

Global High Yield Quarterly

- Data releases corroborating a US soft-landing narrative where growth has been slowing, but still robust enough to avoid an earnings recession, have been supportive for credit.
- The lack of shareholder-friendly excesses and large problem sectors in this cycle, remarkably strong corporate earnings, solid fundamentals and improving credit-lending conditions are all supportive for the high yield asset class to experience a longer, but shallower, defaults cycle.
- Global high yield (GHY) spreads can remain well anchored at the lower ends of the range, even as the market reassesses the prospect of rate cuts. Yields in the range of 7.5% are still at reasonably healthy levels and total return-oriented investors need not position too conservatively.

Performance/ Market Highlights

GHY spreads ended the quarter flat in the wake of softer, but not necessarily weak, economic data (especially in the US), benign inflation prints, light net new issuance and supportive fund flows. The markets have been pricing in a soft-landing macroeconomic scenario throughout this year. A majority of growth assets benefitted from this narrative, led by the S&P 500 which was up by 4.3% in Q2, taking its YTD performance to 15.3%.

Figure 1

Total Returns of High Yield in Recent Periods

Returns	3m (%)	6m (%)	12m (%)	YTD (%)
Global HY (\$ Unhedged)	1.21	2.70	10.62	2.70
Global HY (\$ Hedged)	1.44	3.52	11.44	3.52
Global HY (€ Hedged)	1.05	2.73	9.44	2.73
Global HY (£ Hedged)	1.37	3.39	10.91	3.39
US HY (\$)	1.09	2.62	10.46	2.62
Euro HY (€)	1.48	3.13	10.69	3.13
EM HY (\$)	2.25	6.24	13.09	6.24

Source: State Street Global Advisors, BofA. As of 30 June 2024.

Figure 2

Spread Changes by Region

OAS (bps)	Current Level	Δ3m	Δ12m	ΔYTD
Global HY	338	-3	-111	-46
US HY	321	6	-86	-18
Euro HY	353	-6	-93	-43
EM HY	382	-33	-233	-144

Source: State Street Global Advisors, BofA. As of 30 June 2024.

Figure 3

Return Breakdown of Global High Yield

Returns	3m (%)	6m (%)	12m (%)	YTD (%)
Global HY (\$ Hedged)	1.44	3.52	11.44	3.52
Spread Return	0.72	3.01	7.45	3.01
Treasury Return	0.72	0.51	3.99	0.51

Source: State Street Global Advisors, BofA. As of 30 June 2024.

Total returns were split equally between the rates and the credit spread component — with treasury yields higher due to an increase in political risk in Europe (France) and an unclear direction of fiscal policy in the US. Lower quality maintains a slight lead for the year in excess return terms (BB: 2.9%, Single-B: 2.5%, CCC & Lower: 4.2%). All industries except Telecom and Media were up on the year in excess return terms — with the highest from Real Estate (8.0%), which saw a bounce back from 2023's sharp underperformance, and Retail (5.0%).

Gross issuance in Q124 for US HY totaled \$77.9bn, and for EUR HY they totaled €38.5bn — a reasonably strong quarter, with the most two quarters of active primary market activity since mid-2021. Refinancing activity led the use of proceeds though, with net issuance numbers at \$11.1bn for US HY and €8.0bn for EUR HY.

US HY realized default rate was 2.0% L12M, and in 2Q24 defaults totaled \$4.1bn of bonds, lower than last quarter's tally of \$5.6 bn. European HY defaults saw the L12M par default rate moving above US HY for the first time this cycle to 2.1%, with €3.2 bn of defaults rolling off over the quarter.

Rising stars have significantly outpaced so-called fallen angels in Q2 (US HY \$5.4 bn vs 1.8 bn), a supportive technical for the market, as it has reduced overall net supply, acting as an additive to reasonably healthy flows in US HY (+5.5bn YTD).

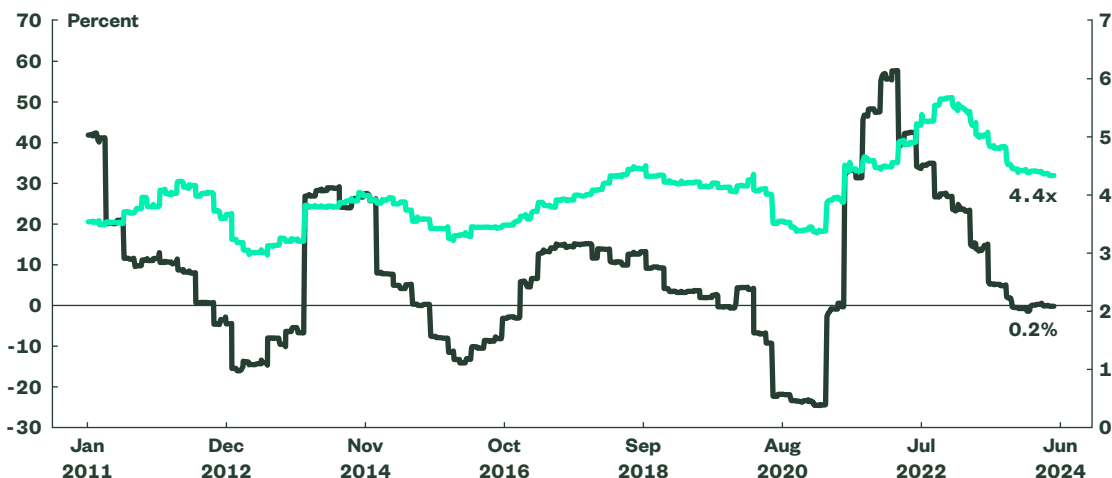
Outlook

The global macro backdrop remains quite supportive for high yield - with gradually slowing growth, and moderating inflation across most major regions. US growth is expected to downshift to 1.6% quarter-over-quarter in Q3 and Q4, with a slight uptick in unemployment to 4.1%, a core PCE moderating to 2.7% and the Fed going ahead with one or two cuts in the second half of the year. The outlook for the eurozone is brightening as well, with a cyclical upswing in GDP growth expected in the latter half supported by robust household savings, low unemployment and the ECB which has started easing already.

High yield companies delivered strong earnings and positive guidance in 1Q23, with 3.5x High Yield companies beating EBITDA expectations as missed, and in terms of fundamentals, HY balance sheets in 1H have held up well, with the pace of deterioration from a strong position slowing down. L12M EBITDA growth has declined, but is still close to zero, rather than the typical negative teen numbers seen in a slowdown, and EBITDA margins have been stable. Net leverage is firm at 3.7x, off a record low (3.3x) albeit still below where it stood pre-pandemic, and the long-term average (4.0x). While the interest coverage ratio has declined to 4.4x, coming quickly off 4Q22's record high (5.7x), it is much higher compared to historical levels and has held up better than expected. Similar trends were seen across European issuers as well, with gross leverage of 3.4x and net leverage at 2.0x near cycle lows. Cash/debt for the median HY issuer reached back a post-Covid high of 28.0%, only 0.3 percentage points below the all-time high. Coverage ratios remain at high levels as well, with the EBITDA based ratio at 5.2x, despite growing interest expenses, as they are offset with continued earnings growth.¹ (Source: JPM, Morgan Stanley).

Figure 4a
The Deterioration in Fundamentals From Strong Levels Has Slowed — US HY

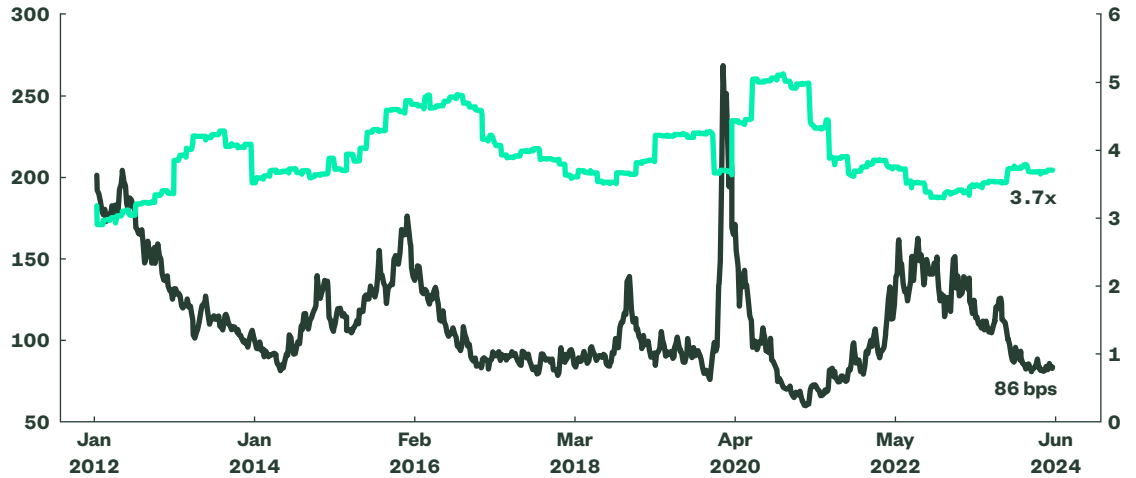
■ EBITDA, L12M % Change
 ■ Interest Coverage Ratio (x) (RHS)



Source: State Street Global Advisors, BofA. As of 30 June 2024.

Figure 4b
The Deterioration in Fundamentals From Strong Levels Has Slowed — US HY

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

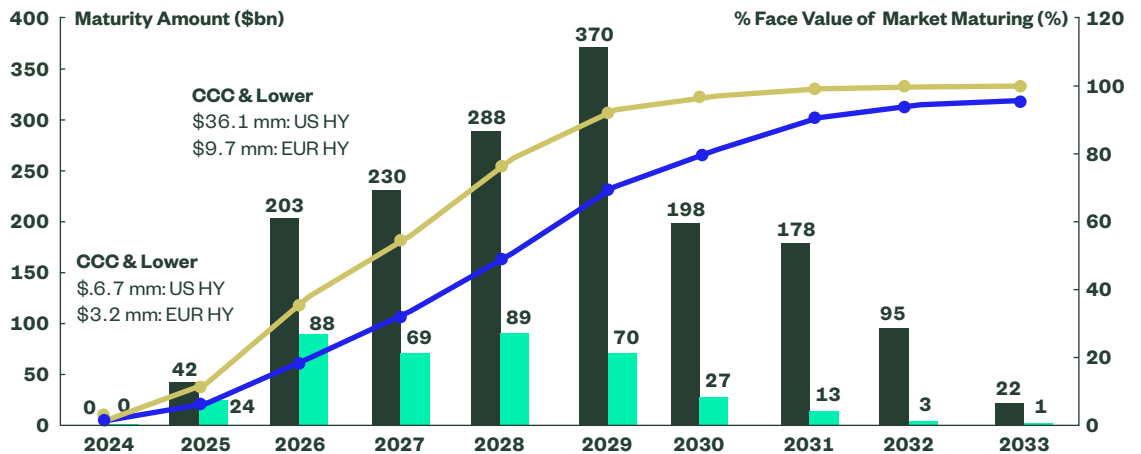


Source: State Street Global Advisors, BofA. As of 30 June 2024.

Capital markets saw busy refinancing activity from issuers in 2024, who slowly got to terms with the higher for longer narrative, and a need to address near-term maturities. Bonds maturing in the years 2025 & 2026 were reduced by more than 50% from the end of 2022, with most of the refinancing activity having taken place in the higher-rated segments first, but recently B3 or lower rated issuers have been active as well. This trend is set to continue throughout the year, as the market's acceptance of slower interest rate cuts is offset by tighter spreads. The in-place refinancing gap (yield minus current coupon) has come down for both US HY and Euro HY, but the overall market has become sharply bifurcated recently — as both the gap between the widest and tightest cohorts of the market, and dispersion within the distressed segment has grown.

Figure 5a
Divergence in Cost to Refinance for Lower Quality Issuers Between US and Europe

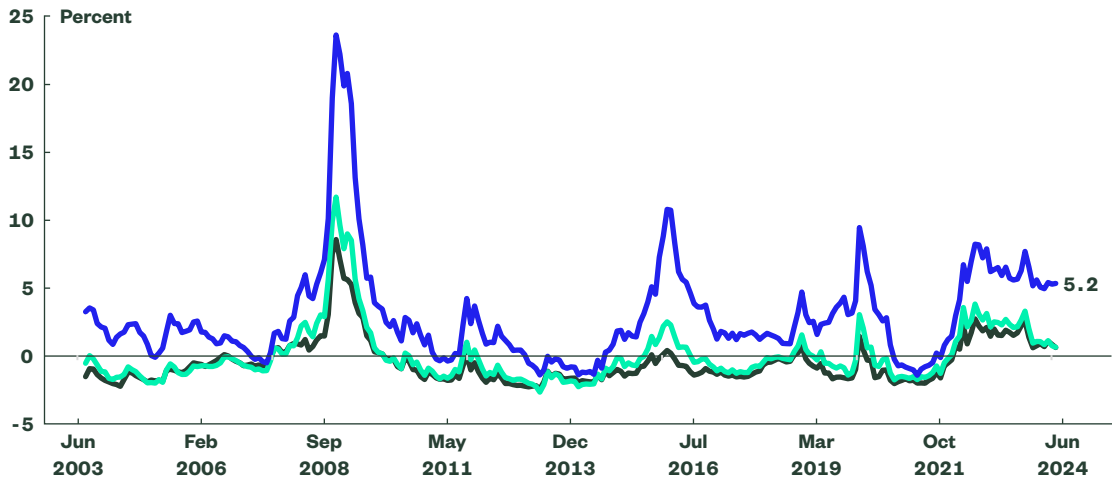
■ USD
 ■ EUR
 ■ % USD
 ■ % EUR



Source: State Street Global Advisors, BofA. As of 30 June 2024.

Figure 5b
Divergence in Cost to Refinance for Lower Quality Issuers Between US and Europe
 Refinancing Gap (% points)
 — US HY

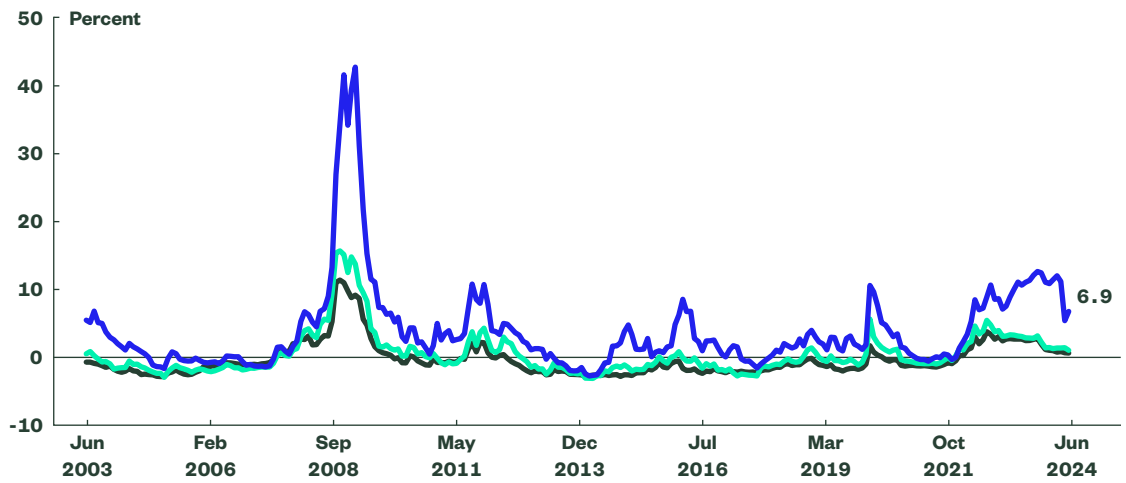
■ BB
 ■ B
 ■ CCC



Source: State Street Global Advisors, BofA. As of 30 June 2024.

Figure 5c
Divergence in Cost to Refinance for Lower Quality Issuers Between US and Europe
 Refinancing Gap (% Points)
 — EUR HY

■ BB
 ■ B
 ■ CCC



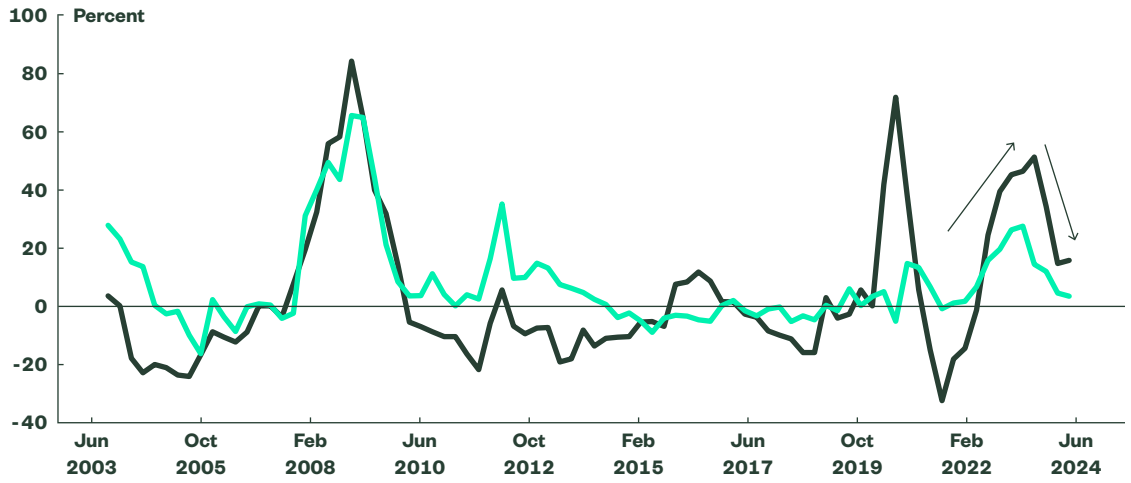
Source: State Street Global Advisors, BofA. As of 30 June 2024.

Without a severe downturn in macroeconomic data, broadening access to capital and easing credit conditions (Fig 6), healthy balance sheets and conservative positioning by investors, 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. The moderate but steady distress levels of around 7–8%, which has persisted even through the recent rally (Fig 7) corroborates our view, and a subjective observation of the default watchlist and the most distressed names — indicates that the next 12M expected defaults in US HY would be in the 3.0% range. Even though EUR HY has been a very low default market in the past decade, the presence of a small number of larger distressed capital structures as well as a handful of real estate names which face headwinds from elevated energy and construction costs and increasingly expensive financing, tells us that the next 12M expected defaults in EUR HY could be in the 2.0% range.

Figure 6
Credit Conditions and Overall Lending Appetite Has Reversed From Being Too Restrictive

% of Banks Tightening Standards for Corporate Loans

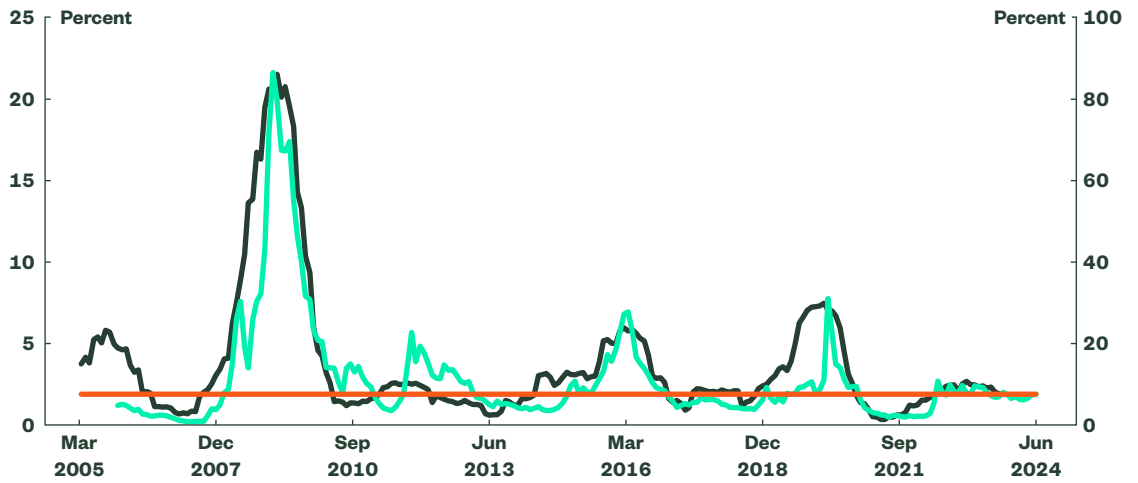
■ US
 ■ Eurozone



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 June 2024.

Figure 7a
Prolonged Period of Medium Levels of Distress
 US High Yield

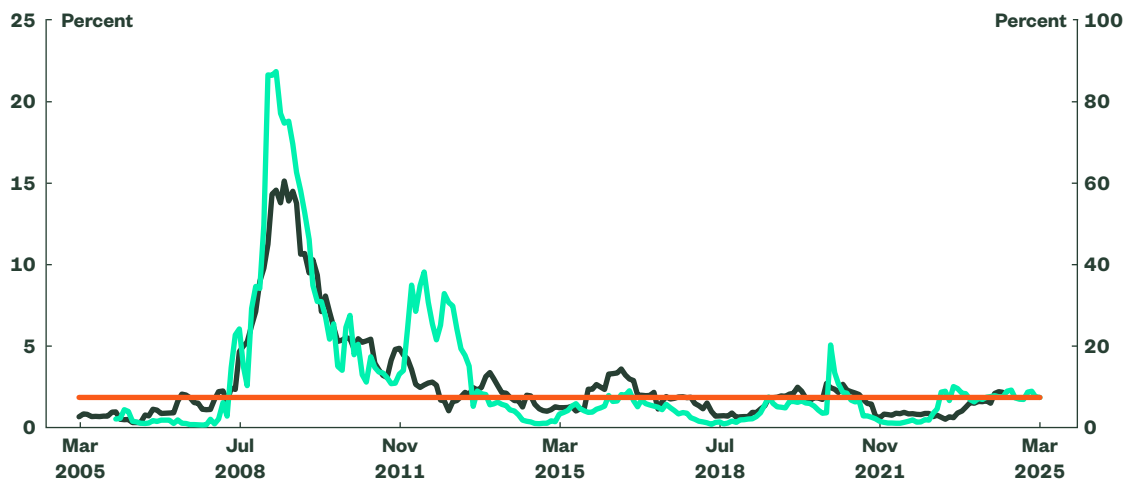
■ L12M Default Rate
 ■ Distress Ratio (RHS, Shifted by 3 Quarters)
 ■ Defaults at Current Level of Distress



Source: State Street Global Advisors, BofA. As of 30 June 2024.

Figure 7b
Prolonged Period of Medium Levels of Distress
 EUR HY

■ L12M Default Rate
 ■ Distress Ratio (RHS, Shifted by 3 Quarters)
 ■ Defaults at Current Level of Distress



Source: State Street Global Advisors, BofA. As of 30 June 2024.

The biggest near-term risk to GHY now is a material slowdown in growth or inflation, unwinding the goldilocks outcome for 2024 that markets had priced in, but the probability of that seems to be quite low, given the direction of recent data releases. GHY spreads of 338bps alone, are close to its richest decile and don't seem to compensate enough for probable bearish outcomes. However, reasonably strong starting points of balance sheets, 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, good retail inflows and all-in yields at around 7.5% do provide reasons to attract total return-oriented investors.

Conclusion

GHY is in a balanced territory now, where still reasonably high yields offer a decent amount of carry and rolldown given the index's short duration — but there is not a lot of excess risk premium in spreads, that would lay the stage for a subsequent outsized spread-return performance. Markets looking forward to positive economic impacts of the upcoming rate cuts — and growth which doesn't slow down too much to materially affect earnings estimate — are good for high yield to continue to give out coupon like returns in this environment. 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 that a shallower-than-expected easing path delays balance sheet repair for lower-rated capital structures, as well as lower recoveries expected from distressed exchanges.

Endnote

1 Source: JPM, Morgan Stanley.

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* Pensions & Investments Research Center, as of December 31, 2023.

[†] This figure is presented as of June 30, 2024 and includes ETF AUM of \$1,393.92 billion USD of which approximately \$69.35 billion USD is in gold 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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