Commentary
Fixed Income

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Global High Yield – Year in Review

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- Aggressive policy tightening by the Fed and ECB led to a sharp surge in yields, and this along with a risk off tone throughout most of 2022 translated into one of the worst years for global high yield.
- Gross primary market activity decreased nearly fivefold in 2022 to a low since the financial crisis, amid significant market volatility. Defaults and fundamentals have been benign, and Europe has a wider range of possible outcomes due to binary risks.
- Performance started to reverse and inflows started to resurface in 4Q, as inflation reached a peak across regions and started to come down, setting the stage for more moderate pace of rate hikes.
- Yields at 9% provide a decent cushion to absorb any further periods of draw-downs and there appears to be a fair opportunity to deploy additional capital in phases during periods of weakness.

2022 Performance/ Market Highlights

Last year saw the emergence of inflation across the globe, leading central banks to embark on an intense policy-tightening cycle. Geopolitical risks lead to significant energy price rises, and a marked increase in interest rate volatility, given the significant and persistent rise in inflation.

The higher cost of debt refinancing, as well as the expected impact on corporate margins from rising raw material cost and wages, alongside a slowing growth outlook for the global economy were additional factors driving this challenging backdrop for Global High Yield.

Over the course of the year, spreads of Global High Yield issuers remained under pressure, widening overall by 142 bps with bouts of rallies and reversals frequently occurring. A strong rally of almost 100bps in spreads during the fourth quarter, helped recover a significant amount, as the peak in rates began to be priced into markets.

Figure 1
Total Returns of High Yield in Recent Periods

Returns	3m (%)	6m (%)	12m (%)	YTD
Global HY (in $ terms)	6.96	4.18	-13.22	-13.22
Global HY ($ -Hedged)	5.19	4.11	-11.38	-11.38
Global HY (€- Hedged)	4.31	2.58	-13.59	-13.59
US HY (in $)	3.98	3.28	-11.21	-11.21
Euro HY (in €)	4.68	4.29	-11.48	-11.48
EM HY (in $)	9.37	5.58	-14.78	-14.78

Source: State Street Global Advisors. As of 31 Dec 2022.

Figure 2
Spread Changes by Region

OAS (bps)	Current Level	Δ3m	Δ12m	ΔYTD
Global HY	515	-98	142	142
US HY	483	-62	172	172
Euro HY	498	-127	167	167
EM HY	645	-219	11	11

Source: State Street Global Advisors. As of 31 Dec 2022.

Figure 3
Return Breakdown of Global High Yield

Returns	3m (%)	6m (%)	12m (%)	YTD
Global HY ($ -Hedged)	5.19	4.11	-11.38	-11.38
Spread Return	4.44	6.65	-3.12	-3.12
Treasury Return	0.74	-2.53	-8.25	-8.25

Source: State Street Global Advisors. As of 31 Dec 2022.

The rates component of returns had been a significant drag on GHY total returns throughout the year as investors recalibrated government bond yields across the curves in response to quantitative tightening, concerns around higher bond supply, and some surprisingly expansive fiscal plans. Deeper, lower quality issuers and sectors fared worst in excess returns terms (BB: -2.4%, Single-B: -4.5%, CCC & Lower: -8.2%) while industries sensitive to rate hikes and consumer spending also underperformed (Real Estate: -18.5%, Retail: -7.3%).

Primary market activity was muted for most of the year, with US HY Gross supply coming in at $116Bn, down 75–80% on 2020/21 levels, while Europe only saw €48bn, down 50–70% on 2021, 2020 levels. This illustrates the degree of front loading down in the pandemic years, and is a supportive technical for the market. Investor flows for high yield were unsupportive throughout the majority of the year. During the strong fourth quarter, both issuance and flows seemed to have turned a corner recently, particularly in US HY — with November seeing nine deals worth $9.2bn (the highest monthly total since June 2022) along with the highest monthly inflows since June 2020 and with US HY ETFs posting their largest inflow on record (+$7.7bn).

Realized default rates have begun to rise from cycle lows although these remain benign and as a lagging indicator are expected to rise from here given 8% funding levels, choking access to markets for the most leveraged issuers. US high-yield L12M par default rate ended December at 1.47%, well below the historical average of 4.0%. European HY saw a relatively larger rise, with L12M par default rate at 1.16%, but still below the historical average of 2.5%.

Outlook and Scenarios

We expect to see an end to the hiking cycle in the US around Q2 2023 — as CPI continues to decline from 2022's surge, which seems to have peaked in June at 9.1% year over year. The Fed is expected to pause at around a 5% terminal policy rate, as they await the lagged response from GDP and labour markets, after such a rapid shift to a restrictive policy stance. With the terminal rate coming into sight, this should lead to reduced interest rate volatility this year. Risks to this scenario would hinge on inflation increasing further or not settling low enough, or for the soft-landing scenario to deteriorate into a deeper recession. A period of stagflation could also become protracted thereby keeping companies on a defensive footing.

Lower chances of the Fed overtightening now make us anticipate that US HY and earnings can hold up better than feared earlier in 2022. EBITDA margins decreased to 15.8% in 3Q, down marginally from Q2's 17.2%, which was the highest level since 4Q18; however, this was still above the historical average margin of 15.2%. With HY debt expected to grow only modestly in the next 12 months, as issuers have pre-funded and are more likely to dip into their cash reserves going into a weaker economy. From an earnings perspective, EBITDA is forecast for negative single-digits contraction, far less than the typical -25–30% seen in full recessions. Therefore, we believe that the HY market will see this cycle through without seeing a material deterioration in underlying leverage or coverage ratios, given the strong starting point. Things will remain challenging and deteriorated but will likely be manageable for companies such that a full blown credit crisis remains very much a tail risk event.

Figure 4a
Current Spread Levels Provide Good Compensation Relative to the Solid Fundamentals in Place

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

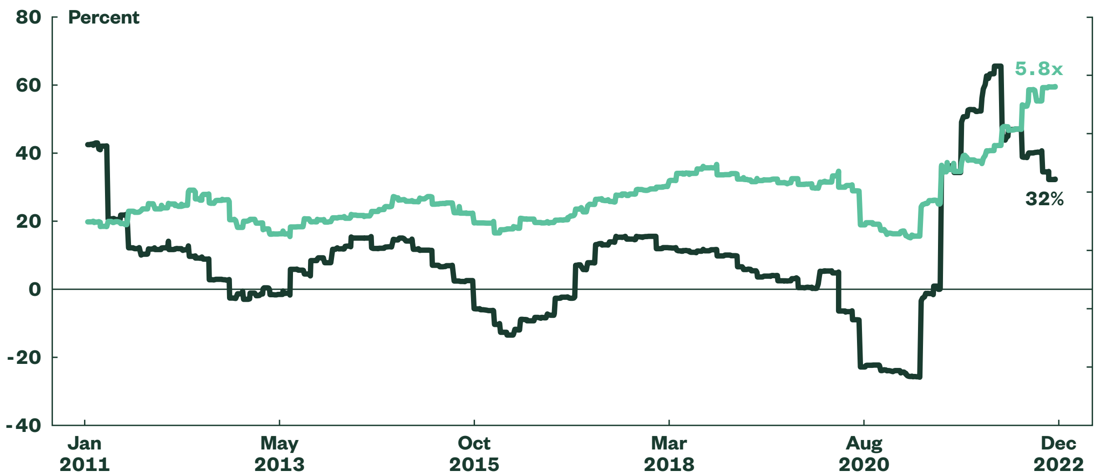
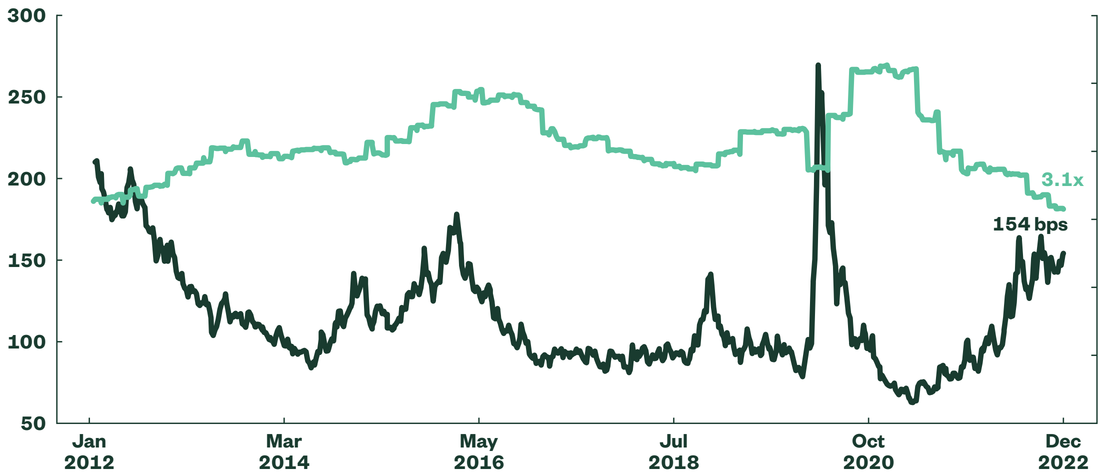


Figure 4b

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

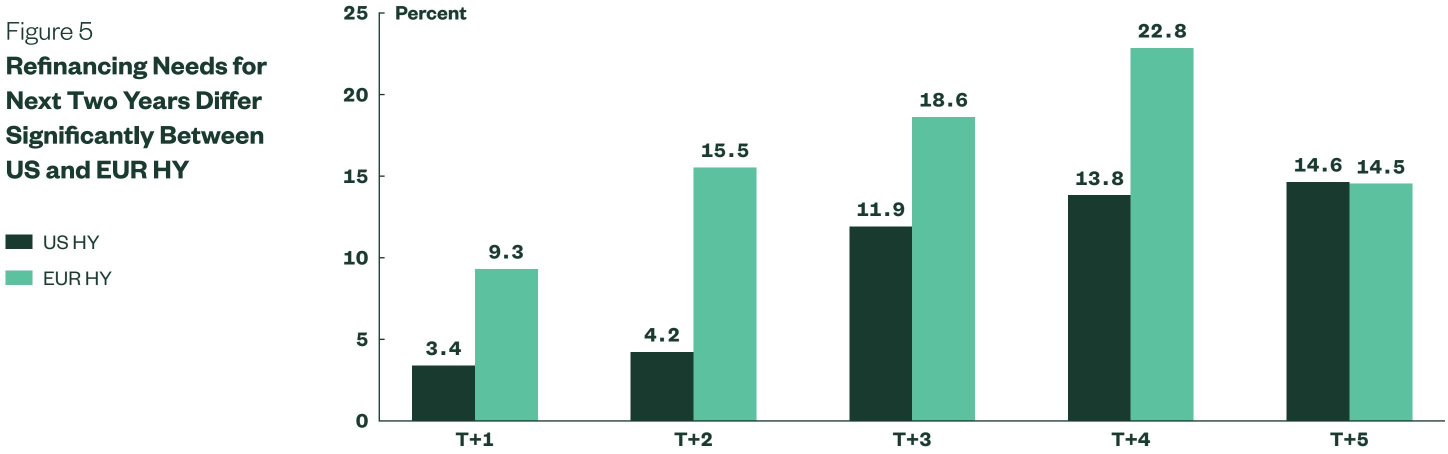


Source: State Street Global Advisors. BofA-ML. As of 31 Dec 2022.

Evidence of distress remain low, with just 8% of the US HY market trading at distressed levels currently, compared to 35% seen at the peak of Covid or the 30% seen during the mini 2015–6 energy default cycle. Given the historically strong relationship between distress (and specifically in CCC bonds) vs the following twelve month's defaults, the outlook will deteriorate but not significantly. We can see that the distribution of distress across sectors to be quite limited as opposed to broad based, with distress concentrated in the Healthcare, and asset heavy telecom sectors as well as the consumer-facing Retail and Services industries. The share of CCC bonds from Energy issuers has fallen considerably as weaker names dropped out in the oil price crash in 2020, and stronger ones were eventually upgraded into single-Bs. Subjective observation of the default watchlist and the most distressed names tells us that the next 12M expected defaults in US HY is likely to be 3% to 4.0% range.

Refinancings are likely to remain low this year given that the cost of doing so is very high and this will likely force many companies to prioritize debt reduction. US HY issuers have availed of the cheaper funding available in the previous couple years to term out maturity structures well, and the asset class does not face a significant maturity wall until 2025 (Fig 5). Market illiquidity and cost of trading have slightly eased off their summer highs, but are expected to remain structurally at a higher level, when compared to the supportive credit conditions of the last few years.

Figure 5
Refinancing Needs for Next Two Years Differ Significantly Between US and EUR HY



Source: State Street Global Advisors. HSBC. Dealogic. As of 31 Dec 2022.

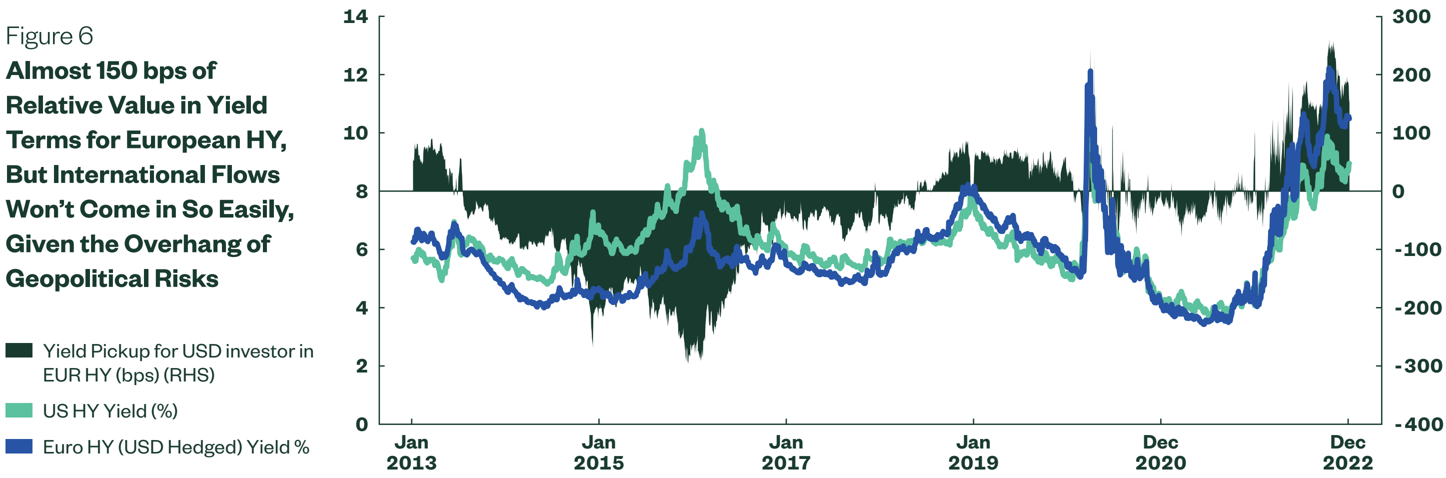
The outlook for Euro HY is less clear and contrasts with the US, as eurozone inflation has not shown clear signs of peaking yet. Much of the energy price rise has become entrenched into the broader economy through second-round effects. Even though drastic downside energy scenarios have thankfully been avoided, the ECB is expected to keep hiking until policy rates are well into restrictive territory above 3% and possibly closer to 3.5%. This, along with ECB Quantitative Tightening to start in Q2, along with a surge in government bond supply in 2023, this has the potential drive European Government bond yields much higher and to potentially crowd out corporate issuers. Fundamental challenges also exist given the impact of the war and its unpredictable path.

The aggregate effect of the success of government programs such as bailouts, support schemes and cheap loans during 2020 and earlier, means that Euro High Yield hasn't really been cleansed of lower quality companies to the same extent as in US HY. Also, its quality mix is now just at the last 10-year average (which include the eurozone sovereign debt crisis period) and is worse than the 2016–9 cycle. Also, European HY firms tend to term out their maturity structure only by a few years, it faces a larger than usual maturity wall in 2023 and 2024 (Figure 5), forcing more issuers to have to test the market.

Almost 13% of EUR HY market is at distressed levels now. While this number seems low, the market hasn't seen such levels since the 2011 sovereign crisis (with the exception of Covid), and for the last decade, defaults have almost been absent from the European HY market. We believe that could change this cycle, as government measures to keep stressed companies/sectors afloat would be scrutinized more in this environment, and energy-intense sectors in Europe need to adjust their business to a different operating model. Subjective observation of the default watchlist and 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 3.0–3.5% range.

Fundamental metrics such as coverage ratios and cash to debt do compare favorably versus long-run averages in Euro HY as well, even as they are expected to worsen at the margin. The potential impact from the euro-area recession coming in at 4Q22/1Q23 would be felt by corporates, and their ability to pass on higher input costs would be tested more in Europe than the US. In a global context, hedged relative value of Euro and Global HY for a US based investor has increased, as Euro HY saw the largest degree of underperformance in spread terms vs US HY since the Eurozone crisis, and also as the more aggressive and front-loaded hiking cycle by the Fed compared to the ECB has led to reduction in the cost of hedging euro-exposure for a USD investor.

Figure 6
Almost 150 bps of Relative Value in Yield Terms for European HY, But International Flows Won't Come in So Easily, Given the Overhang of Geopolitical Risks



Source: State Street Global Advisors. Bloomberg. As of 31 Dec 2022.

We outline below some scenarios with various assumptions about future levels of spreads, government bond yields, default and recovery rates and rating migrations for US & Euro High Yield (Figure 7). In our base case, we expect the Fed to hike rates into the 5% range in the first half of 2023, and that the default rate would to rise to 4% from current levels. We foresee spreads ending up at similar to current levels as today as a balance is achieved between (i) the optimism of an inflation rollover coming to sight in major economies and (ii) the structural demand of a higher risk premia, as the era of easy capital and low volatility ends. The Bull and Bear cases are around this illustrates that while downside risks still remain — much has been priced in to current levels and given the higher spreads and yields on offer and increasing case of a soft landing, there is a case for allocation to HY and deploying capital there during bouts of weakness. Bringing all these factors together we see US High Yield as being in a position to deliver total returns around 8% and for EUR high yield around 4.7% given the additional challenges there.

Figure 7
Expected 1Y Total Returns Under Different Scenarios
As of 30 December 2022

US High Yield			
Effective Yield of US HY (%)			8.89
OAS (bps)			483
5Y UST (%)			4.00
L12M Defaults (%)			0.57
L12M Recovery Rates (%)			47.2
Effective Duration (yrs.)			4.0
Spread Duration (yrs.)			4.0
Average Annual Fallen Angel Net Outperformance vs HY (%)			2.56
Probability Scenarios for 12M Horizon (%)	**20**	**70**	**10**
Credit Scenario	**Bull**	**Base**	**Bear**
OAS Estimate (bps)	350	480	700
5 Y UST Estimate (%)	3.50	3.82	4.75
Default Rate Estimate (%)	2.50	4.00	8.50
Recovery Rate Estimate (%)	45	40	25
Net Fallen Angels (% of HY Index par)	5.0	13.3	20.0
Yield Carry (%)	**8.89**	**8.89**	**8.89**
Return from Treasury Component (%)	2.04	0.73	-3.01
Return from Spread Change (%)	5.28	0.12	-8.61
Loss Given Defaults (%)	-1.38	-2.40	-6.38
Impact of Net Fallen Angels (%)	0.26	0.68	1.02
Expected Total Returns (%)	**15.09**	**8.02**	**-8.09**
Probability Weighted Return			**7.82**

European High Yield			
Effective Yield of EUR HY(%)			7.51
OAS (bps)			498
4Y Eurozone Govt yield (%)			2.58
L12M Defaults (%)			0.85
L12M Recovery Rates (%)			55.3
Effective Duration (yrs.)			3.1
Spread Duration (yrs.)			4.1
Average Annual Fallen Angel Net Outperformance vs HY (%)			0.97
Probability Scenarios for 12M Horizon (%)	**20**	**60**	**20**
Credit Scenario	**Bull**	**Base**	**Bear**
OAS Estimate (bps)	300	500	700
4Y Eurozone Rates Estimate (%)	2.50	2.91	3.75
Default Rate Estimate (%)	2.50	3.50	7.00
Recovery Rate Estimate (%)	45	40	25
Net Fallen Angels (% of HY Index par)	4.0	7.9	15.0
Yield Carry (%)	**7.51**	**7.51**	**7.51**
Return from Treasury Component (%)	0.24	-1.03	-4.84
Return from Spread Change (%)	8.18	-0.08	-8.34
Loss Given Defaults (%)	-1.38	-2.10	-5.25
Impact of Net Fallen Angels (%)	0.20	0.40	0.29
Expected Total Returns (%)	**14.76**	**4.70**	**-10.63**
Probability Weighted Return			**3.65**

Source: State Street Global Advisors. As of 31 Dec 2022.

Conclusion

With Global HY Spreads now around 515bps, these are at the middle of long-time historical averages and do not flag as particularly cheap anymore given strong recent performance in Q4. However, all-in yields at around 8.9% do provide a good cushion to weather out any further periods of drawdowns from adverse economic, inflation or earnings surprises. Investors who have normally been unwilling to allocate to GHY for the last few years at par dollar price, with tight spreads of 300 bps and all-in yields of 4% are now looking at a completely different landscape. This appears to be a fair opportunity to stay invested, or to deploy additional capital in phases. This has been recognized by investors as well, who are beginning to see the proverbial light at the end of the tunnel, and the sharp inflows in the last 4 weeks for both US and EUR HY ETFs is evidence of that.

About State Street Global Advisors

Our clients are the world's governments, institutions and financial advisors. To help them achieve their financial goals we live our guiding principles each and every day:

- Start with rigor
- Build from breadth
- Invest as stewards
- Invent the future

For four decades, these principles have helped us be the quiet power in a tumultuous investing world. Helping millions of people secure their financial futures. This takes each of our employees in 29 offices around the world, and a firm-wide conviction that we can always do it better. As a result, we are the world's fourth-largest asset manager* with US $3.26 trillion† under our care.

* Pensions & Investments Research Center, as of December 31, 2021.
† This figure is presented as of September 30, 2022 and includes approximately $55.12 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.