Credit Market Perspectives

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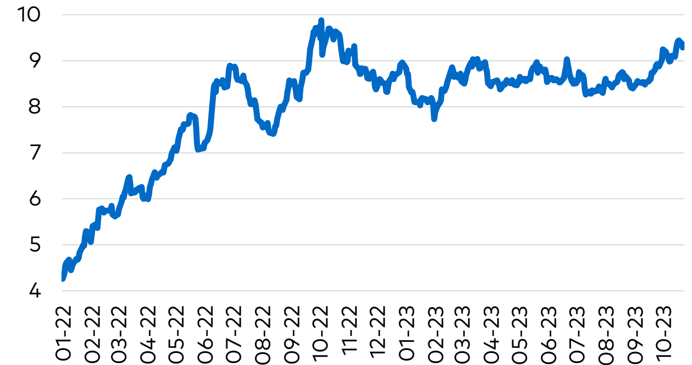
Insights from Polen Capital's credit investment team

Key Questions Addressed

- How did leveraged credit markets evolve in 2023?
- What are the opportunities and risks on the horizon for investors?
- How well can issuers withstand a scenario where economic conditions soften and interest rates remain higher for longer?

Figure 1: U.S. Corporate High Yield to Worst



Source: Bloomberg. As of October 31, 2023.

Fixed Income: Don't Call It a Comeback

In the aftermath of the 2008 global financial crisis, many investors reduced their exposure to fixed income as yields sank to historic lows following years of quantitative easing during the "easy money" era. By late 2020, more than $18 trillion worth of low-risk bonds carried a negative real yield—after accounting for inflation—giving rise to the acronym "TINA," or "there is no alternative" to equities.[1] However, since the Fed's tightening cycle started in March 2022, many investors have revisited their portfolio allocations as bond yields surged to their highest levels of the past decade, exhibiting equity-like total returns in many cases.

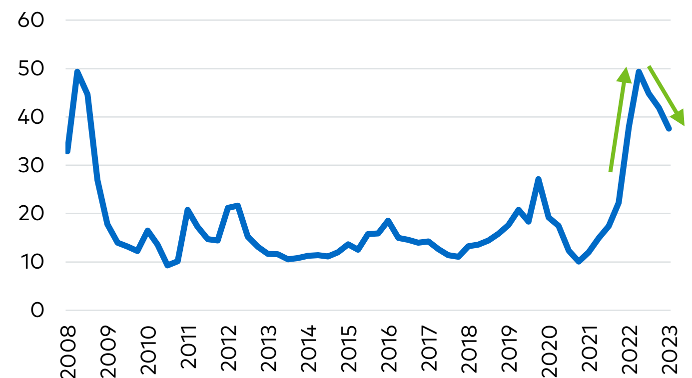
Across the credit spectrum, high yield bonds and leveraged loans currently offer some of the most compelling yields we have seen in years. At the time of this writing, the Bloomberg U.S. Corporate High Yield Bond Index average yield hovered above 9%, having more than doubled since early 2022, as seen in Figure 1. Floating rate loans as measured by the Credit Suisse Leveraged Loan Index are yielding north of 10% as of the same period. In addition, Bloomberg Intelligence estimates that the number of bonds yielding at least 9% grew by about $45 billion in April 2023 to $325 billion in October 2023, representing 30% of the high yield index.[2]

Despite a more constructive outlook, caution is warranted, as macroeconomic risks still loom on the horizon. Nevertheless, we believe these sectors will continue to remain attractive in the year ahead, as robust corporate fundamentals should result in the potential for active investors to generate attractive returns on a risk-adjusted basis.

Not Your Grandparents' High Yield Market

Despite the attractive yields within the high yield and leveraged loan space, investors gravitated away from that segment of the fixed income market during 2023 as fears of a recession added to risk aversion. As we have seen in the past, market participants tend to assume—often erroneously—that high yield bonds and leveraged loans are inherently vulnerable to capital losses during challenging economic times, given the perceived likelihood of their issuers facing rating downgrades and defaults as a result of a deterioration in company earnings. Yet, though unforeseen shocks are still possible, fewer economists are projecting a recession in the next two quarters, as seen in Figure 2.

Figure 2: U.S. Recession Odds Two Quarters Ahead (%)



Source: Philadelphia Fed's Survey of Professional Forecasters. As of October 31, 2023.

1 Source: https://www.bloomberg.com/news/articles/2020-12-11/world-s-negative-yield-debt-pile-at-18-trillion-for-first-time

2 Source: https://www.bloomberg.com/news/articles/2023-10-16/junk-bonds-yielding-over-10-hit-325-billion-tempting-investors.

More importantly, our research indicates that despite the risks surrounding high yield bonds, the market in recent years has seen an exceptional improvement in credit quality and fundamentals, marking a sharp contrast with the speculative conditions that characterized it during the 1980s and 1990s. Since then, the market has evolved from a collection of "fallen angels"—bonds that have lost their investment-grade rating—into an established capital market for raising funds.[3] Although loan issuers face greater pressures than their fixed rate peers, in our view, fundamentals in that corner of the market are stable and attractive opportunities can be uncovered.

Fundamentals Matter

Looking forward, one of the questions investors are asking is how well can high yield and leveraged loan issuers withstand an environment where economic conditions soften and interest rates remain "higher for longer." In our view, most issuers are well-placed to navigate such a scenario, given that companies are in a stronger financial position today than in previous credit cycles. Contrary to conventional wisdom, we believe that even if a recession unfolds, the high yield and leveraged loan markets will remain on solid footing next year.

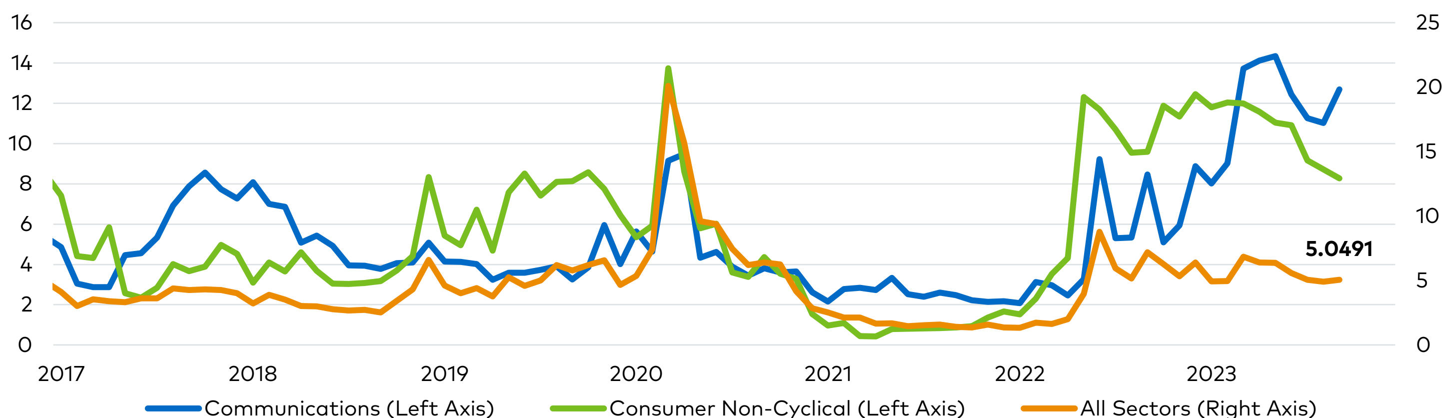
Our analysis indicates that cash ratios among high yield issuers—which gauge a company's ability to repay its short-term obligations—reached their highest levels since the global financial crisis, while leverage ratios—which measure the level of debt load that a business has incurred—fell to their lowest levels since 2008. Further, even though the rapid rise in base rates has resulted in the deterioration of interest coverage ratios for loan issuers, we believe that leverage ratios remain manageable.

Though we project default rates to rise next year, it is essential to remember that the increase would come from the low base that we have seen over the last two years. Hence, rather than witnessing a wave of companies going underwater, we estimate that an increase in defaults will be within the range of the long-term average for the market.

Another reason the high yield market showcases solid fundamentals is that following the COVID-19 pandemic, many of the most vulnerable credit names defaulted and fell out of the index. Even at their pinnacle in October 2020, defaults peaked around 6%. Given this dynamic, credit quality is meaningfully healthier today than in the past with BB-rated bonds comprising nearly half of the market as compared with 40% on average over the last 20 years. In contrast, according to Bloomberg data, the proportion of CCC-rated debt—considered the riskiest part of the high yield market—has halved from 18% to 9% during the same period.

According to data from J.P. Morgan, the COVID-era default rate for leveraged loans peaked around 4.5%. However, unlike the high yield bond market, the leveraged loan market has seen a steady deterioration in credit ratings. This march lower in aggregate creditworthiness stems from the increase in the percentage of B-rated loans, which also coincided with the rapid growth of the loan market during the ultra-low-rate environment that marked the era following the Global Financial Crisis.[4] For years, investors have noted with concern the excesses building within the leveraged loan market. Perhaps, then, it shouldn't come as a surprise that the default rate forecast for loans is projected to exceed that of the high yield bonds.

Figure 3: High Yield Bond Market Value of Distressed as % of Total



Source: Bloomberg. As of October 31, 2023.

3 Source: The Federal Reserve Bank of New York – Understanding Aggregate Default Rates of High Yield Bonds (Helwege and Kleiman, 1996).

4 The Global Financial Crisis was a severe worldwide economic crisis. The National Bureau of Economic Research dates the recession around this crisis from Dec-2007 through Jun-2009.

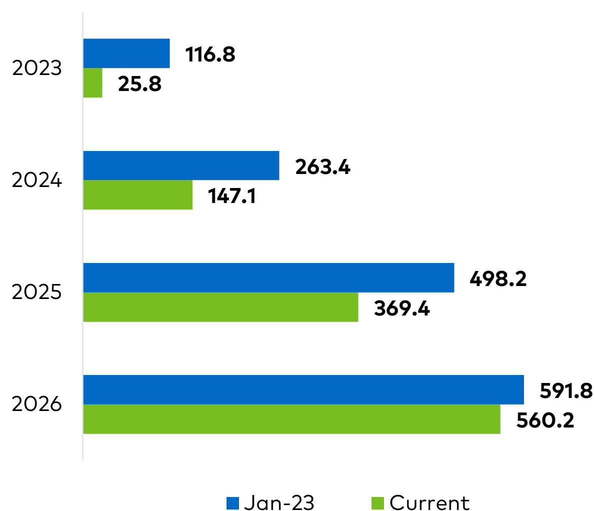
Meanwhile, a report by Bloomberg Intelligence noted that the proportion of distressed issuance in the high yield index—debt trading wide of 1,000-basis points spread—reached 5.1% exiting Q3, well below the 2022 highs of nearly 9%. As seen in Figure 3, the communications and consumer staples sectors were the upside outliers, thereby greatly influencing the aggregate percentage. At the same time, the technology sector was the only other sector with a distressed ratio above 5% entering into Q4.

Loans have also seen distressed issues ebb and flow. J.P. Morgan defines a distressed loan as a loan priced below $80. While the percentage of distressed issues peaked at 8.2% in 2022, it sat at 7.2% on October 31, 2023. This distress ratio provides further evidence that leveraged loans are under slightly more pressure than high yield bonds. However, like their fixed rate peers, distress in the loan market is concentrated in a handful of sectors with healthcare and telecommunications being the largest contributors.

Climbing the Maturity Wall

In addition to showcasing more robust fundamentals, companies have alleviated financial pressure by extending their maturity runways. Yet, in early 2023, many market pundits speculated that rising rates and the likelihood of a recession would cause mayhem across the high yield market as a flood of debt was coming due. Looming maturities of high yield debt raised fears that companies would find their cash reserves insufficient to cover the increased financing costs. However, high yield issuers have climbed the so-called maturity wall without much trouble, as credit spreads narrowed from the wider levels seen earlier in 2023.

Figure 4: Pending Maturities by High Yield Bond Issuers (in billions)



Source: Bloomberg. Data includes active outstanding U.S. dollar-denominated bonds and loans rated sub-investment grade by S&P or Moody's and with at least $150 million outstanding. As of September 30, 2023 (latest data available).

In turn, other companies took advantage of attractive conditions in 2020-2021 to boost their balance sheets by reducing leverage, extending maturities, and locking in low coupons. According to Bloomberg, at the start of 2023, high yield issuers had about $878 billion in bond and loan issues coming due through 2025. Since then, issuers have reduced the number by about 38% to $542 billion, as seen in Figure 4. As we enter the new year, we believe most companies will continue to progress in extending their debt calendars, which should keep a lid on refinancing risk.

> **It is also worth noting that high yield bonds are less exposed to interest rate risk because they typically have maturities of less than 10 years on average, much shorter than government and investment grade bonds.**

The higher a bond's duration, the more its price is likely to fall if interest rates rise as the bulk of future cash flows are spread deeper into the future. Hence, high yield bonds' lower duration profile is another important reason we believe yields and total returns will remain attractive in 2024.

Looking Ahead in Leveraged Credit: Key Takeaways for Investors

In our team's experience, several myths and misconceptions surrounding the high yield bond and leveraged loan markets can hold market participants back from investing in these asset classes, leading them to overlook hidden gems in the space. In assessing current valuations across the investable universe, we believe that high yield bonds and leveraged loans provide adequate compensation for current levels of credit risk. Thus, in our view, the market offers a compelling window to lock in an attractive income level with further upside potential if the economic environment improves.

Not only are these markets offering the potential for attractive total returns, but because the leveraged credit sector has historically had a low correlation to other areas of the credit market, investing in high yield bonds and leveraged loans also may provide portfolio diversification benefits. That said, careful credit selection will remain paramount as the market backdrop remains uncertain. With volatility likely to stay elevated in the year ahead, we believe an active management approach is best suited to capitalize on market dispersion opportunities.

Going Beyond with Polen Capital

Polen Capital is a team of experienced investment industry professionals who share an unwavering commitment to our clients, investors, community, and each other. We have been dedicated to serving investors by providing concentrated portfolios of what we believe are the highest-quality companies for more than three decades. At Polen Capital, we have built a culture of results, and in this, an inherent belief in going beyond what's expected for the people and communities we serve.

We adhere to a time-tested process of researching and analyzing companies around the globe—seeking only the best to build highly concentrated portfolios. Then, we invest for the long haul and with a business owner's mindset—giving these companies time to grow.

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Past performance is not indicative of future results. There can be no assurances that any portfolio characteristics depicted herein shall be replicated in the future.

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The volatility and other material characteristics of the indices referenced may be materially different from the performance achieved by an individual investor. In addition, an investor's holdings may be materially different from those within the index. Indices are unmanaged and one cannot invest directly in an index.

The Bloomberg U.S. Corporate High Yield Bond Index measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below. Bonds from issuers with an emerging markets country of risk, based on the indices' EM country definition, are excluded. The US Corporate High Yield Index is a component of the US Universal and Global High Yield Indices. The index was created in 1986, with history backfilled to July 1, 1983.

The Credit Suisse Leveraged Loan Index tracks the investable market of the U.S. dollar-denominated leveraged loan market. It consists of issues rated "5B" or lower, meaning that the highest rated issues included in this index are Moody's/S&P ratings of Baa1/BB+ or Ba1/BBB+. All loans are funded term loans with a tenor of at least one year and are made by issuers domiciled in developed countries.

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