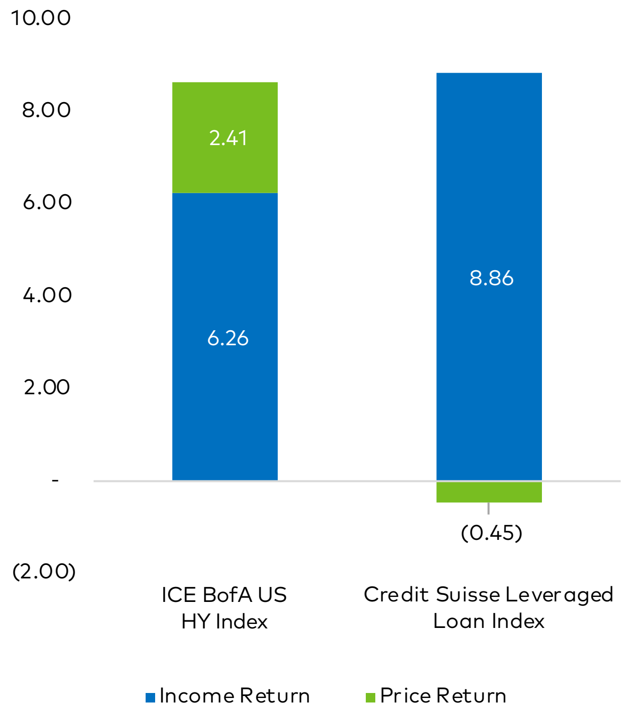
Leveraged Credit 2024 Review and 2025 Outlook

Highlights

- Moderating inflation, resilient economic growth, and easing monetary policy provided a supportive backdrop for high yield bond and leveraged loan performance in 2024. Spreads remain tight, hovering just above all-time lows set in June 2007.
- Primary market activity for high yield bonds has already topped the last two years combined. Leveraging transactions, such as dividend deals, buyouts and other M&A activity increased, a trend that we think will continue in 2025.
- Although default rates have been at or below long-term averages, so have recovery rates. These lower recovery rates are indicative of a trend of looser covenants coupled with challenging capital market conditions for overleveraged issuers.
- We believe that we are reaching the top of the cycle for the broader high yield and leveraged loan markets. Consequently, we are being more cautious in our investment approach and are willing to sacrifice yield for safety.

During 2024, inflation moderated, economic growth in the U.S. was resilient, and after a long pause, monetary policy began to ease. While geopolitical risks persist, in hindsight, concerns associated with a contested U.S. presidential election appear overdone. This backdrop was supportive of high yield bond and leveraged loan performance. Although they took different paths to get there, total returns for both markets in 2024 have been similar, with bonds gaining 8.67% and loans returning 8.41% (Figure 1).

Figure 1: High Yield Bond and Leveraged Loan 11/30/2024 YTD Performance (%)



Source: ICE BofA and Credit Suisse

Focusing on high yield performance, through the first half of 2024, returns were a bit volatile. Early on, rising rates offset spread tightening and took a bite out of total returns. However, in Q3, the Fed's first rate cut in over four years marked the beginning of its path to normalizing monetary policy. The high yield market's response was euphoric, as a rally in longer duration, higher-rated bonds as well as spread compression among CCC-rated issues and low-dollar price bonds both supported total returns (Figure 2).

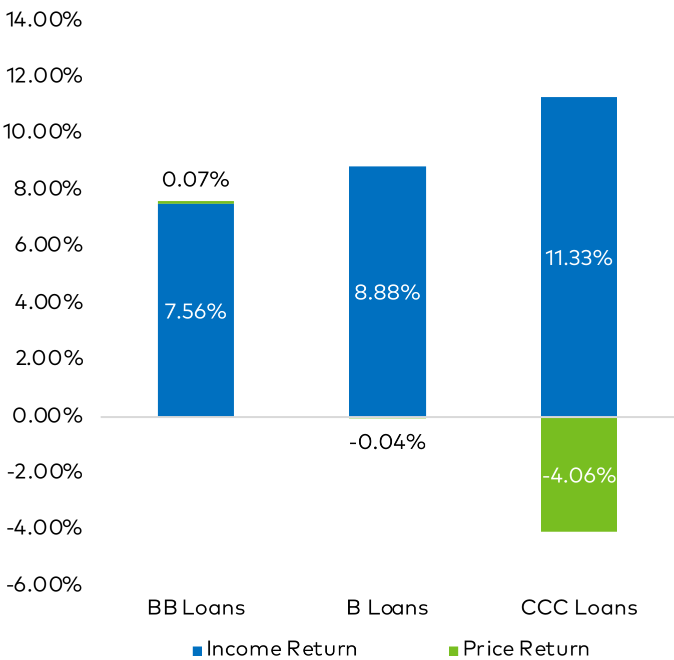
Figure 2: High Yield Bond 11/30/2024 YTD Performance by Rating and Price Bucket (%)

Price Bucket	BB	B	CCC
0-70	11.9	11.7	24.6
70-80	11.1	0.4	21.1
80-90	8.1	12.3	20.1
90-95	6.2	8.4	15.0
95-100	6.4	7.8	13.9
100-105	7.3	8.1	10.7
105-110	8.3	8.1	14.6
>=110	6.9	5.6	18.7
Total Return	7.0	7.9	18.0

Source: ICE, ICE BofA U.S. High Yield Index

All the while leveraged loans plowed ahead, month after month, producing positive performance. As Figure 1 above shows, coupon income was responsible for 2024's year-to-date performance. So far this year, B-rated loans in the index outperformed their BB-rated and CCC-rated peers. However, while the effect from price has been minimal for BB- and B-rated loans, price declines eroded a meaningful amount of performance for CCC-rated loans (Figure 3).

Figure 3: Leveraged Loan 11/30/2024 YTD Performance (%)

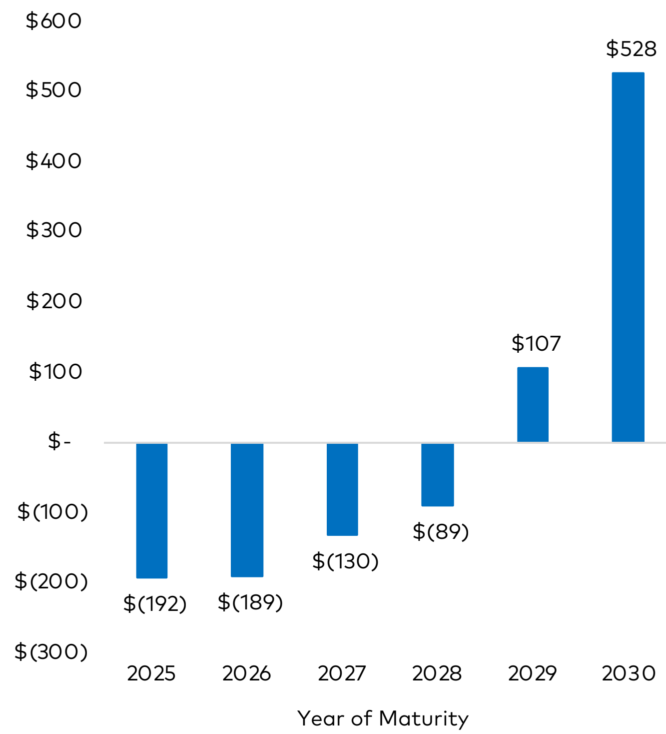


Source: Credit Suisse, Credit Suisse Leveraged Loan Index

Throughout the year, issuers took advantage of an improved rates backdrop and robust investor demand. In 2024, primary market activity for high yield bonds has already topped the last two years combined. Meanwhile, as of this writing, leveraged loan primary market activity, supported by a record year of CLO issuance, has surpassed $1.1 trillion, shattering its previous record of approximately $974 billion set in 2017.

Further, the refinancing and repricing of existing debt was the primary use of new issue proceeds. These actions resulted in an extension of the maturity profile of the leveraged credit market (Figure 4). That said, as the year wore on, leveraging transactions, such as dividend deals, buyouts, and other M&A activity increased, a trend that we think will continue next year.

Figure 4: High Yield Bonds & Leveraged Loans – Change in Face Value Outstanding by Year of Maturity



Source: ICE BofA and Credit Suisse, Change in par amount outstanding by maturity date between 12/31/2023 and 11/30/2024.

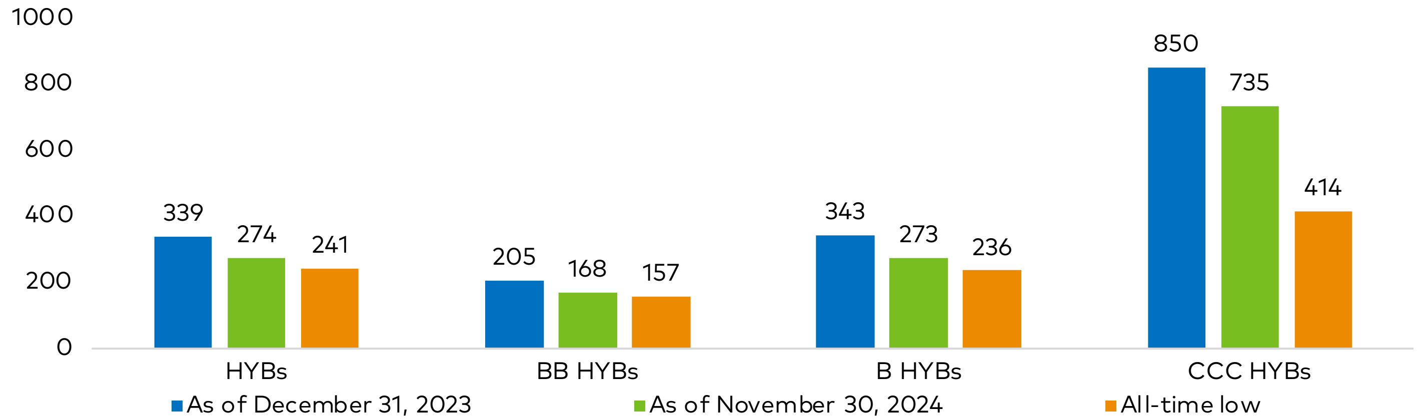
Lastly, 2024 experienced limited default activity. However, in the leveraged loan market particularly, distressed exchanges and liability management exercises, or "soft" defaults, have become more prevalent, resulting in a significant difference in default rates between the two markets. According to data from J.P. Morgan, at the end of November, the trailing 12-month default rates for high yield bonds and leveraged loans including distressed exchanges sat at 1.14% and 4.04%, respectively.

However, excluding distressed exchanges, the difference between the two asset classes narrows, as the default figures decline to 0.34% and 1.54%, respectively.

As we turn the page on 2024, we continue to assess the factors and trends that will influence the markets in which we invest. A new but familiar presidential administration in the United States, together with the change in direction of monetary policy, is expected to support markets in the near term, with intermediate to long-term effects still up for debate. Markets are always in an endless state of transition, and we believe 2025 will be no different.

In our view, when thinking about 2025, it seems appropriate to start with a discussion on credit spreads. Quite simply, spreads were tight at the end of 2023 and have since tightened even further (Figure 5). For the broader high yield market, spreads are hovering just above all-time lows set in June 2007. However, drilling down by ratings categories reveals that spreads for B-rated and CCC-rated high yield bonds remain above their all-time lows, which were also set in June 2007. Alternatively, in 2024, BB-rated bond spreads dropped to a new all-time low of 157 bps, below the previous mark set in March 2005.

Figure 5: High Yield Bonds: Option Adjusted Spreads ("OAS") Current Levels and All-Time Lows (in basis points "bps")



Source: ICE, ICE BofA U.S. High Yield Index

Though possible, it seems unlikely that spreads will finish 2025 at levels tighter than where they are as of this writing. Finding investments that offer spread above the market average is challenging. For example, as of the end of November, the option-adjusted spread of the ICE BofA U.S. High Yield Index was 274 bps. The percentage of the index that was trading inside of 274 bps was approximately 73%, meaning just 27% was trading at or wide of the market. With respect to that 27%, more than half of that percentage trades within 200 bps of the market average.

Although there was a meaningful rally among stressed and distressed credits in the second half of 2024, that could reverse quickly. While fundamentals remain supportive, as the credit cycle ages, market participants historically have demonstrated little patience for issuers that guide lower. Further, while leveraged loan issuers have received relief from the Fed's rate cuts as well as lower spreads, interest burdens remain elevated. Therefore, when seeking to invest within the high yield market, credit selection remains paramount.

This last point is so critical because although default rates have been at or below long-term averages, so have recovery rates.

These lower recovery rates are indicative of a trend of looser covenants coupled with challenging capital market conditions for overleveraged issuers during an uncertain macroeconomic environment, which is especially true for 2025.

Notably, looser covenants enable issuers to delay negotiations with creditors, which often results in an erosion of the issuer's enterprise value. Relative to historical averages, this battered enterprise value tends to lead to lower recoveries if the issuer does indeed default on its debt obligations. In fact, recovery rates for high yield bonds weakened in 2024. Meanwhile, recovery rates for leveraged loans this year finished only slightly above the record low set in 2023, while recoveries on first lien loans have been below their long-term average for nine consecutive years.

For the time being, the prevalence of liability management exercises (LMEs) and their effect on recovery rates is here to stay. Equity owners will try to extend their option and extract value at the expense of lenders, who are frequently infighting amongst each other. Unfortunately, legal documents governing most deals in the market today provide borrowers with wiggle room to promote this lender-on-lender violence.

However, given the borrower-friendly terms that dominate the underlying credit documentation, the best defense against being disadvantaged by sponsors and other lenders is to invest in competitively positioned businesses that generate free cash flow and have a history of returning capital to creditors.

Shifting to primary markets, throughout 2024, capital market activity for high yield bonds and loans has been strong. A shift in Fed policy, a stable environment for growth and corporate earnings, easing inflation, and declining yields all contributed to this change in activity after two meager years of new issuance. However, refinancing activity was the primary use of new issue proceeds in leveraged credit markets, with only modest net new origination activity occurring in 2024.

Looking ahead to 2025, we anticipate a decrease in the amount of refinancings and an increase in "net" new issuance in high yield bonds and loans, fueled by a resurgence in M&A activity aided by a more accommodative regulatory environment and lower yields. This prediction is not to say that repricing and refinancing activity will disappear, only that its share of new issue proceeds in 2025 will decline.

On the private equity front, our view is that sponsors will increasingly look to exit from their portfolio company investments. The slowdown in deal making over the last few years has driven private equity holding periods higher. These sponsors borrowed extensively to acquire these companies 3-5 years ago when interest rates were near zero. Of course, since then, interest rates have risen 400-500 basis points while valuation multiples have declined. This unfamiliar environment has proven challenging for sponsors, as the economics of monetizing their investments is not ideal.

As limited partners' patience grows thin following the expiration of their funds' investment periods and they begin to demand a return of their capital, we expect that sponsors will start monetizing these investments. While monetary policy remains restrictive, we are entering a lower yield environment, which should be supportive of this type of activity and in turn generate compelling opportunities for fixed income asset managers like Polen Capital.

Key Takeaways for Investors

Our view is that the significant rally in equities and leveraged credit during the past two years reflects market participants' growing belief that the Fed can orchestrate a soft landing. However, the market's confidence in this outcome could be disrupted if the Trump administration attempts to remove the Fed chairman prior to the end of his current term in 2026. Be that as it may, market participants seem to have shifted their attention away from inflationary risks to concerns about the consumer and the economy. However, economic indicators continue to be supportive of markets.

As we approach 2025, our primary concerns today include a monetary policy mistake, a weaker consumer, larger fiscal deficits, and growing geopolitical risks. Further, while the new administration may facilitate business-friendly deregulation and enact tax cuts, the implementation of certain trade policies such as tariffs could have a less favorable impact on the overall U.S. and global economy. With that in mind, at the moment, markets seem complacent. However, handicapping the impact any of those broader risks will have on the markets is, in our view, a bit of a fool's errand, to say nothing of trying to incorporate all of them. That is why each day we maintain our focus on the individual businesses in which we invest and their ability to pay back or refinance their debt.

We believe that we are reaching the top of the cycle for the broader high yield and leveraged loan markets. Though spreads are tight, as a long-only fixed income manager, we must nonetheless manage our client portfolios through the cycle. As a result, today, we are being more cautious and are willing to sacrifice yield for safety. Safety for us means investing in competitively advantaged businesses that generate sustainable free cash flow and offer a reasonable margin of safety. In our view, remaining patient and not overreaching for yield will leave our portfolios well positioned to take advantage of compelling opportunities as the cycle ages.

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.

The ICE BofA U.S. High Yield Index tracks the performance of U.S. dollar denominated below investment grade corporate debt publicly issued in the U.S. domestic market. Please note that one cannot invest in the index. The Credit Suisse Leveraged Loan Index is designed to mirror the investable universe of USD institutional leveraged loans, including U.S. and international borrowers. Please note that one cannot invest in the index.

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