Commentary
Fixed Income

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Global High Yield — Recent Rout Provides Attractive Entry Point for New Allocations

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- Global high yield markets saw a sharp sell-off in June, taking year-to-date (YTD) returns deeper into negative territory to -16.80%. Persistent inflation through 1H, and a more front-loaded response from the Fed drove bond yields higher.
- However, this has now led markets to price in the probability of a slowdown and even possibly a recession. Upside surprises on core US CPI lately, along with weaker manufacturing activity and outlook, as well as declines in consumer confidence led to fears that the past few months' tightening in financial conditions has already led to a slowdown in activity taking hold.
- Continued geopolitical risks and high energy prices have been adding another sizable layer of risk.

Most risk assets such as Global Investment Grade (IG) (-12.96%), S&P (-19.96%), Emerging Market (EM) Hard Currency (HC) Sovereigns (-20.31%) have seen similar repricing YTD, as the anticipated transitory inflation and a concomitant slow retreat of central bank liquidity never materialized. An exception has been leveraged loans (-4.45%), which have proved reasonably resilient due to their floating rate nature, and saw fund inflows as well as demand from robust collateralized loan obligation (CLO) issuance activity.

Regionally, US high yield has modestly outperformed European and EM high yield. Rising energy costs and the threat of a gas embargo are threatening to derail the European recovery, with margins also expected to come under pressure from increased interest costs and weaker disposable incomes. European HY markets were also impacted by second order effects due to the end of European Central Bank corporate bond purchases. Challenges for EM HY corporates continue, with a string of defaults from China property developers unable to find liquidity, as home sales and demand for new projects cratered.

Figure 1
Total Returns of High Yield in Recent Periods

Returns	3m (%)	6m (%)	12m (%)	YTD
Global HY (in $ terms)	-11.37	-16.70	-17.63	-16.70
Global HY ($-Hedged)	-9.93	-14.88	-14.98	-14.88
Global HY (€-Hedged)	-10.60	-15.77	-16.29	-15.77
US HY (in $)	-9.98	-14.03	-12.67	-14.03
Euro HY (in €)	-10.81	-15.11	-14.84	-15.11
EM HY (in $)	-10.14	-19.28	-24.31	-19.28

Source: State Street Global Advisors, as of 30 June 2022. Past performance is not a reliable indicator of future performance.

Market Highlights

- Investor sentiment continues to be negative, with US high yield mutual funds reporting outflows in all months of the year, taking total YTD outflows to $42.5bn. For context, this is the highest cumulative outflow ever for any six-month period in history. Even though leveraged loan funds saw outflows in May and June, they still have been the preferred high yield sector given their low sensitivity to duration, experiencing YTD inflows of +$16.5bn. Outflows from European HY funds totaled €8.6 bn YTD.

- The volatility experienced throughout 2022 has led to very subdued primary market activity, with US high yield gross issuance YTD totaling only $71.0bn compared to $301.3bn for the first half of 2021. A similar trend was seen in European HY as well, with YTD gross issuance at €20bn (compared to €93bn in 1H21). While lower supply can be a positive technical in the short term, long periods of much lower issuance compared to market size have an impact on liquidity, and companies' unwillingness to test the market signals that debt cost of capital may be becoming too expensive.

- The number of bonds trading at distressed levels (>1000 bps of OAS) has increased quite sharply during June, doubling from 5% to 10.1% of US HY, 12.8% of European HY and 28.7% of EM HY. Realized default rates however continue to be close to cycle lows but are a lagging indicator and expected to rise. US high-yield L12M default rate ended in May close to cycle lows at 0.57%, much below the historical average of 3.8%. European HY saw similar trend, with L12M par default rate at 0.85%, well below the historical average of 2.5%.

Figure 2
Spread Changes on Key High Yield Sectors

OAS* (bps)	Current Level	Δ 3m	Δ 12m	Δ YTD
Global HY	642	230	295	269
US HY	589	245	283	278
Euro HY	641	241	345	310
EM HY	845	177	318	211

Source: State Street Global Advisors, as of 30 June 2022.
* Option Adjusted Spreads.

Figure 3
Return Breakdown of Global High Yield

Returns	3m (%)	6m (%)	12m (%)	YTD
Global HY ($-Hedged)	**-9.93**	**-14.88**	**-14.98**	**-14.88**
Spread Return	-8.11	-9.03	-8.84	-9.03
Treasury Return	-1.82	-5.85	-6.14	-5.85

Source: State Street Global Advisors, as of 30 June 2022. Past performance is not a reliable indicator of future performance.

Performance Highlights

- The Treasury component of returns was less of a driver of negative returns in Q2 than earlier in the year, with focus switching to downside growth risks resulting from aggressive central bank tightening and the impact of inflation on consumption.
- All high yield sectors are in negative territory in excess return terms YTD, with Banking (-5.65%) and Energy (-5.83%) holding up the best. Real Estate (-22.17%) continues to be seriously challenged and is 5.7% of the index in face value terms, of which China is 1.7%.
- BB (-15.07%) and Single B (-15.49%) rated segments performed quite in line in total return terms, and slightly outperformed the CCC-and lower rated (-16.76%) segment. This is a contrast from overall 2021 performance, which saw significant outperformance of deeper credit with 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

Global HY spreads, currently around 640 bps, are at the 73rd percentile of all time and the 93rd percentile of the last 10 years. With all-in yields now at close to 9%, the carry alone provides significant cushion for investors to ride out any further bouts of volatility. The default outlook has indeed deteriorated quickly as margin pressures are expected to develop from elevated input costs, along with weaker household demand due to the squeeze from inflation. This may ultimately send default rates higher, but likely at a slower and lower rate than what the market is pricing.

We are probably looking at a technical recession that is shorter and shallower than usual, with defaults going up to 3% possibly 5% at most. Investors who normally have 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% yields are now looking at a completely different picture. This appears as a rare opportunity to deploy capital with strong one year expected returns.

Outlook and Scenarios for US HY

The US HY market is down -14.03% YTD, its worst first half of a calendar year since inception. While there have been the dual impacts of duration and more recently spread moves, the current spread level of approx 600 bps is consistent with an imminent 4.5–5% default rate and a 35–40% recovery rate, assuming the long-term risk/liquidity premium of 300 bps. Another way of looking at current valuations is that, the current spread offers a cushion of approx 250 bps over and above the current level of defaults and recovery rates. Historically, this has been an excellent 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%	4.5%	5.0%	5.5%	6.0%
Expected Recovery Rate	25%	375	413	450	488	525	563	600	638	675	713	750
	30%	370	405	440	475	510	545	580	615	650	685	720
	35%	365	398	430	463	495	528	560	593	625	658	690
	40%	360	390	420	450	480	510	540	570	600	630	660
	45%	355	383	410	438	465	493	520	548	575	603	630
	50%	350	375	400	425	450	475	500	525	550	575	600
	55%	345	368	390	413	435	458	480	503	525	548	570
	60%	340	360	380	400	420	440	460	480	500	520	540
	65%	335	353	370	388	405	423	440	458	475	493	510

Source: State Street Global Advisors, as of 30 June 2022.

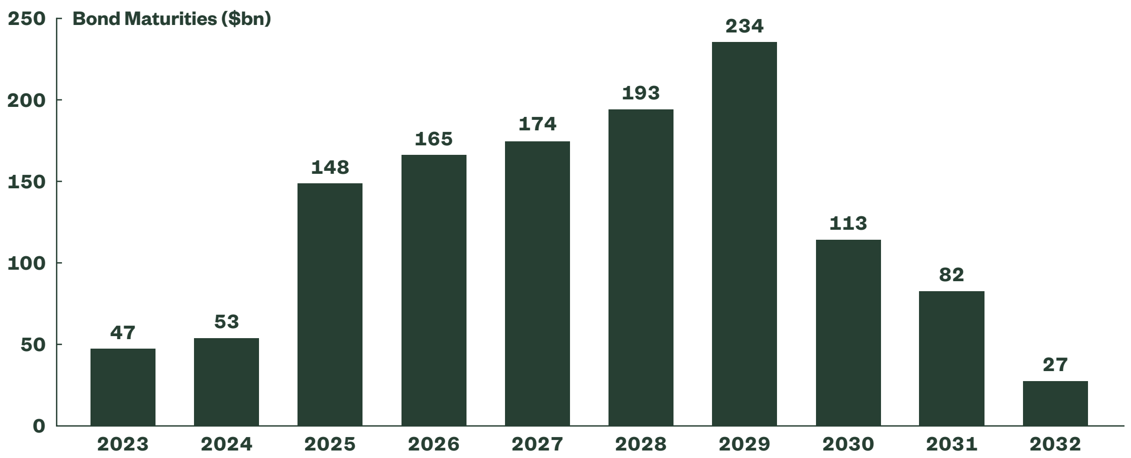
Distress Levels Remain Low and Underlying Fundamentals Are Strong

Over 10% of the bonds in the index are currently trading at distressed levels with Healthcare and Media being the most affected sectors. The Retail, Autos and Travel segments were recently added to the most affected sectors in June, as markets priced in the slowdown in consumer-oriented industries. Given the historically tight relationship of distress (and specifically in CCC bonds) vs N12M defaults in stressed environments, a simple regression as well as a subjective observation of the default watchlist tells us that the next 12M expected defaults would be in the 2.5%–3% range.

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-Global Financial Crisis (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 Figure 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.

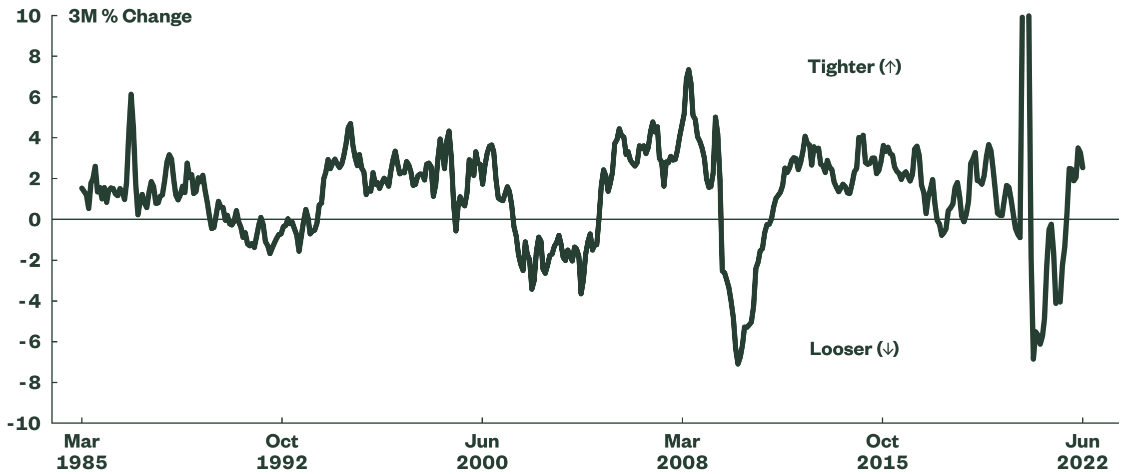
While lending conditions have tightened and primary issuance has reduced significantly, trading volumes are also down and transaction costs have gone up in secondary markets (Figure 7). The level of dispersion within the market has also started to rise, which indicates that investors have begun to shun specific issuers that could struggle to refinance, or are expected to be downgraded further given stretched balance sheets, especially within Retail and Autos.

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



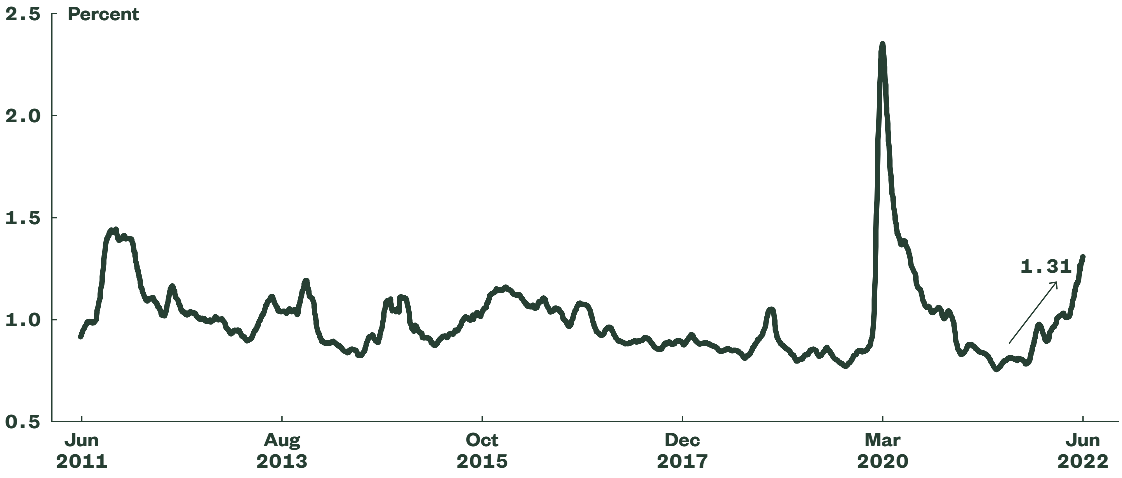
Source: State Street Global Advisors, as of 30 June 2022.

Figure 6
US Commercial and Institutional Loan Lending Conditions



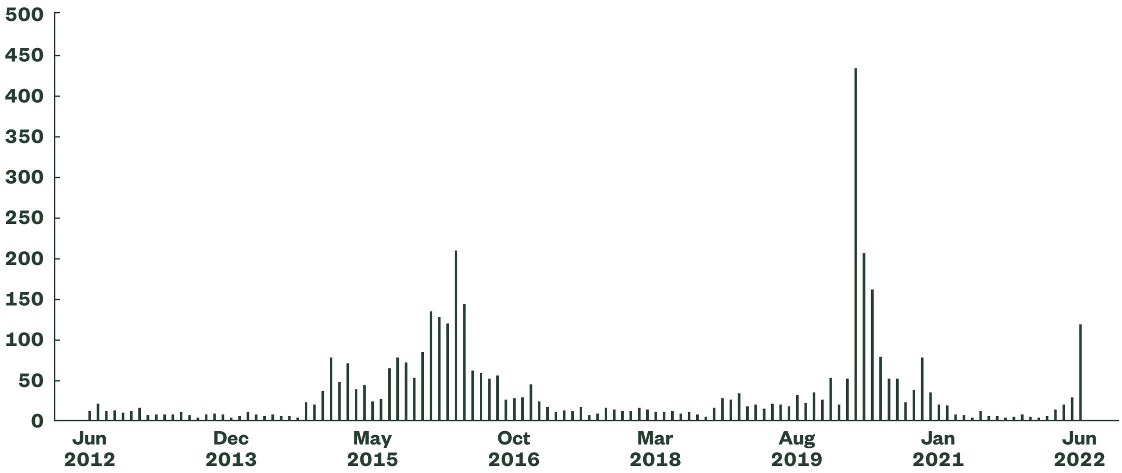
Source: State Street Global Advisors, as of 30 June 2022.

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



Source: State Street Global Advisors, as of 30 June 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 30 June 2022.

Outlook — Scenario Analysis for US High Yield

To provide some context on the potential returns for high yield over the next 12 months, we outline below some scenarios with various assumptions about future levels of spreads, Treasury yields, default and recovery rates and rating migrations (Figure 9). In our base case, we expect the Fed to hike rates into the 3.25%–3.5% range in the first half of 2023 and then pause and lower rates in response to lower inflation, and a slower economy. We allow the default rate to rise to 4% from current 0.57% levels, but see spreads moving a leg tighter from the broad-based moves in the June sell-off.

Some of the extreme negative sentiment around inflation expectations also seems to have peaked, with the 5y5y inflation swap (common measure used to look at the market's future inflation expectations) starting a downtrend ever since the beginning of June, to end at 2.4%. Rates volatility is certainly elevated around the 90th percentile, but there is really only one way to go from there.

The Bull and Bear cases around this are highlighted in Figure 9 and illustrate that downside risks from here for high yield are not that significant. This is because so much has been priced in given the higher spreads already available and also because higher Treasury yields now have some decent room to rally should a bearish credit environment to materialize.

Figure 9

Expected 12 Month Total and Excess Returns of US HY Under Different Scenarios

US High Yield			
Effective Yield of US HY (%)	8.90		
OAS (bps)	589		
5Y UST (%)	3.04		
L12M Defaults (%)	0.57		
L12M Recovery Rates (%)	47.2		
Effective Duration (yrs.)	4.50		
Spread Duration (yrs.)	4.40		
Average Annual Fallen Angel Net Outperformance vs HY (%)	2.86		
Scenarios for 12M Horizon (%)	**20.00**	**60.00**	**20.00**
Credit Scenario	**Bull**	**Base**	**Bear**
OAS Estimate (bps)	400	525	750
5 Y UST Estimate (%)	3.75	3.25	2.00
Default Rate Estimate (%)	2.00	4.00	8.00
Recovery Rate Estimate (%)	45	35	25
Net Fallen Angels (% of HY Index par)	-12.00	5.00	15.00
Yield Carry (%)	**8.90**	**8.90**	**8.90**
Return from Treasury Component (%)	-3.17	-0.94	4.62
Return from Spread Change (%)	8.33	2.82	-7.10
Loss Given Defaults (%)	-1.10	-2.60	-6.00
Impact of Net Fallen Angels (%)	-0.69	0.29	0.86
Expected Total Returns (%)	**12.28**	**8.46**	**1.28**
Expected Excess Returns	15.45	9.41	-3.34
Probability Weighted Return			**7.79**

Source: State Street Global Advisors, BoA, as of 30 June 2022.

Like many fixed income sectors, high yield markets have been hit hard this year, driven initially by the rapid rise in Treasury yields and more recently by the rapid rise in credit spreads. On closer examination, at current levels of valuation a significant cushion has now been created for investors. Importantly, this can offset much of the impact of the expected rise in the credit default cycle ahead and also any further impact from spreads widening further. The scenario analysis outlined in Figure 9 above illustrates how the key drivers of high yield might perform and interact. On the balance of risks, a meaningful cushion has now been built in, making new allocations to high yield quite attractive.

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* 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.

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