

# Comprehensive Research, Broad Diversification

## Strategy overview

Total return approach, investing in below investment grade corporate securities.

## Key takeaways

- Despite intra-quarter volatility, risk assets largely produced positive returns led by equity markets while bond markets were flattish in the second quarter.
- For the quarter, the Strategy outperformed the Index on a net asset value (NAV) basis.
- The macro outlook remains supportive despite the expected slowdown in economic growth, as expectations of U.S. Federal Reserve cuts later in the year have increased amid cooling inflation and signs of softening in labor markets.

## Portfolio review

**Despite intra-quarter volatility, risk assets largely produced positive returns, led by equity markets, while bond markets were flattish in the second quarter.** Volatility early in the quarter was driven by continued solid economic growth data in the United States, resilience in labor markets, and an uneven decline in inflation data. This led to a bouncing around of both interest rates as well as expectations of potential Fed cuts later in the year. Heading into June, economic and payroll data began showing signs of weakness, while the May Consumer Price Index (CPI) report surprised to the downside, which resulted in a decline in yields from their peak. By the end of the quarter, the yield on the U.S. 10-Year Treasury closed 20 basis points (bp) higher overall at 4.40% but off its peaks seen earlier in the period.

**High yield (HY) spreads finished the quarter modestly wider at 309 bp on an option-adjusted spread (OAS) basis.** The Bloomberg High Yield 2% Issuer Cap Index (Index) posted a positive total return for the quarter of 1.09%, bringing its year-to-date return to 2.58%. From a quality perspective, higher-rated bonds outperformed, as BB, B and CCC rated bonds returned 1.32%, 1.03%, and -0.01%, respectively, though the CCC rated bonds underperformance was more attributable to credit-specific negatives than to a broad aversion to risk. Primary market issuance remained active, as total supply has crossed the U.S. \$160 billion mark YTD. Use of proceeds continues to primarily consist of refinancings, while mergers and acquisitions and leveraged buyout deals remain subdued due to high financing costs. Investor flows into HY were broadly positive during the quarter, driven by attractive all-in yields and strong equity market performance.

**For the quarter, the Strategy outperformed the Index on a NAV basis.** Security selection within the CCC rating cohort was the primary contributor to relative performance during the quarter. This mostly reflected the Strategy's avoidance of many of the negative idiosyncratic outcomes referenced above, such as Lumen, iHeart, Uniti Communications and Hertz. The largest negative in the period came from the Strategy's position in television broadcaster EW Scripps, as concern about rapidly changing dynamics in the media space weighed on bond prices.

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## Current strategy and outlook

**The macro outlook remains supportive despite the expected slowdown in economic growth, as expectations of Fed cuts later in the year have increased amid cooling inflation and signs of softening in labor markets.** Fundamental factors in the HY market remain generally healthy, barring a few pockets of stress in the more secularly challenged sectors. We believe the main risks include a more meaningful slowdown in growth and the possibility of margin compression, as pricing power diminishes against the backdrop of disinflation. The prevailing supply and demand imbalance should continue to persist, with net issuance remaining muted, while fund flows and coupon reinvestment support demand. Although spreads do not appear particularly cheap, solid credit fundamental factors should limit spread widening and the carry from high all-in yields should cushion total returns.

**We maintain an overweight to single-B rated bonds, while being modestly underweight in BB and CCC rated bonds, and we continue to focus on name-specific risk, which we expect to drive performance as dispersion remains elevated.** In sector positioning, we remain positive on the healthcare space given higher utilization rates and easing labor costs, and the energy sector, which continues to benefit from firm commodity prices. In addition, we have become more constructive recently on the chemicals sector, as we believe the economic weakness in Europe and China has bottomed. Meanwhile, we continue to maintain a cautious stance in industries that face secular challenges, such as media and cable.

The **Bloomberg Barclays High Yield Bond—2% Issuer Constrained Composite Index** is an unmanaged index that includes all fixed income securities having a maximum quality rating of Ba1, a minimum amount outstanding of \$150 million, and at least one year to maturity. **Investors cannot invest directly in an index.**

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