Insights
Fixed Income

February 2024

Global High Yield — 2023 in Review

- A combination of global inflation showing signs of cooling, better-than-expected corporate earnings, and an apparent end to DM hiking cycles saw Global High Yield return in the low teens for 2023.
- Even with a refinancing wave coming, lack of large problem sectors and the presence of a private credit backstop make us expect a longer, but shallower defaults cycle this time, with N12M expected defaults for US HY at 3.0–3.5%, and EUR HY at 2.0–2.5%.
- At 384 bps at the end of the year, GHY spreads are now quite rich and leave little cushion for downside outcomes — so, use rally in November and December to take profits. Yields at 7.5% are still at reasonably healthy levels and total-return-oriented investors need not position too conservatively.

Performance/ Market Highlights

Global High Yield spreads ended the quarter tighter by 54 bps in the wake of resilient economic data, a dovish pivot by the Fed, a strong rally in DM equities, a continued decline of the 10yr US Treasury yield off its highs, and the VIX dropping below 15. Over the year, spreads tightened by 131 bps overall, as concerns earlier in the year about US regional banks' frailties and worries of a synchronised DM recession retreated — and successive prints of declining inflation data, dovish central bank rhetoric, and still resilient growth — caused investors to price-in an earlier and more aggressive easing from DM central banks in 2024 and increased probability of a soft-landing outcome.

Figure 1
Total Returns of High Yield in Recent Periods

Returns	3m (%)	6m (%)	12m (%)	YTD (%)
Global HY ($ Unhedged)	7.61	7.71	13.41	13.41
Global HY ($ Hedged)	6.68	7.65	12.97	12.97
Global HY (€ Hedged)	6.09	6.52	10.35	10.35
Global HY (£ Hedged)	6.41	7.27	11.92	11.92
US HY ($)	7.07	7.64	13.47	13.47
Euro HY (€)	5.56	7.33	12.01	12.01
EM HY ($)	6.19	6.45	8.76	8.76

Source: State Street Global Advisors, BofA. As of 31 December 2023.

Figure 2
Spread Changes by Region

OAS (bps)	Current Level	Δ3m	Δ12m	ΔYTD
Global HY	384	-54	-131	-131
US HY	339	-67	-144	-144
Euro HY	396	-49	-102	-102
EM HY	526	-25	-119	-119

Source: State Street Global Advisors, BofA. As of 31 December 2023.

Figure 3
Return Breakdown of Global High Yield

Returns	3m (%)	6m (%)	12m (%)	YTD (%)
Global HY ($ Hedged)	6.68	7.65	12.97	12.97
Spread Return	2.82	4.20	8.28	8.28
Treasury Return	3.86	3.45	4.69	4.69

Source: State Street Global Advisors, BofA. As of 31 December 2023.

Both the rates component and the spread component aided total returns both in Q4 and the year 2023, as a powerful Q4 rally in rates flipped back losses over the summer. Lower quality maintained its lead for the year in excess return terms (BB: 6.6%, Single-B: 9.5%, CCC & Lower: 13.3%). All industries except one, were up on the year in excess return terms — with the highest from Leisure (12.4%) and Retail (11.3%). The outlier was Real Estate (-4.4%), which had been hit by some names in China's property sector melt-down, as well as the recent higher interest rate environment.

Gross issuance in 2023 for US HY totaled $174.7bn, and for EUR HY they totaled €48.0bn — even though these numbers are ahead of equivalent 2022 values, it has been a below average year for primary market activity, if we look at past 5 years. Net issuance numbers come out to be even smaller, at $56.2bn for US HY and €3.0bn for EUR HY.

US HY Realized default rate was 2.4% L12M, and YTD's US HY combined bond and loan total of $83.7bn defaults/distressed exchanges ranks as the fourth largest annual total on record. European HY defaults have seen a pickup from ultra-low levels as well, following two large capital structures defaulting, and some distressed exchanges — 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 impact of tighter financial conditions push distress up among the most leveraged issuers.

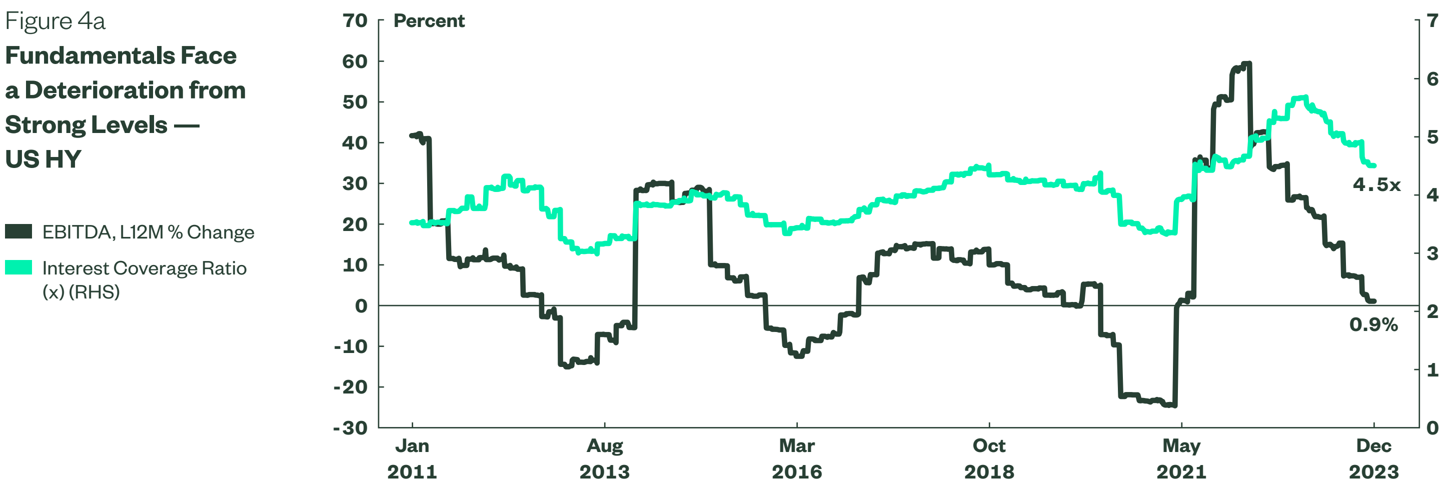
Rising stars have significantly outpaced fallen Angels YTD in both US ($124.7 bn vs 14.2 bn) and EUR HY (€23.2 bn vs €7.1 bn), a modestly supportive technical for the market, as it has reduced overall net supply, acting as a cushion for rather weak flows in US HY (-$7.9bn YTD) and flat flows in EUR HY (+€1.7 bn YTD).

Outlook

With no clear indications of a traditional US recession (involving a big rise in unemployment and a fall in consumer spending) in sight, and given the unusual nature of this cycle whereby inflation has already slowed much more than wage growth, nudging central banks on to the path of earlier/faster rate cuts — we believe that the macro backdrop is quite benign.

In terms of fundamentals, HY balance sheets in 3Q have started to show slow signs of deterioration from a strong position. L12M EBITDA growth has seen a significant decline to just under 1% now, and EBITDA margins have seen an erosion as well. Net leverage at 3.7x is now off a record low (3.3x) albeit still below where it stood pre-pandemic, and the long-term average (4.0x). Growth in interest expense has led to a continued decline in coverage ratios to 4.5x, coming quickly off 4Q22's record high (5.7x). Similar trends were seen across European issuers as well, with the interest/debt ratio for the median EUR HY issuer reaching 5.8%, the highest reading since 2016. Coverage ratios for the median issuer declined as well by 0.4x qoq, to 4.7x, respectively, with an increasing portion of HY issuers reporting deteriorating metrics versus last year. (Source: BofA, Morgan Stanley).

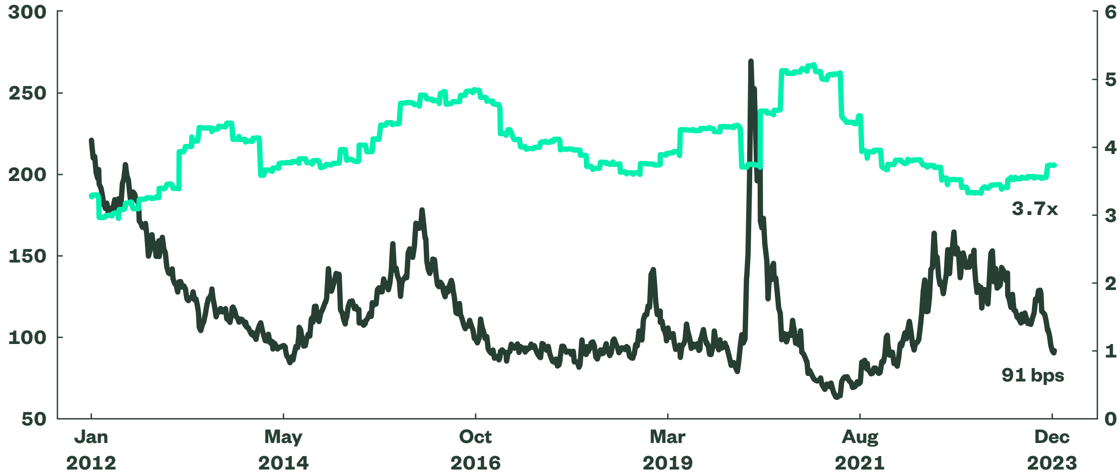
Figure 4a
Fundamentals Face a Deterioration from Strong Levels — US HY



Source: BofA. As of 31 December 2023.

Figure 4b

Fundamentals Face a Deterioration from Strong Levels — US HY



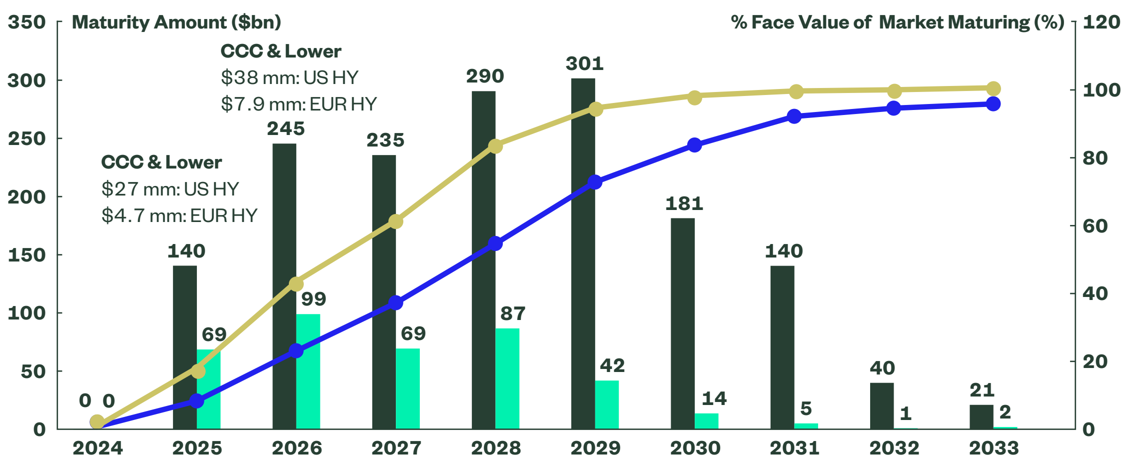
Source: BofA. As of 31 December 2023.

A reasonably strong summer for primary market activity this year saw some 2024 and 2025 maturities being addressed, but a bulk is still ahead of us with a significant % of Global HY debt set to retire by 2025 and 2026 ($553 bn of global HY), which may prompt imminent refinancings as 2025 maturities will go current on balance sheets this year, and issuers typically prefund 12- to 18- months before maturity. In contrast to what we've experienced in 2023, when corporates had some time-cushion to wait for a period of lower costs, the impending maturity hurdle suggests that they may be more compelled to act this time around. Even though the market has been willing to fund companies at high coupons as long as there is no credit freeze, higher funding costs (even as softer data and more dovish Fed commentary has convinced markets that borrowing costs will fall into next year, it remains unlikely that rates will return to the sub-3% average (on the US 10y) we've seen since the GFC) and refinancing needs will keep the default cycle longer but less intense, as the growth in private credit in this cycle has proved to be an important buffer/backstop — especially for weaker-quality companies, given the certainty of execution and flexibility in debt structuring there.

Figure 5a

Cost of Capital to Go Up, Particularly for Lower Quality Borrowers

Sizable Portion of the HY Market is Set to Mature in 2025 and 2026



Source: JPM, BofA. As of 31 December 2023.

Figure 5b

Cost of Capital to Notch up Significantly for Lower Quality Borrowers

% of Bonds Maturing in the next 2 Years Compared to History

EUR HY (RHS)

US HY

Source: JPM, BofA. As of 31 December 2023.

Figure 5c

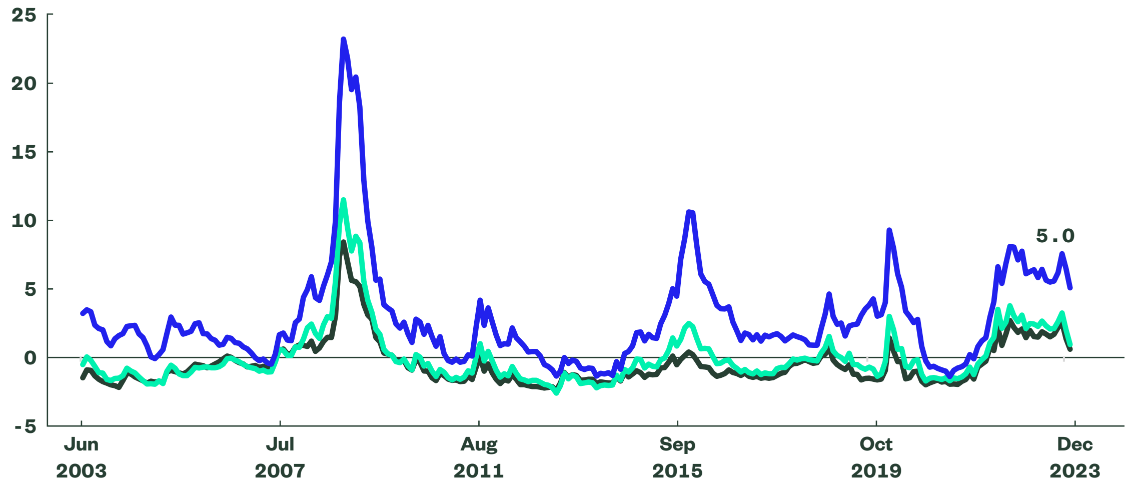
Cost of Capital to Notch up Significantly for Lower Quality Borrowers

Refinancing Gap (% points) — US HY

BB

B

CCC



Source: JPM, BofA. As of 31 December 2023.

Figure 5d

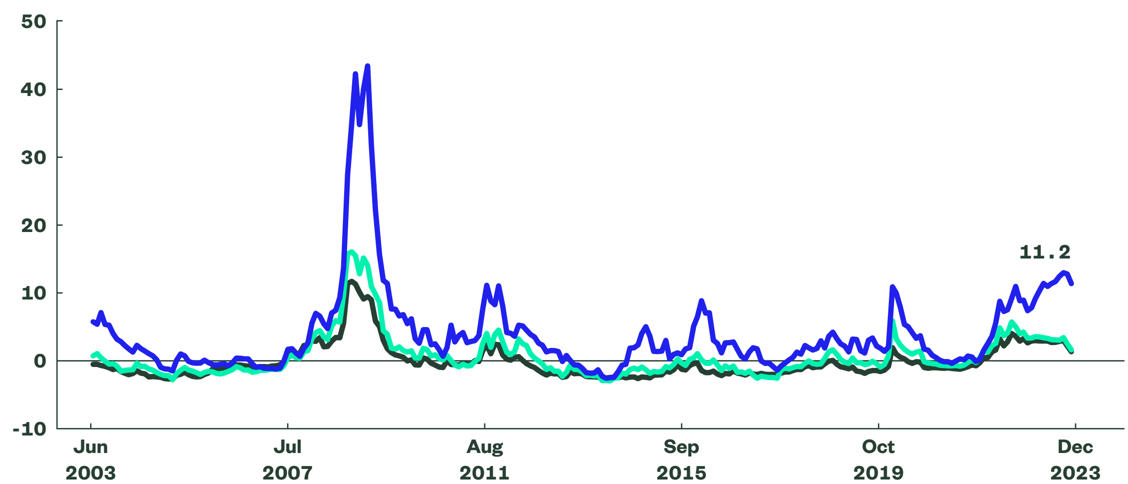
Cost of Capital to Notch up Significantly for Lower Quality Borrowers

Refinancing Gap (% Points) — EUR HY

BB

B

CCC

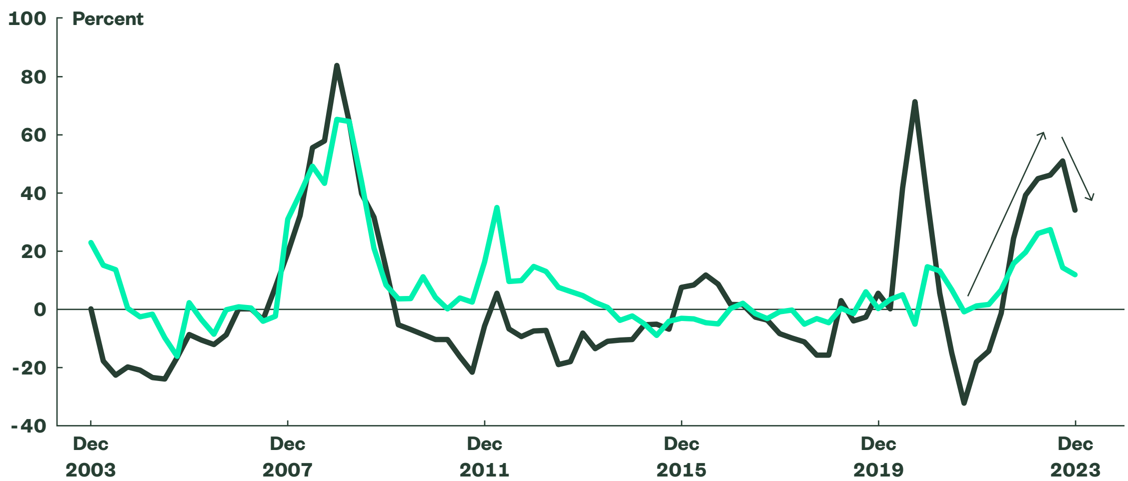


Source: JPM, BofA. As of 31 December 2023.

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. The moderate but steady distress levels of around 7–10% through 2023, 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 3.0–3.5% 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% of the euro high yield index by MV% tells us that the next 12M expected defaults in EUR HY could be in the 2.0–2.5% range.

Figure 6
Credit Conditions and Overall Lending Appetite Still Restrictive
% of Banks Tightening Standards for Corporate Loans

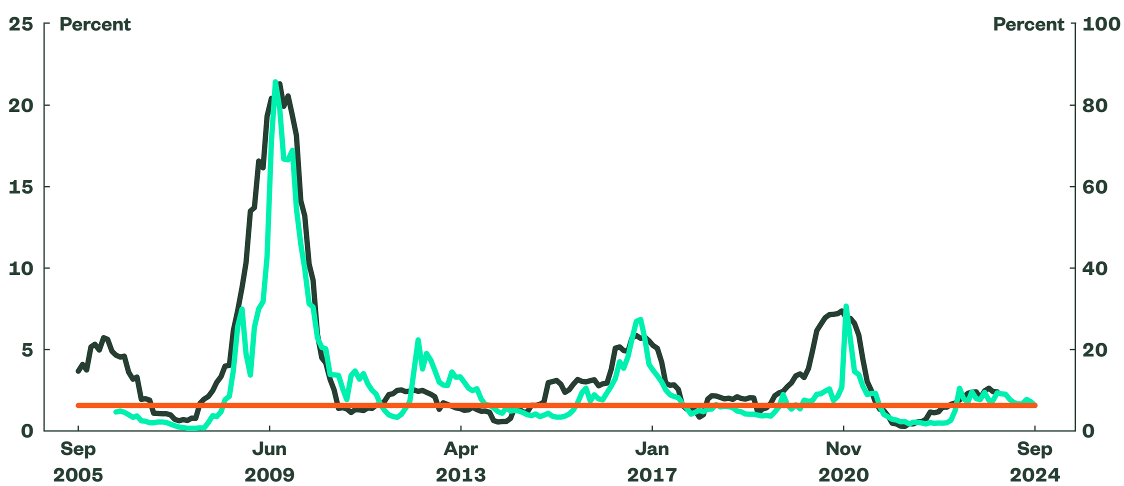
US
Eurozone



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 31 December 2023.

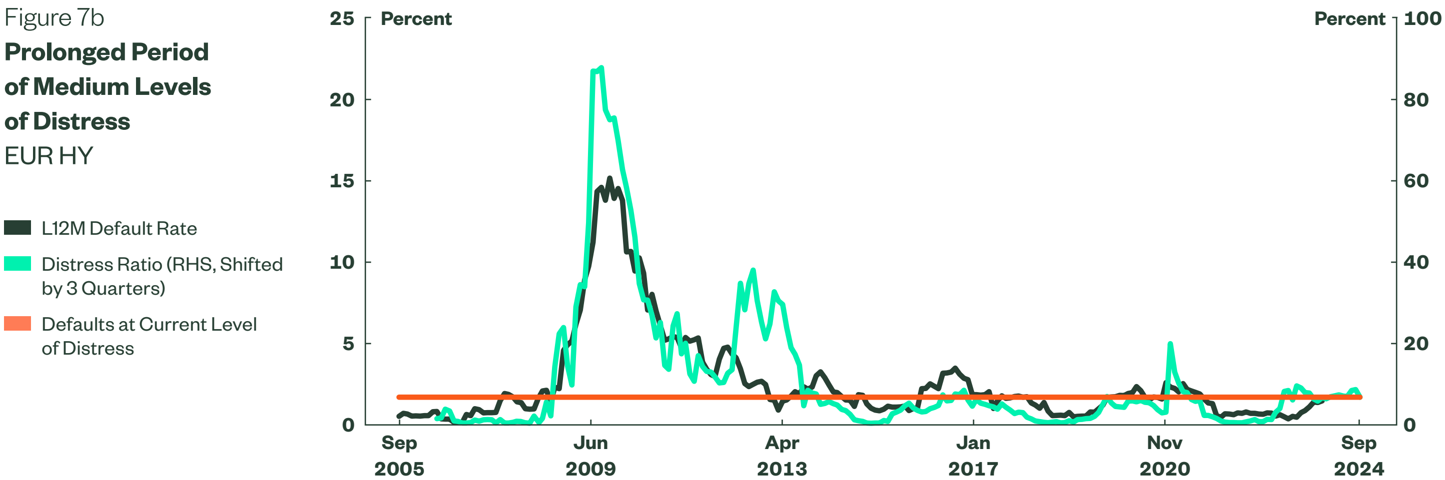
Figure 7a
Prolonged Period of Medium Levels of Distress
US High Yield

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



Source: BofA. As of 31 December 2023.

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



Source: BofA. As of 30 September 2023.

The biggest near-term risk to Global High Yield now is from an unwinding of the perfect goldilocks outcome for 2024 that markets had priced in. This is particularly relevant, given recent propensity for elevated cross-asset correlations (rates and spreads moving in tandem). Global HY spreads of 384bps are only at the 22nd percentile of all-time, and spreads alone seem rich and don't seem to compensate enough 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 7.5% do provide reasons to attract total return-oriented investors. Existing investors may be better off tactically taking profits after the rally in November and December and moving to cash, and new investors are recommended to wait for better entry points into the asset class, when sentiment and positioning is less stretched.

Conclusion

With the strong rally in November and December, Global HY seems to have moved over into a territory of delicate balance where still reasonably high yields offer a decent amount of carry and rolldown given the index's short duration — but a combination of the lateness of the credit cycle dynamics, pressure to refinance which would remain a drag on balance sheet liquidity, weakening credit metrics and tight spreads might mean the return from carry and roll may not be sufficient to offset drawdowns from a wider spread and higher rate environment — which can materialise due to a high degree of uncertainty surrounding the economic outlook, as well as any unexpected threat in inflation's progress towards central bank targets. We recommend taking profits/waiting in cash to deploy capital into HY at better spread levels, at this stage-for taking cyclical risk.

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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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