The Incredible Shrinking Asset Class and the Imminent Fall of the Zombies

November 2023

The high-yield bond market has been having a relatively good 2023 as technicals remain firm and the feared recession has so far failed to materialize. Through mid-November, the ICE BofA U.S. High Yield Index has generated 7.8% total return year-to-date and a 6.4% return in excess of duration-matched Treasuries. We see a mixed picture for the asset class ahead as all-in yields remain attractive, while challenges are increasing as a maturity wall looms.

Shrinking Size of the Market

Technicals in the high yield market are currently positive, driven partly by a shrinking universe of bonds over the past two years. As of October 31, 2023, the par value of the ICE BofA U.S. High Yield Index was $1.3T, down 7.6% from $1.5T at the end of 2020. We attribute this to several factors, including net upgrades into investment grade post-pandemic, light primary market issuance in the last two years, outflows from the asset class, and an increase in loan-only issuance in the leverage loan market.

Money Flows

High yield has seen significant outflows over the last two years. In 2022, outflows amounted to $46.6B, equivalent to approximately 3.8% of starting assets under management (AUM). Through October 2023, year-to-date outflows from high yield exchange-traded funds (ETFs) and actively-managed funds totaled almost $24B.

Rising Stars/Falling Angels

In 2020, the market saw $202B of downgrades into high yield from investment grade with just $23B of upgrades into investment grade, due to the pandemic. Thanks to fiscal and monetary stimuli and timely crisis management, company fundamentals rebounded strongly in 2021 and 2022, driving rising stars[1] of $56B and $110B, respectively, compared to fallen angels[2] of just $9B and $20B. The trend has continued this year, including the upgrade of Ford in October, which represented approximately 3% of the high yield universe. Year-to-date through October, the dollar volume of rising stars was $111B compared to $17B of fallen angels.[3]

Increase in Loan-Only Leveraged Borrowers

The leveraged-loan market has more than doubled in size over the last ten years and is now roughly equivalent in size to the high-yield bond market. This growth has featured an increase in issuance by companies that we believe would otherwise have tapped the high-yield bond market.

Primary Issuance and Leveraged Buyout (LBO) Activity

High yield primary market issuance was strong in 2020 and 2021 as companies proactively extended upcoming maturities at attractive (for issuers) coupons. Primary volume in 2020 was $432B, increasing to a record $458B in 2021. As rising Treasury yields slowed the pace of opportunistic refinancing, issuance declined precipitously in 2022 to just $102B. Thus far in 2023, primary market volume has risen to approximately $155B but remains below typical annual issuance of $200B to $300B. Similarly, the higher interest rate environment of the last 18 months has depressed mergers and acquisitions (M&A) and LBO volumes, reducing another source of supply in the high yield market.

In summary, while the high yield market has seen outflows over the last two years, lower issuance has led to a firm underlying bid for risk. Considering coupons alone (and excluding calls, maturities and tenders), the high yield market was on pace to generate approximately $70B of internal cash in 2023, most of which needs to be reinvested. High-yield credit fundamentals have also been supportive, as discussed in further detail below.

[1]A “rising star” is a bond that could be upgraded due to improvements in the issuing company’s credit quality. [2]A "fallen angel" is a bond that has been classified to "junk bond" status because of its issuer’s financial difficulties. [3]Data is as of 01.03.2022. Source: Bloomberg U.S. High Yield Corporate Update. Yields are subject to market conditions and are therefore expected to fluctuate. The views expressed represent the opinions of Sterling Capital Management. Any type of investing involves risk and there are no guarantees that these methods will be successful. Past performance is not indicative of future results.

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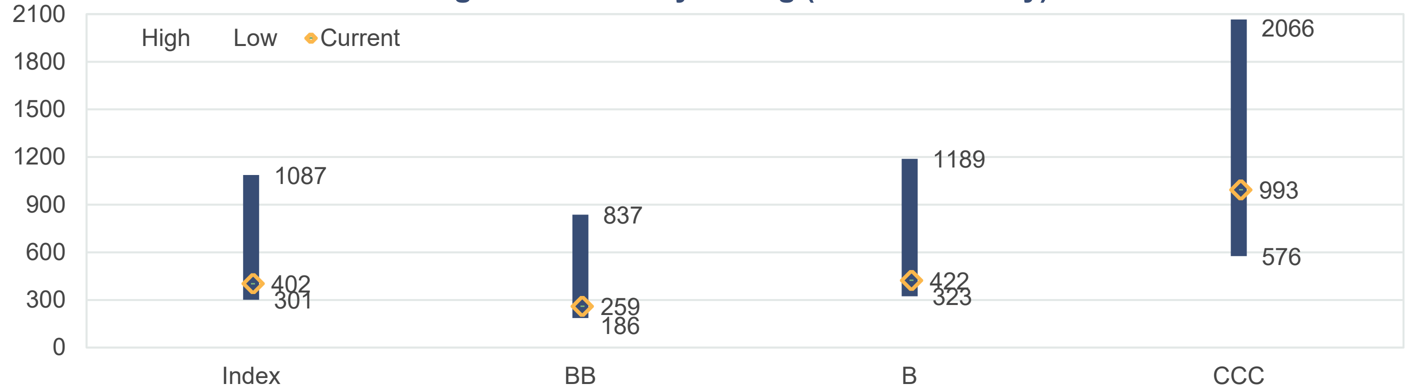
Improvement in Index Quality

Another factor contributing to relatively low high-yield spreads is improvement in the quality of the high-yield index over time. Since 2000, the market value percentage of BBs increased from approximately 35% to just over 50% of the index, while the percentage market value of issuers rated single-B has decreased from 56% to 39%.[4]

Valuation

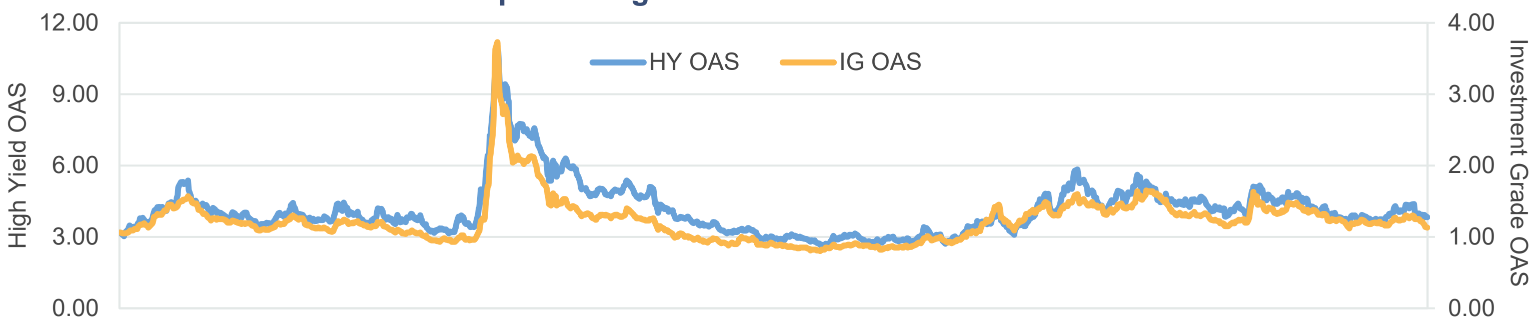
The option-adjusted spread (OAS) on the ICE BofA U.S. High Yield Index ended October 2023 at 442 basis points (bps) and, as of mid-November, has tightened to 402bps, which is in the 46th percentile and 42bps below the mean over the last ten years. However, the all-in yield on the index is currently 8.76%, which is in the 92nd percentile over the same period.

High Yield OAS by Rating (10-Year History)[5]



Relative value compared to investment grade is also average, with the high-yield/investment-grade index spread ratio currently trading at 3.35x, which is in the middle of its five-year range of 2.7x to 4.2x.

U.S. Corporate High Yield/Investment Grade OAS[6]



U.S. Corporate High Yield/Investment Grade OAS Ratio[6]

[4]Source: ICE BofA HY Index. [5]Data is as of 11.16.2023. Chart source: ICE BofA. [6]Data is as of 11.20.2023. Chart source: Bloomberg L.P. Charts are for illustrative purposes only. Yields are subject to market conditions and are therefore expected to fluctuate. The views expressed represent the opinions of Sterling Capital Management. Any type of investing involves risk and there are no guarantees that these methods will be successful. Past performance is not indicative of future results.

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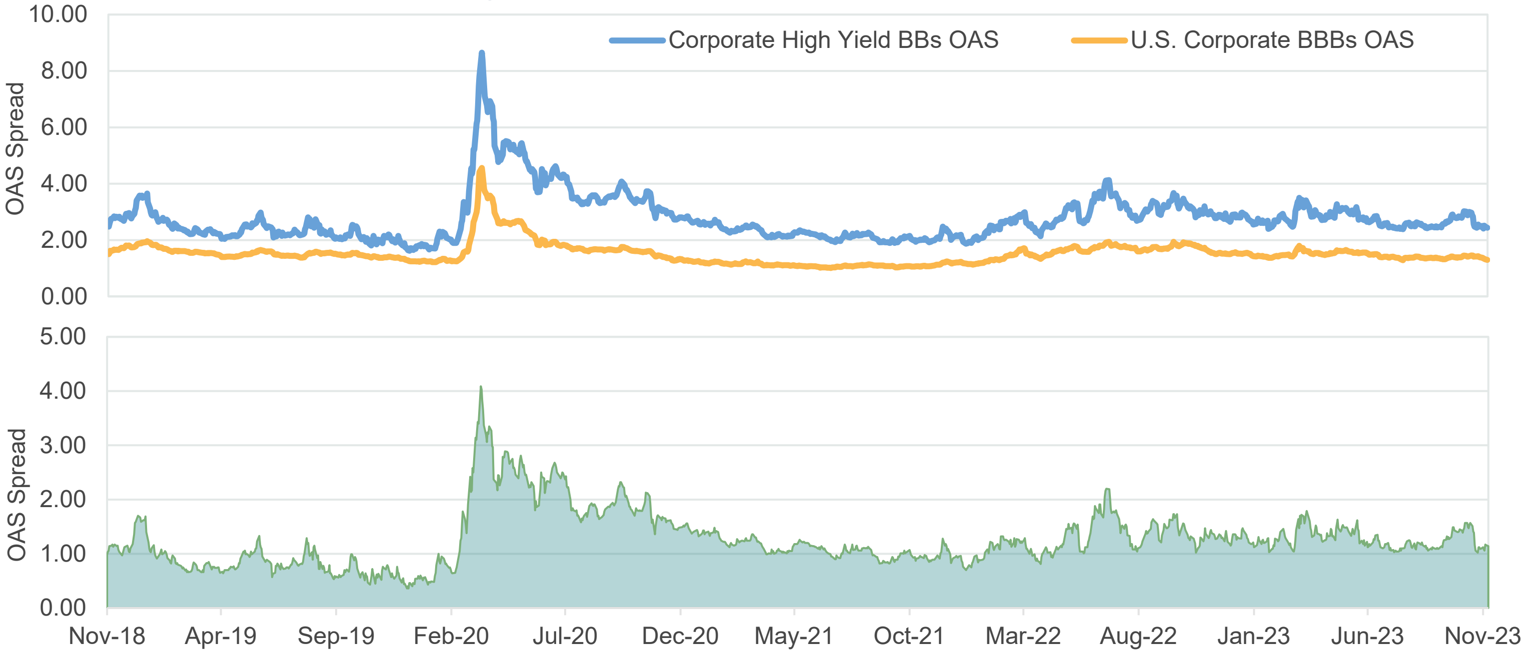
Similarly, the BB-BBB (ex-financials) spread is currently 117bps, which is at the lower end of the five-year range of 36-409bps.

U.S. Corporate High Yield BBs - U.S. Corporate BBBs ex. Financials OAS Spread[7]



Overall, from a valuation perspective we think beauty is in the eye of the beholder. For excess return-focused investors, spreads are currently not attractive over a medium-term horizon, especially in a weakening economy scenario. However, for total return-focused investors, elevated yields may provide some cushion for spread widening. With a weighted average duration of approximately 3.7 years, the high-yield index can absorb approximately 20bps of monthly widening in the OAS to break even.

Corporate Credit Fundamentals

In the near term, relatively low credit spreads are justified, in our opinion, by the strong current credit fundamentals of high-yield corporates. While credit metrics for high-yield issuers have trended slightly weaker in recent quarters, they remain strong in an absolute sense. Leverage ended the first half of 2023 at 4.17x, below pre-pandemic levels and down from a peak of 6.2x in the first quarter of 2021. Interest coverage has deteriorated slightly in recent quarters but remains strong at 5.25x and above the long-term average of 4.48x.[8]

Default Rate Outlook

Tightening financial conditions and the need for companies to address upcoming maturities in the high-yield market are leading to an increase in default rate expectations going forward. Moody's recently noted that U.S. high-yield companies face $1.9T of leveraged loans and below-investment-grade bonds falling due through 2028, with debt maturing in the next two years accounting for about 18% of the total. Moody's expects the U.S. speculative default rate to peak at 5.6% in January 2024 before easing to 4.6% by August 2024. However, this remains well below recent peak recession default rates of 9.0% in August 2020 and 14.7% in November 2009.

[7]Data is as of 11.20.2023. Chart source: Bloomberg L.P. [8]Source: J.P. Morgan 2Q23 HY Credit Fundamentals.

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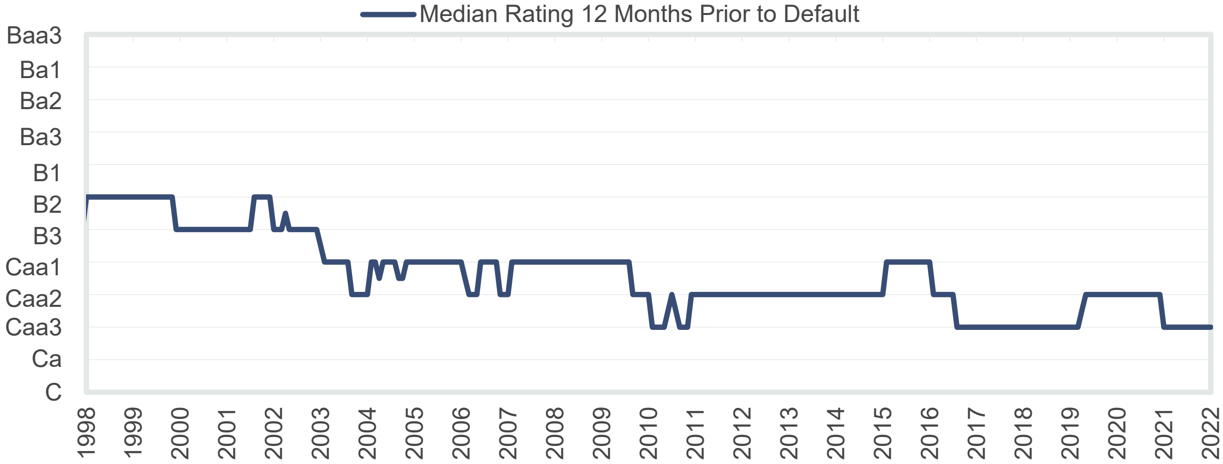
Attractive Risk-Adjusted Historical Returns

We believe high yield offers attractive risk-adjusted returns over the long term. Since the beginning of 2010, the Sharpe ratio for the Bloomberg U.S. High Yield Index is 0.73, which compares to 0.71 for Bloomberg U.S. Corporate Crossover Index and 0.26 for the Bloomberg Aggregate Index. Risk-adjusted returns for BBs are even stronger, with a Sharpe ratio of 0.76 over the same period.[9]

Default Migration Favors BBs

Default experience in BBs is also favorable relative to lower-rated segments of the market. Moody's default migration studies show low default probabilities for non-financial BBs over subsequent 12-month periods (although the financial sector showed elevated migration to default from BBs during the financial crisis). Since 1980, only 0.5% of bonds rated BB1 or BB2 and 1.3% of bonds rated BB3 have defaulted within 12 months.

North America[10]

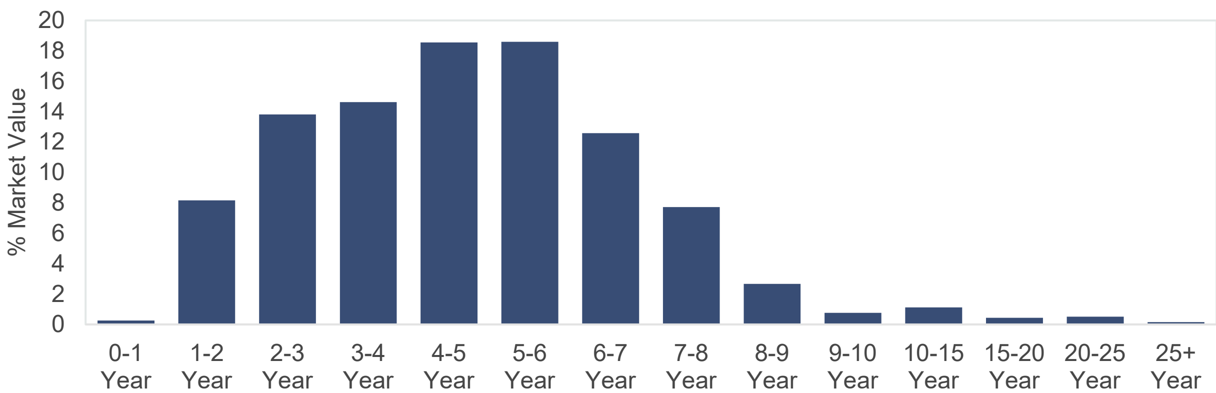


The Maturity Wall and Rising Interest Costs

We are less sanguine on high-yield valuations over the medium term, partly due to the maturity profile of the high-yield index, which shows a significant maturity wall in the 2025-2028 period. After active refinancing years in 2020 and 2021, high-yield maturities inside one year are very modest but pick up significantly over the next five years:

High Yield Maturity Distribution[11]

ICE BofA U.S. High Yield Index



[9]Source: Bloomberg U.S. High Yield Corporate Update, October 2023. [10]Data is as of 01.01.2022. Chart source: Moody's. [11]Data is as of 11.09.2023. Chart source: ICE BofA. Charts are for illustrative purposes only. Yields are subject to market conditions and are therefore expected to fluctuate. The views expressed represent the opinions of Sterling Capital Management. Any type of investing involves risk and there are no guarantees that these methods will be successful. Past performance is not indicative of future results.

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While we're confident the market can navigate this, average coupons are 6.2% while average effective yields are nearing 10.5% for bonds maturing between now and YE 2026. The contrast is more pronounced for companies rated B3 or worse with maturities over the next two years, where average coupons of 7.5% compare to average market yields of 16.7%. This implies a steep increase in interest costs over the next few years for companies that need to refinance into the current high interest rate environment. We believe lower-rated companies that have delayed tapping the markets in the hope that prevailing yields will decrease in the future are likely to regret that decision. In short, we think it's time to be mindful of zombies in the high-yield market, companies with high leverage that have scraped by and may struggle to cover elevated interest costs, even if they are able to refinance upcoming maturities.

Thoughts on Positioning Going into 2024

Pulling all of this together, we are neutral to slightly positive on high-yield returns over the next quarter, especially for total return-focused investors given high all-in yields. Over the medium term, we see spreads moving moderately higher as economic growth slows due to higher interest rates and tightening in financial conditions. Recognizing currently strong corporate credit fundamentals and favorable technicals as a starting point, as well as high all-in yields, we do not see spreads blowing out to levels typically seen in recessions. However, we think risk-adjusted returns favor positioning in BBs and selective positioning in single-Bs, while avoiding or having very low exposure to CCCs where many of the zombies hang out.

Important Information

Robert Brown, CFA®
Managing Director | Head of Non-Investment Grade Credit

Robert A. Brown, CFA®, Managing Director, joined Sterling Capital Management in 2016 and has investment experience since 1986. Robert is a Fixed Income Portfolio Manager and is Head of Non-Investment Grade Credit. Prior to joining Sterling, he worked at Concerto Asset Management specializing in high yield credit management. He was also managing director and head of credit research for Wachovia Securities Principal Credit Trading Group. Robert received his B.A. in Geography with Economics from the University of Exeter. He holds the Chartered Financial Analyst® designation.

Past performance is not indicative of future results. Any type of investing involves risk and there are no guarantees that these methods will be successful. Economic charts are provided for illustrative purposes only. The information provided herein is subject to market conditions and is therefore expected to fluctuate.

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Technical Terms: Option-adjusted spread (OAS) is the measurement of the spread of a fixed-income security rate and the risk-free rate of return, which is then adjusted to take into account an embedded option. Typically, an analyst uses Treasury yields for the risk-free rate. The spread is added to the fixed-income security price to make the risk-free bond price the same as the bond. A **Zombie Company** is a term used to describe an uncompetitive company that needs a bailout to operate successfully or an indebted company that is only able to repay interest on its debt (interest-coverage ratio of 1 or less). Such companies generate only enough cash flow to pay the interest on the debt and are unable to reduce the actual principal amount. Therefore, they do not have excess cash or capacity and are stagnant, which means they are too weak to invest or grow. **Sharpe Ratio** is commonly used to gauge the performance of an investment by adjusting for its risk. The higher the ratio, the greater the investment return relative to the amount of risk taken, and thus, the better the investment. The ratio can be used to evaluate a single stock or investment, or an entire portfolio. (The technical terms are sourced from Corporate Finance Institute and Investopedia.)

A Note on Indices: The volatility of an index varies greatly. All indices are unmanaged and investments cannot be made directly in an index.

The ICE BofA U.S. High Yield Index is an unmanaged, market capitalization-weighted index that measures the performance of USD-denominated, below-investment-grade corporate debt with at least 18 months to maturity at the time of issuance.

The Bloomberg U.S. Corporate High Yield Index is an unmanaged, U.S. dollar-denominated, nonconvertible, non-investment-grade debt index. The index consists of domestic and corporate bonds rated Ba and below with a minimum outstanding amount of $150 million.

The Bloomberg U.S. Aggregate Bond Index is an unmanaged index composed of securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities. It is not possible to invest in the Bloomberg U.S. Aggregate Bond Index, which is unmanaged and does not incur fees and charges.

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