4Q 2024

Investment Highlights

Western Asset US High Yield Sector

This is a marketing communication.

Key Takeaways

- *The Bloomberg US High Yield 2% Issuer Cap Index returned 0.17% in the fourth quarter.*
- *Spreads tightened by 8 bps in the fourth quarter to 287 bps and the yield-to-worst increased to 7.49%.*
- *Both CCC rated and B rated bonds outperformed the index, returning 2.26% and 0.31%, respectively, while BB rated bonds returned -0.49%.*
- *High-yield issuance totaled $49.1 billion for the quarter, bringing YTD issuance to $288.8 billion (64% higher YoY).*
- *High-yield funds saw inflows of $0.9 billion, bringing YTD flows to $16.4 billion (compared to outflows of -$7.0 billion for the same period a year ago).*
- *We are still seeing opportunities in rising-star candidates and a robust primary market at attractive concessions.*
- *We continue to maintain a "reopening trade" bias at the margin, with more modest overweights to sectors like airlines and cruise lines, as well as opportunities in the energy sector, particularly E&P companies.*

Market Review

During the fourth quarter, US Treasury (UST) yields moved significantly higher due to a number of factors, including the election of Donald Trump, renewed concerns over an escalating fiscal deficit and potentially inflationary trade policies. Additionally, while the Federal Reserve (Fed) cut rates, it also lowered guidance for rate reductions in 2025. Risk assets weakened in December, but strengthened over the quarter as the S&P 500 Index edged higher and credit spreads compressed.

In the US, data releases reinforced the trend of a resilient labor market and somewhat sticky inflation. Nonfarm payrolls rebounded by 227,000 jobs in November after a weak October report, which was impacted by a severe storm and a labor strike. The three-month payroll average of 173,000 ran above the third-quarter pace of 159,000, and the unemployment rate remained steady at 4.2%. Meanwhile, inflation measures were mixed. Some components were sticky, but we have seen some weaker-than-expected increases in rents and owners' equivalent rents (OER), which bodes well for inflation remaining in a downward trend. Over the last three months, the core Consumer Price Index (CPI) and the core Personal Consumption Expenditures (PCE) Index rose year-over-year (YoY) from 3.2% to 3.3% and 2.7% to 2.8%, respectively.

As expected, the Federal Open Market Committee (FOMC) cut rates by 25 basis points (bps) at both its November and December meetings, bringing the range for the fed funds rate to 4.25%-4.50%. While the cuts were expected, it was the Fed's updated December guidance for 2025 and 2026 that surprised the market and caused a substantial move higher in UST yields in December. The newly updated Summary of Economic Projections (SEP) indicated just 50 bps of additional rate cuts in 2025 and 2026 versus the 100 bps and 50 bps, respectively, that were forecast in the September SEP. During the post-meeting press conference, Fed Chair Jerome Powell admitted that this was "a closer call" than prior cut decisions, but that policy rates were still widely viewed as restrictive and that further cuts would likely be necessary to balance both sides of the dual mandate. Powell went on to describe the Fed's policy as entering a "new phase" in which higher-than-expected growth and inflation data, a lower-than-expected unemployment rate, 100 bps of already-implemented rate cuts and election-related uncertainty altogether necessitate a more gradual path toward neutral rates. He went on to emphasize the important role of incoming inflation data in determining the "extent and timing of" additional policy actions. At the end of the quarter, fed funds futures contracts were pricing in a meager 10% chance of a 25-bp rate cut at the January FOMC meeting.

Within the high-yield market, spreads tightened by 8 bps to end the fourth quarter at 287 bps, based on the Bloomberg US High Yield—2% Issuer Cap USD Unhedged Index. The yield-to-worst (YTW) of the index increased to 7.49%. Both CCC rated and B rated bonds outperformed the index, returning 2.26% and 0.31%, respectively, while BB rated bonds returned -0.49%. The broad index returned 0.17% during the period. The top-performing industries were transportation and communications, while REITs and utilities were the worst-performing sectors. High-yield issuance totaled $49.1 billion for the quarter, bringing year-to-date (YTD) issuance to $288.8 billion (64% higher YoY). High-yield funds saw inflows of $0.9 billion, bringing YTD flows to $16.4 billion (compared to outflows of -$7.0 billion for the same period a year ago), according to JPMorgan.

Outlook

Our base case is for further weakening in global growth and further declines in inflation with a greater emphasis on services disinflation. Goods price inflation is running modestly below pre-pandemic levels, but with ongoing deflationary pressures from Asia, it's hard to see a meaningful persistent uptick moving forward. Services inflation remains elevated, but wage pressures are abating as job markets soften and service sector demand is slowing. Headline inflation is close to target in most advanced economies, which has allowed central banks to reduce policy rates as their inflation concerns lessen while growth concerns rise. Growth is slowing in the US and remains moribund in the rest of the world. At the same time, lower policy rates and the recent Chinese stimulus package should lessen recessionary fears. We remain overweight interest rate duration but less so as rates have fallen and markets have moved closer to our base case. Spread sectors have performed well and we expect this to continue if the downward growth trajectory remains gentle and services disinflation continues. However, valuations now have less yield advantage to offset potential macro and political risks going forward. EM debt appears to remain fundamentally attractive, but both internal and external political risks have hampered performance in some countries.

Within high-yield, the potential for total returns at mid- to high-single-digit yields remains relatively attractive compared to equity and other higher-volatility alternatives. Spreads still offer a premium likely in excess of default risk, with our expectations for default rates to be similar to last year—about 4% on an issuer-weighted basis and 1%-2% less on a par-weighted basis. As growth moderates, leverage and interest coverage metrics indicate that high-yield issuers have maintained resilient balance sheets, reflecting predominantly conservative management practices. From a technical perspective, we expect continued demand to persist from both institutions and retail investors as they search for incremental yield in their portfolios, especially as interest rates on cash and government bonds decline. We are still seeing opportunities in rising-star candidates and a robust primary market at attractive concessions. In terms of industry positioning, we maintain a "reopening trade" bias at the margin, with more modest overweights to sectors like airlines and cruise lines, as well as opportunities in the energy sector, particularly E&P companies.

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All investments involve risks, including possible loss of principal. Fixed-income securities involve interest rate, credit, inflation, and reinvestment risks; and possible loss of principal. As interest rates rise, the value of fixed-income securities falls. International investments are subject to special risks, including currency fluctuations and social, economic and political uncertainties, which could increase volatility. These risks are magnified in emerging markets. Asset-backed, mortgage-backed or mortgage-related securities are subject to prepayment and extension risks. High yield bonds are subject to greater price volatility, liquidity, and possibility of default.

The **Bloomberg US High Yield 2% Constrained Index** is a component of the U.S. Corporate High-Yield Bond Index, which covers the universe of fixed-rate, non-investment-grade corporate debt of issuers in non-emerging market countries. It is not market capitalization-weighted; each issuer is capped at 2% of the index.

Bloomberg US High Yield—2% Issuer Cap USD Unhedged Index is an issuer-constrained version of the flagship US Corporate High Yield Index, which measures the USD-denominated, high yield, fixed-rate corporate bond market. The index follows the same rules as the uncapped version, but limits the exposure of each issuer to 2% of the total market value and redistributes any excess market value indexwide on a pro rata basis.

The **Consumer Price Index (CPI)** tracks prices for a basket of more than 80,000 goods and services.

Credit quality is a measure of a bond issuer's ability to repay interest and principal in a timely manner. The credit ratings discussed are based on a security's rating as provided by Standard and Poor's, Moody's Investors Service and/or Fitch Ratings, Ltd., and they typically range from AAA (highest) to D (lowest), or an equivalent and/or similar rating. The credit quality of the investments in a fund's portfolio does not apply to the stability or safety of the fund. These ratings are updated monthly and may change over time. Please note that the closed-end funds have not been rated by an independent rating agency. Investment-grade bonds are bonds t hat are rated Aaa, Aa, A and Baa by Moody's Investors Service and AAA, AA, A and BBB by Standard & Poor's Ratings Service, or that have an equivalent rating by a nationally recognized statistical rating organization or are determined by the manager to be of equivalent quality. A below-investment-grade bond or high-yield security has a rating of BB or lower; it pays a higher yield to compensate for its greater risk.

The **Fed Funds Rate** is the interest rate at which depository institutions trade federal funds (balances held at Federal Reserve Banks) with each other overnight.

Gross domestic product (GDP) is an economic statistic that measures the market value of all final goods and services produced within a country in a given period of time.

High-yield bonds possess greater price volatility, illiquidity and possibility of default.

Investment-grade bonds are generally rated BBB and above.

The **S&P 500 Index** is an unmanaged index of 500 stocks that is generally representative of the performance of larger companies in the U.S.

Spread refers to the difference between Treasury securities and non-Treasury securities of similar maturity but different credit quality.

Summary of Economic Projections are released by the Federal Reserve four times a year. SEP features the Federal Open Market Committee (FOMC) participants' projections for GDP growth, the unemployment rate, inflation and the appropriate policy interest rate.

U.S. Treasuries are direct debt obligations issued by the U.S. government and backed by its "full faith and credit." The U.S. government guarantees the principal and interest payments on U.S. Treasuries when the securities are held to maturity.

Yield to worst (YTW) is based on a portfolio's current holdings on one specific day, is gross of all portfolio expenses, and is calculated based on assumptions that prepayment occurs if the bond has call or put provisions and the issuer can offer a lower coupon rate based on current market rates.

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