Commentary
Fixed Income

Q1 2023

Global High Yield Quarterly

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- A volatile quarter in which GHY showed remarkable resilience, helped by a strong tailwind from rates.
- Even as regional bank stress and contagion appears to have been avoided, credit tightening in the medium term remains a concern.
- Fundamentals, defaults, distress, and dispersion all worsening at the margin — with central banks not likely to ease, as inflation remains sticky at fairly high levels.
- Spreads are not excessively cheap, but it is expensive to be underinvested in a short-duration asset class yielding 8.5%.

Performance/ Market Highlights:

Global High Yield spreads ended the quarter tighter by 14 bps, even amidst significant volatility. High yield started 2023 on a strong note with receding near-term recession risks, improved capital market access and strong seasonality. However, March saw turmoil in the US regional and European banking sectors — which led to a surge in rate volatility, outflows from a sharp risk-off turn, and a stall in capital market activity.

Even though quick action by governments and central banks alleviated fears of a broader contagion, investor focus eventually shifted from systemic banking risks to the longer-term implications on growth from eventual credit tightening from banks.

Figure 1
Total Returns of High Yield in Recent Periods

Returns	3m (%)	6m (%)	12m (%)	YTD (%)
Global HY (in $ terms)	3.59	10.80	-4.35	3.59
Global HY ($ -Hedged)	3.30	8.65	-3.13	3.30
Global HY (€ -Hedged)	2.59	7.00	-5.93	2.59
US HY (in $)	3.72	7.84	-3.58	3.72
Euro HY (in €)	2.65	7.46	-4.51	2.65
EM HY (in $)	1.63	11.16	-3.58	1.63

Source: State Street Global Advisors, BofA. As of 31 March 2023. **Past performance is not a reliable indicator of future performance.**

Figure 2
Spread Changes by Region

OAS (bps)	Current Level	Δ3m	Δ12m	ΔYTD
Global HY	501	-14	89	-14
US HY	460	-23	116	-23
Euro HY	474	-24	74	-24
EM HY	681	36	13	36

Source: State Street Global Advisors, BofA. As of 31 March 2023. **Past performance is not a reliable indicator of future performance.**

Figure 3
Return Breakdown of Global High Yield

Returns	3m (%)	6m (%)	12m (%)	YTD (%)
Global HY ($ -Hedged)	3.30	8.65	-3.13	3.30
Spread Return	1.20	5.79	-0.82	1.20
Treasury Return	2.10	2.87	-2.31	2.10

Source: State Street Global Advisors, BofA. As of 31 March 2023. **Past performance is not a reliable indicator of future performance.**

The rates component was a significant aid for GHY total returns in Q1, on the back of a flight to quality into treasuries, and the recalibration of Fed hike expectations. In excess-return terms, lower quality remains in the lead YTD, despite losses in March (BB: 0.66%, Single-B: 1.66%, CCC & Lower: 2.59%). Except for Banking (-0.31%), Media (-1.11%) and Telecom (-0.3%), all industries saw positive excess returns.

Primary market activity collapsed near the latter part of the quarter after seeing a sharp surge in January. Year-to-date, US HY issuance totals $40.5bn and EUR HY issuance totaled around €14.6bn, and those numbers were in the same ballpark as those seen in YTD22 also. US HY saw significant outflows of around -$17.3 bn, of which around -$11 bn came from ETFs, a record high for US ETF outflows in 1Q. EUR HY saw neutral/modestly positive inflows in Q1, at just +€0.9bn.

US HY realized default rates have risen from cycle lows to 1.9% L12M, and 1Q's US HY default/ distressed volumes of $20.6bn already accounts for 43% of 2022's total, and has crossed 2021's full-year 14-year low of $13.9bn. European HY defaults haven't seen a pickup, reflecting the small size of defaulting capital structures, as well as base effects from a year ago, with L12M par default rate still at just 0.5%.

Outlook

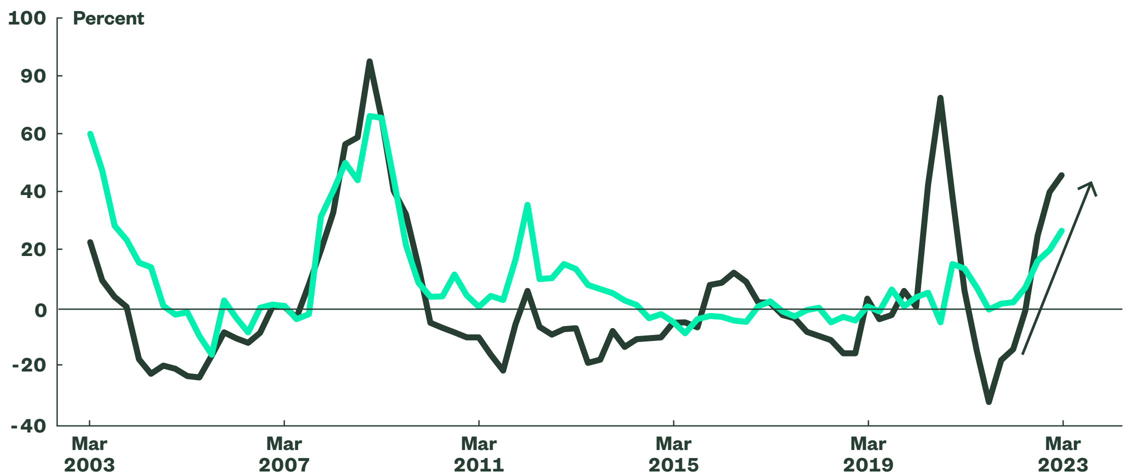
With market consensus shifting back and forth between narratives rapidly in recent months, correctly timing entry into high yield and being nimble has been crucial. From pricing in a 'mild global recession' during 4Q22, markets have sequentially priced in an increased probability of a 'soft landing', and until two weeks ago a 'hard/no landing' scenario. High-yield investors face a difficult choice of either positioning for an imminent recession and giving up carry, or to try and ride the still-low default environment a while longer.

The speed at which systemic vulnerabilities in the banking sector arose, uncertainty around the lagged effects of policy tightening on growth, as well as the lateness of this cycle — which has already started to translate into a noticeable inflection upwards in default rates — justifies investors looking for a larger risk premium than before. With recent upside surprises on inflation in the US and euro area, central banks would likely find it difficult to back away from further rate hikes, let alone cut policy rates, increasing risks of a more front-loaded slowdown in growth.

While tail risks related to the banking crisis have receded, the developments have resulted in a rethink of banks' cost of capital, particularly for mid-cap banks. This regulatory and investor scrutiny of bank fundamentals would lead to them tightening credit conditions and shoring up liquidity to make sure their capital position is robust. This tightening in lending standards, which had started even before the banking crisis (Fig 4), in turn will slow growth and weigh disproportionately on the high yield market segment characterized by smaller, lower-quality borrowers.

Figure 4
Sharp Tightening in Credit Conditions

US
Eurozone



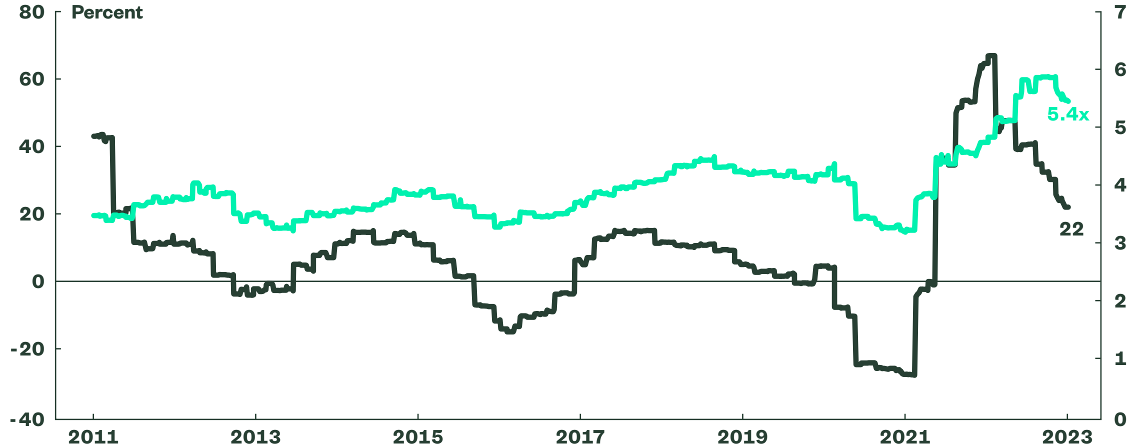
Source: Bloomberg, as of 31 March 2023.
US depicts: Senior Loan Officer Opinion Survey on Bank Lending Practices for Commercial and Industrial Loans for large and medium firms.
Eurozone depicts: ECB Bank Lending Survey for change in Credit Standards Lending to Businesses.

The earnings environment still appears reasonably healthy (Fig 5) as L12M EBITDA growth is still at 22%, and at a strong 15%, EBITDA margins are not affected yet. However, there are clear signs of an earnings slowdown when focusing on sequential trends, as well as now that higher debt servicing costs are expected to flow into LTM measures, with interest expense growth expected to surpass EBITDA growth in the coming quarters.

Despite earnings pressure building, net leverage is still just at 3.4x, aided by a stabilization of cash balances and few signs of re-leveraging. With debt levels staying in check, an increasing share of HY companies have been able to maintain or improve cash/debt ratios as well.

Figure 5a
Fundamentals Degrading from Strong Levels, but Still Holding Up Well

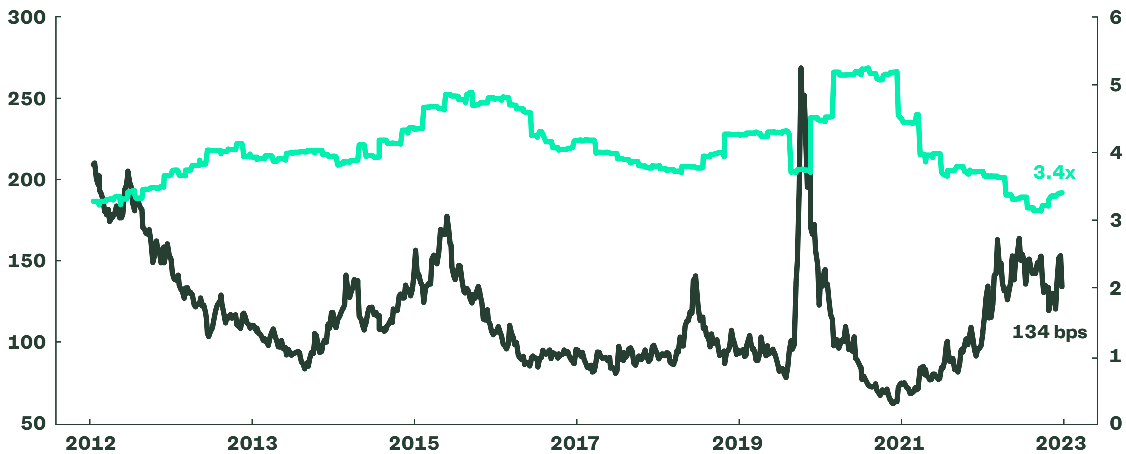
EBITDA, L12M % change
Interest Coverage Ratio (x) RHS



Source: State Street Global Advisors, BofA. As of 31 March 2023. **Past performance is not a reliable indicator of future performance.**

Figure 5b

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

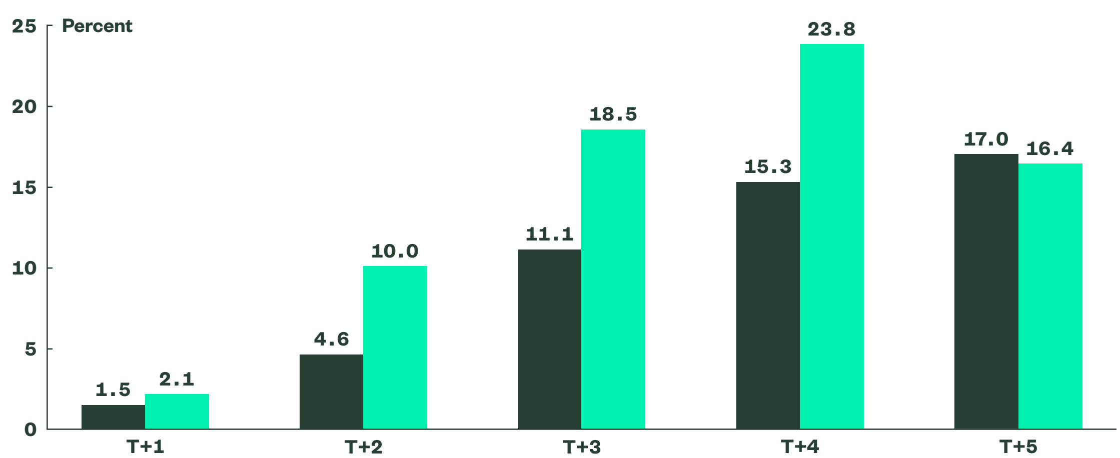


Source: State Street Global Advisors, BofA. As of 31 March 2023. **Past performance is not a reliable indicator of future performance.**

The strong return of primary market activity for EUR HY earlier this year has been for the purposes of terming-out liabilities, and a bit of progress was made by the European issuers in the nearer maturities, but far less progress has been made in pushing back 2025–6 maturities (Figure 6), given the interest expense shock that this would entail. Thus, EUR HY remains vulnerable to a sustained period of rate hikes and/or lockup of primary markets, especially when compared to the US.

Figure 6
Refinancing Needs More for EUR HY

US HY
EUR HY

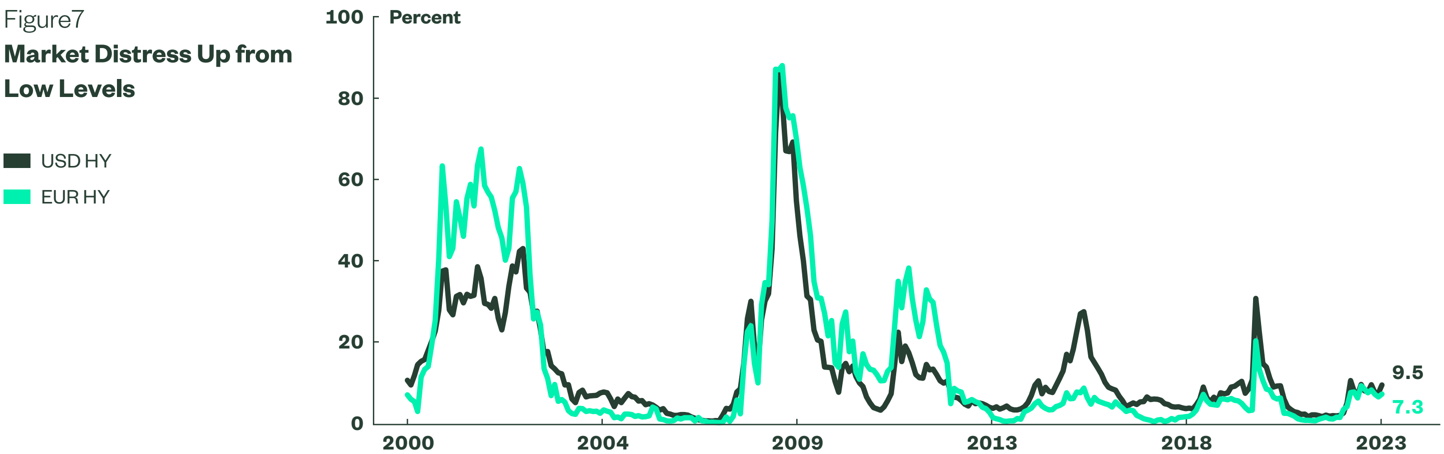


Source: State Street Global Advisors, BofA. As of 31 March 2023.

9.5% of the US HY market is trading at distressed levels now, much less than the ~30% seen at the peak of Covid or the ~27% seen during the mini 2015–6 cycle. Given the historically tight relationship of distress (and specifically in CCC bonds) vs N12M defaults in stressed environments, we observe the industry distribution of distress, and find that in US HY the main sectors that had seen a continued increase in distress has been in asset-heavy telecom and the consumer-facing Retail and Services industries.

Technology is beginning to see an increased trend as well. Subjective observation of the default watchlist and the most distressed names tells us that the next 12M expected defaults in US HY would be in the 3.5% range. Even though EUR HY has been a very low default market in the past decade, presence of two outsized idiosyncratic distressed names in the CCC space tells us that the next 12M expected defaults in EUR HY would be in the 3.0% range. Markets however are pricing in benign scenarios of 2.5% and 2.7% for US/EUR HY, given a 35% recovery rate.

Figure7
Market Distress Up from Low Levels



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

Conclusion

Global high yield spreads around 500bps are only at the 51st percentile of all-time, and don't seem outright very attractive, and, given that credit is an asymmetric asset class, there doesn't seem to be enough compensation for worst case outcomes were we to get a deep recession that lasts a long time where balance sheets would not be fully immune. However, earnings and issuer fundamentals do remain in reasonably good shape now, and all-in yields at around 8.5% provide some cushion to weather out near-term drawdowns.

Investment opportunities to deploy capital do arise frequently as crowded positions get unwound, and sentiment moves around as part and parcel of a normal policy tightening cycle. Investors need to exercise caution at this stage of the cycle though, and may consider going up-in quality such as BB-B rated segments, or liquidity screened segments (versus broad market high yield).

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* Pensions & Investments Research Center, as of December 31, 2021.
† This figure is presented as of March 31, 2023 and includes approximately $65.03 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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