December 2022 High Yield Market Insights

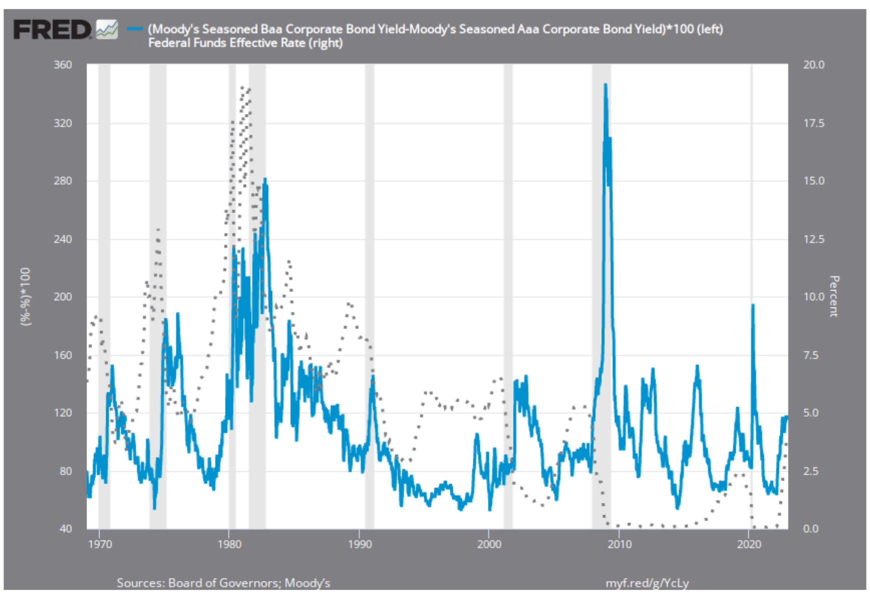
- Credit market risk premiums have not risen excessively despite Fed rate increases
- Firms are in good financial shape, for now
- Leverage is under control, but should rise given higher rates and a potential recession
- Firms should work to reduce leverage later in the economic cycle, a boon for bondholders

This past year has been an unhappy one for both bonds and stocks. Much of this unhappiness can be traced to the Federal Reserve's tightening campaign. Rates have been raised faster and by a larger amount than at any other time in the past forty years. Despite these market selloffs and their accompanying volatility, credit spreads, the yield premiums corporate borrowers pay over government bond rates, have only widened modestly.

In Figure 1, we use the quality spread, the difference in yields between Aaa rated bonds and Baa rated bonds, as a proxy for the corporate credit premium. While this is not a perfect analog for the high yield spread to treasuries, it does offer a long term view of the premium for lower versus higher quality credit.

During the 1970s and early 1980s, the last time inflation was as salient as it is today, the quality spread spiked. Except for the global financial crisis and Covid pandemic, the spread has not risen above 150 basis points in over thirty-five years. This year has not been an exception, despite inflation touching nine percent.

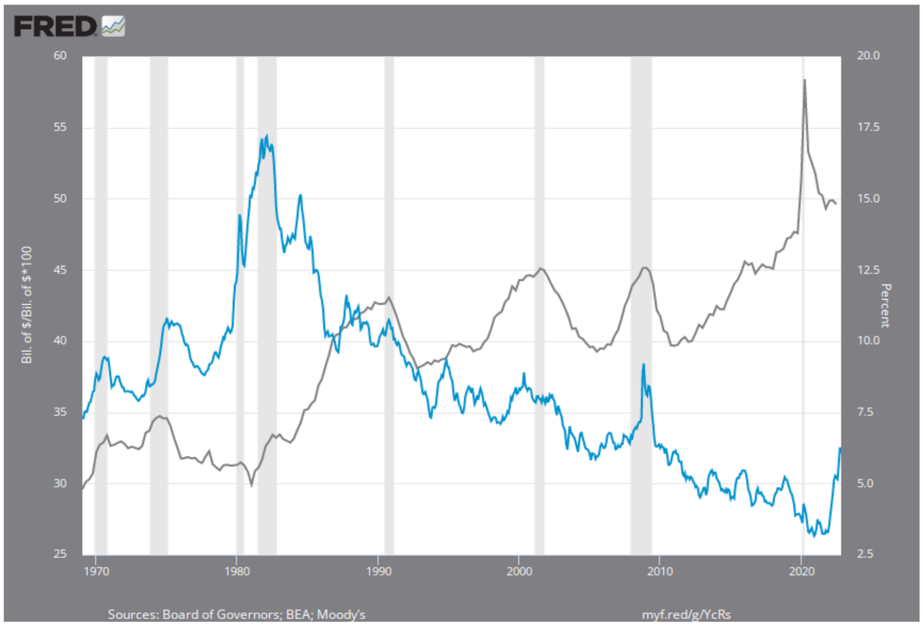
Figure 1: Baa-Aaa Spread and Fed Funds Rate (1970-2022)



The last big bout of inflation would seem to be the template for how credit should have reacted in 2022, but credit markets did not panic. Why? Two things stand out in stark contrast to debt finance in the 1970s. First, non-financial corporate debt is much higher. It rose sharply after inflation was contained. From 1985 until 2018, corporate debt cycled between 38% and 45% of GDP. After that debt breached 45% and rose to 50%, where it stands today. (We are ignoring the spike to 58%, caused by COVID's hit to earnings).

Second, rates were lowered to zero by the Fed in 2008 and spent nine of the next fourteen years at that level, with an interlude from late 2015 to early 2020 wherein Fed Funds roundtripped from zero to 2.5% and back.

Figure 2: Baa Yield and US Non-Financial Corporate Debt/GDP



Low rates allowed firms to carry much more debt, lowered the cost of debt, and increased profits. Those halcyon days are over. Rates have risen; and spreads have widened, though not to panic levels. Firms are in good shape. Gross debt is low relative to EBITDA. Similarly, EBITDA coverage of interest is at its highest in over a decade. Many high yield firms refinanced themselves at low fixed rates for multiple years. Still, this all could change and change rapidly in the event of an economic slowdown.

Figure 3: HY Issuers' Gross Debt/EBITDA

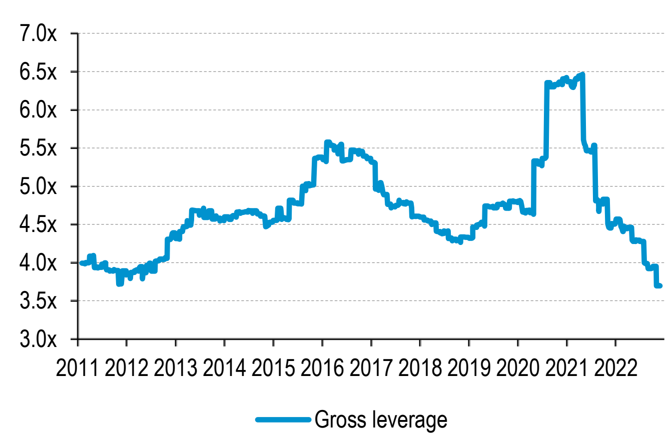
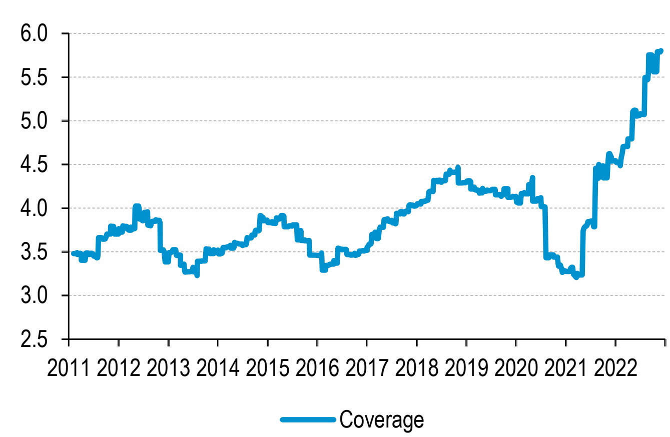


Figure 4: HY Issuers' Interest Coverage

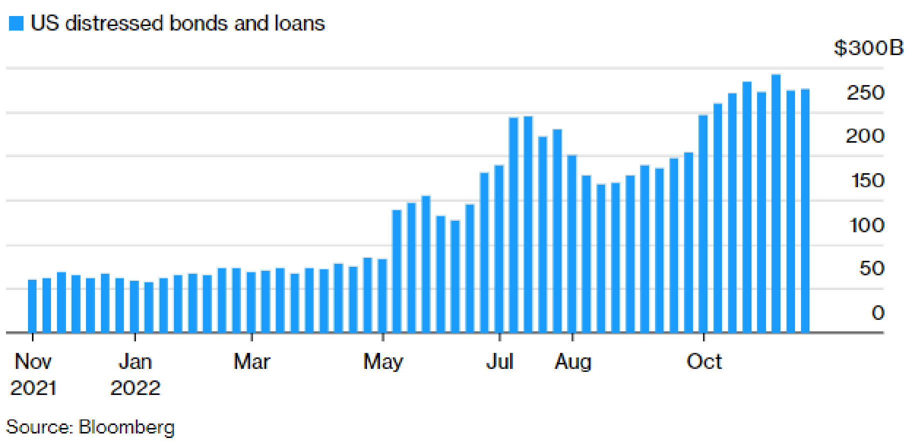


It seems almost inevitable that earnings will decline eventually, slowdown or no. The improvement in corporate earnings in the last decade came largely from lower interest rates and lower taxes. Interest rates are now materially higher and tax rates are unlikely to go any lower.

Rates are likely to stay high as the Fed fights inflation. We might not return to the world of disinflation we inhabited prior to Covid. Reshoring due to the fragility of supply chains, as exposed by the pandemic, along with the current shortage of service workers, might underpin price pressures even if at a lower level than today.

In earlier cycles, firms reduced leverage. This cycle will probably see a similar dynamic play out. Some companies will work to repay debt. Others could issue equity to help cut their obligations. Still others will enter distress, which appears to be happening already.

Figure 5: US Distressed Bonds and Loans



Deleveraging is likely to be good for debt, high yield in general, and short-term high yield in particular. Shorter maturities stand in front of the maturity wall that begins in 2025. As for equity, if this turns out to be a deleveraging cycle, stocks could be held back as managements work in the interests of the bondholders.