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HIGH YIELD FORECAST: DEFAULTS HAVE PEAKED, A RETURN TO NORMAL

Our research team periodically provides a credit default forecast to be used internally across portfolio management teams to gauge both specific and relative asset class risk for high yield (HY) bonds. The team of analysts evaluates the companies that they cover and assigns a specific probability of default to those companies. This bottom-up method is intended less to identify individual companies that may be at risk—that analysis is ongoing—but more to evaluate overall sector and asset class risk through aggregated bottom-up company analysis.

High yield bond market outlook

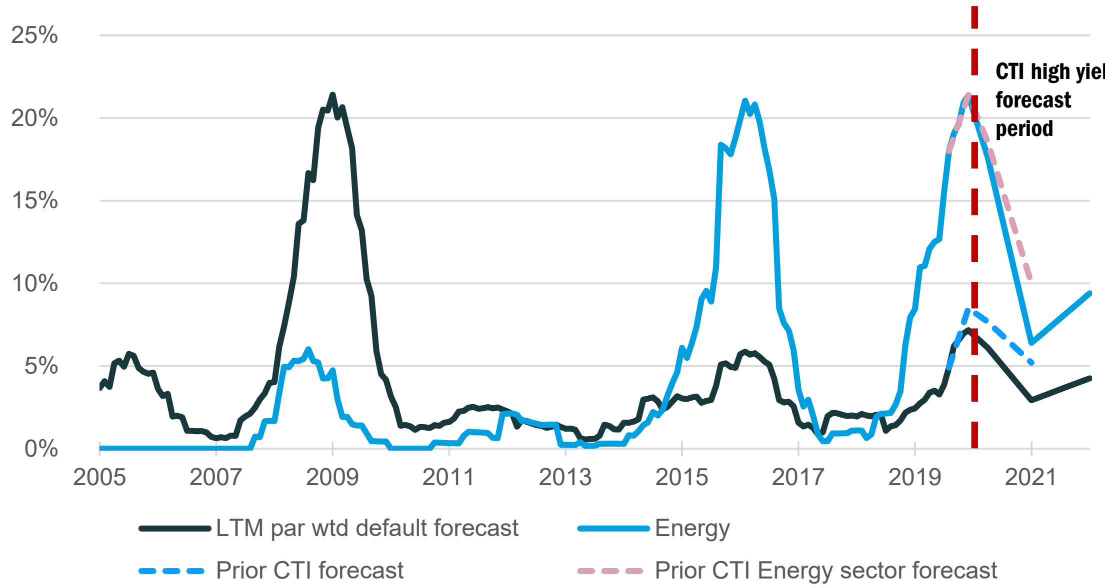
Exhibit 1: Columbia Threadneedle forecasted default rates

Par-weighted forecast	Forward 12-month	Forward 24-month
Total default rate	2.9%	7.2%

Source: Columbia Threadneedle Investments High Yield Research Team; as of November 2020. The 24-month forecast is cumulative and incorporates 12-month defaults. Forecast is for the High Yield Research Team coverage universe of approximately 590 issuers or 85% of the HY universe.

- The HY Research Team's par-weighted, default rate is forecasted to be 2.9% for the forward 12-month period and 7.2% for the forward 24-month period (cumulative). As of December 1, Bank of America Merrill Lynch calculated the last 12-month actual default rate to be 7.4%, with the Energy sector default rate at 23.6%.
- The chart below shows historical and forecasted HY defaults, with the dark blue line portraying the overall HY market default rate and the lighter blue line the Energy sector. Our previous forecast is shown in the dashed line.

Exhibit 2: High yield par-weighted default rate — historical and forecast



Source: Bank of America Merrill Lynch; Columbia Threadneedle Investments High Yield Research Team; as of September 2020.

It is our expectation that defaults have peaked and that we return to a default environment more in line with long-term historical averages. The higher 24-month forecast serves as a potential indicator for forecast risks and would most likely be driven by higher-than-expected defaults in the energy, real estate, leisure and transportation sectors.

Fundamental mile markers to watch

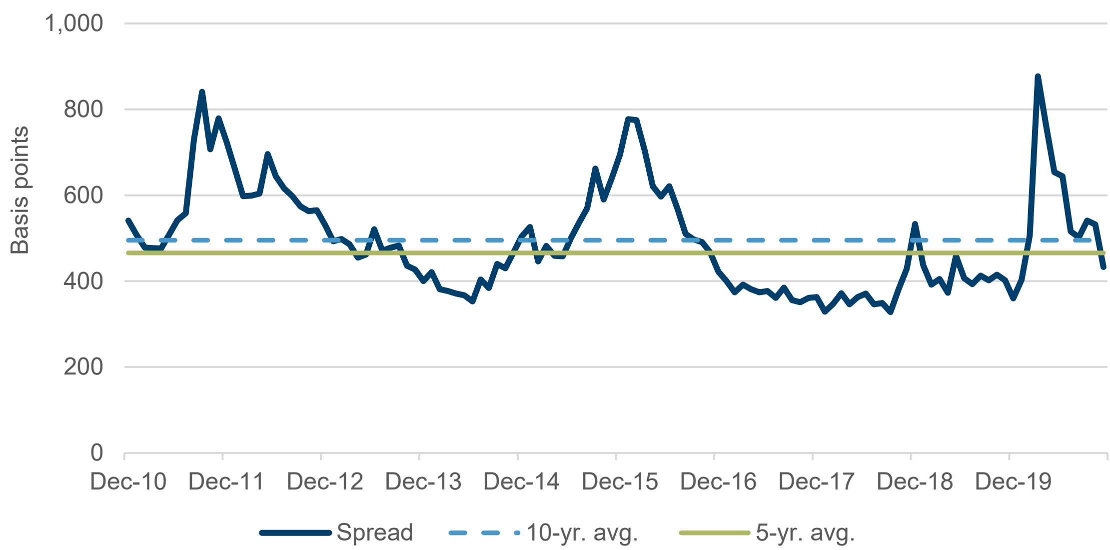
For purposes of evaluation, we divided the HY universe into Positive (companies that have benefited directly from the pandemic), Neutral (neither benefiting nor directly impacted) and Negative (companies adversely affected). We expect a recovery to drive Positive/Neutral sectors back to 2019 levels on a revenue and EBITDA basis in 2021. Additionally:

- We don't foresee Negative sectors recovering in the forward 2-year period.
- Financial flexibility and capital market access will be key for Negative sectors.
- Markets have facilitated the extension of liquidity runways in 2020. Thus, we believe defaults have peaked; and a return to levels more in line with historical averages is anticipated.
- The pace of balance sheet repair will be a key focus. Balance sheet repair is expected to take two years for the market overall, but the process will be uneven. Company management teams will need to remain diligent in the face of difficult-to-predict economic events.

What do valuations look like?

- Spreads are currently tight to historical averages after widening considerably during the crisis.
- We see less broad-based value; and lower compensation for taking incremental credit risk.
- Our research indicates that periods of economic growth and low defaults often result in credit spreads in a high-200 basis points (bps) to high-400 bps range.

Exhibit 3: Historical high yield spreads versus comparable Treasuries



Source: Bank of America – High Yield Master II Index; Columbia Threadneedle Investments; through November 30, 2020.

Summary outlook

We will be monitoring the pace of recovery. We expect Positive/Neutral sectors to come back to greater than or equal to 2019-level results on a revenue and EBITDA basis in 2021, while we aren't expecting the sectors we identified as Negative to recover in the forward 2-year period.

Financial flexibility and capital market access will be key for these Negative sectors. But we believe defaults have peaked and will return to levels more in line with historical averages.

Balance sheet repair is expected to take two years for the market overall but at an uneven pace. Management teams and companies will need to remain diligent, as there is increased potential for missteps in implementing capital allocation policies.

Past performance does not guarantee future results.

There are risks associated with fixed-income investments, including credit risk, interest rate risk, and prepayment and extension risk. In general, bond prices rise when interest rates fall and vice versa. This effect is usually more pronounced for longer term securities.

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