

## GENERAL MARKET ENVIRONMENT

Markets advanced in the fourth quarter aided by better-than-expected earnings, positive economic datapoints, and a dovish U.S. Federal Reserve (Fed) pivot heading into year-end. Third-quarter earnings exceeded expectations with most companies surpassing top- and bottom-line estimates, though management outlooks were mixed. Unemployment remained low and economic growth surpassed forecasts. In addition, inflation continued to slow, allowing for a dovish pivot by the Fed at December's Federal Open Market Committee meeting. Chair Powell stated that policy easing discussions had commenced and Fed projections were revised higher to show 75 basis points (bps) of rate cuts in 2024. The European Central Bank and Bank of England also left interest rates unchanged in December. Against this backdrop, global yields fell, and the U.S. dollar weakened. All these factors lifted investor sentiment driving demand for both risk assets and safe havens, and more than offset concerns around rising geopolitical tensions over the quarter.

## Equities Market Environment

- > The S&P 500® Index returned 11.69% for the period. For the full year, the Index returned 26.29%.
- > Real estate, technology, and financials sectors were the best performing sectors during the quarter. Energy was the only sector that closed lower, while consumer staples and health care sectors also underperformed.
- > Equity volatility notably decreased, finishing at 12.45 from 17.52 to start the quarter.

## Convertible Securities Market Environment

- > The ICE BofA US Convertible Index returned 6.79% for the period. For the full year, the Index returned 12.99%.
- > Convertible securities were positively impacted by rising stock prices, falling interest rates, and credit spread tightening.
- > All sectors except for energy finished higher in the fourth quarter. Materials, technology, and financials were the best performers, while transportation and media sectors also underperformed.
- > Investment grade (IG) issues outperformed below-IG issues. Equity-sensitive issues outperformed both total return (balanced) and yield alternative issues.
- > New issuance declined with 16 new deals pricing \$12.3 billion in proceeds. Total new issuance for the year was \$53.4 billion.

## High-Yield (HY) Bond Market Environment

- > The ICE BofA US High Yield Index returned 7.06% for the period. On a year-to-date basis, the Index returned 13.46%.
- > BB rated bonds returned 7.34%, outperforming B and CCC rated bonds, which returned 6.78% and 6.60%, respectively.
- > Spreads tightened to 339 bps from 403 bps, the average bond price rose to 92.86, and the market's yield decreased to 7.83%.
- > Industry performance was broadly higher for the period. Media, retail, and real estate outperformed whereas transportation, energy, and packaging & paper underperformed.
- > New issuance increased quarter-over-quarter with 65 issues priced, raising \$42.1 billion in proceeds. Total issuance for the year was \$175.9 billion.
- > Trailing 12-month default rates increased but remained below historical averages, rising to 2.84% on a dollar-weighted basis and 2.44% on an issuer-weighted basis.

## OUTLOOK

Heading into 2023, many strategists anticipated a U.S. economic recession. Instead, economic growth exceeded expectations. 2023's momentum should carry over into 2024, but conflicting factors make it difficult to predict a path with certainty. Economic tailwinds include low unemployment, steady consumption, government spending, waning inflation, an end to the rate hike cycle, and inflecting earnings. Economic challenges include restrictive monetary policy, quantitative tightening, less savings, manufacturing sector weakness, as well as U.S. and international political risks, among others.

Changes in any of these conditions will likely influence investor sentiment, causing equity market volatility over the course of the year. The path of the markets is also difficult to predict, especially after a strong fourth quarter rally. HY credit and convertible securities should be better positioned to weather market volatility given current market dynamics, which in some respects are more favorable today than they were exiting 2022. Consequently, today's market outlook resembles 2023's with mid to high single-digit returns possible by year-end 2024 for HY credit, convertible securities, and equities.

The U.S. HY market, currently yielding nearly 8%, offers the potential for equity-like returns but with much lower volatility. Credit fundamental factors are stable, near-term refinancing

obligations remain low, and management teams continue to prioritize debt reduction. Given these factors, defaults should remain well below historical cycle peaks. The market's attractive total return potential is a function of its deep discount to face value and increased coupon, which also serves to cushion downside volatility. Notably, after recording an annual decline, the HY market has historically delivered two consecutive years of positive returns in six of the seven cases,<sup>1</sup> and forward 12- and 24-month return projections based on the current market yield have been consistent with mid to high single digits.<sup>2</sup>

U.S. convertible securities should continue to provide benefits to investors, including an attractive asymmetric return profile and potentially lower volatility relative to the equity market. The shift in the universe's composition exiting 2022 remains largely unchanged heading into 2024. Many securities offer higher current yields and exhibit defensive characteristics given lower deltas and closer proximities to bond floors. This dynamic may allow for greater downside protection if equity volatility rises. If the prices of underlying stocks advance, convertible securities could be positioned to participate in the upside. Lastly, higher straight debt financing costs should draw issuers to the convertible market for coupon savings. As a result, new issuance, estimated to reach \$60–80 billion in 2024 (per strategists), is expected to increase year over year.

U.S. equity valuations reside near long-term averages. Visibility around 2024 and 2025 earnings, U.S. dollar and Treasury market stabilization, and an end to the rate hike cycle could be positive developments for stocks. Any equity market volatility will present opportunities for active managers to take advantage of better prices in attractive investments.

A covered call options strategy could also benefit from elevated or rising equity volatility by collecting premiums that translate into attractive annualized yields.

Collectively, these three asset classes can provide a steady source of income and a compelling “participate and protect” return profile.

<sup>1</sup>Source: ICE Data Services; data as of December 2022.

<sup>2</sup>Source: JP Morgan; data as of October 2022.

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