. Energy was a net neutral contributor. Credit quality allocation contributed with an underweight to BB-rated credits, which are typically more interest rate sensitive. Yield curve positioning detracted slightly due to an underweight to the 1-5 year maturity bucket and was offset by an underweight to the 10+ year maturity bucket. Accounts with bank loans benefitted from rising short-term rates.

Opportunistic High Yield

During the quarter, our Opportunistic HY strategy slightly underperformed the ICE BofA US HY Constrained Index. Selection within the Energy, Media, Pharmaceuticals and Utilities sectors contributed in addition to being underweighted the Banking sector. An overweight to Automakers, which helped last quarter, detracted this quarter as did rate-related weakness in Homebuilding and Transports as well as credit selection within Telecommunications. Credit quality allocation contributed with an underweighting to BB-rated credits, which are typically more interest rate sensitive. Yield curve positioning detracted due to an underweighting to the 1-3 year maturity bucket and an overweighting to the 7-10 year maturity bucket. The convertible bond allocation was a detractor, but accounts with bank loans benefitted from rising short-term rates.

Outlook

With the Fed already embarking on a rate hiking cycle, we expect continued pressure on the duration sensitive segments of the HY market. Some yield curve indicators have flirted with temporary inversion indicating recessionary risks have grown and geopolitics continues to increase market uncertainty. Yet, if the Fed is able to successfully juggle taming inflation without drastically slowing economic growth, we believe there is still scope for spreads to end the year lower than where they started.

Both consumer and corporate balance sheets are strong. Job openings are still flirting with all-time highs and HY issuers leverage (ex-Gaming and Transports) is currently at a post-Lehman low. Further, March 2022 marked the 17th consecutive month of three or fewer default actions in the HY market. With default rates sitting near historic lows at 0.50%, we believe that a continued benign default environment will eventually calm fears seen early in the year and allow spreads to remain capped. (Source: JP Morgan).

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Employing a fully integrated credit and equity research process, we focus on non-investment grade companies in the micro to mid-capitalization range, where we can take advantage of inefficient security pricing.

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