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Industry Voices

Commentary: Reading the macro and credit messages from high-yield corporates

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By **ROBERT COHEN**

The high-yield corporate credit market historically has acted as an early warning signal for weakening economic conditions. In general, the constituents of this market are highly sensitive due to their narrow product mix, weak competitive position or the maturity of their industries. All have elevated debt levels.

Consequently, in times of approaching economic weakness, these credits tend to decline in price before investment-grade corporates or equities. In 2022, however, the high-yield market performed relatively well compared to other financial asset classes — even as a raft of leading economic indicators turned yellow or red.

Today, compared to past slowing cycles, high-yield spreads are low to moderate. Some might feel tempted to misread the anomalous buoyancy of the below-investment grade securities as an all-clear signal for the economy. It is not.

An upgrade in issuer fundamentals and a changing of the guard in the sector's composition, a decade in the making, undergirds this market's resilience in the face of recessionary indicators.

Almost every asset class last year suffered losses. Rising inflation triggered a sell-off in U.S. Treasuries. The reciprocal surge in risk-free discount rates inflicted losses on asset classes in proportion to their interest-rate sensitivity, or duration. With a long average duration of seven years, investment-grade corporates fell more than 15% over the calendar year — record losses for that asset class.

With a duration of under four years, the high-yield corporate market sustained a relatively lighter decline of around 11%. The bank loan market, which has a duration effectively of zero due to its floating-rate nature, lost less than 1%. That performance indicates that the great 2022 repricing reflected changes in interest rates, not changes in growth expectations or default assumptions.

Thus, in this cycle, it is logical that the high-yield corporate market has sent no early warning signal.

This market, as represented by the Bloomberg U.S. Corporate High-Yield Bond index, is of significantly higher quality than has been the case over the last decade. So, even when the economy starts to weaken, it is possible that the sector will not provide as clear a signal of earnings weakness as it has in the past.

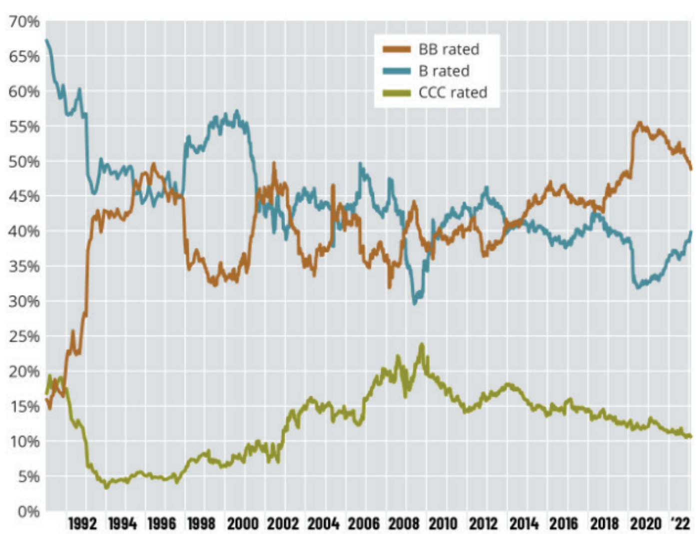
A review of fundamental characteristics of the high-yield market reveals the improvement in credit quality.

Consider ratings. The percentage of credits in the sector rated BB (the highest below-investment-grade rating) has increased from under 40% in 2008 to over 50% in 2022. (Figure 1.) Then, consider total leverage. Total debt to EBITDA stands around 4x, near record lows over the last decade and off the peak of over 6x in 2021. (Figure 2.) If one strips out gaming and transportation, the two sectors with the highest leverage due to pandemic stress, leverage falls to 3.5x, the lowest level since the global financial crisis.

What story underlies the fundamental picture? The asset class has no new "bubble" sector. The overinvestment in

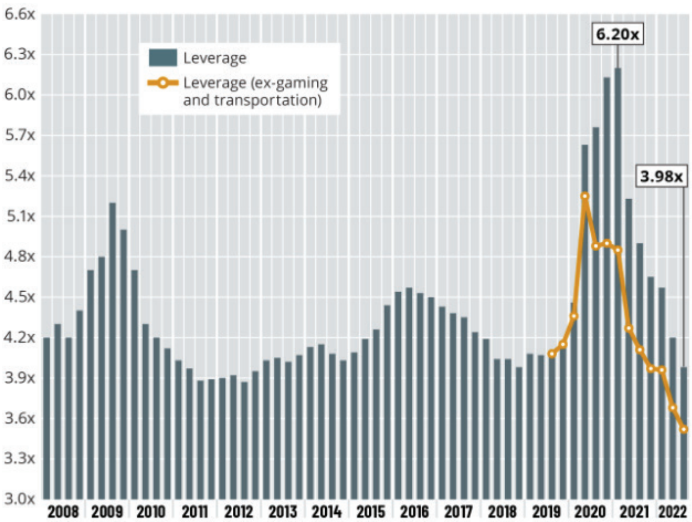
FIGURE 1 Bloomberg U.S. High Yield index composition by ratings cohort

Jan. 4, 1991 - Dec. 9, 2022



Sources: Bloomberg Financial, DoubleLine Capital energy, which occurred from 2010 to 2014, has not been replaced by a new overinvested sector. The excess capital in the leveraged finance market instead found its way into leveraged loans, notably those extended to the software sector. Software companies have increased their share of the Morningstar LSTA U.S. Leveraged Loan TR USD index to 12% in 2022 from 3% in 2008. As in the equity markets, technology investment has driven large amounts of capital into bank debt and driven up the risks.

FIGURE 2 U.S. high yield leverage ratios, Q1 2008 - Q3 2022



Sources: J.P. Morgan, Capital IQ

At $1.7 trillion in debt outstanding, the high-yield market is the same size as in 2014.

In contrast, the loan market grew from $830 billion in 2014 to $1.4 trillion in 2022, a 69% increase. Over the last 13 years, the loan market has issued $52 billion of loans to refinance existing high-yield bonds, transferring that risk from one market to the other. Excesses in asset classes typically coincide with large flows of capital into those markets. The excess in the high-yield market occurred when energy companies grew in size leading up to the collapse in energy prices in 2014-15 and 2020. After the completion of that default cycle and the emergence of broad global inflation, energy became a tailwind for the high-yield sector.

Given the higher credit quality and restrained size of the high-yield market, the resolution of energy credit risk and the absence of overinvestment, it is unlikely that this market will deteriorate substantially before other risk asset classes and provide the early warning that it has before recessions past.

In addition, barring a severe recession, it is unlikely that high-yield spreads will test the "wides" of 1,000 basis points that were characteristic of recessionary market drawdowns in the past.

Since the wides of 583 bps last July, the high-yield market has run up in price, with spreads tightening to 408 bps as of Feb. 15. For investors considering entering the sector or raising allocations to it, given the run-up in price, now is probably a better moment to pause and wait for more-attractive entry points.

I would look for high-yield spreads to cross into the high 400s to low 500s before putting new capital to work there. Since the creation of the high-yield market in the 1980s, this sector of fixed income has not experienced a negative return over a two-year time horizon when starting spreads were above 500. Volatility likely will persist in 2023, taking spreads wider as investors assess and reassess the odds of a recession in the back half of 2023 or early 2024. I would be ready to add to high-yield corporates if spreads exceed this threshold again.

Sector outlooks

Credit selection, however, will be critical. In an environment of restrictive Federal Reserve policy, slow growth and the unusual pairing of elevated recession risk with persistent inflation, not all sectors will fare equally. My outlooks on key sectors of below-investment grade corporate credit are as follows:

Positive

Energy — The energy sector is a beneficiary of underinvestment in hydrocarbon production. Balance sheets improved over time due to lower capital spending. The weaker credits defaulted out of the index in 2020. In a growth slowdown, these higher-quality credits should be able to survive a transient drop in commodity prices.

Communications — Telecom is relatively less sensitive to economic slowdowns, so the outlook is positive provided that telecom companies are disciplined with capital spending projects.

Utilities — Power generation is less economically sensitive, and the power producers capture a spread on the price of natural gas and oil. If commodity supplies remain constrained, prices should remain elevated, supporting the utility sector.

Insurance — Stable policy premium revenue is less economically sensitive and has inflationary tailwinds as premium levels rise.

Negative

Consumer cyclicals — Many industries are rebounding from COVID-19 lockdowns and "boycotts" as consumers shift demand from goods to services such as leisure, lodging and gaming. However, such discretionary spending will be at risk if consumers get pinched in an economic slowdown.

Home construction and building materials — These industries are directly exposed to restrictive Fed policy and are likely to weaken even without broader macroeconomic weakness.

Neutral

Health care is exposed to persistent labor shortages and wage inflation. Thus, while this sector is less sensitive than most others to economic conditions, it is likely to face persistent labor issues.

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