Fixed Income Insights

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The Impact of Higher for Longer on High Yield

Author

David Peterson
Lead Research Analyst
Investment Solutions Group

In brief

- Higher for longer continues to be a major theme for global markets; however, concerns over its negative impact on the high yield (HY) asset class are overblown, in our view.
- We see resilience in high yield from several factors such as a benign maturity wall, low percentage of distressed credits in the coming years, favorable market technicals and prudent balance sheet management from issuers.
- Overall, high yield remains supported by strong fundamentals and technicals. While it is true that the valuation landscape has become more challenging, there are still plenty of attractive opportunities that can be identified through a thorough security selection process. We believe investors should continue to consider exposure to US HY as part of their fixed income asset allocation.

Is history going to repeat itself for high yield? Historically, an environment of sharply tightening financial conditions has been perceived as challenging, if not treacherous, for high yield issuers. In fact, there are many examples of rate hiking episodes in the past that resulted in economic or financial instability. This in turn increased the volatility of the asset class while also triggering a sharp rise in corporate defaults.

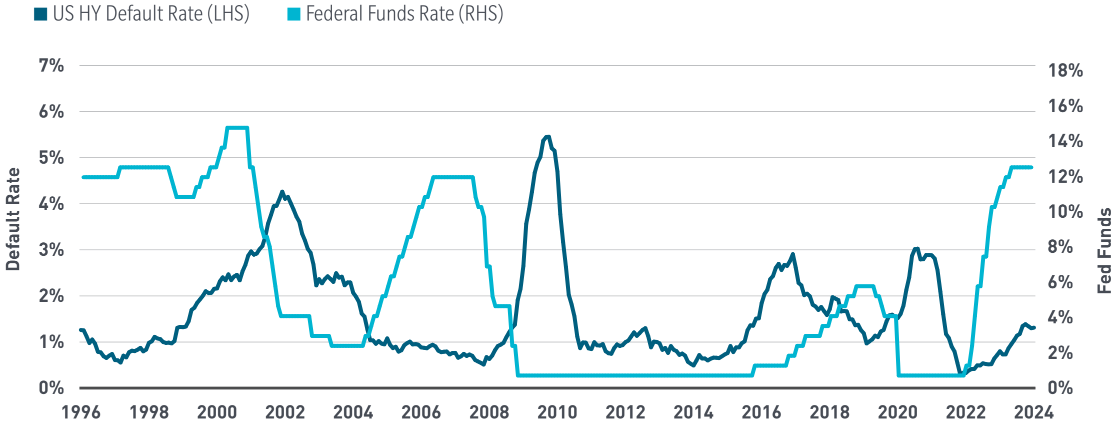
Recent experience has been different, however. In the face of an aggressive tightening cycle by the US Federal Reserve, the asset class has been able to weather the rate shock, mainly reflecting a combination of stronger fundamentals post-Covid and market technical tailwinds.

Concerns over the impact of Higher for Longer are overblown. While policy rates now appear ready to decline in the period ahead, they are not expected to be lowered to their pandemic or even pre-pandemic levels and seem poised to remain elevated from much of what was experienced during the prior business cycle. Hence the higher for longer theme that has dominated the market discussions over the past few months. In keeping with historical experience, investors have grown concerned over high yield in a higher rate environment, especially with respect to the risk of higher defaults, refinancing risks and the maturity wall. While these are all valid concerns, we believe that the risks for high yield are not as significant as initially feared. In this regard, we believe that high yield will continue to play a key role as a potential return generator in investors' broader fixed income allocations, reflecting a combination of prudent balance sheet management from issuers, a gradual improvement of the interest rate environment and strong market technicals.

Outlook for High Yield Defaults

This time could be different. Historically, there has been a strong relationship between the rise in central bank policy rates and a subsequent rise in high yield corporate defaults, as illustrated in Exhibit 1. While interest rates have risen considerably over the past few quarters, this time around we do not expect default rates to move much at all. This is mainly owed to the strength of fundamentals and balance sheets, in particular the stronger interest coverage ratios and lower levels of net leverage (Exhibit 2).

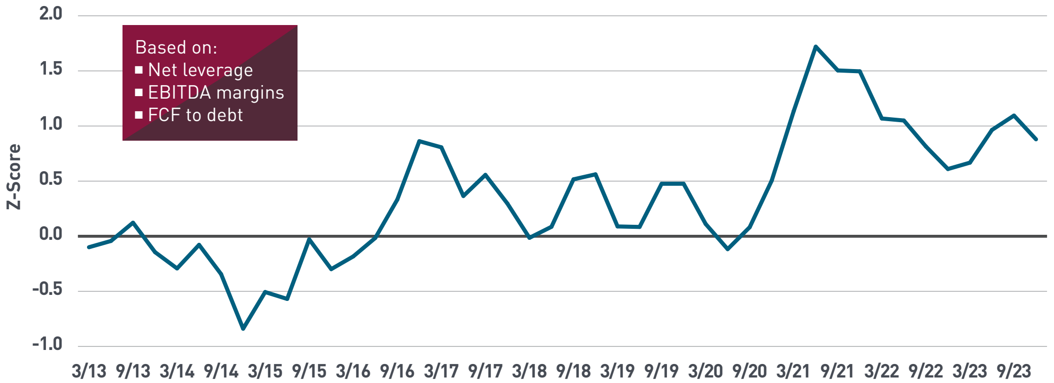
Exhibit 1: US Federal Funds Rate and High Yield Defaults



Source: Bloomberg, Morgan Stanley Research, Moody's. Monthly data from February 1996 to 29 February 2024. Defaults are last 12-month issuer count weighted.

The outlook for expected defaults is also supportive. According to recent Moody's data, default rates for US HY are expected to stay below 4% over a 12-month horizon.[1] Aside from the fundamentals, we believe that near-term refinancings will be easily manageable. Overall, we do not think that high yield default will rise dramatically in the period ahead, a supportive signal for the asset class.

Exhibit 2: US HY Fundamental Score

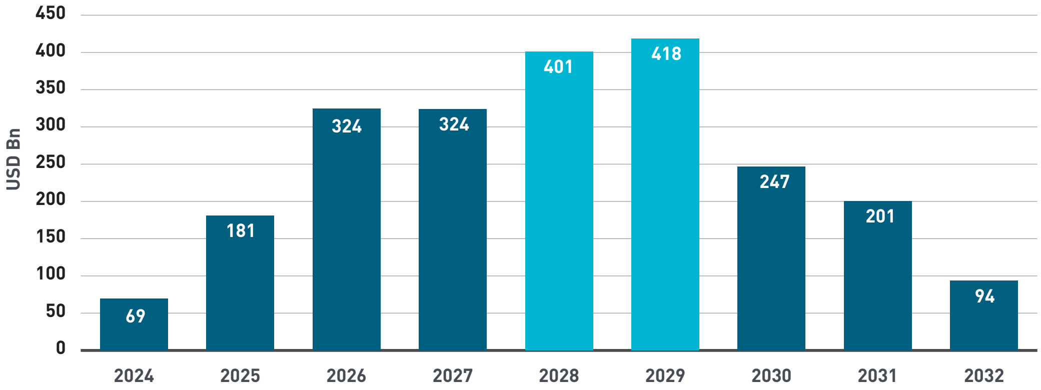


Source: Morgan Stanley, quarterly data up to December 2023. The fundamental score is the simple average of the 10-year z-scores for the three following indicators: net leverage, EBITDA margins and free cash flow to debt. A z-score is a measure of deviation from long-term average in units of standard deviation.

How High is that Maturity Wall?

Not that high at all, in our view. The maturity wall is one of the most often quoted concerns about high yield this year. Many investors know that the high yield market saw a large wave of issuance during the COVID pandemic to shore up balance sheets during a tumultuous period. As of the end of 2021, the weighted average maturity of the ICE BofA Global High Yield index was 6.25 years, putting the average maturity date at that time somewhere near 2027. This means that while there certainly are credits in the index that will need to refinance over the next year or two, these do not constitute the majority of issuers, as highlighted in Exhibit 3.

Exhibit 3: Maturity Distribution of Global High Yield Bonds

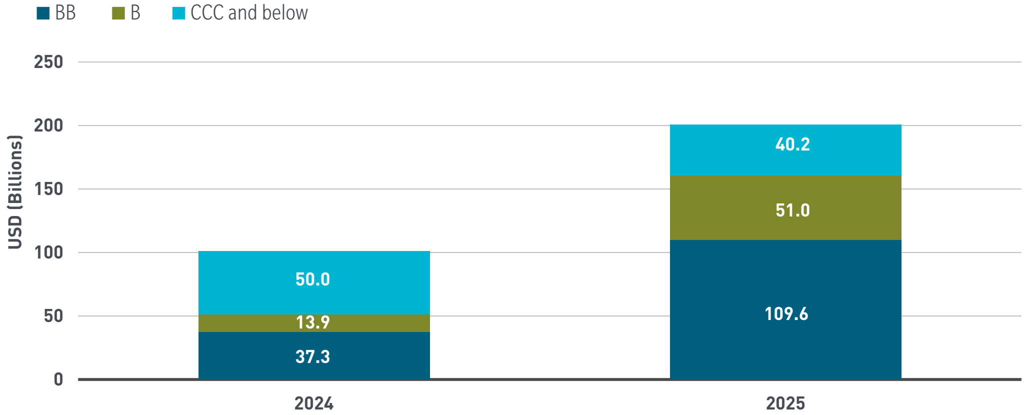


Source: Bloomberg. Data as of 15 April 2024. Maturity distribution is for outstanding high yield bonds issues above $150 million in amount outstanding, expressed in USD. Maturity values are principal repayments due.

For 2024, only $69 billion in bond principal repayments are due, which rises to $181 billion in 2025. Both years combined represents only 11% of the total maturities through 2032. Research from Bank of America suggests that the low percentage of maturities in the near term is due to issuers proactively managing their upcoming debt maturities, showing that maturities due in 2024 and 2025 have declined by 40% from a year ago.[2] Maturities begin to escalate to 14% of the index due in a single year in 2026, but because of the proactive refinancing strategy of high yield issuers, the largest segments of the maturity wall have been shifted out to 2028–2029. While some refinancing risks certainly remain, we believe that the concerns over the maturity wall are overblown, given the delayed timing of the maturity peak.

Not only is the size of the near-term maturities reassuring, but the rating composition of these maturities is also supportive. Issuers across the credit rating spectrum will likely face higher refinancing rates in the future, but those with lower credit ratings will see their rates escalate the most. However, looking at the first few years of maturities in the next exhibit, the lowest credit rating buckets only make up a small portion of near-term maturities. About 86% of the high yield bonds coming due over the next two years carry a BB or B credit rating. The overwhelming majority of refinancings taking place will be done at reasonable spreads above policy rates. Given the healthy composition of issuers who will need to refinance, we are not concerned about material increases in defaults as a potential result of issuers being shut out of capital markets from punitively high refinancing rates.

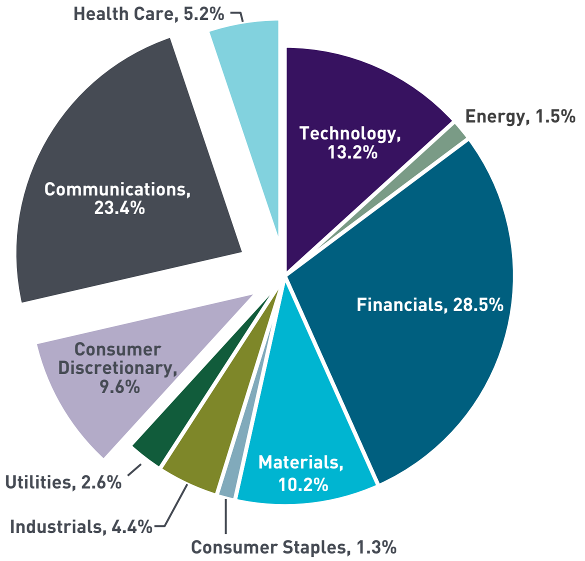
Exhibit 4: Near-Term Maturities by Credit Rating



Source: Bloomberg. Data as of May 2024. Maturity distribution is for outstanding high yield bonds issues above $150 million in amount outstanding that mature in the next two years, expressed in USD. Maturity values are principal repayments due.

For those issuers who do end up at the bottom of the credit quality spectrum, it is highly likely that some of these companies will face complications with refinancing their existing debt. In the CCC and below rating categories, the key bonds at risk of default are those trading at distressed levels, as defined by a credit spread of 1000 basis points or higher. We have mapped the sector composition of those bonds that are distressed through 2025 in the chart below.

Exhibit 5: Sector Composition of Global HY Distressed Credits Due by 2025



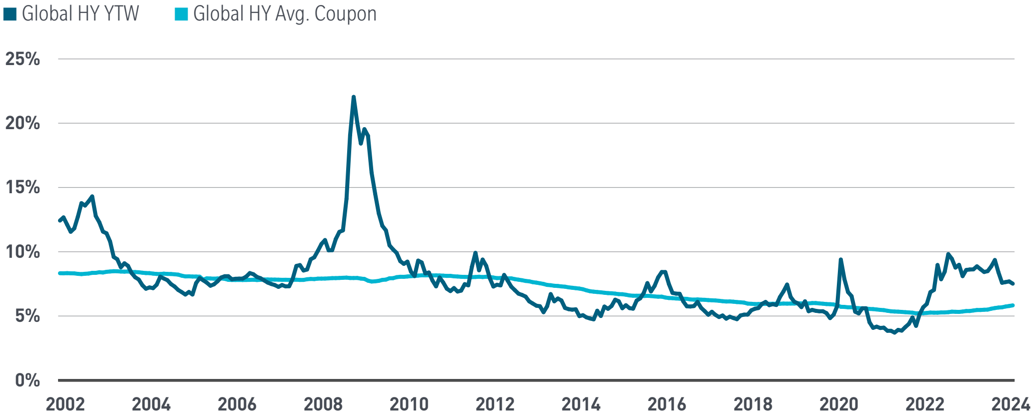
Source: Bloomberg. Data as of 7 May 2024. Maturity distribution is for outstanding high yield bonds issues above $150 million in amount outstanding that mature in the next two years, expressed in USD. Maturity values are principal repayments due.

There are a few notable sectors that bear watching, namely communications, consumer discretionary and health care. While the problems facing these issuers are likely to be idiosyncratic, the general pattern for many of these distressed names is found in members of industries that are seeing strong secular headwinds and structural challenges. In particular, industries such as local radio and brick and mortar retail will likely continue to experience financial stress regardless of the interest rate environment. Given the risks involved in being active in the distressed market, we believe that it makes sense for an investor to partner with an active asset manager with substantial credit research capabilities who can conduct credit analysis on an issuer-by-issuer basis.

Looking Into Refinancing Options for HY issuers

When assessing the impact refinancing activity will have on debt service, it is the coupon rate that matters. Despite the adverse optics of current yields being quite high relative to the prior 10 years of history, the index average coupon rate is still relatively low. This is mainly due to the lack of new issuance given the higher rate environment. Specifically, the average coupon currently stands at 168 bps below the current yield, as illustrated by Exhibit 6. As issuance for high yield recovers, we anticipate that stronger refinancing activity will be driving the average coupon higher in the period ahead. However, owing to the low volume of maturities due in the near term, we expect the rise in the coupon rate to be fairly gradual. From a historical standpoint, it is worth highlighting that the yield-to-worst for the asset class may appear high compared with the post-GFC period but is only returning back to its pre-GFC levels. In other words, we do not consider the current levels to be abnormally elevated. In fact, this normalization of rates has been instrumental to reviving investor interest for fixed income, including high yield.

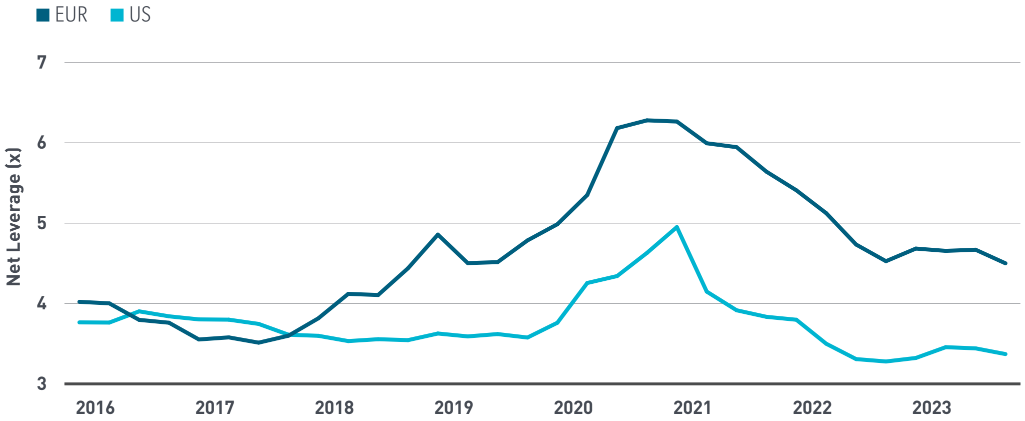
Exhibit 6: Global High Yield-to-Worst Versus Average Coupon



Source: Bloomberg. Monthly data from 31 January 2002 to 31 March 2024. Global High Yield = Bloomberg Global High Yield Index.

What strategies can high yield issuers pursue to help manage their overall interest obligations? There are trends that we can observe today in the market that tell us how issuers may be able to manage the impact of the higher rate environment. A simple yet highly effective method to reduce interest cost is to simply carry less debt and reduce leverage. Looking at the levels of net leverage in the US and European high yield markets, both have seen net leverage decline by about 1.5x each (see Exhibit 7). The reduction in leverage should help bolster balance sheets in the near term with less impact on interest expense expected due to lower levels of debt. Over the long term, this also provides flexibility to issuers who will have greater balance sheet capacity to add back leverage should a need arise.

Exhibit 7: US and European High Yield Net Leverage (Ex-financials)

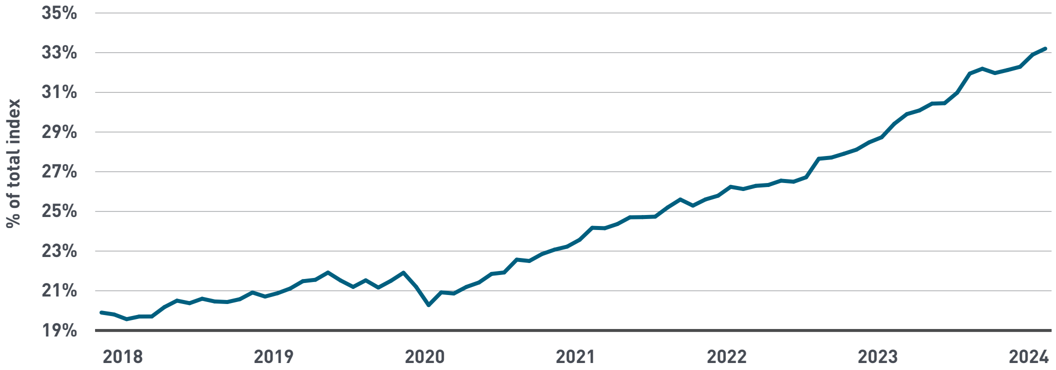


Source: J.P. Morgan. Quarterly data from 31 March 2016 to 31 December 2023. Net leverage defined as net debt over EBITDA.

Two of the factors behind the decline in high yield debt have been the overall low levels of issuance into the market and the large imbalance of rising stars to fallen angels. When looking at net supply of high yield bonds — that is, the amount of issuance coming to market after accounting for maturities, refinancings and ratings migrations — companies have opted to shy away from issuing into the high yield market. Beyond that, high yield has seen a much higher volume of credits upgraded by ratings agencies than downgraded. Due to the large difference in value between upgrades and downgrades, there was an overall reduction of debt from high yield as credits transitioned into the investment grade market. There has also been a trend of smaller issuers leaving the public markets and instead tapping private credit markets for financing solutions. A confluence of all these facts has seen a decline in debt levels for the asset class over the post-covid period. We have also seen an overall recovery in revenue and earnings. The combination of muted debt levels and the recovery in earnings has prompted the decline in leverage, which ultimately will help create more room for issuers to borrow again in the future.

Another trend has been the growth of secured bonds. Indeed, secured bond issuance within the index has been on the rise. A secured bond is backed by collateral and can be used to help reduce the coupon payments as the assets pledged help reduce risk to investors by giving them priority in the event of a default. As seen in the exhibit below, the amount of secured bonds outstanding as a percentage of the index has been steadily increasing over the last few years from a prior decline during COVID. At the time, interest rates were quite low, reflecting the impact of monetary policy in the wake of COVID. As a result, high yield issuers did not feel the pressure to pledge collateral on already low borrowing costs. Looking ahead, with an increasing number of companies seeing their bonds come due, we expect to see the shift to secured bonds sustained as a strategy to manage interest costs, if issuers own adequate assets to pledge.

Exhibit 8: Secured Bonds as a Percentage of the Global High Yield Index



Source: Bloomberg. Monthly data from 31 January 2018 to 30 April 2024. Amount outstanding is measured in USD. Global High Yield = Bloomberg Global High Yield Index.

Overall, while interest costs are expected to rise, we believe there are several factors that will help alleviate financial pressure put onto high yield issuers. Near-term maturities are only a small percentage of the overall index, and the number of distressed credits within that cohort are manageable. Companies have also been able to reduce debt levels, shore up balance sheets, and should continue to use inventive financing techniques like collateralized lending to reduce borrowing costs. These factors lead us to believe that high yield is well positioned to weather the higher interest rate environment and continue to deliver strong relative performance going forward.

Endnotes

[1] Source: Moody's, Trends global default report, March 2024.

[2] Source: Bank of America Global Research. *High Yield Strategy: Tear Down This Wall* as of 22 March 2024.

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