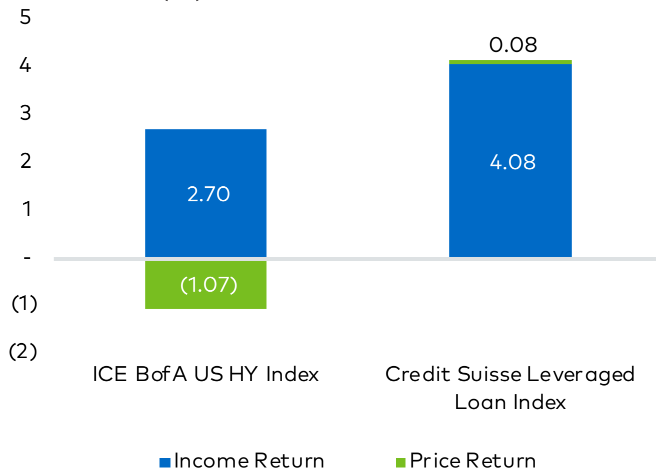
Leveraged Credit 2024 Midyear Review and Outlook

Our Perspective on Credit Markets

The start of 2024 was marked by elevated but generally moderating inflation, a slowdown in the pace of monetary policy tightening, and an eventual focus on the timing and magnitude of future rate cuts. Further, better-than-expected economic data helped moderate concerns of an impending economic slowdown. In addition, corporate earnings appeared to be more resilient than assumed at the start of the period. Growing confidence for a soft landing resulted in spread tightening among high yield bonds and leveraged loans. As a result, high yield bond market performance was positive, registering a modest gain. Leveraged loans also produced positive performance and outperformed their fixed-rate peers through the first five months of the year (Figure 1).

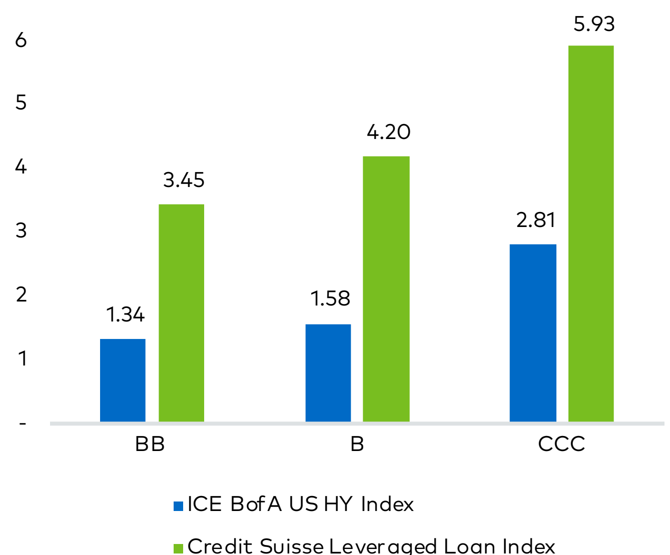
Figure 1 – High Yield Bond and Leveraged Loan YTD Performance (%)



Source: ICE and Credit Suisse as of May 31, 2024

Both high yield bond and leveraged loan markets continue to grind tighter in the face of increasing U.S. Treasury yields as well as continued domestic and geopolitical angst. As the previous chart shows, the rise in yields has taken a bite out of high yield returns. Loans, on the other hand, are winning the year-to-date performance race on the back of much higher income coupled with modest price gains. Further, the relative strength of the economy has led to a rally among the lowest credits. As Figure 2 below demonstrates, CCC-rated credits in both markets are meaningfully outpacing their higher-rated peers. These lower-rated credits have also benefited from very accommodative capital markets to start the year.

Figure 2 – High Yield Bond and Leveraged Loan YTD Performance – By Rating (%)

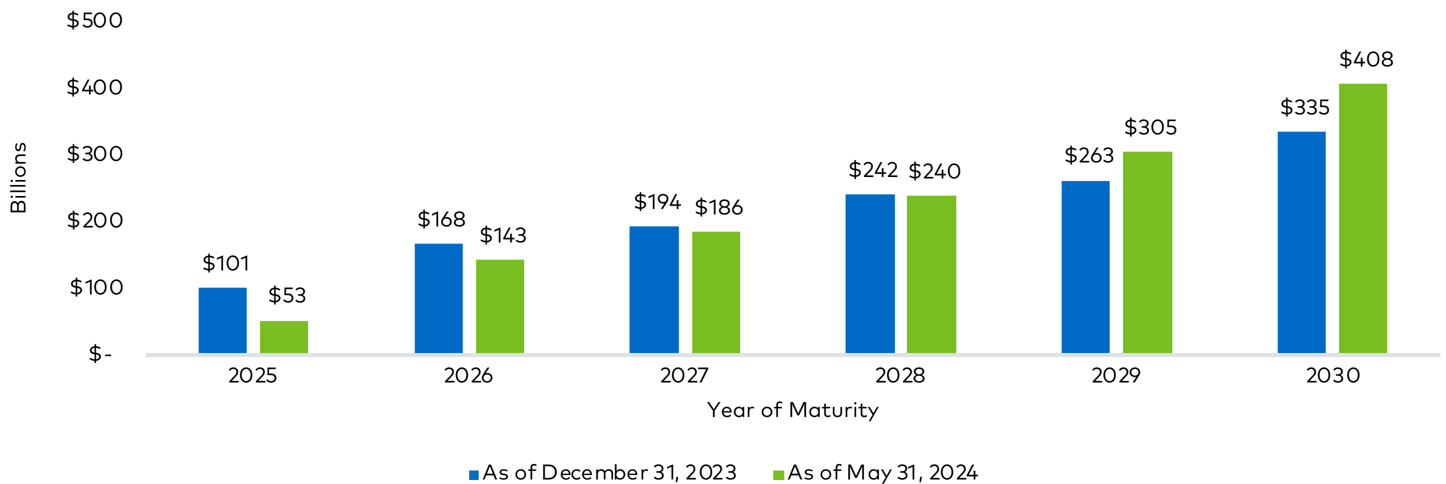


Source: ICE and Credit Suisse as of May 31, 2024

Thus far in 2024, leveraged credit issuers have exploited wide-open capital markets to refinance existing debt (Figures 3 and 4). This dynamic was the case across the ratings spectrum and brought issuers of lower-rated credits, which had been on the sideline for most of 2022 and 2023, back to the primary market. Assuming this environment persists and economic activity remains positive, we believe that this issuance trend should continue. Although it may slow from its breakneck pace to start 2024, open primary markets provide issuers a chance to extend maturities. As maturities are pushed further into the future, the market gains more breathing room, improving its overall health.

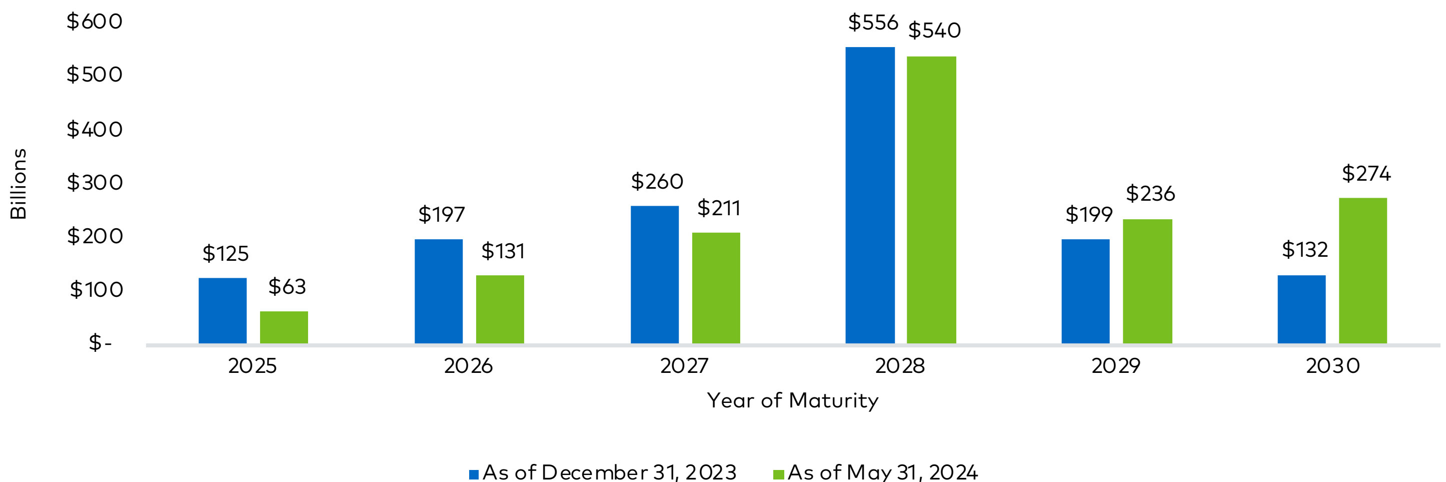
Moreover, the increase in capital market activity has resulted in growth for leveraged credit markets for the first time in several years. As a result of robust CLO issuance and improved market sentiment, the broadly syndicated loan market, which had previously lost market share to private credit, is fighting back. Although most new loans have been used to reprice or refinance existing structures, several private credit deals have been refinanced in the syndicated market because of the lower spreads and better terms available.

Figure 3 – High Yield Bonds – Face Value Outstanding by Year of Maturity



Source: ICE

Figure 4 – Leveraged Loans – Face Value Outstanding by Year of Maturity



Source: Credit Suisse

Furthermore, following several years of decline largely resulting from the loss of "Rising Stars" to the investment grade market together with the exit of defaulted issues, high yield bond market growth has also returned. While refinancing is also a dominant theme for the high yield primary market to start the year, the sheer volume of new issue activity, which is already close to matching that of all last year, has helped push the total amount of high yield bonds outstanding higher.

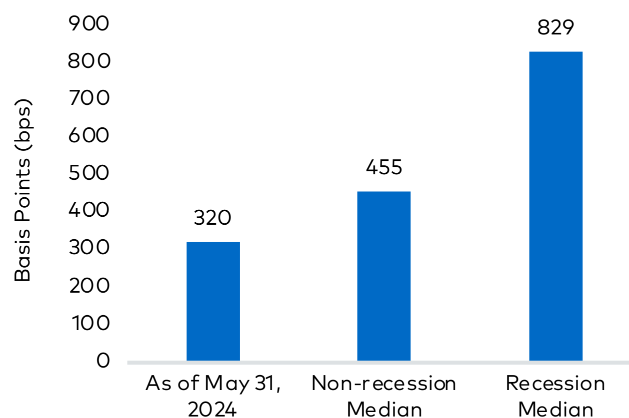
Given that financial conditions remain relatively accommodative, default rates, although elevated from the historical lows of 2021-2022, remain around the long-term average of 3%. Distressed debt in the ICE BofA US High Yield Index (defined as those issues priced with an option-adjusted spread or OAS >1000bps) is approximately 4.4% as of this writing. Similarly, distressed loans in the Credit Suisse Leveraged Loan Index (defined as those priced at or below $80) is about 4.2%. Lastly, the most recent Senior Lending Officer Opinion Survey, which historically has served as a good leading indicator of defaults, has shown a steady loosening of lending standards for the past two quarters. In our view, all of these data points signal a somewhat typical default environment for the remainder of the year.

Be that as it may, given where spreads sit today, we cannot help but remain cautious and vigilant. Our belief is that rates will remain "higher for longer." These higher rates will continue to place pressure on the fundamentals of issuers of both broadly syndicated leveraged loans and direct loans. Further, there is growing evidence of an increase in payment-in-kind deals in the direct lending market, something that has historically indicated a froth in public leveraged credit markets. This action also highlights the burden that issuers of floating rate debt are facing, which high yield bond issuers have yet to bear, but in a higher-for-longer rate environment they certainly will.

However, one should recognize that these higher rates reflect not just elevated inflation but also a resilient economy due in part to strong labor metrics and consumer demand. Of course, in time, these metrics will turn, and we will have a recession, which will lead to rate reductions. Timing rate reductions and economic contractions is not something that we attempt as part of our investment process. Although the Fed's most recent minutes released in May communicated a more hawkish tone, we believe the Fed will tread lightly on rate decisions heading into the U.S. election season. Further, current high yield bond market spreads suggest to us that the risk of recession in the near term is essentially zero (Figure 5). As a result, in our opinion, an economic contraction is unlikely to occur until 2025 or beyond.

Additionally, as the year progresses, the upcoming presidential election in the U.S. will certainly be the topic *du jour*. Election years have generally coincided with positive (albeit modest) performance for leveraged credit markets. There are other factors, besides the timing of the U.S. presidential cycle, that have affected high yield market performance, like the Global Financial Crisis in 2008 and COVID in 2020, but presidential elections typically create market uncertainty. At least this time around, the likely party nominees have been designated relatively early in the process, and there is a general understanding of their expected policy stances. As such, market participants may begin to factor that expectation into their investment approach. In any event, we believe that the election cycle will contribute to market volatility for the balance of the year.

Figure 5 – High Yield OAS Says Little to No Risk of Recession



Source: ICE, ICE BofA US High Yield Index Option Adjusted Spread (OAS). Medians calculated using monthly observed OAS for the 27 years ending December 31, 2023.

Overall, we maintain a constructive view of the high yield bond and leveraged loan markets. That said, we anticipate volatility in the coming quarters. The current environment demands a higher degree of caution, and therefore, careful credit selection within the high yield and leveraged loan markets remains paramount.

Leveraged credit markets continue to benefit from the belief that the Fed can orchestrate a soft landing. Inflation has fallen, resulting in a pause in rate activity. Further, although economic activity has slowed, it nonetheless continues to expand. However, an unexpected turn in inflation could lead to higher rates and less accommodative capital market conditions. Moreover, if economic activity does decline, fundamentals would suffer, leading to wider spreads and, ultimately, higher defaults.

That said, we believe current yield levels in high yield bond and leveraged loan markets are compelling and more than compensate investors for the increased risk associated with tighter spreads. We continue to identify attractive opportunities amongst issuers across each segment of the leveraged credit markets, as we view the current environment as favorable for experienced active managers like us to identify opportunities for significant alpha.

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