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High Yield: Four Considerations for the Months Ahead

INSIGHTS

High yield has faced a multitude of challenges this year, but we believe there is still value on offer across both high yield bonds and loans—including in some less conventional places.

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Global markets, including high yield, have faced a multitude of challenges this year. But the outlook for the asset class is not all negative. In fact, while challenges and uncertainty are likely to persist, we believe there is value on offer across both high yield bonds and loans, and we expect opportunities will continue to emerge in the months ahead—sometimes in surprising places.

Against this backdrop, we have identified four key considerations for high yield investors in the months ahead.

1. High Yield Issuers on Solid Footing

From high inflation and decidedly hawkish central banks, to concerns of a looming recession and escalating geopolitical conflict, the risks facing markets today are prevalent, and unlikely to be resolved anytime soon. As rising interest rates begin to sting in the broader economy and demand softens accordingly, there are questions around how high yield issuers will fare, and to what extent margins may be impacted.

The good news is, many **companies are in a stronger financial position** coming out of COVID than they would have been pre-COVID. Following the onset of the pandemic, many high yield issuers took advantage of previously healthy capital markets to refinance debt, reducing coupon payments while also extending maturities. Cash flows, in many cases, have returned to or surpassed 2019 levels—which in turn has led to record margins, with many companies still able to pass inflationary pressures through to the consumer. As a result of the strong fundamental backdrop, the percentage of bonds trading at extremely distressed levels (spreads > 1000 bps) has remained relatively contained, at around 7%, especially compared to previous periods of elevated market stress.[1] This suggests that a material increase in defaults is less likely in the near-term.

Also on the positive side, earnings estimates for the remainder of this year and into 2023 have been far more durable than some market participants were expecting, even in the face of negative sentiment. One reason for this is the still-strong nominal growth environment, as revenue and EBITDA* are driven in nominal dollars. Thus, even as we head into a difficult economic period, **earnings may be able to hold up better than in previous down cycles.**

It is also worth noting that unlike equities, **high yield does not require strong economic growth to perform well.** Rather, what matters most is an issuer's ability to meet the interest payments on its outstanding debt obligations. And in our view, the combination of solid financial positioning, a controlled default outlook and potentially more durable earnings puts most high yield issuers in a strong position to meet their obligations going forward.

1. Source: Bank of America. As of August 31, 2022.

*EBITDA stands for earnings before interest, taxes, depreciation and amortization.

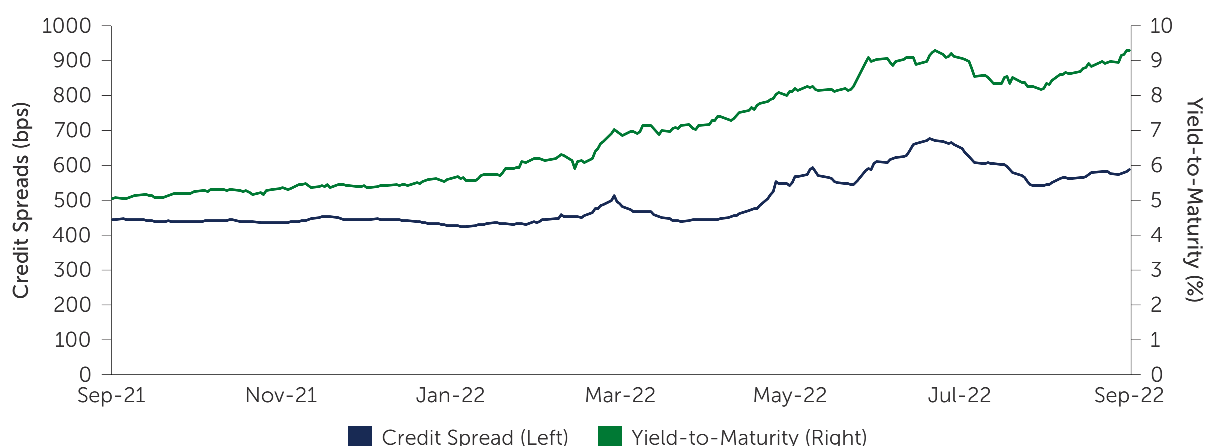
2. Technical Factors Creating Opportunities in Loans

In a rising-rate environment, and with volatility continuing to test financial markets, loans offer a number of potential benefits. For one, loans are **secured by a borrower's assets** and typically have first-priority claim on these assets in the event of default—which can provide substantial downside protection if defaults begin to rise. Loans are also **senior in the capital structure**, which means a loan's interest and principal payments must be paid before other creditors receive payment. Finally, loans provide a **floating-rate coupon payment**, which in a rising-rate environment can provide steadily increasing income as interest payments adjust higher with rates. In essence, loans can be seen as a hedge against a rising rate and inflationary environment.

However, despite the potential benefits on offer, flows have yet to return meaningfully to the market in recent months. This is partly due to the flight to cash, quality and stability that is common during more challenging periods. But it is also a result of lower demand from collateralized loan obligations (CLOs), which make up roughly 60% of the loan buyer base, relative to last year.[2] Specifically, as a number of large AAA CLO buyers have pulled back from the market this year, CLO new issuance has been negatively impacted.

Credit spreads have accordingly remained wide relative to the fundamental risks of the asset class. In fact, with current spreads in the range of 550–650 bps in the U.S. and Europe, and in the context of historical recovery rates, it would take a default rate of over 10% in order to fully erase the excess credit spread that is being offered today.[3] Yields also remain attractive, at around 9% in both the U.S. and Europe, or roughly 400 bps higher versus a year ago **(Figure 1)**. As such, absent an unprecedented increase in default rates—which is not our base case scenario—and given the continued tailwind from rising rates, we believe **the asset class is in a position to generate healthy returns over the next 12 months**, as has historically been the case when spreads have experienced similar widening.

Figure 1: Average Secondary Market Credit Spreads and Yield-To-Maturity for Global Leveraged Loans Remains Elevated



Source: Credit Suisse. Spread represented by the average three-year discount margin for the index.
As of September 16, 2022.

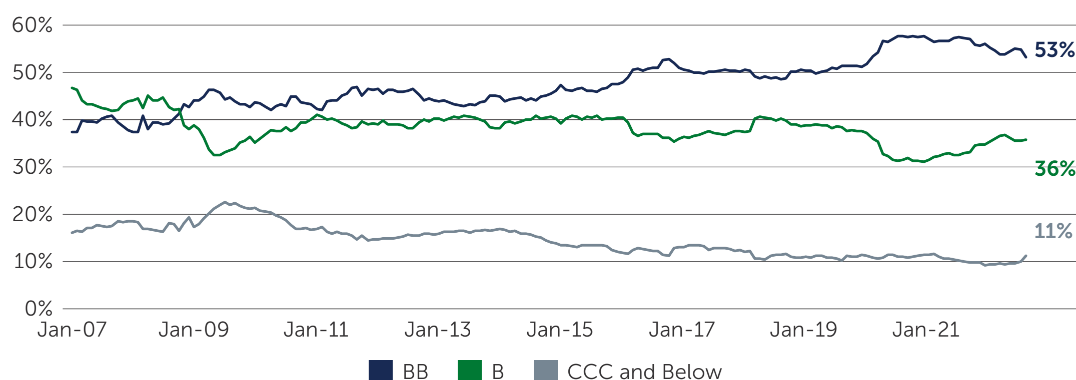
2. Source: J.P. Morgan. As of August 17, 2022.
3. Source: Credit Suisse. As of August 31, 2022.

3. Timing the Market is Hard to Do

High yield bonds have certainly faced challenges this year, with interest rate volatility and widening credit spreads substantially impacting performance. However, we believe there is still a strong case for a strategic allocation to the asset class. Coming off of a period where spreads were fairly tight on a historical basis—and with spreads currently hovering around 500 bps—some investors have started to question whether now is a good time to buy high yield. But the question of whether spreads are appropriate or less appropriate versus history is more nuanced, for a couple of reasons.

For one, over the last 15 years, **the quality of the high yield market has improved significantly.** BBs now account for 53% of the global high yield bond market, for instance, up from 38% in 2007; in the same period, the percentage of single-Bs has dropped to 36% **(Figure 2)**. This increase in quality is a function of several factors. During the commodity crises in 2016, for instance, many of the weaker companies in the space went through a restructuring process and dropped from the index. Over the last couple of years, the notable uptick in quality came on the back of strong new issuance and also record fallen angel activity, as a number of investment grade-rated names were downgraded into high yield following the initial onset of COVID.

Figure 2: Global High Yield Bonds: Credit Quality Evolution



Source: Bank of America. As of September 16, 2022.

Another consideration is that while wider spreads imply greater long-term total return potential, **periods of significant spread widening—such as we saw in June—are infrequent.** In fact, since 2010, there have been only eight instances where global high yield bond spreads have surpassed 600 bps, and only two instances where spreads have widened beyond 800 bps.[4] These spread widening events are also extremely difficult to time, as the inflection points come and go very quickly. For this reason, we believe a tactical approach to the asset class is less efficient; rather, in a market sure to be characterized by further bouts of volatility, a **strategic allocation can put investors in a position to quickly and efficiently capitalize as the market rebounds.**

4. Source: Bank of America. As of July 31, 2022.

"In the past, periods of dislocation and outsized moves—from the sovereign debt crisis to the COVID-induced market selloff in 2020—have provided active, bottom-up managers with an opportunity to generate alpha."

4. Opportunities Emerging in Less Conventional Places

The trends and dynamics shaping markets today are also giving way to select opportunities, in some cases in less conventional areas. From a sector standpoint, we see **interesting opportunities in the services sector relative to consumer durables.** Following the initial onset of COVID, demand for consumer durables like furniture and appliances surged, buoyed by the enormous fiscal stimulus efforts. Demand for services, on the other hand, virtually collapsed as social distancing measures became prevalent. More recently, those trends have reversed, shifting the opportunity set accordingly.

Another area where we have identified potential opportunities stems from the depressed prices in the bond market. In the CLO market, 2.0 CLOs—or post-financial crisis CLOs—have a bond bucket, which typically has a maximum allocation of around 5%. In the past, this bucket has primarily served as a means of enhancing spread. But with opportunities emerging to buy bonds at a discount, there is a **potentially significant pull-to-par opportunity**, which we saw with U.S. BBs late in the second quarter. More recently, the spread differential between BBs and BBBs has compressed, and as a result, we believe higher-quality BBBs have, somewhat unconventionally, started to look attractive as well.

Opportunities can also arise as **relative value shifts between the U.S. and Europe** based on market conditions. Spreads in the European bond and loan markets are currently wider than in the U.S., which is not uncommon, even with Europe being a higher-quality market. However, as history has shown, the market is highly technical and can become significantly dislocated during periods of volatility, such as we may experience with the growing energy crisis. In the past, periods of dislocation and outsized moves—from the sovereign debt crisis to the COVID-induced market selloff in 2020—have provided active, bottom-up managers with an **opportunity to generate alpha.**

Takeaway

There are plenty of risks that could impact markets in the months ahead. Beyond inflation, rates, economic growth and geopolitical conflict, the potential repercussions of quantitative tightening and Europe's partial oil embargo will be worth monitoring going forward. As we consider high yield in the context of this uncertain environment, we believe a credit-intensive, global approach is key. At Barings, we leverage the expertise of our large team to select credits that can withstand headwinds and hold up through credit cycles. We also take an active approach to investing, which allows us to move away from credits that exhibit fundamental weakness in favor of healthier issuers, and capitalize on relative value opportunities as they arise across geographies.

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