Commentary
Fixed Income

YTD 2022

Global High Yield – Under Pressure but Underlying Fundamentals Strong

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- Global High Yield markets remained under pressure throughout April and into May as several factors combined to undermine investor comfort with the outlook for the sector. Specifically, the impact of persistently elevated inflation on corporate profit margins was a concern, along with the growth impact of tightening financial conditions.
- There was also some distress in certain Healthcare and Retail issuers. With recession risk rising in the US, albeit from very low levels, as well as the slower growth outlook elsewhere, in China and eurozone particularly, the macro outlook remained challenging.
- The high yield market did see a sharp rebound in the last week of May, as the elevated valuations and a peak in rates volatility attracted investors and enabled the market to retrace approximately 35% of the spread widening year to date.

Figure 1
Total Returns of High Yield in Recent Periods

Returns	3m (%)	6m (%)	12m (%)	YTD
Global HY (in $ terms)	-5.72	-8.67	-10.96	-10.19
Global HY ($-Hedged)	-4.58	-7.50	-8.09	-8.82
Global HY (€-Hedged)	-5.09	-8.28	-9.20	-9.45
US HY (in $)	-4.29	-6.01	-5.00	-7.74
Euro HY (in €)	-4.20	-7.91	-7.89	-8.72
EM HY (in $)	-6.89	-13.05	-19.03	-13.66

Source: State Street Global Advisors, as of 31 May 2022. Past performance is not a reliable indicator of future performance.

Leveraged loans also experienced weakness during the period and underperformed US high yield by 274 bps in May, having outperformed significantly from Jan–April by 827 bps. This performance deviation suggests that investor concerns have moved on from expectations of higher rate volatility, to risks of a broader growth slowdown. For comparison, most risk assets such as Global IG (-10.51%), S&P 500 (-12.76%), EM HC Sovereign (-15.03%) are now lagging HY performance on a YTD basis.

Regionally, US high yield has outperformed Euro and EM high yield on both a total return and excess return basis. Euro HY has been facing a more acute problem of primary markets completely drying up, with YTD gross supply at just 18bn (down 75% y/y), along with the deteriorating macro backdrop due to the impact on growth forecasts from supply-side inflation due to the ongoing war in Ukraine. Even before the conflict began in late February, the EM complex was under stress related to concerns around credit deterioration on the back of a sharp increase in US interest rates, with those economies just getting back on their feet after the pandemic. Russia's invasion led to a broad risk aversion towards EMD, leading to -$7.6 bn of outflows YTD out of EM HC Corporate focused retail funds alone, causing them to significantly underperform YTD.

Market Highlights

- Investor sentiment continued to be negative, with US high yield mutual funds seeing a fifth consecutive month of outflows during May (-$3.6 bn), which took YTD outflows to $36.6bn. For context, this is the highest cumulative outflow for any five-month period in history. Even though leveraged loan funds saw their first outflow month of the year in May (-$2.8bn) as well, they still have been the preferred high yield sector given their low sensitivity to duration from its floating rate structure. It saw YTD inflows of $21.7bn. Outflows from European HY funds totaled €7.0bn YTD.

- The volatility experienced throughout 2022 has led to very subdued primary market activity, with US high yield gross issuance YTD only $61.3bn compared to $260.7bn for the first five months of 2021. The majority of the issuance YTD (45% of gross volume) has been used for refinancing activity. A similar trend was seen in Euro HY as well, with YTD gross issuance at €18bn (down 75% y/y).

- Q1 earnings were strong with L12M EBIDTA growing by 45% yoy (6% qoq), with leverage broadly unchanged; gross leverage down 0.2x to 4.2x and net leverage down 0.1x to 3.6x. The rating cycle, while a lagging indicator, continues to maintain the positive momentum seen in 2021, with $141 bn of US HY debt (excluding Fallen Angels and Rising Stars) seeing upgrades YTD, and the ratio of upgrades/downgrades (by $ face value) remaining at a solid 1.5x for US HY YTD (vs 2.5x in 2021).

- The number of bonds trading at distressed levels (>1000 bps of OAS) has increased as spreads have widened with 5.2% of US and 6.2% of Euro HY trading at distressed levels respectively. Realised default rates however continue to be at cycle lows. US high-yield L12M default rate ended May at a cycle low of 0.57%, much below the historical average of 3.8%. Euro HY saw similar trend, with L12M par default rate at 0.76%, much below historical average of 2.5%.

Figure 2
Spread Changes on Key High Yield Sectors

OAS* (bps)	Current Level	∆ 3m	∆ 12m	∆ YTD
Global HY	479	21	118	106
US HY	423	45	88	112
Euro HY	474	29	171	143
EM HY	689	-73	184	55

Source: State Street Global Advisors, as of 31 May 2022.
* Option Adjusted Spreads.

Figure 3
Return Breakdown of Global High Yield

Returns	3m (%)	6m (%)	12m (%)	YTD
Global HY ($ -Hedged)	**-4.58**	**-7.50**	**-8.09**	**-8.82**
Spread Return	-0.74	-1.92	-2.70	-3.56
Treasury Return	-3.84	-5.59	-5.39	-5.26

Source: State Street Global Advisors, as of 31 May 2022. Past performance is not a reliable indicator of future performance.

Performance Highlights

- The treasury component of returns has been the key driver of negative returns in high yield YTD. This has recently started to recover as yields have come off their highs, particularly in the US, as economic data has surprised to the downside.

- All high yield sectors are in negative territory in excess return terms YTD, with Energy (-0.06%) holding up the best. Real Estate (-14.23%) continues to be an underperforming outlier. It is 5.7% of the index in face value terms, of which China is 1.7%. Home sales of China's top 100 developers plummeted 59% in May from a year earlier, and the outlook remains gloomy due to weaker demand for mortgages as well as covid lockdowns hindering new projects.

- BB (-8.73%) and Single B (-8.69%) rated segments performed in line in total return terms, and slightly outperformed the CCC- and lower-rated (-9.59%) segment. This is a contrast from overall 2021 performance, which saw significant outperformance of the CCC- and lower-rated segment (+8.75%) compared to BB (+2.97%) and the single B (+1.22%) segments.

Valuations are Attractive Once Again, Provided a Deep Recession is Not Imminent

Even though current Global HY spreads at 479 bps have retraced part of their widening since April, they remain around the median (46th percentile) historic level. The recent snapback in spreads (in the latter parts of March, May) is a reflection of investors still trying to price-in recession and tighter liquidity. These periods of episodic volatility, as well as underperformance for issuers triggered by earnings misses, idiosyncratic news etc., are likely to persist in the future. However, with its lower sensitivity to interest rates than other FI sectors, and a higher credit element in expected total returns, yields at 7.25% level offer an attractive entry point now for investors, and particularly for investors who have been on the sidelines due to the previously low risk premia that prevailed throughout much of 2021.

Outlook and Scenarios for US HY

The US HY market is down -7.74% YTD, its worst (Jan-May) performance in a calendar year since inception. While there have been a multitude of factors which have led to such significant price action, much of this has been driven by the repricing of interest rate risk from the lows after the pandemic. The current spread level of around 430 bps is consistent with a default rate of 2% and a recovery rate of 35% (assuming the long-term risk/liquidity premium of 300 bps). Alternatively, the current spread of 430 bps offers a cushion of over 75 bps for the current level of defaults and recovery rates. Historically, this has been a good margin of safety which has attracted investors to reallocate back to high yield.

Figure 4
Spread Matrix For Given Level of Default/ Recovery Rate (bps)

		Liquidity & Volatility Premium Used					300 bps	
		Expected Default Rate						
		1.0%	1.5%	2.0%	2.5%	3.0%	3.5%	4.0%
Expected Recovery Rate	25%	375	413	450	488	525	563	600
	35%	365	398	**430**	463	495	528	560
	45%	355	383	410	438	465	493	520
	55%	345	368	390	413	435	458	480
	65%	335	353	370	388	405	423	440

Source: State Street Global Advisors, as of 31 May 2022.

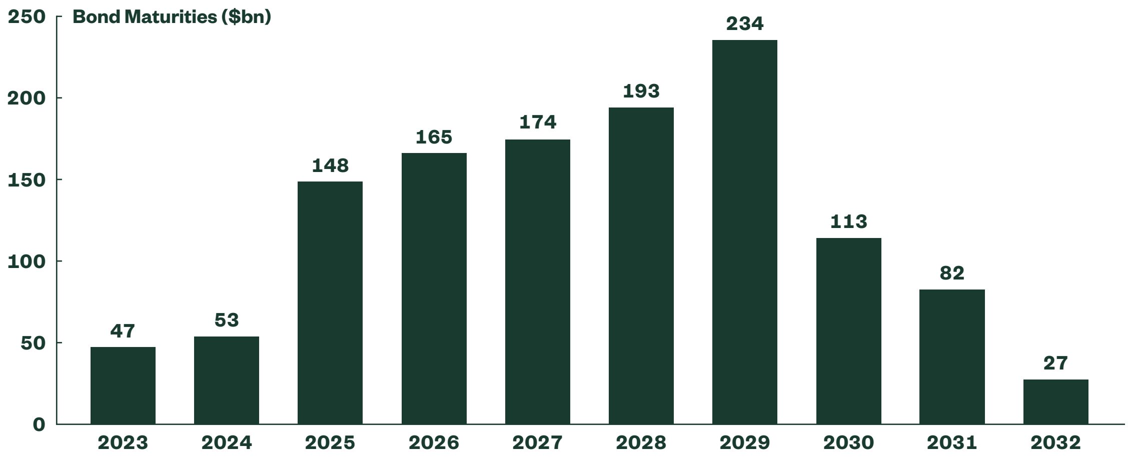
Distress Levels Remain Low and Underlying Fundamentals are Strong

5.1% of bonds in the US HY index are trading at distressed levels now. Healthcare, Retail and Media the most affected sectors, with almost 40% of distressed bonds coming from those. While a large part of the price movements in Healthcare and Media are dominated by idiosyncratic price action in Bausch, Endo (Healthcare) and DISH (Media), the Retail segment is more broadly affected, as recent earnings start to reveal the impact of supply chain and inflationary pressures on operating performance and overall profitability.

Underlying issuer fundamentals remain strong and have rarely been in better shape entering a hiking cycle. Both gross (4.2x) and net leverage (3.6x) are close to decade lows, while median cash/debt ratios are close to 15% — a post-GFC peak. This is even after two years from the peak of pandemic-related stress. Coverage is at an all-time high of 6.1x as significant refinancing activity in 2020–21 reduced debt costs materially. Consequently, upcoming refinancing requirements are extremely low with only $50Bn of maturities in 2022 and 2023 (see Fig 5). Cash balances are also elevated so issuers have considerable financial flexibility and will not be forced to test market appetite for refinancing in the near term.

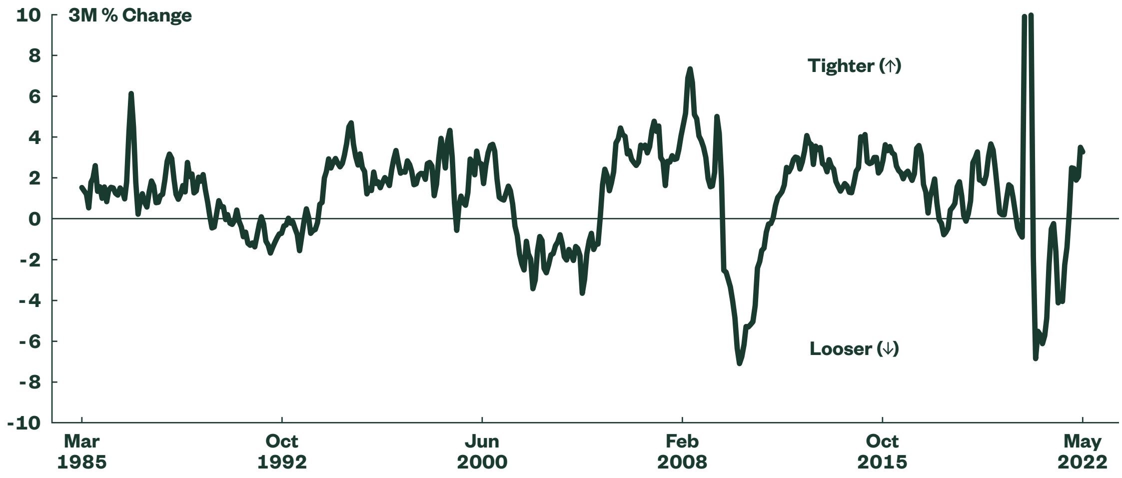
While lending conditions have tightened and primary issuance has reduced significantly, trading volumes are also down and transaction costs have gone up in secondary markets (Fig 7). Notably however, there has not been any significant ratcheting wider in specific sectors, with the price action continuing to remain broad based rather than concentrated (Fig 8).

Figure 5
Very Low Refinancing Requirements Across US High Yield in Next Two Years



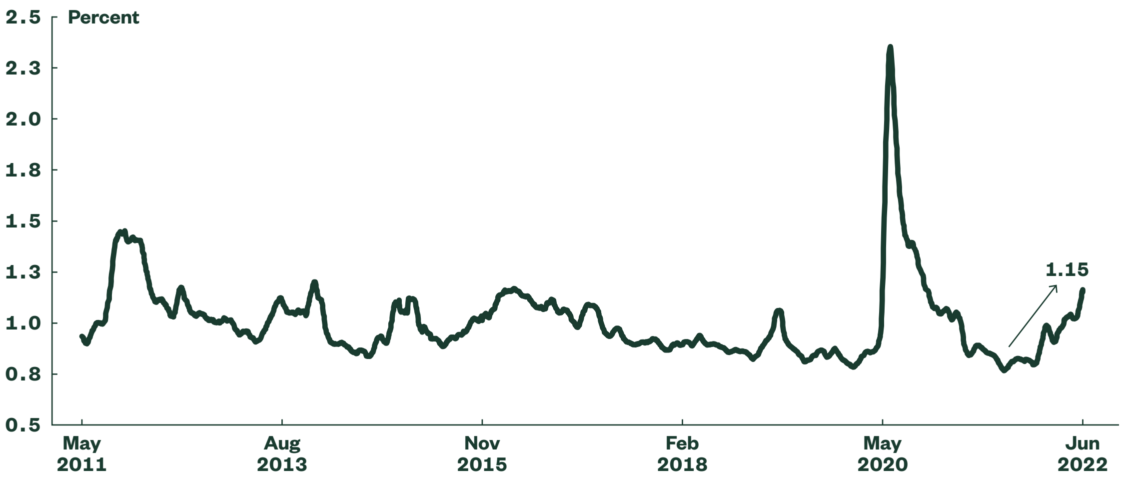
Source: State Street Global Advisors, as of 31 May 2022.

Figure 6
US Commercial and Institutional Loan Lending Conditions



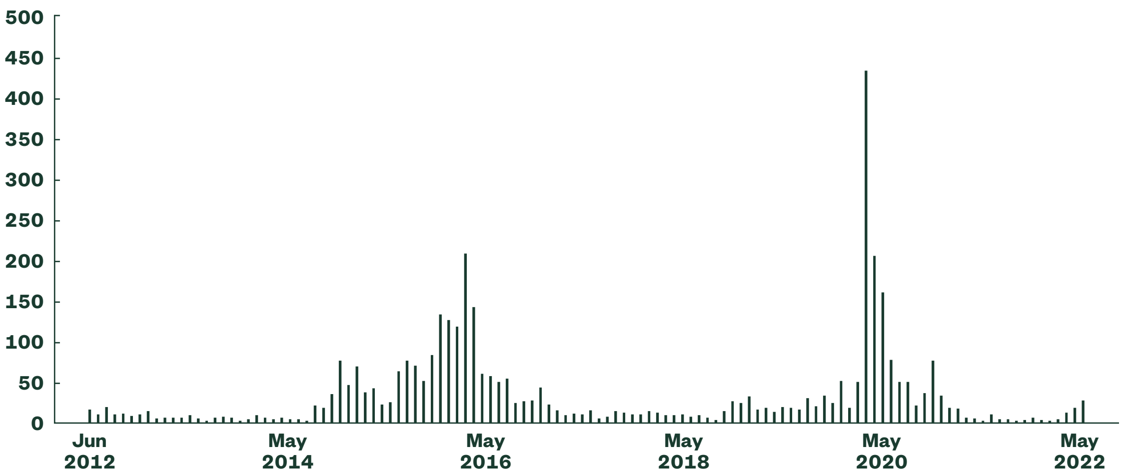
Source: State Street Global Advisors, as of 31 May 2022.

Figure 7
30-Day Average US High Yield Bid-Ask Spreads



Source: State Street Global Advisors, as of 31 May 2022.

Figure 8
Number of Issuers with More Than 10% Change in Monthly Price Relative to the Index



Source: State Street Global Advisors, as of 31 May 2022.

Outlook — Scenario Analysis for US High Yield

For context on the potential forward-looking returns for high yield, we outline some scenarios with various assumptions about future levels of spreads, treasury yield, default and recovery rates and rating migrations (Fig 9). In our base case, we see growth remaining strong enough for the Fed to complete most of its expected hiking path, keeping bond yields at current to slightly higher levels given the inflationary backdrop. Being conservative, we allow the default rate to rise to 2% from current 0.57% and we see spreads marginally wider, oscillating around the 400 to 425 levels. With a 7% entry yield this ensures sufficient cushion to weather the marginally wider spreads and higher treasury yields to deliver a 4% total return and 6% in excess return on a one-year horizon/holding period. The Bull and Bear cases around this are highlighted above and illustrate that downside risks for high yield are not significant given the higher spreads already but also the higher treasury yield which now have significant room to rally, were a bearish credit environment to develop.

Figure 9
Expected 12 month Total and Excess returns of US HY under different scenarios

US High Yield			
Effective Yield of US HY (%)	7.01		
OAS (bps)	423		
5Y UST (%)	2.82		
L12M Defaults (%)	0.57		
L12M Recovery Rates (%)	47.2		
Effective Duration (yrs.)	4.4		
Spread Duration (yrs.)	4.2		
Average Annual Fallen Angel Net Outperformance vs HY (%)	2.86		
Scenarios for 12M Horizon:	**25%**	**60%**	**15%**
Credit Scenario	**Bull**	**Base**	**Bear**
OAS Estimate (bps)	300	425	700
5 Y UST Estimate (%)	3.50	3.25	2.00
Default Rate Estimate (%)	0.70	2.00	6.50
Recovery Rate Estimate (%)	45	40	25
Net Fallen Angels (% of HY index par)	-10.0	4.0	12.0
Yield Carry (%)	**7.01**	**7.01**	**7.01**
Return From Treasury Component (%)	-2.97	-1.88	3.56
Return from Spread Change (%)	5.13	-0.08	-11.55
Loss Given Defaults (%)	-0.39	-1.20	-4.88
Impact of Net Fallen Angels (%)	-0.57	0.23	0.69
Expected Total Returns (%)	**8.21**	**4.07**	**-5.17**
Expected Excess Returns	11.18	5.96	-8.73

Source: State Street Global Advisors, BoA, as of 31 May 2022.

Some of the extreme negative sentiment surrounding high yield and specific issuers seems to have peaked and is now reversing, at least temporarily. The last week of May saw the new issue market reignite with 7 new deals pricing for a total of $6.1bn, as well as HY retail funds receiving inflows of $2.9bn over the week. Rates vol has begun to subside from the extreme levels in May of 95+ percentile of the last 35 year range, to about 65th percentile now. The slight change in tone from Fed officials who confirmed a pause for assessment after next two 50bp hikes should also help ease investor concerns.

We expect there to be a low probability of a deep recession in the US that would result in several quarters of meaningfully negative real GDP growth, negative nominal GDP growth and along with defaults rising above 7%. While there are concerns on the horizon regarding inflation and growth, the current level of spreads seems attractive given the strength of credit fundamentals which are unlikely to deteriorate rapidly from here. Therefore on a carry and spread basis, investors should now be considering adding allocations back into high yield.

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- 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 30 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 $4.02 trillion† under our care.

* Pensions & Investments Research Center, as of December 31, 2020.
† This figure is presented as of March 31, 2022 and includes approximately $73.35 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.