AEGON Asset Management

November 2023

GLOBAL FIXED INCOME 2024 OUTLOOK

Beyond borders

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Economic backdrop

After a steady stream of interest-rate hikes, the world's central banks seem to finally be making progress in reining-in inflation. European and UK inflation rates have declined sharply in recent months, however, worries about a looming recession remain. Meanwhile, in the US, the annual core rate of inflation in October dropped to its lowest point since August 2021. Overall, the US economy has held up quite well, especially when compared to those elsewhere in the world. While it has been able to avoid recession, there are hints that economic growth may finally be slowing in the wake of the Federal Reserve's higher-for-longer interest-rate policy.

US consumers pulled back on retail spending in October, raising concerns they may be running out of steam as they head into the holiday season. On the manufacturing front, recent surveys showed a dimmed outlook with a noticeable negative shift in the comments from participants. This sets up a more challenging dynamic for the economy going forward.

Still, despite the recent signs of cooling, the US economy has fared better than those in Europe and the UK, which appear to be on the precipice of recession. GDP for the 20 countries that comprise the eurozone declined by an annualized 0.4% in the third quarter after scratching out a meager 0.6% gain in the second quarter. Meanwhile, China's property bust continues to serve as a drag on that country's economy, despite government efforts to mitigate the fallout.

We currently hold that the US economy will experience a recessionary-type environment in 2024 but are cognizant to the prospect of a positive, albeit sub-trend growth scenario playing out. A main difference in these two scenarios is the speed of rate cuts on the other end—faster in the former and slower in the latter. We also see Europe and the UK heading into a shallow recession next year as the impact of central banks' higher interest rates feeds into those economies.

Global corporate credit research overview

- Fundamentals generally stable, but softer economic environment to pressure growth and margins
- Increasing divergence between higher- and lower-quality issuers with companies with near-term maturities and limited access to the markets becoming more concerning
- Consumer sectors, especially services, are expected to be more resilient than companies in the basics and industrial space
- Continue to favor sectors and companies better positioned to weather a softer economy and higher rates

The anticipated slowdown in economic activity is taking hold, putting some pressure on margins and earnings growth. The impact on balance sheets and overall credit metrics will likely remain somewhat muted, resulting in continued stable fundamentals across most sectors. That being said, with higher rates and a weakening economy we expect a greater divergence between high-grade and levered issuers in 2024.

The rate hike cycle seems to be largely complete, which has reduced demand and begun to lower inflation, although it still remains at elevated levels. Lower inflation is more notable in consumer goods sectors, as services-focused companies continue to see strong demand as the post-pandemic shift toward travel and other experiences continues. Wage inflation remains resilient however, buoyed by low unemployment that has only recently showed signs of easing. This has also supported consumer spending, with concerns concentrated in lower-income cohorts impacted by rising borrowing costs and tightening lending standards. At the same time, higher-income consumers have also become more cost conscious with increased purchasing activity at higher-value/lower-cost retailers.

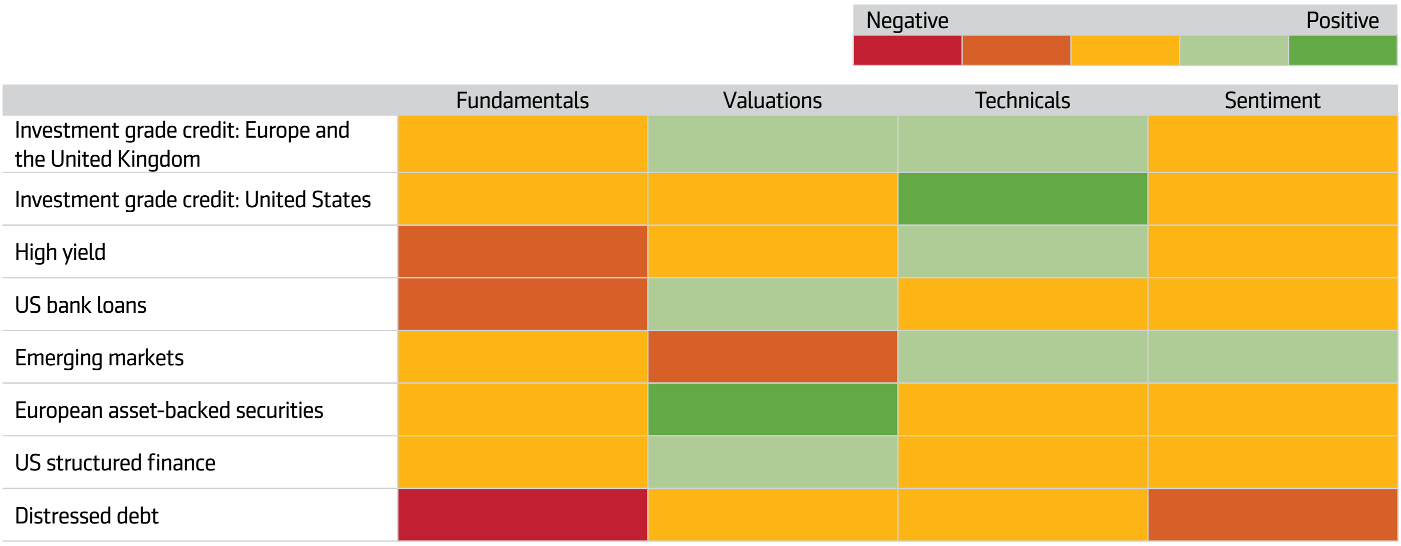
Supply chains have largely normalized, allowing inventory levels to come down, free up capital and lower just-in-time logistics costs. However, there are pockets of issues in certain consumer and basics sectors that could lead to some price discounting to preserve market share. The slow recovery in China has created headwinds for many industrial companies, including those exposed to commodity prices in the chemical, metals/mining and energy sectors. Interest-rate sensitive sectors such as housing and autos are relying on increased incentives to support demand. Financials appear to have stabilized following difficulties in US regional banks and Credit Suisse's failure early in the year. Consumer credit profiles and commercial real estate loans remain in focus, but most larger firms appear to have manageable exposures.

Capital adequacy levels across financial companies and leverage ratios across corporates in most industries are healthy, though interest coverage ratios and cash balances are expected to continue declining from recent highs, notably in the levered credit markets.

We expect debt-financed mergers and acquisitions and leveraged buyout activity will remain subdued due to higher financing costs, increased regulatory scrutiny and an uncertain economic environment. As a result, those with strong free cash flow generation and well-positioned balance sheets may shift some capital allocation toward shareholder-friendly activities.

After several rating upgrades in the energy sector, we expect more balance going forward between rising stars and fallen angels, though within high yield we expect downgrades to outpace upgrades. In a higher-for-longer interest-rate environment, companies with near-term maturities are becoming more concerning, particularly for those with the lowest ratings that may have limited market access. Overall, we remain cautious, favoring companies and sectors better positioned to weather an uncertain economic landscape.

Fixed income outlook



- Higher yields present opportunity despite ongoing volatility, economic uncertainty
- Sector and security selection will be key given the likely economic slowdown
- Avoid taking on risk without getting paid for it given weakening growth

Fixed income assets are set to begin 2024 at broadly attractive levels, with Treasury yields near their highest since the financial crisis, albeit off recent peaks. The repricing higher in yields has increased breakevens (or yield per unit of duration) to their most compelling levels in years, which can offer protection against ongoing volatility or further increases in yields.

The recession, which many market participants had anticipated in 2023, never materialized. Instead, a surprisingly resilient economic backdrop amid restrictive monetary policy sent long-dated yields higher, leading to a challenging return environment for fixed income investors. Expectations continue to suggest an economic slowdown next year and the evolution of economic activity will drive market conditions in 2024.

While our base case implies a recessionary-type environment in 2024, a period of positive, but below-trend growth, remains a possibility. As the economy slows, excess returns for lower-quality credit products could face challenges, but an easier stance of monetary policy holds the potential to support total returns. Sector and security selection will be of heightened importance in an economic slowdown given the likelihood of concentrated pockets of weakness in the economy following a prolonged period of elevated funding costs. It is wise to be selective when considering spread-based fixed income opportunities and to avoid credits where investors are not getting paid for the risks given this slowing to no/negative growth environment.

Investment grade credit: Europe and the UK

	Negative				Positive
Fundamentals			X		
Valuations				X	
Technicals				X	
Sentiment			X		

- Expected benign interest-rate outlook should be supportive for investment grade credit
- Generic valuations (on yield basis) are historically attractive
- Appeal of cash as an alternative asset class should dissipate
- Subordinated financials are likely to be the sweet spot under this scenario

The prospects for the euro and sterling investment grade (IG) markets have for some months been inextricably linked to the outlook for global interest rates and the ongoing debate as to how long interest rates will need to be restrictive. We have been of the view for most of the second half of 2023 that the inflation threat—most notably in the US and Europe—will likely start to dissipate and negate the threat of further rate hikes.

The final months of 2023 have seen tangible evidence of an ongoing downturn in mainland Europe, as well as tentative evidence of US economic activity starting to turn negative. It is our view that this correlation will continue in the opening months of 2024, with the (likely) incontrovertible evidence emerging that central banks may well end up having to cut rates over the next 12 months, ultimately underpinning IG spreads in both euros and sterling. As cash starts to become a less attractive option as an asset class in this environment, we would anticipate that the likely allocation toward IG should prove to be a very supportive technical driver.

Generic valuations (on a yield basis) are as attractive as they have been for several years, and it is our contention that the potential for a growing disparity in returns between cash and IG to emerge should only serve to underline this point. Against this backdrop, it would be our expectation that subordinated (and higher-yielding) financial paper would likely be the sweet spot under such a scenario. In terms of acknowledging the threats to this view—albeit ones we believe to be low probability outcomes—should the expected (mild) economic downturn we foresee prove to be more pronounced, then it would necessitate a reappraisal of our constructive outlook.

Investment grade credit: United States

	Negative				Positive
Fundamentals			X		
Valuations			X		
Technicals					X
Sentiment			X		

- A shallow recession in 2024 can still be good for investment grade corporates
- Most companies appear well-positioned for future headwinds
- Supply/demand technicals will likely remain very supportive
- Look for rangebound credit spreads and carry-type excess returns

The anticipated economic slowdown continues to be pushed forward, so much so that 2024's outlook will be very similar to last year's. We believe a shallow recession in 2024 could be a decent environment for US investment grade corporate bonds. Valuations look in-line with long-term averages and will likely remain rangebound given the push/pull between a softening economy and positive supply/demand technicals. Ultimately, we are expecting carry-type excess returns for 2024 for investment grade credit.

From a fundamental perspective, most companies are well positioned for a slowing economy. Ratings momentum remained positive throughout 2023, leaving the overall credit quality of the Bloomberg Investment Grade Credit Index at its highest levels in years. We expect much of the positive ratings momentum to have run its course, but it potentially leaves an adequate ratings cushion to withstand the deterioration we will likely see in company balance sheets.

Supply/demand technicals are likely to remain strong. Higher yields bolstered demand from yield-sensitive buyers in 2023 and this buyer base should continue to support investment grade credit in 2024, particularly as rate volatility winds down on the back end of the Fed's rate hiking cycle. In addition, supply should remain at tolerable levels given issuers' concerns with the economy and overall higher funding costs.

High yield

	Negative				Positive
Fundamentals		X			
Valuations			X		
Technicals				X	
Sentiment			X		

- Late-cycle market dynamics warrant caution, however high yield bonds can present opportunities for long-term investors
- Most company fundamentals are starting from a position of strength, but early signs of deterioration are emerging and bifurcation is increasing, warranting a sharp focus on issuer selection
- For long-term investors, yields above 8% look attractive as the starting yield tends to be a reasonable estimate of forward five-year returns.[1,2]
- Spreads are likely biased toward widening in the short term, which could expose compelling entry points for tactical investors and opportunities to capitalize on market dislocations

Solid fundamental starting point, emerging warning signs

As the cycle evolves and the economy slows, we expect to see increasing divergence across the high yield market. Many companies maintained solid fundamentals in 2023 with well-managed balance sheets and sufficient liquidity. Although leverage increased and interest coverage ratios deteriorated during the year, on average, most companies' credit metrics were coming off historically strong levels. In addition, many companies have been able to maintain margins regardless of elevated inflation.

Despite the strong fundamental starting point, macro headwinds are expected to inevitably pressure companies in 2024 as they strive to maintain prices and volumes in a slowing economic environment. The potential for higher rates for longer could exacerbate these concerns as companies face higher refinancing costs. Although the maturity wall appears manageable in the near term, the refinancing runway is shortening and companies will become increasingly focused on addressing refinancing needs over the coming 12 to 24 months. The looming maturity wall will likely become a key focal area for the market in the year ahead.

Increasing bifurcation, emphasis on selection

Based on our base case scenario, we believe many high yield companies are well-positioned to navigate a mild downturn. Given the solid fundamental starting point and higher-quality market, we expect defaults will rise toward long-term averages but remain lower than during prior recessions. However, bifurcation is increasing across the market and we expect the divide to widen in 2024. Weaker companies with lower margins and little room for error are most at risk. Although the maturity wall in 2024 looks manageable, challenged credits may have difficulty accessing capital markets and refinancing upcoming maturities. As a result, caution and focus on selection are warranted as idiosyncratic situations create more dispersion across the market.

Attractive yields and long-term return potential

High yield valuations are mixed with high all-in yields and average spreads. While it is unlikely that spreads will tighten significantly in the near term, the asset class continues to look attractive from a yield perspective. Historically the starting yield to worst of the index has been a reasonable estimate of the forward five-year returns. Given the current index yield to worst[1] is above 8%, we think high yield bonds look attractive for long-term investors who can withstand some short-term volatility.

Despite high yields, spreads are likely biased toward widening in the short-term as volatility resurfaces. After trading range-bound throughout most of 2023, we expect bouts of spread widening to present interesting buying opportunities in 2024. For example, historically a starting OAS of 500 to 800 basis points has resulted in an average total return of 9% or more over the following five years.[2] We expect wider spread levels will present intriguing entry points for more tactical investors. However, wider spread environments have historically been short-lived, requiring investors to act quickly.

Balancing caution and optimism

Although caution is warranted in the short term, we remain relatively constructive on high yield. Most companies have well-managed balance sheets with fundamentals starting from a position of strength. However, idiosyncratic credit risks remain high, requiring a sharp focus on bottom-up research and selection. Broader market dislocations and volatility should present opportunities in 2024. Although each cycle is different, yields above 8% have historically provided above-average long-term returns. While macro headwinds persist, we think high yield bonds have the potential to present attractive opportunities for long-term investors in the year ahead.

Data is provided for illustrative purposes only. Indices do not reflect the performance of an actual investment. It is not possible to invest directly in an index, which also does not take into account trading commissions and costs. All investments contain risk and may lose value. [1]As of November 17, 2023, the yield to worst on the ICE BofA US High Yield index and ICE BofA Global High Yield index was 8.74% and 8.72%, respectively. [2]Based on monthly Bloomberg US Corporate High Yield Index data from January 31, 1994 to September 30, 2023. The five-year annualized return for the index ranged from 9.02% to 13.63% in periods in months where the starting OAS was at 500, 600, 700 and 800 basis points.

US bank loans

	Negative				Positive
Fundamentals		X			
Valuations				X	
Technicals			X		
Sentiment			X		

- We are cautious in the face of potential fundamental headwinds
- Valuations are attractive especially for long-term investors
- Collateralized loan obligations (CLOs) remain the bedrock of the market

Our outlook for US bank loans in 2024 is for another year of decent return potential, as starting valuations are attractive enough to offset the fundamental concerns that will likely persist. These worries include:

- Declining interest coverage ratios for borrowers as the secured overnight financing rate is expected to stay well above long-term averages and interest-rate hedges should roll off
- A 2025 maturity wall that is nearing ever closer
- The ongoing threat of a recession in the United States as the Fed attempts to cool the economy and achieve a soft landing, which has historically been difficult to attain.

That said, the Credit Suisse Leveraged Loan Index offered a coupon of 9.36% and a relatively low average index price of $94.48 as of November 9, 2023. However, we believe that while the index price is currently discounted relative to historical averages in the 97 to 98 range, much of the performing single B/BBs are already back near par and a further rally in the index price would likely come from lower quality, which is difficult to assume given the fundamental concerns mentioned above and expanded on below. As such, while the coupon supports an attractive return environment on its own, we expect prices to move largely sideways throughout 2024 with pockets of volatility as the late-in-the economic-cycle dance between the Fed and risk assets continues for another year.

From a fundamental perspective, we expect to see ongoing margin challenges as companies battle sticky inflation and slowing US consumer spending. Companies have largely done a good job at managing through the dual threats of significant cost inflation and supply chain challenges in the last few years, but the higher cost of debt has largely wiped out much of the corporate profit gains as more cash flow gets diverted to paying interest.

While that is great news for investors in the asset class, it has stretched certain balance sheets, especially for the B3/B- and below-rated issuers. Given that backdrop, defaults have picked up thus far in 2023 (1.76% by issuer count according to the S&P/LSTA Leveraged Loan Index as of October 31, 2023). We expect defaults to increase further and could move closer to long-term averages (around 2.75%) by the end of 2024 as the 2025 maturity wall nears. The volume of loans maturing between now and the end of 2025 has narrowed to $128.7 billion (roughly 9% of the index) as of the end of October 2023, as the market has been active in pushing out short-dated loans. But the maturity wall remains a key risk as capital markets might not be as robust and open if volatility picks back up during 2024. A positive offset to the potential for periods of weakness in capital markets has been the growth of private credit, which has been instrumental in providing refinancing for many issuers, especially smaller ones and even for some CCC loans that no longer are a great fit in the broadly syndicated loan market.

Although Aegon Asset Management's macro team is calling for a shallow recession in the US at some point in 2024, we still tend to favor US-dominated firms with less exposure to the potentially weaker growth environments in Europe and Asia. This bias results from a view that if a recession occurs, the unemployment rate isn't expected to spike to dangerous levels given the low starting point (3.9% as of October 2023) and the Fed has ample monetary easing it can deploy if a recession does indeed occur since it's starting at 5% plus on its benchmark fed funds rate.

The regulatory and political environment in the US continues to be positive for corporate issuers (albeit with intermittent challenges from Washington, D.C.) and the combination of industrial re-shoring to the US and government infrastructure investment is expected to provide an earnings tailwind for years to come. At the rating agency level, downgrades have continued to outpace upgrades as interest-coverage ratios have tightened across the asset class. The pace of downgrades has been measured for the most part, which has allowed the market to absorb most of the downgrades without significant selling pressure. This is evidenced by CCCs being the best-performing ratings category year to date in 2023, according to the Credit Suisse Leveraged Loan Index, as non-traditional bank loan buyers have stepped in where collateralized loan obligation (CLO) selling has occurred. While we don't expect CCCs to rally much further in 2024 as a broad ratings category due to fundamental concerns, the amount of non-CLO capital deployed into the space and the additional capital sitting on the sidelines for lower-quality situations makes us comfortable that CCCs are not likely to significantly detract from returns either.

Technicals and sentiment are fairly neutral for the asset class as retail funds are flattish on flows and new CLO creation is expected to be strong enough to offset older CLOs exiting their reinvestment periods. With CLO liability spreads remaining wider than historical averages, new deal issuance is firmly lower than the record levels seen back in 2021 and 2022, but CLOs remain a bedrock of support for the market. From a loan supply outlook, we expect a modest pick-up in leveraged buyout and merger and acquisition activity after a weaker 2023 for those categories, but still don't expect issuance to be materially positive on a net-issuance basis, as private credit takes some share from the syndicated market and overall deal flow remains constrained given the ongoing overhang of recession risk.

Lastly, from a valuation standpoint, we see the current entry point as attractive for long-term investors. Prices have rallied to this point year to date, resulting in less upside price potential in 2024, but higher coupons are still compensating investors nicely. We expect volatility to pick up again in 2024 due to the fundamental concerns outlined above, general uncertainty around the potential end of the Fed's hiking cycle and the presidential election later in the year. As such, we would not be surprised to see a pullback of the loan index at some point, which could result in attractive entry points for tactical investors. However, for investors willing to see through the potential volatility, we believe 2024 could offer another year for solid return opportunities in bank loans.

Emerging markets

	Negative				Positive
Fundamentals			X		
Valuations		X			
Technicals				X	
Sentiment				X	

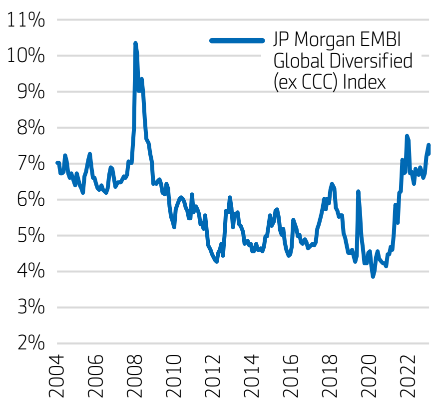
- The majority of emerging market (EM) economies are well-placed to manage a slowdown in global activity
- With reduced inflationary pressures, policymakers have the scope to support growth if needed
- Low net issuance has supported bond pricing, but erratic sentiment and flows remain a hindrance
- Despite near decade high all-in yields, valuations are uncompelling in the context of global fixed income

We believe the emerging market debt (EMD) asset class should perform well in a more benign rates backdrop, which will be further buoyed if the decline in long-dated Treasury yields we expect is realized. Our outlook is, however, tempered by challenged valuations, as investment grade debt spreads are near lows and the high number of distressed sovereigns facing elevated debt repayments remains. As evidenced in recent years, the market remains acutely sensitive to exogenous events, namely excessive rates volatility and the frequency of geopolitical flashpoints, which risk global trade and economic activity.

Despite these challenges, the fundamental growth outlook for emerging markets in 2024 remains positive. Central banks in emerging markets have substantial room to adopt more pro-growth policies, given the easing of core inflation and, for the most part, the fiscal prudence exhibited by governments. This optimistic growth outlook persists despite expectations of softening demand in developed markets and reduced optimism regarding China's pro-growth policy contributing positively to global liquidity and commodity demand, as seen in previous cycles.

The distinct divide in the asset class between "the haves" and the "have nots"—a direct result of the Covid-19 polycrisis of 2020-22—will mostly remain; the sovereigns who have ready access to market finance (typically BB-rated and above with relatively sound fundamentals) and those continuing to suffer from the economic damage incurred during the past three years. In such cases, an increase in bond maturities from 2024 is putting additional onus on the role of the International Monetary Fund and bilateral lenders as the lenders of last resort. As these lenders have stepped in, fears of a sharp wave of sovereign defaults have calmed. Here there is select opportunity among the long tail of sovereigns that were likely to fall into arrears over a longer time horizon, or not at all, but the margin for error remains thin amid the still high risk of exogenous shocks.

Performing emerging markets debt yields near decade highs



Source: Bloomberg, JP Morgan. Data as of November 10, 2023

While the EMD asset class's overall yield of approximately 8.7%[1] remains close to the decade high observed in 2022, it's crucial to note that 180 basis points of this yield can be attributed to the historically high number of distressed sovereigns, particularly those rated CCC or lower. As lower-rated credits may not realize all of that spread if payments become challenged, performing EMD offers a roughly 132 basis-point spread to US investment grade credit,[2] near decade lows. Such obtrusive relative valuations can weigh on appetite for the asset class and after two years of significant outflows, the market would probably like to see a better premium to Treasurys in order to entice investors back. That said, with yields near a decade high, issuance levels well below historical norms and improved sentiment due to the tempering of global recessionary fears in recent months, EM may stabilize heading into 2024 and see investor inflows in an effort to capture high yield levels, despite spreads that are less appealing. EMD fundamentals remain robust enough for the asset class to expect positive excess returns in 2024, although some caution is warranted with respect to low-rated and economically challenged jurisdictions.

[1]Based on the JP Morgan EMBI Global Diversified Index as of November 24, 2023. Data is provided for illustrative purposes only. Indices do not reflect the performance of an actual investment. It is not possible to invest directly in an index, which also does not take into account trading commissions and costs. All investments contain risk and may lose value.
[2]Based on the spread between the JP Morgan EMBI Global Diversified Index (ex CCC) and the Bloomberg US Aggregate Credit Index as of of November 24, 2023.

European asset-backed securities

	Negative				Positive
Fundamentals			X		
Valuations					X
Technicals			X		
Sentiment			X		

- European asset-backed securities (ABS) are attractive from a valuation perspective
- Carry is high and has the potential to partially absorb spread widening
- Low interest-rate duration can potentially provide return protection in the current uncertain environment
- We expect spreads to remain range-bound, with upside if the geopolitical risks abate and/or recessionary fears diminish

We expect European asset-backed securities (ABS) credit spreads to move in tandem with the broader markets in 2024. There will likely be periods of weakness in the markets as the economy is slowing with declining inflation and there is still some uncertainty about the way forward for central banks. In addition, geopolitical issues are not likely to fade any time soon, which could result in volatility in the short term. However, as a weakening of the fundamental picture has already been priced in, investors in ABS seem to be well compensated for the increased credit risk given where spreads are. High-carry products are therefore poised to outperform, particularly if incoming macroeconomic data continues to point to easing inflation.

From a fundamental perspective, we expect arrears in underlying loans in ABS to increase given the higher interest-rate environment and tightened credit conditions and the fact that affordability and the ability of corporates and consumers to refinance are significantly lower. However, collateralized loan obligations (CLO) and ABS structures should be able to withstand substantial stress scenarios and payment disruption owing to structural elements like (liquidity) reserve funds, excess spread, cashflow diversion triggers and subordination, which have almost all increased in newly issued ABS. Additionally, in case of severe deterioration in performance, historical asset price increases will likely limit eventual losses in the case of a forced sale. As such, we have no immediate concerns regarding ABS fundamentals and remain constructive on the asset class.

From a valuation standpoint, as spreads widened in the fourth quarter, European ABS became more attractive and stand out in fixed income markets since they can potentially offer both absolute and relative value. Low interest-rate duration is expected to provide stable returns in the current uncertain interest-rate environment. The high carry is appealing and can dampen spread volatility.

The technical picture is not much of a driver of returns and is looking neutral to slightly negative. However, this may result in a more positive technical if demand remains strong and issuance dries up. Overall, we do not expect spreads to tighten as much as they did in 2023 and they will likely not be the largest contributor to returns. We think primary issuance will continue at its current pace as central banks have ceased to provide cheap funding sources such as targeted longer-term refinancing operations (TLTRO) and banks will need to find other sources of funding like ABS. Issuance for non-bank issuers will likely continue, albeit at a slower pace as financing is more expensive while seasoned warehouses will likely have lower coupon assets in them, which may cause some difficulties in publicly placing those deals. Overall, we believe technicals will be neutral across ABS sectors but could have positive surprises if the fundamental picture is better than we currently expect.

US structured finance

	Negative				Positive
Fundamentals			X		
Valuations				X	
Technicals			X		
Sentiment			X		

- Securitized valuations remain compelling heading into 2024
- The asset class offers an attractive relative-value proposition compared to other assets
- Investment grade tranches appear well protected against performance deterioration
- The technical environment has become more balanced

We remain constructive on our outlook for the securitized market in 2024. Securitized spreads are attractive from a historical perspective, while yields remain elevated, providing very attractive risk-adjusted return opportunities. Like other fixed income asset classes, we view carry as compelling, even in low-beta sectors. We believe securitized offers an attractive relative-value proposition when compared with competing risk assets but favor an up-in-quality bias.

We anticipate modest credit deterioration within the underlying collateral for most consumer asset-backed securities (ABS) in 2024, driven by stubbornly high inflation and tight financial conditions. Increases in delinquencies and losses have been well-behaved for prime borrowers, but have surpassed pre-covid levels for subprime borrowers, indicating certain borrowers are feeling the squeeze more than others. With that said, unemployment remains a tailwind to the consumer and has remained low despite continued fed rate normalization. ABS structures are robust with significant protections for investment grade rated tranches, which can potentially offset the expected weakening in performance over the next year. Within esoteric ABS, performance is specific to each collateral type; however, credit performance for most sub-sectors has remained in check. We believe steeper credit curves and sponsor tiering are here to stay throughout 2024 as investors digest idiosyncratic risks related to sponsor strength and underwriting differences on a deal-by-deal basis.

The housing market weathered rising mortgage rates this year and we expect continued resilience given limited inventory, as homeowners are reluctant to part ways with record low mortgage rates. Supply and demand dynamics will likely further be braced by an increase in new home construction being offset by extending timelines for new home completions, as some homebuilders are grappling with a limited supply of labor, land and materials. At the same time, record home equity could be tapped to limit distressed inventory in an economic slowdown. Further, if mortgage rates move lower in 2024, home prices could benefit as increased affordability should unlock pent-up demand.

Commercial mortgage-backed securities delinquencies have edged up this year and we expect them to continue to trend higher next year, driven by maturing loans and challenges in the office sector. For loans unable to refinance, we expect servicers to lean more toward modification and extension for resolution over liquidation. Stability in rates should lead to a modest increase in issuance next year. However, we expect issuance to be driven mostly by refinancings as transaction volume in the commercial real estate sector experiences a slow recovery.

New issue deal flow across securitized in 2024 is expected to largely mirror the past year as elevated interest rates and wider spreads slow capital market activity, leading to a balanced technical environment. Some sub-sectors could see a slight increase in issuance as rates stabilize, but we do not expect a meaningful pick-up in primary issuance in 2024.

Valuations are attractive in many sectors, but the direction of spreads in 2024 will likely be driven more by economic trends, Fed policy and the broader financial markets than by factors specific to the securitized market. Investors may want to maintain an up-in-quality bias where risk-adjusted returns look especially compelling, at least until more clarity emerges on some of the economic uncertainties. Spread tiering across issuers and sectors coupled with attractive spreads may also provide some openings to be more opportunistic in 2024, but we view credit selection as critical over the next year as additional prudence is required to achieve the best risk-adjusted returns.

While we remain cautious about the macro backdrop in 2024, securitized valuations are compelling, relative value is prevalent and securitization structures remain resilient.

Distressed debt

	Negative				Positive
Fundamentals	X				
Valuations			X		
Technicals			X		
Sentiment		X			

- Deteriorating fundamentals will likely drive default rates higher, approaching levels seen in prior downturns
- Expect more defaults in leveraged loans than in high yield in 2024
- Investor patience for companies missing earnings remains low and is likely to stay that way
- We expect trading levels (and ultimately recovery rates) of underperforming companies to continue to bifurcate from performing companies

We believe there will be significant and compelling investment opportunities within stressed and distressed credit in 2024. While most performing companies reliant on levered credit have improved their liquidity runway and extended their maturities, higher interest rates are pressuring cash flows and impairing access to credit markets. This will be most impactful for stressed and distressed companies. We expect an acceleration of fundamental weakness in the first half of 2024, with improvement toward the back half of 2024.

The risk of elevated defaults in 2024 for both US and European high yield and leveraged loans continues to increase as companies come under pressure amid an economic slowdown. However, many lower-quality companies remain in a solid financial state with stable fundamentals, which could help keep defaults more contained. As a result, we believe default rates could approach historical long-term averages.

Selective access to capital markets, liability management transactions and only moderately deteriorating fundamentals have largely driven modest default activity to this point. However, as we move through 2024, we think some of this muted default activity will likely manifest itself. We should still see substantial liability management (some coercive) and rescue financing transactions but outright bankruptcies should increase too. We still expect distressed and defaulted situations will be driven more by idiosyncratic factors than by broad-based secular forces or sector-specific catalysts with a few exceptions we are seeing in technology, media and telecom, retail and consumer discretionary companies, as well as some health care and pharmaceutical companies. We also think smaller, sponsor-owned companies are more prone to liquidity shortfalls as earnings may take longer to rebound vis-à-vis their debt loads stemming from leveraged buyouts.

Overall, spread and equity volatility in highly levered names will likely remain elevated, particularly for lower-quality companies with capital structure issues. Investor patience for companies missing earnings will likely remain low and we expect a continued bifurcation of performing versus non-performing companies. We expect that capital markets will remain selectively open, but prudent investors will demand higher returns, better security and enhanced protections when they lend to lower-quality companies.

Economic headwinds and market volatility will likely create more bifurcation across the lower-quality market, warranting a disciplined approach and in-depth credit analysis

While we believe investors should tread cautiously, 2024 could present attractive entry points and potential once-in-a-cycle opportunities for active managers to capitalize on dislocations within distressed credit. We expect opportunities to arise in both cyclical and secular stories, rate-driven stressed credits trading below recovery values and outright restructurings. Investors will need to continue to be patient, but those that are focused on rigorous bottom-up research and credit selection likely will be rewarded.

Disclosures

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