

## Talking Heads podcast with Jack Stephenson

**Chris Iggo:** Hello, and welcome to this week's BNP Paribas Asset Management Talking Heads podcast. Every week, Talking Heads will bring you in-depth insights and analysis on topics that really matter to investors. In this episode, we'll be discussing the US high yield market and how it's weathered the turbulence of the last few months.

I'm Chris Iggo, and today I'm joined by Jack Stephenson, a Senior Investment Specialist in the fixed income team at AXA IM Core, part of BNP Paribas Asset Management. Jack focuses on US high yield and investment grade fixed income credit strategies. So, welcome Jack, and thanks for joining me today.

**Jack Stephenson:** Thank you, Chris.

**CI:** We've had a lot of geopolitical risk in markets in the last three months. We've had a rise in oil prices, concern about US and European interest rates going up. How has that impacted on the US high yield market? The performance has been pretty good, but maybe you want to give your take on how things have evolved.

**JS:** Firstly, it does seem like there is now a credible pathway to a resolution of the military conflict in Iran, but that definitely doesn't mean the impact is over. If we think about the time it might take for oil to flow freely again, for stockpiles to be rebuilt, for supply chains to ease, there's clearly a lot that still remains to be seen.

The deal still hasn't been signed yet, of course. Then we also, from a US perspective, have to consider what the fall-out might be of higher energy prices impacting on gasoline prices at the pump, the ultimate pass-through to inflation, and what all this means for the consumer, let alone what the reaction function of a [US] Fed[eral Reserve] under new leadership will be – which happens to be on the day we're recording this podcast.

But all that said, the direct impact on the US high yield market in terms of returns has been relatively limited – we had a max drawdown at the index level of around 2%, so very manageable. The market recovered from that remarkably quickly, which is actually consistent with similar bouts of volatility we've seen over recent years.

Spreads actually tightened at the beginning of March when the conflict began, which surprised some people, but simply because you had rates moving higher; you saw spreads tightening and there was no traditional risk-off [move] that you might expect in such an event.

Eventually towards the end of March, you did see spreads widen modestly, but they peaked at around 350 basis points on the option-adjusted spread there. So still some 100 basis points lower than 2025's Liberation Day-related peak. Then we saw spreads rallying back to levels tighter today than even at the start of the year.

I think that brings it back to whether markets are seemingly so complacent around all these headline risks. And then you have equity markets on fire, spreads tightening, a lot of exuberance around some notable IPOs (initial public offerings). You seem to not be able to keep risk assets down for long.

But I think, stepping back, the US economy has been performing pretty well, and as long as people believe that the AI (artificial intelligence) story could reach its potential, then investors really want a piece of that. For US high yield, I think there's some good reasons why it's held up quite well over recent months.

Even though you've seen the market reprice short-term rate expectations everywhere, and we saw a rate hike in Europe. In the US, it does remain in the balance what the Fed will do. I think in part that's due to the greater energy independence that the US has as a net exporter of oil – lower sensitivity to gas prices than, for example, in Europe. So, the inflationary impact of higher energy prices is likely to be more limited as a result.

Of course, there will be a lot of focus on the new Fed Chair Kevin Warsh's comments after the Fed meeting. We'll wait to see what impact that will have. You could see a Fed that ends up being out of kilter with other central banks. We're seeing a lot of mixed economic data and the overall US economy does look increasingly K-shaped.

But concerns around the labour market, which prevailed into the end of last year, seem to have eased. So for US high yield, with maturity walls in pretty good shape and very low amounts of debt needing to be refinanced in 2026 and 2027, there's no immediate concerns that higher-for-longer rates could significantly impact on refinancing activities.

We also have to consider – in this environment of rates moving higher again – that high yield is a naturally shorter duration asset class, which has mitigated the impact of higher Treasury yields relative to obviously higher quality fixed income, investment-grade credit. The duration of the asset class today is around 3; if you look back to pre-Russia's invasion of Ukraine, it was around 4.5.

Price sensitivity to rates volatility is a lot less today. And yields are higher as a result of that today as well, at around 7% for US high yield, whereas back in 2021, they were down at 4%. There was a lot more legwork that markets needed to do to reprice the inflationary shock at that time.

Then just as a result of those moves that we've seen since that 2022 timeframe, money market and cash balances are already high today after what happened in 2022, when rates went up, whereas pre-2022, the opposite was true. And when we've seen periods of rates volatility like the one in March with the Iran conflict and yields go up, we do see high yield consistently attracting buyers who are more yield than spread-sensitive.

That's been reflected in the flows. So again, since the beginning of April, eight out of the last 10 weeks we've had net positive inflows into US high yield, which is obviously supportive. But energy is the largest sector in high yield, and obviously that's had a tailwind from oil prices going up.

It's notable that energy, despite remaining the largest sector in the US high yield index, is actually a lower yielding, tighter spread part of our market than it was in 2015/2016, when we had the commodities crisis and a lot of the shale oil companies being downgraded from investment grade and lots defaulting as well. So, to some extent, the positive impact of energy and higher oil prices has been more subdued than you might expect.

**CI:** It's certainly been a very resilient asset class and highlights the underlying strength in the US economy and corporate sector.

You mentioned the K-shaped economy. Of course, not everybody in the US is doing well, but there are some very strong themes – AI is clearly the strongest at the moment. You mentioned energy. We've had some concerns about the private credit markets as well. When you look under the hood of the market and start to think about different sectors, are you picking up some of those themes, particularly around the technology aspect?

**JS:** Yeah, definitely. That's absolutely the right question to be asking given that things can look okay at the surface and for the overall market. But for some time, it's true we've been seeing the increasing effects of an uneven US economy, creating what we describe as very idiosyncratic trends across sectors and issuers at different times.

We've referred previously to this idea of rolling recessions and rolling recoveries, even as the overall economy has obviously remained quite strong. I think a lot of that is predicated on the consumer, which is really where the 'K shape' comes from. You have upper and middle income cohorts holding up pretty well, and that's being supported by the wealth effect that comes from the AI story driving equity returns.

But industries that cater more towards [the] lower-income consumer are showing increasing signs of trade-down. As it relates to the geopolitical situation, which has obviously created a bit of noise at the sector level, we've just come through a relatively solid earnings season for high-yield companies.

We've seen year-over-year revenues, EBITDA (Earnings Before Interest, Taxes, Depreciation, and Amortization) growth for the overall market – showing pretty healthy trends. However, fundamentals, albeit still fairly solid overall, have weakened slightly over the last quarter or so in terms of leverage and interest coverage, which we would say is consistent with being midway in the business cycle.

Overall debt and capex have increased, not least because of the technology story that you referred to. So, digging below the surface, there is a lot of nuance needed around specific sectors and industries, which I would characterize from an investment standpoint as being a market where selectivity and underwriting are definitely important.

To give some examples, areas of the high-yield market that are most impacted by what we've seen in the Middle East are those that are clearly more sensitive to raw commodity or fuel prices, whether that be the airlines, basic chemicals, cruise lines, all linked to the consumer goods retail space that could see some increasing pressure from [the] higher gasoline prices that the consumer faces at the pump.

Chemicals been a topical sector. Basic chemicals that use petroleum-based inputs are facing higher costs that they're struggling to pass through. They've seen a lot of supply chain disruption. So a resolution to the war might allow them to reset that supply chain in a way that's beneficial, as customers look to diversify away from the Middle East.

US chemical producers have held up relative to their European peers who've been dealing with those higher natural gas costs. Cruise lines actually have pretty strong balance sheets, and the numbers and the backlogs there in terms of future bookings still look strong.

One area that's been concerning to us for some time is the home builders' building product space. That's linked to a lack of new construction that we've seen over recent years. So, that's one to watch in terms of potential liability management exercises and defaults.

But then linked to that AI story, we've seen this huge amount of capex that has come in largely in investment-grade, but also has fed its way down into high yield. There's clearly a positive side to that, where data centre construction has been booming.

More broadly, any company that's been associated with the AI infrastructure, semiconductors, data centres, continues to report very strong results. And I'd say even more impressive are the backlogs that some of these companies have.

We've seen AI-linked issuance picking up in high yield. There's now about \$40 billion or so of debt linked to AI in the US high yield market specifically, which is ahead of most people's expectations coming into the year. So that's almost created a separate subsector within the index, at roughly 2%-3% today. And telecom is obviously linked to that as well – that also continues to benefit from a supportive M&A backdrop.

But there's another side to the AI story which we need to talk about – the disruptive impact – and that's definitely been playing out in the software space, which has repriced because of those potential AI disruption impacts – which we would argue is justified to some extent, given the uncertainty around how AI will impact on these businesses.

I would say that's not yet reflected in the earnings or credit trends of these companies. But after a fairly indiscriminate sell-off at the start of the year, when equity multiples compressed in line with our expectations, the market is now starting differentiating between what we would call potential winners and losers in these areas.

So it's bounced off the bottom a little bit. And we view the AI disruption analysis as being very credit-specific. There's potential for high dispersion within certain exposed sectors, so it's not just about software, but there's clearly other areas of the market that are more prone to it, which again requires a high degree of selectivity in terms of credit selection.

We've approached that with that mindset, that we've had a consistent AI disruption framework, which has been analyst-driven, and which tries to essentially categorise different companies according to the relative risk that they have of ultimately being made obsolete.

That's not a binary situation in which, one company has tons of risk and won't exist and another company is going to do really well. But it helps to frame the conversation and create a starting point to understand how we should think about these businesses in a AI disruptive world. And the price and the valuation that we see in the bond markets every day has a big role to play in that as well, in terms of giving us adequate compensation for the risks we're taking.

**CI:** Investors will need to focus on this disruption across different markets. But the encouraging thing for high yield is that default rates in aggregate have remained very low. And the market does seem to be in good shape. So, taking all that into account, we're midway through 2026. How are you thinking about the outlook for the second half of the year in terms of spread levels, yields and total returns?

**JS:** Away from the headline noise, the outlook for US high yield remains constructive. And you mentioned default rates. Default rates do remain pretty subdued, at around 2%, if you include the distressed exchanges, or 1.2% if you exclude them, so just focused on the outright bankruptcies. That was at the end of May.

So, although there are pockets of stress and headline risks, a specific catalyst towards a much higher default rate is not immediately apparent to us, as long as the economy remains resilient and fundamentals continue to hold. That said, we are mindful of a potential increase in default rate expectations, which could be linked to trends happening outside high yield bond market.

You mentioned earlier the trends in private credit, some of the semi-liquid evergreen funds that are experiencing some of these redemptions at the moment. And as credit investors, we can't just put our head in the sand and say that if defaults are rising in private credit and other markets, then that won't impact on our market. Which won't, in our view, be so much to do with fundamental concerns in our market due to the limited overlap between issuers across the two markets, but more to do with the technical pressure that investors could come under if they choose to reduce overall credit allocations.

So, with a resolution to the Middle East conflict on the horizon, we do expect the market to shift back towards focusing on AI disruption in the second half [of this year]. And from a yield and spread perspective, I think yields are going to remain attractive, supported by rates that we think are going to remain on hold, at least for the time being.

Spreads, I think, will continue to trade in a range related to these bouts of volatility that we've seen. But I think the path of least resistance, given the things we're talking about, could see spreads trading in a slightly wider range towards the end of the year than what they're in today. But still a pretty healthy return backdrop for the second half.

**CI:** Of course, a lot of that return will come from income, which is reflected in the yields, so that's attractive to investors. How are the teams positioned in terms of the key strategies given the outlook that you've just discussed?

**JS:** We definitely continue to like the short duration segment of the US high yield market. We like the yield capture that's available, given we still have a pretty flat yield curve in US high yield. But it also offers a pretty nice balance of outcomes in a wide range of economic scenarios – helping investors protect against the interest rate volatility that still might remain prevalent, but also spread volatility that we might continue to see.

Actively managed short duration strategies also benefit from having greater predictability on the AI disruption analysis than as you get into longer maturity bonds. We like short duration, and in benchmark strategies we're reflecting that by the fact that we have this overweight to the short duration segment of the market, and then barbell that with the higher yielding part of the market

– being very selective, using our credit picking skills to go into higher yielding securities. So, a barbell positioning within benchmark strategies.

Further up the risk-return spectrum in our higher total return-seeking strategies, we have used some of the recent volatility to increase our yield advantage versus the index – looking for these kind[s] of idiosyncratic opportunities that the volatility may continue to create to elevate both the overall beta of the strategy but also seeking that high alpha potential.

So quite a lot going on underneath the hood, both at the market level, but also in terms of how we're approaching that with our strategies.

**CI:** Well, thanks, Jack. It's a very interesting part of the market and should continue to serve investors well in terms of returns.

That's it for this week's episode of Talking Heads. If you would like to learn more about the high yield strategy or our investment insights, please reach out to your BNP Paribas Asset Management contact, or check out Viewpoint, our website for investment insights at [viewpoint.bnpparibas-am.com](http://viewpoint.bnpparibas-am.com).

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You've been listening to the BNP Paribas Asset Management Talking Heads podcast with me, Chris Iggo, and Jack Stephenson from the fixed income team. Please do join us again on Talking Heads next week.

And until then, good luck investing and take care.