Commentary
**Fixed Income**

**Q2 2023**

# Global High Yield Quarterly

**Srinivasan Margabandu**
Fixed Income Portfolio Specialist

**David Furey**
Head of Fixed Income Strategists, EMEA

Receding macro risks, fading bank credit issues, the opening-up of capital markets, and better-than-expected earnings all contributed to good performance over the second quarter and year to date.

- Tightening credit conditions, hawkish central bank rhetoric, and lack of strong support from inflows in the medium term remain as concerns.
- We expect a longer but shallower default cycle this time — next 12 months (N12M) expected defaults for US HY are 3.5%, with EUR HY at 2.5%.
- At 450 bps, GHY spreads are not especially 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 52 bps overall, most of achieved in June. Concerns about US regional banks' frailties retreated, and overall economic data (global composite PMI) held up better than initially feared throughout the quarter. Some potential tail risk events, such as the US debt ceiling negotiations also came to a benign end. The significant risk-on move came in June, when it became clear that the resilience exhibited by consumers, and positive earnings surprises from corporates, would push the well-anticipated recession further away, particularly in the US.

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

| Returns | 3m (%) | 6m (%) | 12m (%) | YTD (%) |
|---|---|---|---|---|
| Global HY (in $ terms) | 1.64 | 5.29 | 9.69 | 5.29 |
| Global HY ($ -Hedged) | 1.59 | 4.94 | 9.26 | 4.94 |
| Global HY (€ -Hedged) | 0.98 | 3.59 | 6.26 | 3.59 |
| Global HY (£ -Hedged) | 1.33 | 4.33 | 7.66 | 4.33 |
| US HY (in $) | 1.33 | 4.33 | 7.66 | 4.33 |
| Euro HY (in €) | 1.64 | 5.42 | 8.87 | 5.42 |
| EM HY (in $) | 1.66 | 4.36 | 8.83 | 4.36 |

Source: State Street Global Advisors, BofA. As of 30 June 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 | 449 | -52 | -193 | -66 |
| US HY | 407 | -53 | -182 | -76 |
| Euro HY | 446 | -28 | -195 | -52 |
| EM HY | 615 | -66 | -230 | -30 |

Source: State Street Global Advisors, BofA. As of 30 June 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) | 1.59 | 4.94 | 9.26 | 4.94 |
| Spread Return | 2.50 | 3.76 | 10.61 | 3.76 |
| Treasury Return | -0.91 | 1.18 | -1.36 | 1.18 |

Source: State Street Global Advisors, BofA. As of 30 June 2023. **Past performance is not a reliable indicator of future performance.**

The rates component was a modest detractor of GHY total returns in Q2, driven by hawkish central bank expectations. Lower quality remained in the lead for Q2 in excess return terms (BB: 1.99%, Single-B: 2.77%, CCC & Lower: 4.40%). With the exception of Real Estate (-2.70%), all industries saw positive excess returns in Q2 — with the highest coming from Leisure (3.98%) and Retail (5.08%).

Primary market activity picked up after collapsing earlier in the year with 2Q issuance for US HY at $55.1bn, the highest total since 4Q21. Year-to-date, US HY issuance totals $95.6bn and EUR HY issuance totaled around €29.0bn, and those numbers are ahead of the same period in 2022, but lower than 2017–2021 years' first 6 months.

US HY realized default rates are at 2.4% for last 12 months (L12M), and YTD's US HY combined bond and loan total of $52.0bn defaults/distressed exchanges already exceeds last year's $47.8bn full-year total, and much above 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 0.52%.

## Outlook

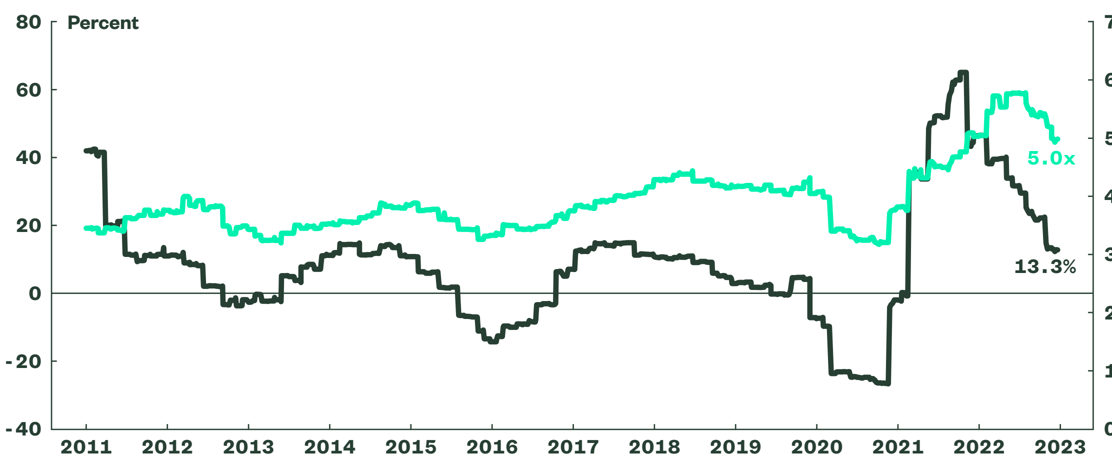
Markets have been struggling to price in correctly the probability, timing, and severity of a US and euro area recession — with idiosyncratic features of the post-pandemic expansion rendering the signals posed by traditional end-of-cycle indicators less effective. High Yield investors continue to be faced with 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.

With the lateness of this cycle and uncertainty around the lagged effects of policy tightening on growth, which has already resulted in a significant uptick in volatility (daily absolute percentage changes), investors should look for a larger risk premium when compared to the last decade. We believe Global HY is a 'cautious hold' for now — given the market-expected significant downturn in economic growth remains elusive, and HY is expected to benefit from a shallower defaults peak in this cycle, the declining probability of a significant earnings recession, and improving capital market access into the second half of the year.

Earnings and guidance remain surprisingly resilient, with almost four times more US High Yield companies beating EBITDA expectations compared to those that missed. While L12M EBITDA growth has declined to 13% from its highs, it is still on par with previous cycle highs, and at a reasonably strong 14%, EBITDA margins have not been affected yet. HY companies' balance sheets are in a strong position with net leverage at 3.5x, a decade low, and coverage only slightly below an all-time high (5.0x). Similar trends were seen across European issuers as well, with leverage at 3.6x — a 15-year low, and EBITDA based coverage at 5.4x, above the long-term average. Cash/debt has improved further as well, at a record 34.8%, with a simultaneous rise in cash balances and decline in debt.

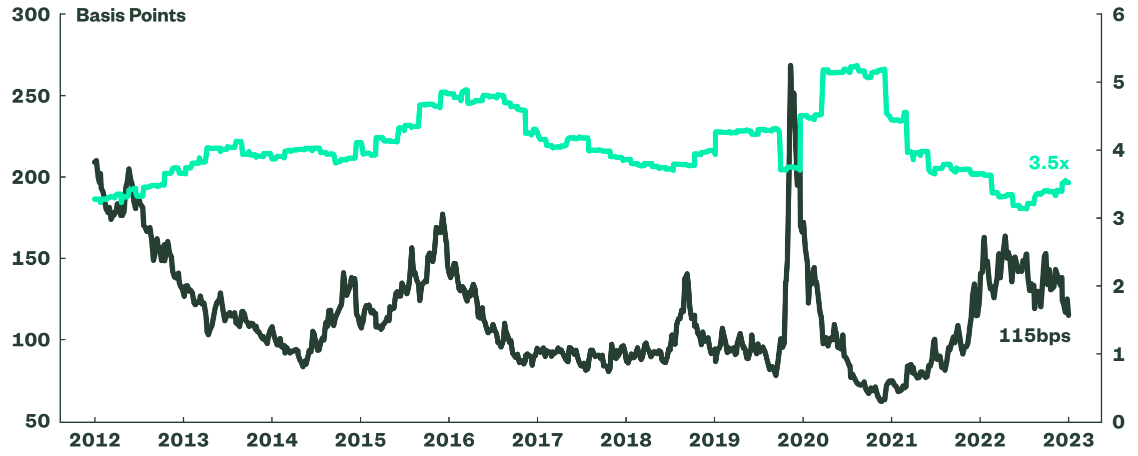
Figure 4a
**Fundamentals Face a Deterioration From Strong Levels, but Still Holding up Well**

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




Source: State Street Global Advisors, BofA, as of 30 June 2023. **Past performance is not a reliable indicator of future performance.**

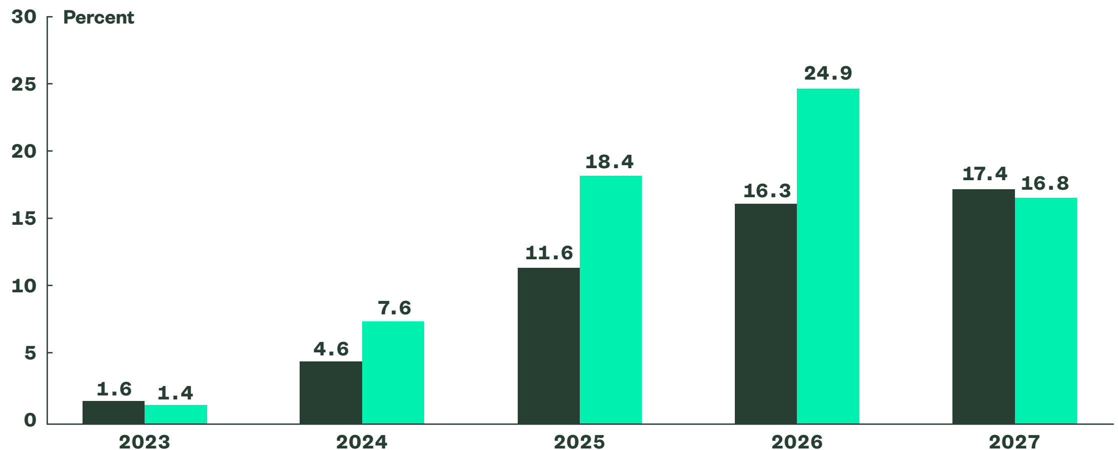
Figure 4b
**US High Yield Spreads Tighten**




Source: State Street Global Advisors, BofA, as of 30 June 2023. **Past performance is not a reliable indicator of future performance.**

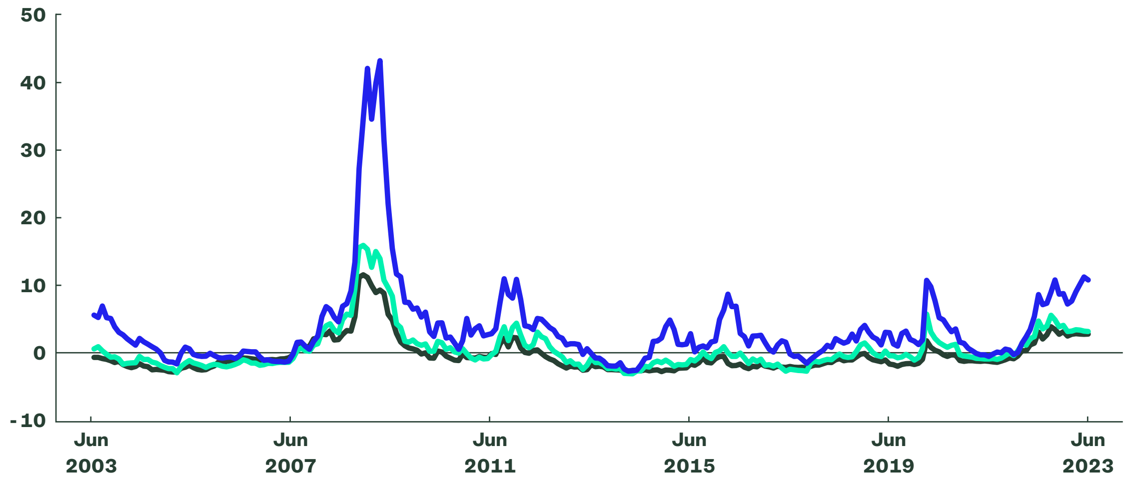
US HY issuers have been taking advantage of the relative stability in yields recently to proactively address the maturity wall, with 2023 YTD's volume of US HY refinancing matching that of FY22. EUR HY issuers have been a bit more resistant to lock in funding at current levels though. The maturity wall is a bit steep in 2025 and 2026, also with a higher share of lower-rated issuers over those years, and the gap between in-place coupon and refinancing yields remains prohibitive for lower-rated borrowers there (the refinancing gap has been a steady 10% for CCC issuers over the last year). With inflation in Europe thus far proving sticky, there's less chance for lower policy rates in the near term, and thus EUR HY remains vulnerable to a sustained period of higher rates.

Figure 5a
**Refinancing Needs Higher for EUR HY**
% Of Index Maturing




Source: State Street Global Advisors, JP Morgan, BofA. As of 30 June 2023.

Figure 5b
**Refinancing Gap — EUR HY**



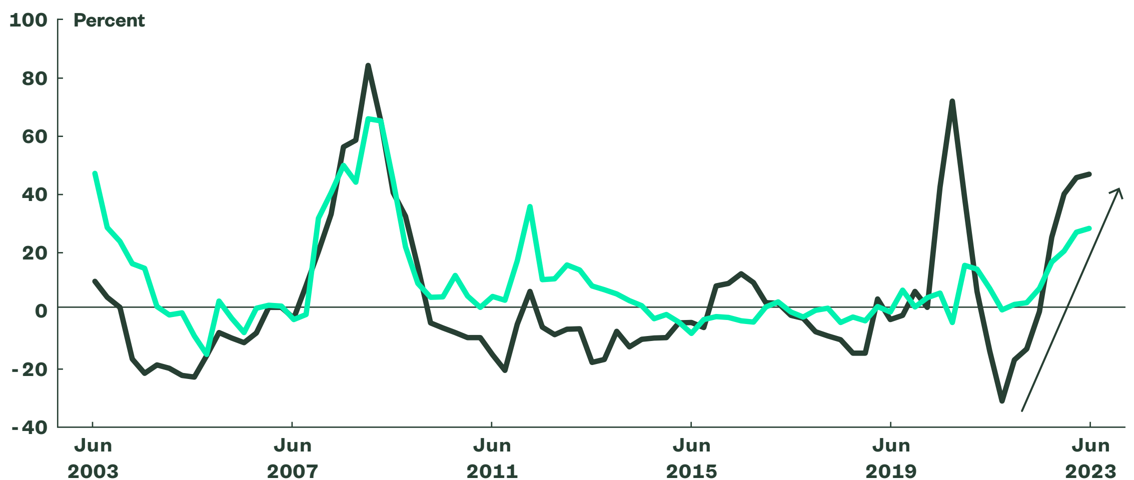

Source: State Street Global Advisors, JP Morgan, BofA. As of 30 June 2023.

Without a significant problem sector in either US or EUR HY, an unambiguous downturn in macroeconomic data, or an immediate maturity wall to tackle in a closed-off primary market — we don't see cause for default rates to spike up into the mid-to-high single digits. We 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 10% for the last year (Figure 7) corroborates our view. 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 3.5% range.

Even though EUR HY has been a very low default market in the past decade, the presence of two outsized idiosyncratic distressed names in the CCC space, and expectations of a prolonged restrictive ECB stance, 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**
% of Banks Tightening Standards for Corporate Loans




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 2023.

Figure 7a
**Prolonged Period of Medium Levels of Distress**
US HY

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

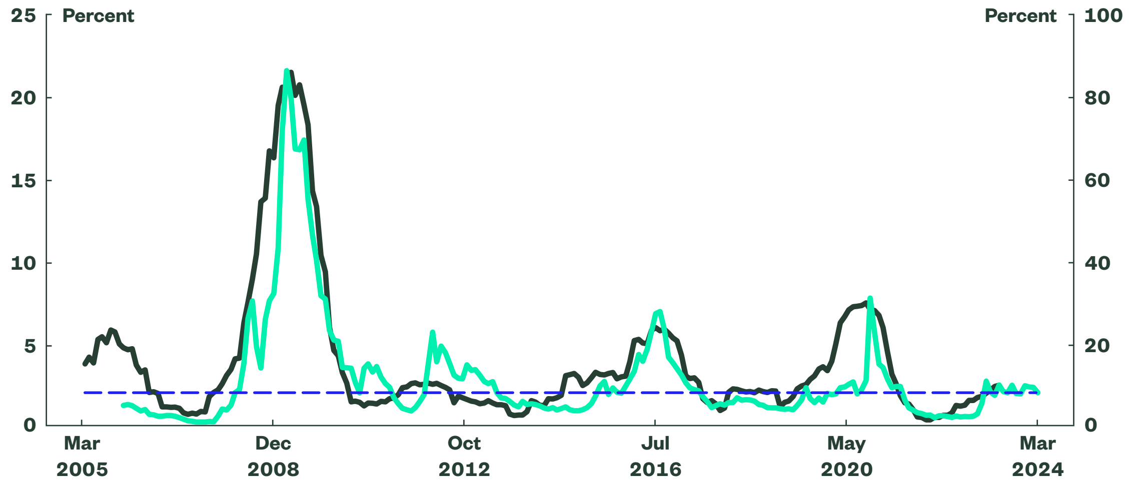
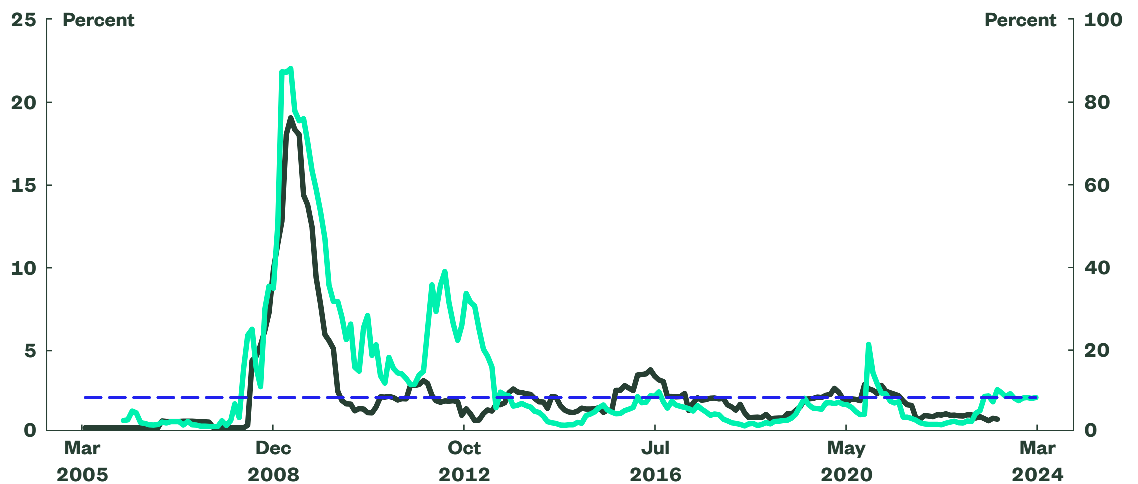



Figure 7b
**Prolonged Period of Medium Levels of Distress**
EUR HY

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 2023. **Past performance is not a reliable indicator of future performance.**

Primary market activity has returned strongly from the pause earlier in March, with 2023 full-year gross issuances expected to track the past-decade average of $200bn in US HY, but below trend in EUR HY, with €75bn expected. Most activity is anticipated to be used to term-out capital structures rather than fund new investment or M&A. Rising stars have significantly outpaced fallen angels YTD in both US and EUR HY, a supportive technical for the market, as it has reduced overall net supply, acting as a cushion for rather weak flows in US HY (-$11.2bn YTD). EUR HY, however, hasn't seen the same trend of outflows, with almost flat flows of €630mm YTD.

## Conclusion

Global HY spreads of around 450bps are only at the 37th percentile of all-time, and don't seem outright attractive at these levels — given that credit is an asymmetric asset class, there doesn't seem to be enough compensation for probable bearish outcomes. However, strong balance sheets, low near-term recession risks, improved ratings quality compared to history, a lack of huge volumes of credit negative transactions — such as new buyouts or dividend recaps this cycle, and all-in yields at around 8.5% — make the bar to withdrawing capital from the asset class far higher than at any point in the past decade.

So — with less of a concern that central banks will need to aggressively kill off the cycle now compared to the previous year, as inflation is moving in the right direction (albeit not back to target) — we would advocate a cautious hold for investors who have already allocated into the asset class, and for investors looking to allocate/increase, we suggest to look for better spread levels, particularly after June's rally.

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 higher 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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- Invest as stewards
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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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