DoubleLine®

Corporate Credit Outlook 2024

Colin Callahan, Product Specialist

Sector Summary

Investment Grade Corporates 3

A Convergence of Yield and Duration

- Investment grade (IG) corporate bonds benefited from the elevated rate environment in 2023, as the sector's yield averaged 5.5%, and the asset class was also boosted by solid investor demand to the tune of $182.1 billion for the year.[1]
- IG corporate bonds are attractive on a historical basis, but relative value has lessened due to a significant rally in corporate spreads over the last two months of 2023.

High Yield Corporates 4

No Landing and Equity-like Returns

- High yield (HY) corporate bond performance was robust in 2023, driven by better-than-expected economic growth, a resilient consumer and a below-consensus default environment.
- Barring a economic slowdown, we believe HY corporate stress will be sector- and credit-dependent, which will support active management in 2024.

Leveraged Loans 5

Higher for How Much Longer?

- Leveraged loans benefited from the increased interest rate environment, as investors were able to purchase loans with high-single-digit and low-double-digit yields throughout the year.
- With expectations for the Federal Reserve to lower the target federal funds rate in 2024, compelling investments remain in the loan market. Despite forecasts for slower growth, potential corporate fundamental headwinds and restrictive rates, attractive opportunities exist in loans rated BB and B that have low default risk relative to their riskier CCC peers.

U.S. Corporate Credit Performance | As of December 31, 2023

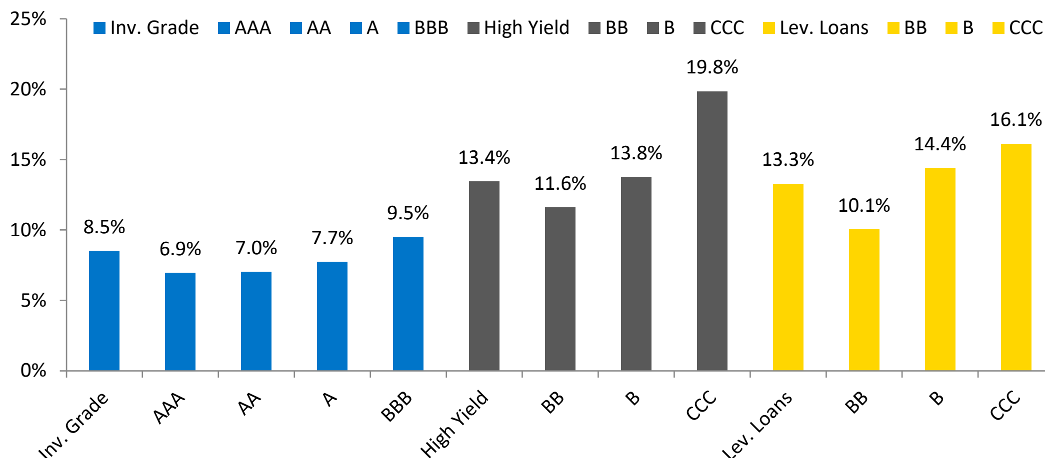


Figure 1
Source: DoubleLine, Bloomberg
Past performance is no guarantee of future results.

DoubleLine®

Corporate Credit Outlook 2024

Summary of DoubleLine Corporate Credit Views

Sector	Fundamentals	Investment Focus
Investment Grade Corporates	• Corporate balance sheets remain in a strong position despite slight margin compression, as cost inflation has outpaced revenue inflation. • IG corporate spreads are tight by historical standards generally due to strong investor demand for IG corporates yielding above 5% and a late-year U.S. Treasury rate rally. • A projected steeper Treasury curve likely incentivize a move out of money market funds and into high-quality assets with excess yield, such as IG corporates.	(+) Pharma that is highly cash-flow generative without significant loss of exclusivity in near term. (+) Tech that has a disciplined capital allocation policy. (+) Globally systematically important banks that are increasing market share, have the ability to weather regulatory changes and exhibit strong relative value. (–) Regional banks, due to a changing regulatory environment, difficulty coping with rising rates and declining market share. (–) Food and beverage companies with eroding fundamentals (declining sales and margins), high merger and acquisition risk and secular risk from GLP-1 diet drug uptake. (–) Credits with flat spread curves in 30-year maturities, particularly in bonds rated BBB.
High Yield Corporates	• Balance sheets for HY corporate issuers are in a strong state heading into a potentially more challenging fundamental landscape. • HY corporate leverage remains comfortably below the long-term average, and interest coverage is slightly below its record high. • Borrowers have increased the quality of issuance to try and stimulate investor appetite, as secured HY issuance set a calendar-year high in 2023.	(+) Hospitals, as volume recovery continues, and staffing headwinds abate. (+) Cruise lines, as demand remains resilient, and companies are focused on multi-year balance-sheet repair. (+) Energy, as elevated commodity prices boost cash flow, combined with corporate leverage discipline. (–) Legacy media, given cyclical concerns about the ad market as well as structural changes in media consumption. (–) Metals and mining, due to broad concerns surrounding future economic growth and weakening fundamentals. (–) Bonds rated CCC, with a focus on issuers whose balance sheets cannot sustain an economic cycle.
Leveraged Loans	• The looming maturity wall should create an environment of winners and losers, as companies with unviable capital structures built primarily on their ability to borrow at low cost will be exposed when coming to market to refinance their debt. • Credit metrics have weakened this year and are expected to show further signs of deterioration, as interest coverage ratios might continue to decline given the lagged transmission of higher policy rates to paid coupons. • Despite the expectations for the Fed to cut rates, loans remain attractive. Loans offer high-single-digit and low-double-digit yields, which can help offset credit risk. Active security selection will be paramount, as economic growth is expected to slow.	(+) Healthcare providers benefiting from enhanced procedure volumes and labor inflation normalizing. (+) Borrowers in the leisure and gaming sectors with persistent consumer demand combined with a continued focus on deleveraging. (–) Overlevered software credits, which have grown substantially as a percentage of the index in recent years. (–) Homebuilder credits that could be vulnerable as higher mortgage rates impact the residential housing market. (–) Cable and telecommunications names with overlevered balance sheets, significant capital expenditure requirements and consumer preferences shifting away from legacy cable and wirelines.

Investment Grade Corporates

A Convergence of Yield and Duration

IG corporates were propelled in 2023 by a combination of investors seeking to lock-in roughly 5%-6% yields and a robust fundamental backdrop. Moreover, spread tightening in the second half of the year reflected optimism surrounding the asset class, as spreads closed the year at 99 basis points (bps). *(Figure 2)* Market stress in the wake of the regional banking crisis caused IG spreads to peak at 163 bps in March. For the year, the Bloomberg US Corporate Bond Index returned 8.5%. *(Figure 1)* 2023 returns were primarily driven by a 10% cumulative return in November and December, which was the best two-month return for the index since the final two months of 2008.

The close of 2023 coincided with a long-awaited shift in monetary policy rhetoric. Given the IG sector's longer duration, the steady march higher in Treasury yields penalized investors in 2022. Despite the yield on the 10-year finishing 2023 flat year-over-year (YoY) at 3.88%, there was significant interest-rate volatility along the way, with a peak yield of nearly 5% in October. We anticipate continued rate volatility in 2024 but overall expect the yield curve to steepen, which should be supportive of IG corporates. (See: IG Corporate Update)

We believe that IG corporates are attractive on a historical basis despite the strong finish to 2023. Valuations, however, have become less attractive due to a significant rally in corporate spreads in November and December. Given the index's yield-to-duration ratio of 0.71, the sector is well insulated to withstand a potential rise in interest rates. *(Figure 3)*

On the technical front, IG experienced a tailwind from fund flows, with an inflow of $182.1 billion in 2023. Corporate earnings remained stable throughout the year and are expected to grow in 2024. Notably, EBITDA margins slightly deteriorated to 30.5% for the third quarter as cost inflation outpaced revenue inflation, but they remain at a strong level. Also of note, higher-rated issuance increased significantly over the past 18 months, causing the share of the index rated BBB to fall to 47%, its lowest level since 2017.

In general, DoubleLine believes there are several opportunities across sectors for attractive risk-adjusted returns. The team is positioning its portfolios to offset any potential economic weakness by favoring credits that are better suited to withstand margin pressures as well as targeting credits that have positively sloped spread curves. We prefer pharmaceutical companies that are highly cash-flow generative without significant loss of exclusivity in the near term. We are avoiding food and beverage companies with eroding fundamentals (declining sales and margins), high merger and acquisition risk, and secular risk from GLP-1 diet drug uptake.

Investment Grade Corporates Bond Spreads
As of December 31, 2023

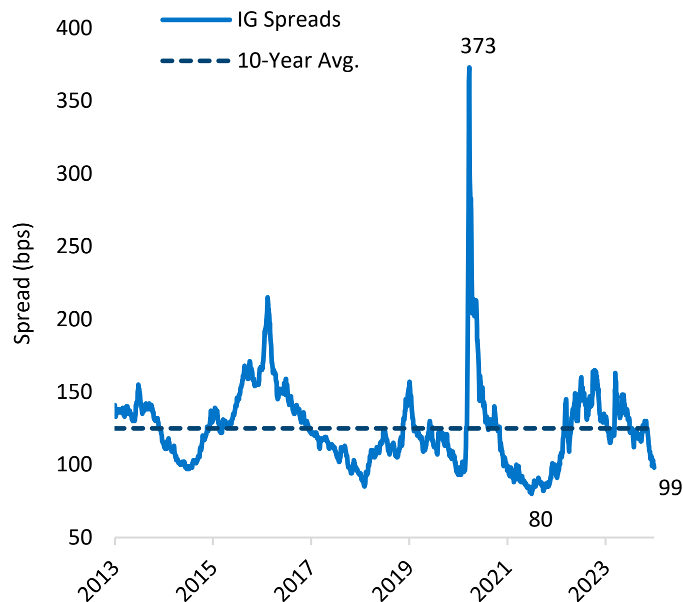


Figure 2
Source: DoubleLine, Bloomberg

Investment Grade CorporatesYield Per Unit of Duration
As of December 31, 2023

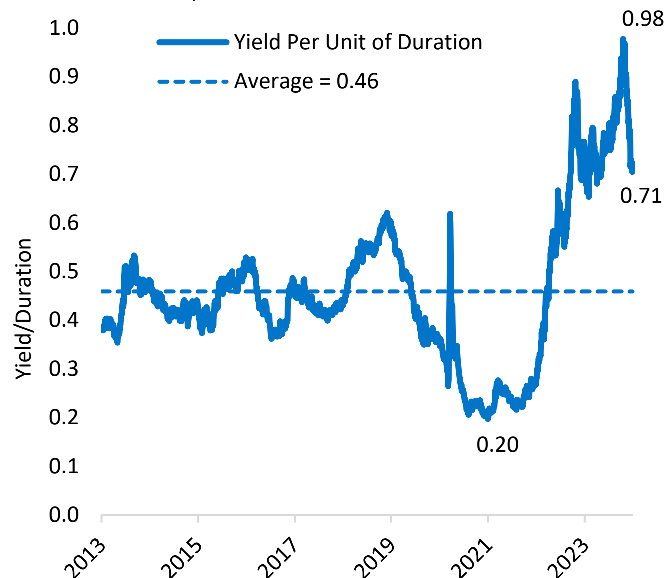


Figure 3
Source: DoubleLine, Bloomberg

High Yield Corporates

No Landing and Equity-like Returns

HY corporates posted strong returns in 2023, boosted by a combination of better-than-expected corporate earnings, surprising economic strength, a solid fundamental backdrop and flattish Treasury yields across the belly of the curve (YoY). Spreads tightened materially in the final two months of 2023, which reflected the optimism surrounding a dovish Fed pivot, as spreads closed the year at 323 bps, just shy of their 2023 low. *(Figure 4)* Market stress in the wake of the regional banking crisis caused HY spreads to peak at 516 bps in March. For the year, the Bloomberg US Corporate HY Bond Index returned 13.5%, as 2023 returns were primarily driven by a 10% cumulative return in November and December.

Looking forward, the impending maturity wall will remain a key issue, however lower rates should increase supply as borrowers look to refinance and term out their debt. To whet investor appetite, HY issuers increased the quality of their issuance as secured bond volume more than tripled YoY, setting an annual record at $100 billion, or 57% of overall issuance volume.[2] *(Figure 5)* Meanwhile, issuance of unsecured bonds dipped to $74 billion, a second consecutive annual post-Global Financial Crisis low. Also of note, many issuers rebalanced their funding mixes away from loans and into fixed-rate bonds, as floating-rate loan costs were relatively higher than those for bonds.

On the technical front, , HY experienced a headwind from fund flows, with an outflow of $7.6 billion for the year. Looking at fundamentals, HY corporate earnings are eroding slowly but are coming from a strong base. For example, net leverage remains below the long-term quarterly average of 4.32x. Meanwhile, revenue and EBITDA growth was roughly flat in the third quarter despite some margin deterioration, as stickier cost inflation ate into revenue.

We believe HY defaults will continue to increase toward their long-term average of 3.2% in 2024 amid sustained higher rates as tight financial conditions weigh on fundamentals. With this in mind, active managers should have an advantage in 2024 relative to index-tracking products. The DoubleLine team is looking to take advantage of resilient consumer spending and prefers companies that are focused on multi-year balance-sheet repair. For example, we are constructive on cruise lines, as consumer travel demand has been buoyed by excess savings. We are avoiding cyclically exposed companies, such as metals and mining, due to broader concerns surrounding economic growth and weakening fundamentals.

High Yield Corporate Bond Spreads | As of December 31, 2023

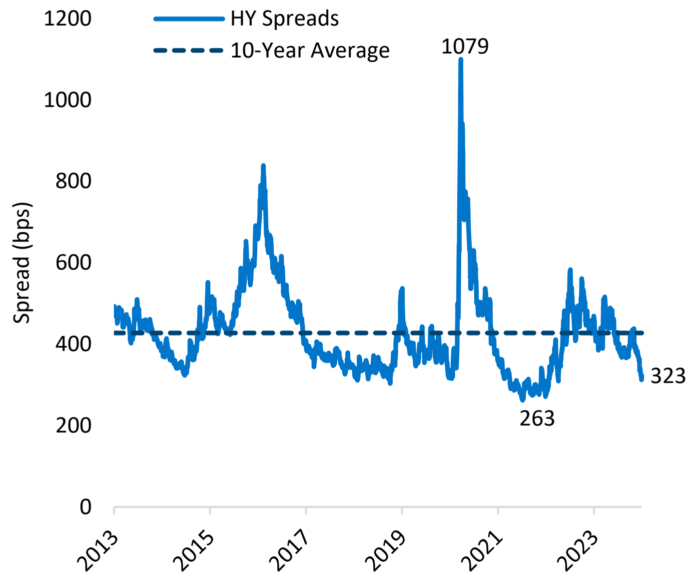


Figure 4
Source: DoubleLine, Bloomberg

Secured HY Bond Issuance Volume
As of December 31, 2023

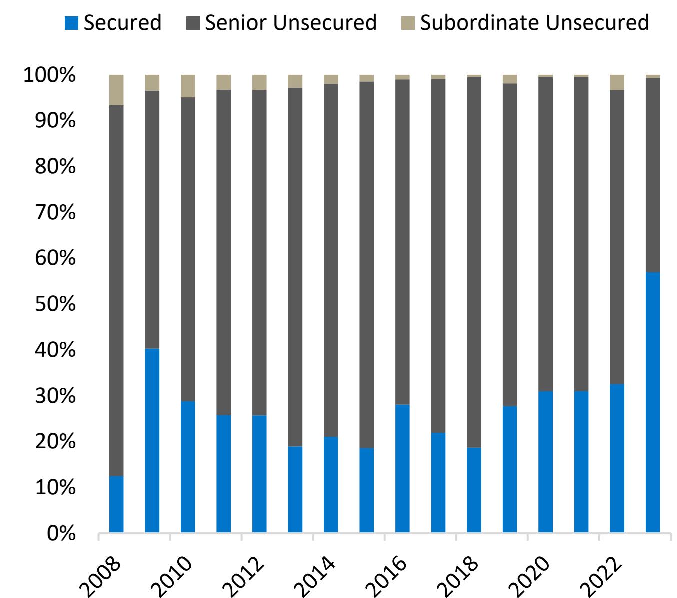


Figure 5
Source: DoubleLine, Bank of America

Leveraged Loans

Higher for How Much Longer?

Leveraged loans were one of the best-performing fixed-income asset classes in 2023. Loan gains defied consensus predictions for economic weakness in 2023 and were driven by a combination of better-than-expected corporate earnings, high interest income from floating-rate coupons and discount margin compression due in part to a generally resilient U.S. economy. Strong demand from collateralized loan obligations (CLOs) also boosted loan prices, as CLO issuance remained strong throughout 2023 despite falling YoY. (See: Securitized Products Outlook) For the year, the Morningstar LSTA US Leveraged Loan TR Index returned 13.3%, boosted by the index's 9.2% coupon, its second best calendar-year return behind 2009.

Moving forward, the focus for 2024 will likely shift to the impending maturity wall, as lower rates should lead to stronger funding conditions and allow issuers to step in from the sidelines. *(Figure 6)* However, DoubleLine expects an environment of winners and losers, as companies with unviable capital structures built primarily on their ability to borrow at low cost will be exposed when trying to refinance their debt. Looking closer, 51% of the 2025 maturity wall is from issuers with a B-minus rating, and these companies could face a challenging refinancing situation due to their high leverage and low rating. As we saw in 2023, private credit will continue to take market share from the loan market, as private credit seems to favor smaller, more highly leveraged companies.

On the technical front, experienced a headwind from fund flows with an annual outflow of $14.3 billion. Looking at fundamentals, loan earnings are giving mixed signals with some signs of weakness. Quarterly leverage, at 4.88x, fell to a post-pandemic low while revenues and EBITDA expanded on a YoY basis but at the slowest rate in 10 quarters, largely due to stickier cost inflation. We anticipate interest coverage ratios will continue to decline given the lagged transmission of higher policy rates to paid coupons.

We believe loan defaults will continue to increase in 2024 toward their long-term average of 2.68% due to slowing economic growth amid sustained higher rates, as tight financial conditions weigh on fundamentals. *(Figure 7)* With markets pricing in a Fed pivot next year in the face of economic uncertainty, pockets of the loan market are poised to outperform. Loans rated B and BB offer high-single-digit yields with less credit risk relative to their CCC peers. DoubleLine favors companies in the leisure and gaming sectors that benefit from resilient consumer demand and a continued focus on deleveraging. We are avoiding overleveraged credits that face a challenging refinancing environment, including telecom issuers that have significant capital expenditure requirements in the face of consumer preferences shifting away from legacy cable and wirelines.

Leveraged Loan Maturity Wall | As of December 8, 2023

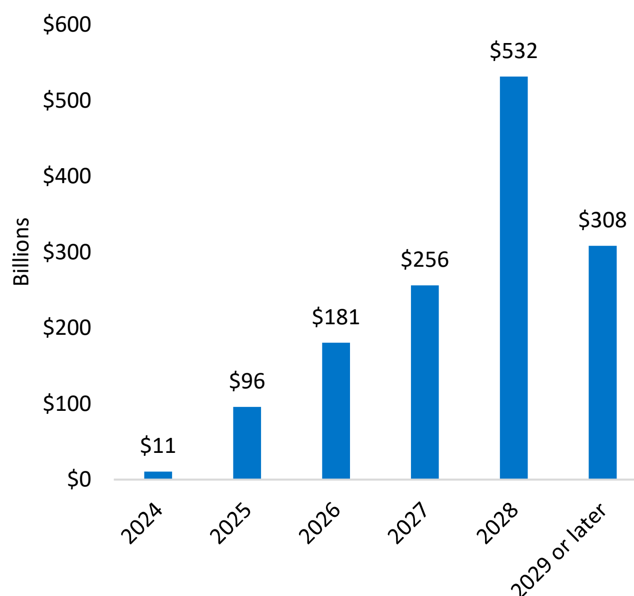


Figure 6
Source: Source: DoubleLine, LCD, Pitchbook

Leveraged Loan Default Rate | As of December 31, 2023

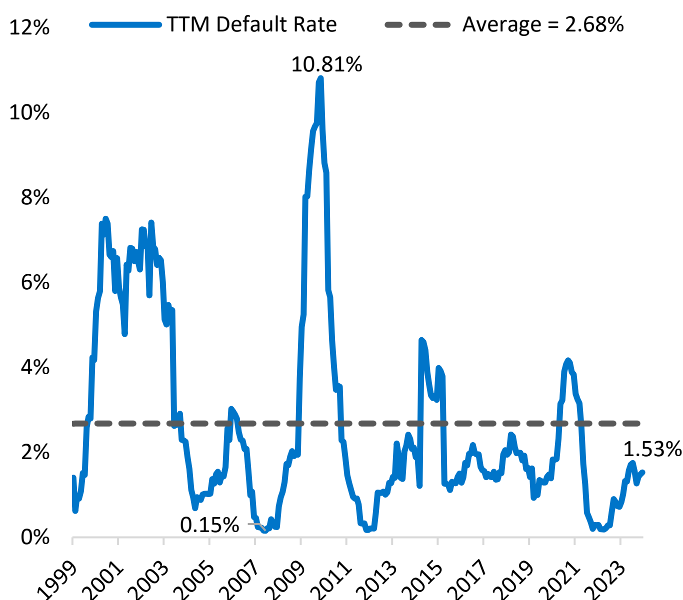
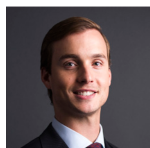


Figure 7
Source: DoubleLine, LCD
TTM = trailing 12-month



Colin Callahan
Product Specialist

Mr. Callahan joined DoubleLine in 2018. He is a member of the Macro Asset Allocation Team, in which he serves as a Product Specialist. In this capacity, he is responsible for various aspects of DoubleLine product marketing, investment strategy updates, portfolio communications and competitive analysis, with a focus on DoubleLine's Global Developed Credit strategies. Mr. Callahan is also responsible for producing market commentary and dedicated strategy content. As part of the Macro Asset Allocation team he attends the Fixed Income Asset Allocation, Macro Asset Allocation, Global Developed Credit, and Structured Product meetings. Prior to DoubleLine, Mr. Callahan was an Assistant Vice President at Gabelli Funds. He holds a BS in Finance from Fairfield University cum laude and an MBA in Finance from the UCLA Anderson School of Management. Mr. Callahan holds the FINRA Series 7 and 63 Licenses.

Endnotes

[1] Per EPFR Global as reported by J.P. Morgan

[2] Source: Bank of America

Definitions

Basis Points (bps) – Basis points (or basis point (bp)) refer to a common unit of measure for interest rates and other percentages in finance. One basis point is equal to 1/100th of 1%, or 0.01% or 0.0001, and is used to denote the percentage change in a financial instrument. The relationship between percentage changes and basis points can be summarized as: 1% change = 100 basis points; 0.01% = 1 basis point.

Bloomberg US Corporate Bond Index – This index measures the investment grade, fixed-rate taxable corporate bond market. It includes U.S. dollar-denominated securities publicly issued by U.S. and non-U.S. industrial, utility and financial issuers.

Bloomberg US Corporate High Yield (HY) Bond Index – This index measures the U.S. dollar-denominated, HY, fixed-rate corporate bond market. Securities are classified as HY if the respective middle ratings of Moody's, Fitch and S&P are Ba1, BB+ or BB+ or below. The Bloomberg US HY Long Bond Index, including bonds with maturities of 10 years or greater, and the Bloomberg US HY Intermediate Bond Index, including bonds with maturities of 1 to 9.999 years, are subindexes of the Bloomberg US Corporate HY Bond Index.

Bloomberg US Credit Index – This index tracks the U.S. credit component of the Bloomberg US Government/Credit Index on a total return basis. It consists of publicly issued U.S. corporate and specified foreign debentures and secured notes that meet the specified maturity, liquidity and quality requirements. To qualify, bonds must be SEC registered. The US Credit Index is the same as the former US Corporate Index.

Collateralized Loan Obligation (CLO) – Single security backed by a pool of debt.

Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA) – Measure of a company's overall financial performance that is used as an alternative to net income in some circumstances.

EBITDA Margin – Measures a company's earnings before interest, taxes, depreciation and amortization as a percentage of the company's total revenue. This margin is used to gauge a company's financial condition.

Federal Funds Rate – Target interest rate, set by the Federal Reserve at its Federal Open Market Committee (FOMC) meetings, at which commercial banks borrow and lend their excess reserves to each other overnight. The Fed sets a target federal funds rate eight times a year, based on prevailing economic conditions.

High Yield (HY) – Bonds that pay higher interest rates because they have lower credit ratings than investment grade (IG) bonds. HY bonds are more likely to default, so they must pay a higher yield than IG bonds to compensate investors.

Investment Grade (IG) – Rating that signifies a municipal or corporate bond presents a relatively low risk of default. Bonds below this designation are considered to have a high risk of default and are commonly referred to as high yield (HY) or "junk bonds." The higher the bond rating the more likely the bond will return 100 cents on the U.S. dollar.

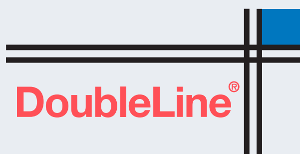
Maturity – Date on which the life of a transaction or financial instrument ends, after which it must be renewed or it will cease to exist.

Morningstar LSTA US Leveraged Loan TR USD – This index (formerly the S&P/LSTA Leveraged Loan Index) tracks the market-weighted performance of institutional weighted loans based on market weightings, spreads and interest payments.

Spread – Difference between yields on differing debt instruments, calculated by deducting the yield of one instrument from another. The higher the yield spread, the greater the difference between the yields offered by each instrument. The spread can be measured between debt instruments of differing maturities, credit ratings or risk.

Yield to Duration (YTD) – The yield of a bond if you were to buy and hold it until the time at which the price of the bond can be repaid by its internal cash flows.

You cannot invest directly in an index.



Corporate Credit Outlook 2024

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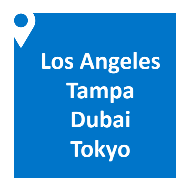

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