

Global High Yield Quarterly

- The much-feared global recessionary outcome not panning out, supportive supply technicals, and strong earnings has led to good performance for the asset class YTD.
- Credit conditions tightening, high cost of capital and lack of strong support from inflows in the medium term remains a concern.
- A longer, but shallower defaults cycle expected this time — N12M expected defaults for US HY at 3.0-3.5%, and EUR HY at 2.5%
- At 438 bps, GHY spreads do not flag as cheap now — but total return-oriented investors need not position too conservatively in a short-duration asset class yielding 8.8%.

Performance/ Market Highlights

Global High Yield spreads ended the quarter tighter by 11 bps overall, with July seeing the tightening trend continue from Q2, and a partial reversal in the last two months. Investors balanced resilient US economic data, lack of periods of extreme market stress, and positive earnings surprises from corporates with recently increased volatility — as the VIX ascended to its highest level since May.

Figure 1
**Total Returns
of High Yield in
Recent Periods**

Returns	3m (%)	6m (%)	12m (%)	YTD (%)
Global HY (\$ Unhedged)	0.09	1.74	12.72	5.39
Global HY (\$ Hedged)	0.91	2.51	11.38	5.89
Global HY (€ Hedged)	0.41	1.39	8.49	4.01
Global HY (£ Hedged)	0.81	2.15	10.16	5.18
US HY (\$)	0.54	2.18	10.20	5.98
Euro HY (€)	1.67	3.36	11.07	6.11
EM HY (\$)	0.24	0.78	12.03	2.43

Source: State Street Global Advisors, BofA. As of 30 September 2023.

Figure 2
**Spread Changes
by Region**

OAS (bps)	Current Level	Δ3m	Δ12m	ΔYTD
Global HY	438	-11	-175	-77
US HY	406	-1	-139	-77
Euro HY	445	-1	-180	-53
EM HY	551	-64	-313	-94

Source: State Street Global Advisors, BofA. As of 30 September 2023.

Figure 3
**Return Breakdown of
Global High Yield**

Returns	3m (%)	6m (%)	12m (%)	YTD (%)
Global HY (\$ Hedged)	0.91	2.51	11.38	5.89
Spread Return	1.31	3.81	9.83	5.11
Treasury Return	-0.40	-1.30	1.55	0.78

Source: State Street Global Advisors, BofA. As of 30 September 2023.

Rates component had been a modest detractor GHY total returns in Q3, driven by higher for longer central bank expectations. Lower quality remained in the lead for YTD in excess return terms (BB: 3.6%, Single-B: 6.2%, CCC & Lower: 9.9%). Except Real Estate (-5.91%), all industries were up in excess returns terms YTD — with the highest from Leisure (8.9%) and Financial Services (6.9%).

Primary market activity picked up near the end of the quarter following a summer lull, with 3Q issuance for US HY at \$44.1bn, compared to an average of \$26.6bn across the 4 quarters of 2022. Year-to-date, US HY gross issuance totals \$136.6bn and EUR HY gross issuance totaled around €46.6bn, and those numbers are ahead of YTD to end September 2022. However, net issuance numbers come out to be much smaller, at \$27.7bn for US HY and €1.5bn for EUR HY.

US HY Realized default rate was 2.5% L12M, and YTD's US HY combined bond and loan total of \$63.2bn defaults/distressed exchanges ranks as the eighth largest annual total on record. European HY defaults have seen a pickup as well from ultra-low levels as well, following a handful of large capital structures defaulting, with L12M par default rate moving to 1.5%. While still below longer-term averages, they have been slowly creeping up ever since 2022 as tight financial conditions push distress up among the most leveraged issuers.

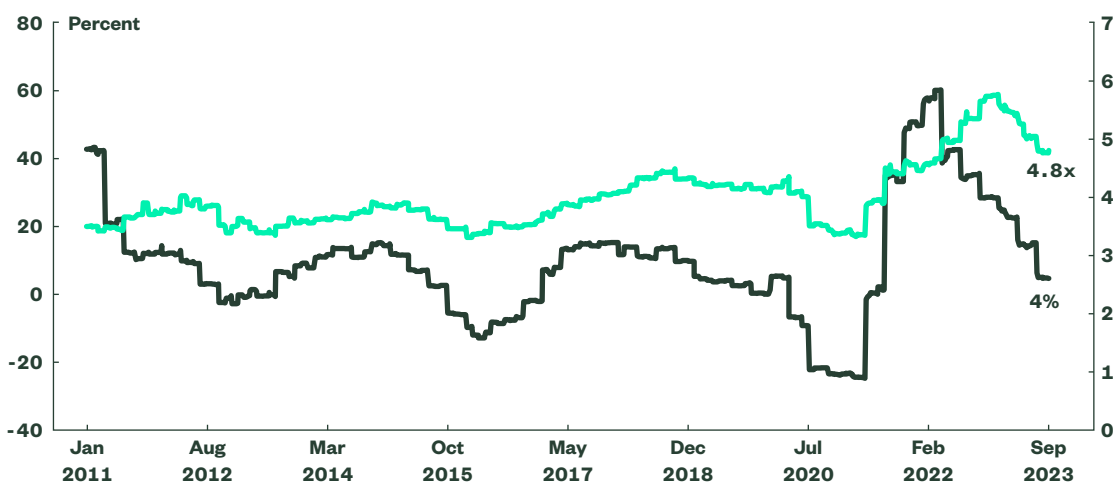
Outlook

The US economy continues to exhibit significant resilience despite the much higher yield environment — and this fading of US recession risk has been a key support for high yield markets this year. In Europe however, the data flow has been more disappointing on aggregate, in particular the weakness in manufacturing data. High-yield investors continue to be faced with a difficult choice of either bracing for impact from a sharp-downturn and giving up carry, or to try and ride the complacently bullish credit market sentiment a while longer. The lateness of this credit cycle, tighter high yield spreads YTD even in the face of more bankruptcies and defaults, rapidly rising funding costs for refinancing issuers, rising headwinds to growth from the stronger USD, higher energy prices, and higher long-end yields — which has already resulted in a significant uptick in bond market volatility (daily absolute % changes) — all make us believe that investors need to be looking for a larger risk premium in terms of spreads as compensation. We believe Global HY is a 'cautious hold/sell on strength' for now — given the risks of an out-of-consensus credit freeze have increased meaningfully, compared to the spread carry (reward) on offer.

Earnings and guidance do remain in a strong state relative to expectations, albeit showing signs of deterioration going into a more challenging economic backdrop. 2.4x US High Yield companies in 2Q beat EBITDA expectations compared to those that missed, and 1.4x companies provided positive earnings guidance, compared to those that guided negatively. L12M EBITDA growth has seen a significant decline to just 4% now, and EBITDA margins have seen an erosion as well, with 2Q numbers coming in at 13.9%, which is below their historical average. Balance sheets remain quite solid — with net leverage now increasing back up from a 11-year low, and at 3.6x, it is still below where it stood pre-pandemic. Same is the case with interest coverage, which decreased -0.25x to 4.8x, but it is coming off 4Q22's record high (5.7x). Similar trends were seen across European issuers as well, with net leverage rising off lows to end at 3.0x, L12M EBITDA growth slowing markedly to 9% in 1Q23 down from 15% in 4Q22 and 31% in 1Q22. Median coverage based on EBITDA declined to 5.2x in 1Q23, the second consecutive fall since a record high of 5.5x in 3Q22.

Figure 4a
Fundamentals Face a Deterioration From Strong Levels, but still Holding Up Well — US HY

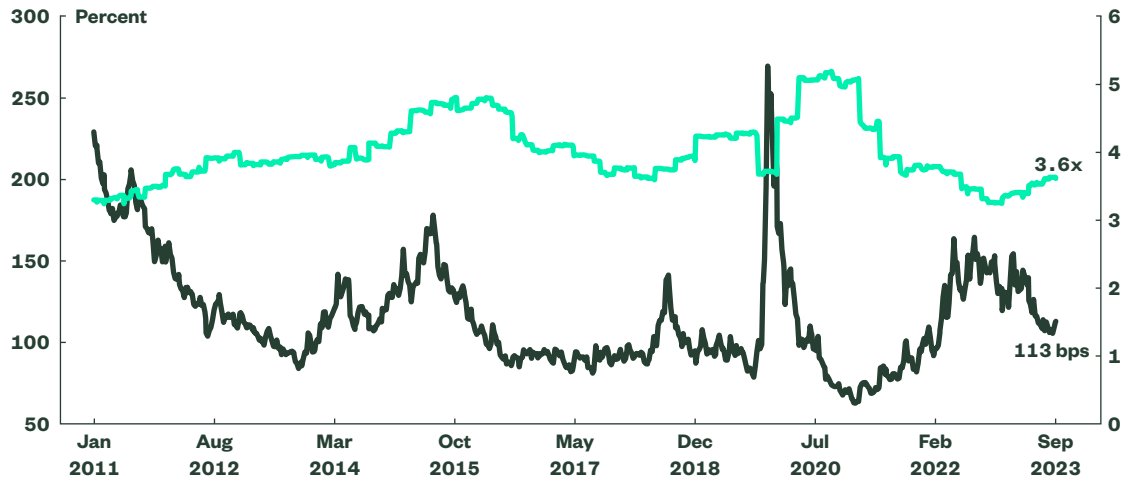
■ EBITDA, L12M % Change
 ■ Interest Coverage Ratio (x) (RHS)



Source: BofA. As of 30 September 2023.

Figure 4b
Fundamentals Face a Deterioration From Strong Levels, but still Holding Up Well — US HY

■ US HY Spread-per-turn, bps/x
 ■ Net Leverage (x) RHS

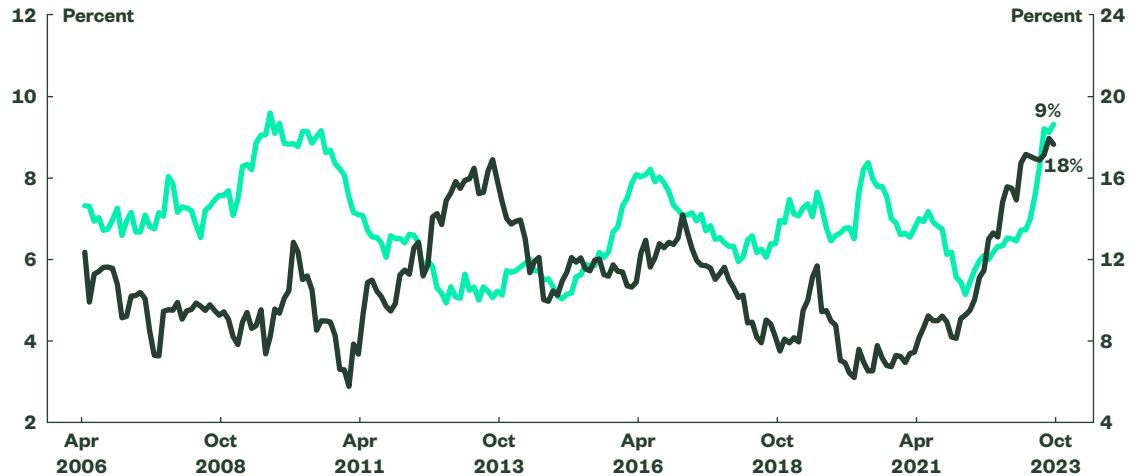


Source: BofA. As of 30 September 2023.

The effect of higher rates hasn't been felt so far in this tightening cycle, as only a small share of HY debt has been reset so far, and there was a quality skew in the issuers who have chosen to reset. Most of the lagged impact is still ahead of us, as more debt in both US and EUR HY comes to reset in coming quarters, and the gap between in-place coupon and refinancing yields has become prohibitive for lower rated borrowers (Figure 5). This lagged impact will force vulnerabilities, particularly if the "higher-for-longer" rates narrative gains ground.

Figure 5a
Cost of Capital to Notch up Significantly for Lower Quality Borrowers
 % of Bonds Maturing in the next 2 Years

■ EUR HY (RHS)
 ■ US HY



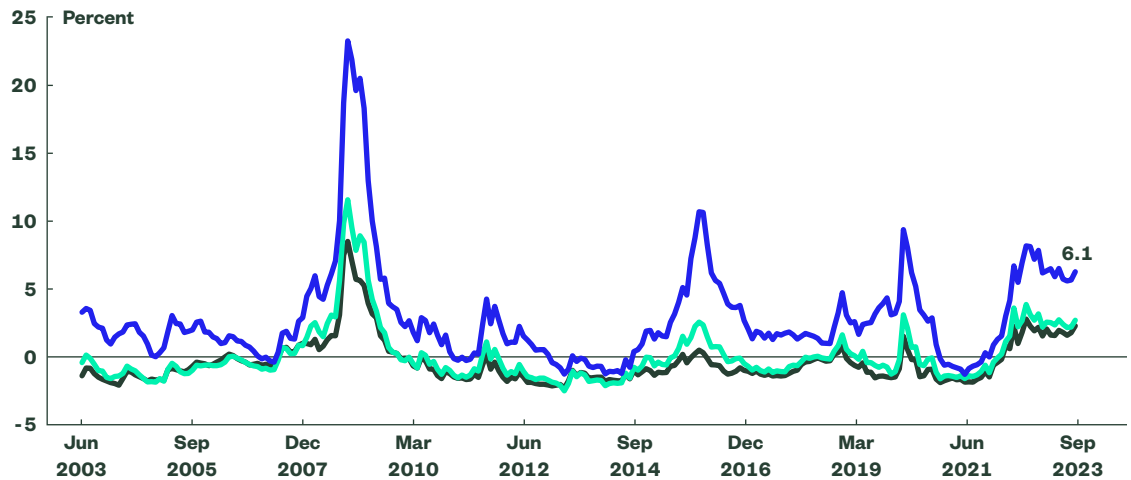
Source: JPM, BofA. As of 30 September 2023.

Figure 5b

Cost of Capital to Notch up Significantly for Lower Quality Borrowers

Refinancing Gap
(% points) — US HY

■ BB
■ B
■ CCC



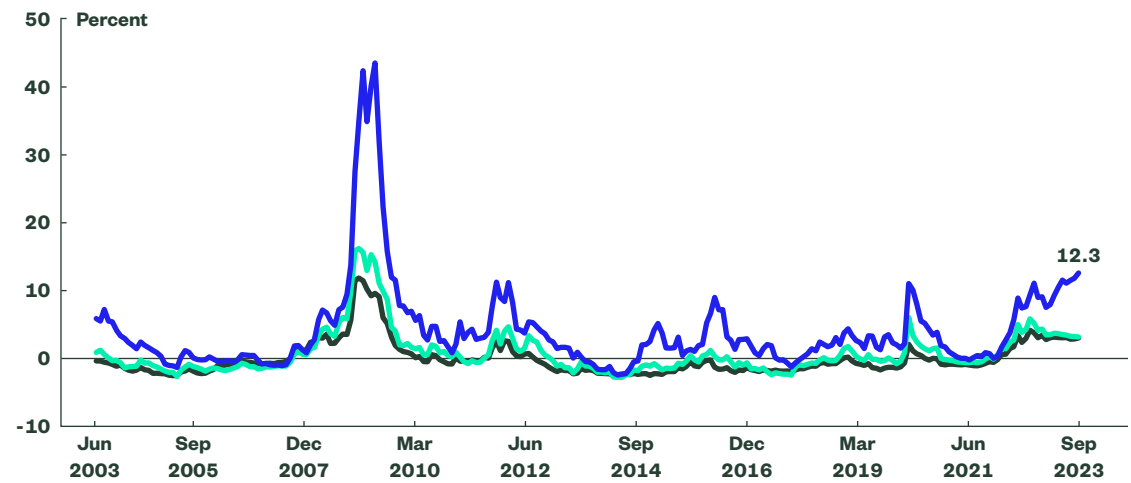
Source: JPM, BofA. As of 30 September 2023.

Figure 5c

Cost of Capital to Notch up Significantly for Lower Quality Borrowers

Refinancing Gap
(% Points) — EUR HY

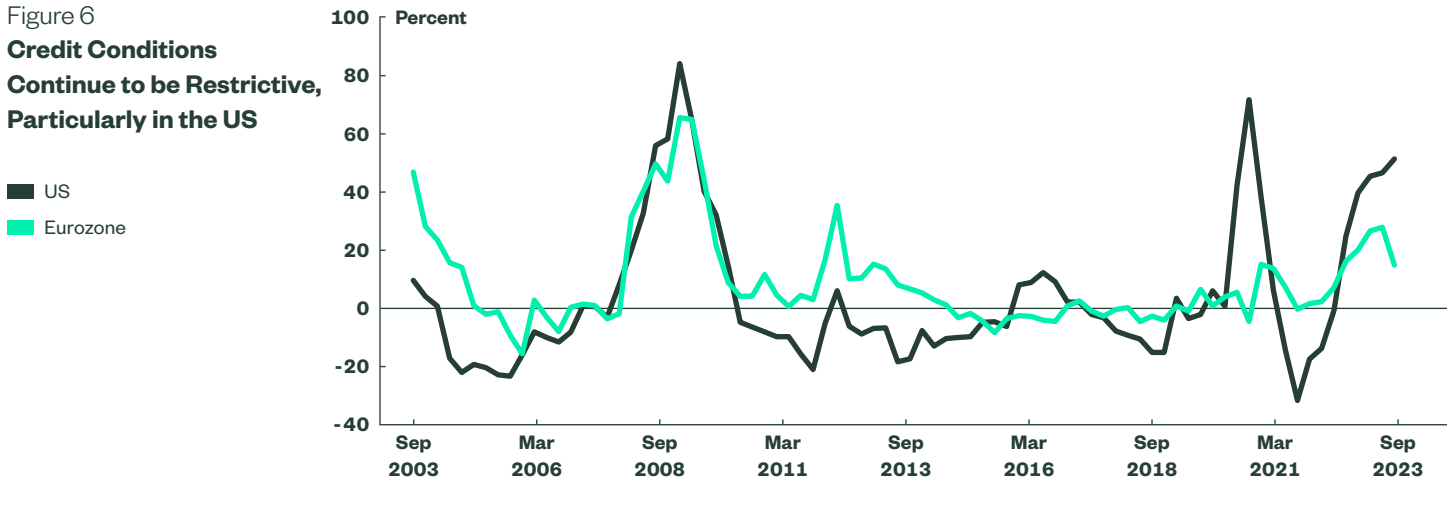
■ BB
■ B
■ CCC



Source: JPM, BofA. As of 30 September 2023.

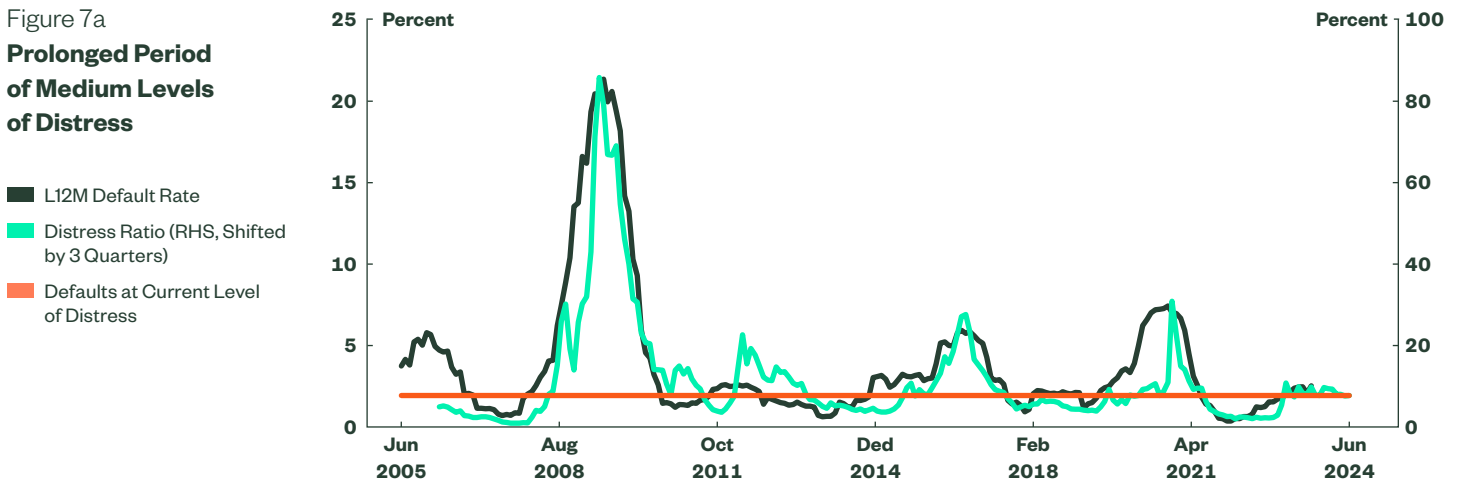
Without a significant, large problem sector in either US or EUR HY, an unambiguous severe downturn in macroeconomic data, or an immediate risk-off trigger shutting down issuer access to primary markets — we don't see cause for default rates to spike up into the mid-to-high single digits, but believe this cycle will carry a lower peak than previous recessions, and will be longer and flatter as the lagged effects of rate hikes and tightening in lending standards (Figure 6) take hold slowly, and maturities come into view. The moderate but steady distress levels of around 7-10% for the last 1 year (Figure 7) corroborates our view and a subjective observation of the default watchlist and the most distressed names, as well as recently increased use of distressed exchanges which can provide some breathing space for borrowers — indicates that the next 12M expected defaults in US HY would be in the 3.0-3.5% range. Even though EUR HY has been a very low default market in the past decade, the pick-up in distress among Real Estate issuers, a sector which has now grown to 4.3% of the euro high yield index by MV% tells us that the next 12M expected defaults in EUR HY would be in the 2.5% range.

Figure 6
Credit Conditions Continue to be Restrictive, Particularly in the US



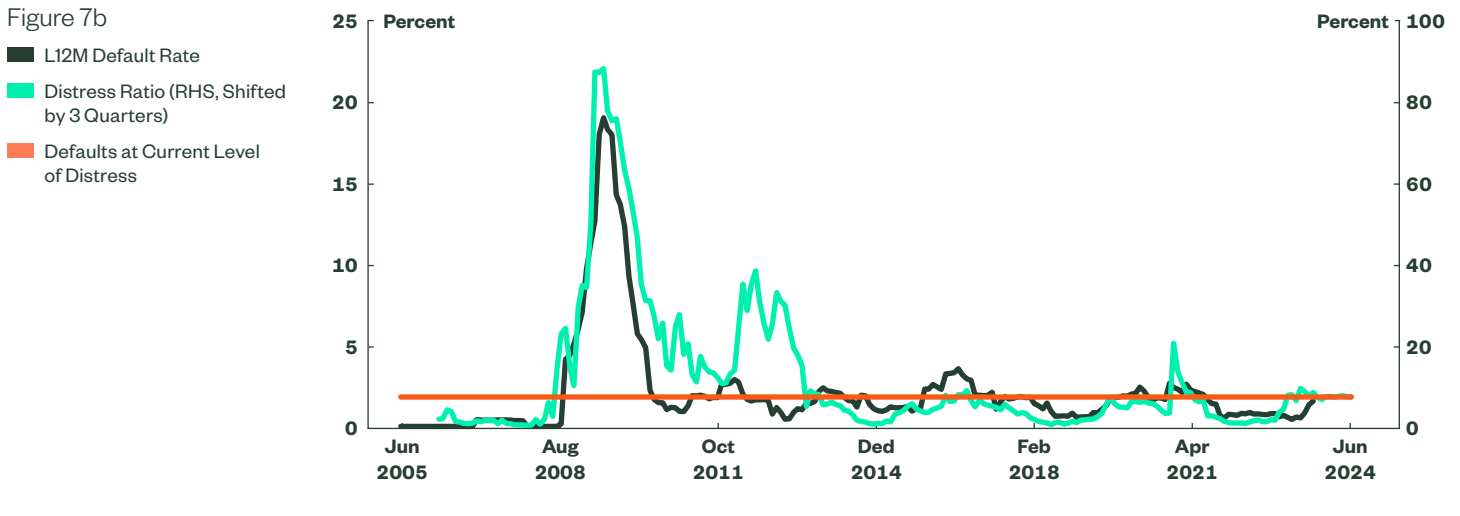
Source: Bloomberg. US depicts: Senior Loan Officer Opinion Survey on Bank Lending Practices for Commercial and Industrial Loans for large and medium firms. Eurozone depicts: ECB Bank Lending Survey for change in Credit Standards Lending to Businesses. As of 30 September 2023.

Figure 7a
Prolonged Period of Medium Levels of Distress



Source: BofA. As of 30 September 2023.

Figure 7b



Source: BofA. As of 30 September 2023.

Rising stars have significantly outpaced fallen Angels YTD in both US (\$69.2 bn vs 4.0 bn) and EUR HY (€18.1 bn vs €6.4 bn), a supportive technical for the market, as it has reduced overall net supply, acting as a cushion for rather weak flows in US HY (-\$14.5bn YTD) and EUR HY (-€78 mm).

Conclusion

Global HY Spreads around 438bps are only at the 37th percentile of all-time, and don't seem outright attractive at these levels — given credit being an asymmetric asset class, there doesn't seem to be enough compensation for probable bearish outcomes. However, reasonably strong starting points of balance sheets in this cycle, improved ratings quality of the asset class compared to history, lack of huge volumes of credit negative transactions — such as new buyouts or dividend recaps this cycle, and all-in yields at around 8.8% — make the bar to withdrawing capital from the asset class high. So, except for yield based long-term total return oriented investors — we would advocate a cautious hold for others already invested, and for investors looking to allocate/increase, we suggest looking for better spread levels, around 500-550 bps. Investment opportunities to deploy capital at better levels do arise frequently as crowded positions get unwound, and sentiment moves around as part and parcel of a normal policy tightening cycle. Investors may consider moving/allocating to up-in-quality such as BB-B rated segments, or liquidity screened segments (versus broad market high yield), depending upon their risk aversion, given the stage of the credit and macroeconomic cycle we are in now.

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* Pensions & Investments Research Center, as of December 31, 2022.

[†] This figure is presented as of September 30, 2023 and includes approximately \$58.13 billion USD of assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated. Please note all AUM is unaudited.

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