ROBECO HIGH YIELD BONDS

# Embracing a soft landing

- A move higher in yields put a halt to the tightening trend of credit spreads
- Some signs of weakness in CCC but limited spill-over
- For high yield we nevertheless adhere to our quality bias

**The performance of global high yield bonds was negative in April, driven by a rise in risk free rates. The tightening trend in credit spreads came to a halt, but despite a modest widening, excess returns were still slightly positive. Primary market activity continued to pick up, underlining the overall healthy appetite for high yield.**

## Market developments

Global risk-free interest rates moved significantly higher during April. The main driver of the sell off was a continued string of upward surprises in US core inflation. Additionally, the US economy and labour market continued to grow at a solid pace. The yield on ten-year US Treasuries increased from around 4.2% to 4.7%. German government bonds were dragged along and yields of 10-year maturity bonds rose 30 basis points from 2.3% to 2.6%. The year started with benchmark yields of 3.9% in the US and 2% in Germany.

The US high yield market experienced a slight downturn in April, with spreads widening by 4 basis points to peak at 311 basis points. At the same time the yield-to-worst rose to 7.77%, an increase of 44 basis points. The US CPI report showed that core CPI rose at a monthly pace of +0.4% in March for the third consecutive month. This makes it increasingly difficult to argue that the stronger prints in January and February were a temporary blip. This is likely to discourage the Federal Reserve from cutting rates in the short term, shifting market expectations for rate cuts to a single 25bps cut by the end of 2024. Unemployment remains at historic lows. However, GDP figures were unexpectedly disappointing, with US real GDP coming in at 1.6% in Q1, well below the consensus of 2.5%.

In the Euro high yield market spreads widened by 13 basis points to a total of 342 basis points. The yield-to-worst increased by 41 bps to 6.40%. The eurozone economies appear to be recovering from the negative growth seen in previous months, and although the rate of decline in inflation has slowed, markets are increasingly confident that policymakers will cut interest rates at the upcoming June meeting. Many officials from both the ECB and the BoE have argued that the causes of inflation are different from those in the US.

During the month, $26bn of high yield bonds were printed in the US versus €9bn in Europe. Most of the primary activity is refinancing related with M&A and LBO activity still subdued.

**PORTFOLIO MANAGER'S UPDATE APRIL 2024**

Marketing material for professional investors, not for onward distribution

From left to right: **Sander Bus** Portfolio manager, **Roeland Moraal** Portfolio manager, **Christiaan Lever** Portfolio manager, **Daniel de Koning** Portfolio manager




## Portfolio positioning

### Maintaining an underweight beta positioning

The beta of the portfolio was kept below one throughout the quarter at around 0.85. This beta target was confirmed during our Credit Quarterly Outlook in March. The main driver behind this beta positioning is the "up in quality" bias, which we intend to maintain given the market outlook. Reducing the allocation to CCCs and increasing the exposure to BBs automatically reduces the beta of the portfolio. Despite the underperformance we have already seen in the CCC segment of the HY market, we intend to maintain this position.

### Sectors

From a sector perspective, we remain cautious on cyclical sectors such as retail, leisure and gaming. In addition, there are some highly leveraged telecom companies (such as Altice and Dish), which we prefer to avoid, leading to a large underweight in the communications sector. Within capital goods and basic industries, we favour companies with relatively good pricing power and less cyclical revenues, for example those serving less cyclical end markets such as pharmaceuticals and food & beverage. Our preference for European financials is maintained as well, as fundamentals are strong, the higher interest rate environment provides a tailwind for profitability and valuations are attractive.

### Ratings

Due to the relatively tight spread in credits and the pressure on margins we see for SME companies (which high yield issuers typically are), we persevere with the quality bias. While not yet a broad market theme there is evidence that investors are scrutinizing upcoming refinancing needs, in particular for the lowest rated companies. It is also in this segment that a maturity wall is more evident. Next to CCCs we express this view in the lower part of the B segment of the market.

### Transactions

We took profit on Selecta, a restructuring situation of two years ago, after an upgrade back to B . We sold exposure to Schaeffler, B&G Foods and Canpack among other companies. Within the broader Altice structure, to which we have only limited exposure compared to the benchmark, we geared our exposure to senior-secured only. Through the primary market we added new deals from Vallourec, Boels, Valeo and other companies. Through the secondary market we added exposure to Merlin Entertainment, Kontoor Brands (apparel) and Lamb Weston (food).

## Performance

### Negative total returns due to higher risk-free rates

In April the high yield bond index posted a total return of -0.90% in euro terms and -0.79% in USD terms. Excess returns were slightly positive, but underlying government bonds drove the negative performance, with the yield on 10-year Treasuries rising to almost 4.7%. The fund underperformed its benchmark by 2 basis point. Issuer selection contributed 4 bps, while beta positioning was a small detractor.

On a risk-adjusted basis, the BB category was a clear outperformer in both regions, with negative risk-adjusted returns in the lowest rated parts of the market. Our allocation to EUR names proved beneficial. The overweight in capital goods contributed negatively, but was offset by our underweight in communications.

In particular, we avoided Altice USA (CSC holding), LVLT, the fiber-optic services arm of Lumen, and CommScope bonds, which underperformed. At the same time, our exposure to the capital structure of Ardagh was a detractor.

| Annualized performance Robeco High Yield Bonds | | | | | | 30 April 2024 |
|---|---|---|---|---|---|---|
| | Apr-24 | 3-month | YTD | 1-year | 3-year | 5-year |

| | | | | | | |
|---|---|---|---|---|---|---|
| **Robeco High Yield Bonds (DH EUR)** | **-0.92%** | **-0.18%** | **0.07%** | **6.37%** | **0.58%** | **2.27%** |
| Benchmark (hedged into EUR) | -0.90% | 0.16% | 0.15% | 7.37% | -0.13% | 1.77% |
| Relative performance | -0.02% | -0.34% | -0.08% | -1.01% | 0.71% | 0.50% |
| **Robeco High Yield Bonds (DH USD)** | **-0.79%** | **0.21%** | **0.59%** | **8.54%** | **2.59%** | **4.28%** |
| Benchmark (hedged into USD) | -0.77% | 0.54% | 0.66% | 9.49% | 1.86% | 3.81% |
| Relative performance | -0.02% | -0.33% | -0.06% | -0.95% | 0.73% | 0.47% |

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## Outlook

### Race to the bottom

The ideal scenario for credit appears to be materializing, characterized by declining inflation and the likely avoidance of a recession. Credit markets have wholeheartedly embraced this narrative and are to a large extent priced for perfection. Demand for credit has been robust, as evidenced by significant inflows into credit strategies from both institutional and retail investors. Inflation has come down from the very high levels a year ago and this allows central banks to start easing monetary policies in the third quarter. Any delay in the materialization of these rate cut expectations will be taken negatively by credit markets.

While we acknowledge the high probability of the consensus scenario, we remain mindful of the fragility of sentiment and the omnipresence of risks in a changing world. With current tight valuations and risk positioning, there is ample room for disappointment. The US economy has shown remarkable resilience. One major factor for this strong performance has been fiscal stimulus that has supported households and kept consumer and government spending high.

The performance of the corporate sector though is more mixed. While large cap tech stocks are posting record profits, the SME sector is feeling the pressure of higher rates. When we look at a corporate EBIT proxy for the broader economy, we see that profits are actually down. In the high yield universe there are several companies that are now struggling to refinance upcoming maturities and creditor unfriendly debt restructurings are on the rise.

As long as we are in an environment where rate cuts are more likely than not, we judge that the technical support from central bank policy remains constructive. However, we should not anticipate another round of spread tightening after the initial rate cut. Historical data shows that even in a soft landing environment, spreads typically do not tighten further following the first rate cut.

Overall, in this environment issuer selection is key. It is important to firmly hold on to our quality tilt and accept a beta below 1.

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