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April 2022 High Yield Market Insights

- Interest rate changes impact high yield bonds less than other bonds
- Credit quality of high yield issuers has steadily improved over time

Interest rates have been rising due to inflation and anticipated Fed tightening. Rate changes affect all bonds, but high yield bonds less so than investment grade corporate bonds or treasuries. Shorter maturities and higher yields make high yield bonds less rate sensitive.

Changes in perceived credit quality tend to be high yield's Achilles heel. Its issuers are considered riskier. They are either more levered or are in more cyclical businesses than investment grade companies. The interest rate shoe has already dropped, but the credit shoe, thus far, has not.

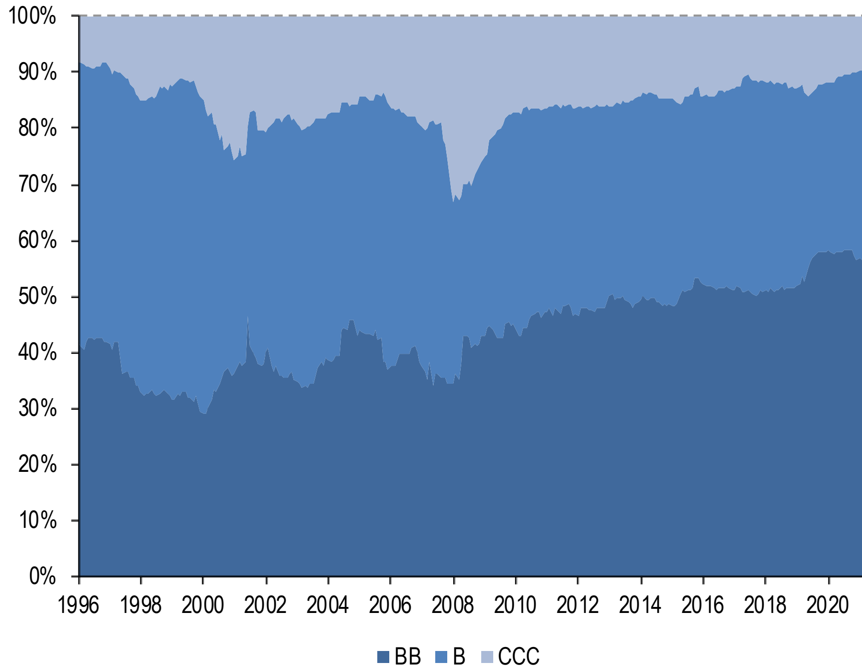
Figure 1: US HY Spread to Treasuries

Source: BAML

When and if credit quality does deteriorate, will high yield be as affected as it was during previous cycles? A few factors point to the possibility that high yield could weather a deteriorating economy better than it did in the past. First up is the improvement in the credit quality of the high yield index.

The quality of high yield issuers has gotten progressively better since the Bank of America/Merrill Lynch (BAML) Index began in 1996. The BB share of high yield debt has been rising versus the shares of B and CCC issuers. Improvement in credit quality has accelerated since the end of the global financial crisis.

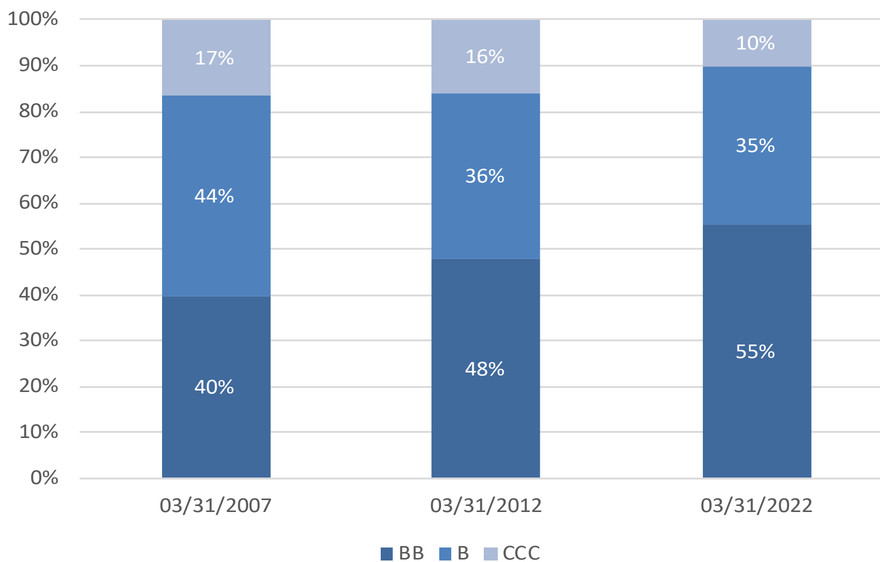
Figure 2: BAML High Yield Index Credit Rating Distribution (1996-2022)



Source: BAML, Concise Capital

This is easier to see if we compare the BAML index proportions of BB, B and CCC rated bonds ten and fifteen years ago to those of today. BB rated bonds comprise 55% of the high yield market now versus 40% of high yield debt in 2007, just prior to the financial crisis. CCC bonds, the least creditworthy, have fallen from 17% then to 10% of the index today.

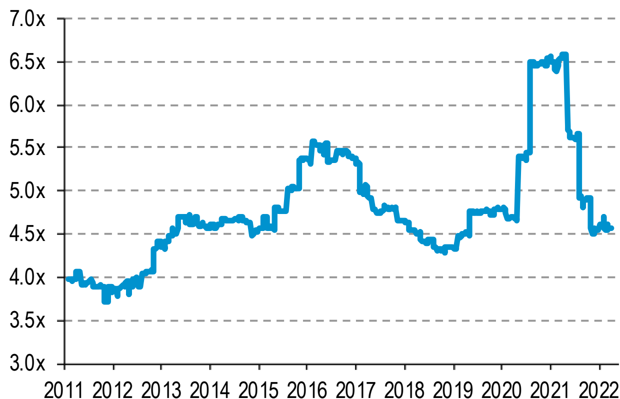
Figure 3: BAML High Yield Index Credit Rating Distribution (10Y, 15Y lookback)



Source: BAML, Concise Capital

High yield issuers look better fundamentally. Leverage is not at its lowest, but nor should it be. It makes sense for firms to carry somewhat higher debt burdens due to lower rates.

Figure 4: Gross Leverage of HY Issuers



Source: BAML, Concise Capital

Figure 5: HY Interest Coverage

Source: BAML, Concise Capital

Debt over the amount of earnings before interest, tax, depreciation and amortization (ebitda), is at the lower end of its range since 2011. Coverage, the term for ebitba to interest, has risen steadily in the last ten years.

High yield debt has fixed coupons. Issuers have financed themselves at very low rates over the last several years. Inflation will help initially, offsetting margin compression, as companies' nominal earnings rise in comparison to their fixed rate debts.

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