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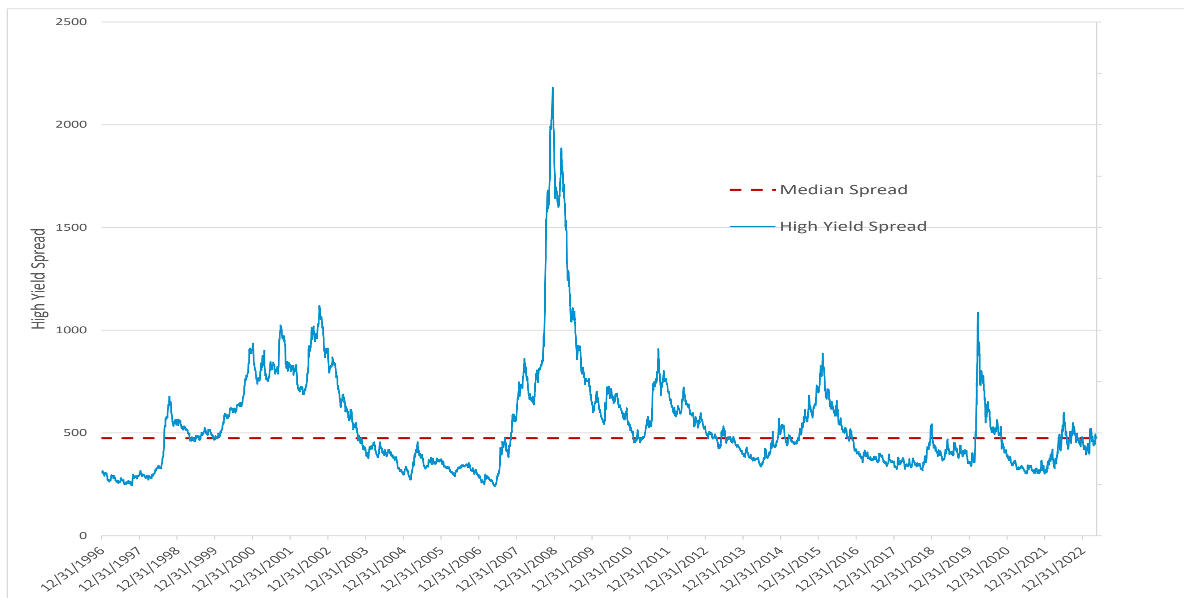
June 2023 High Yield Market Insights

- High yield bond yields have risen as the Fed has tightened
- Fixed rate issuers could be insulated from this tightening cycle
- High short-term yields appear to be an opportunity:
    - HY refinancing needs are low in the next two years
    - The Fed could cut rates before refinancing needs kick in

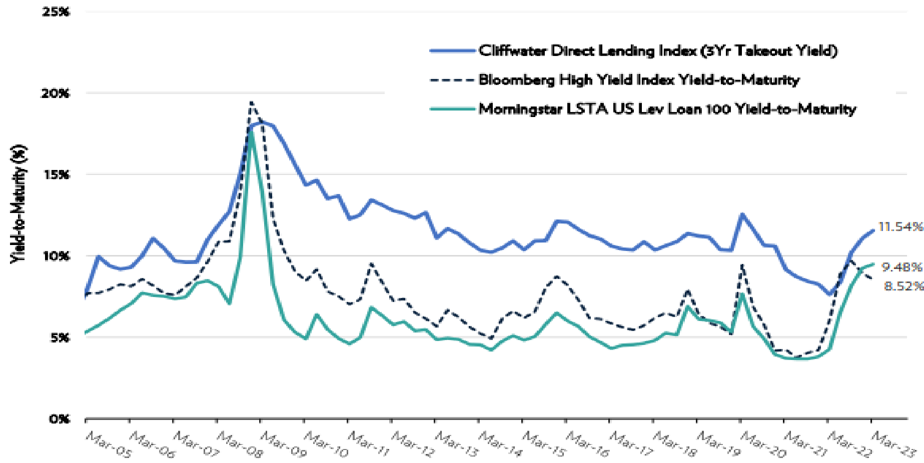
The Federal Reserve paused rate hikes at the June 2023 meeting, after having raised the funds rate from a range of 0-0.25% last March to 5.00-5.25% in May. Due to the swift and pronounced tightening cycle, high yield bond yields have risen. Despite the rise in yields, their spreads to treasuries have not widened. When rates rise this much, something somewhere in the economy usually breaks. If such fragility has not affected HY, we should ask what it does affect and whether this can be viewed as an opportunity.

Figure 1: High Yield Spread (in basis points)



Borrowers currently, or soon to be, challenged by the rise in rates are floating rate issuers. When rates were close to zero and credit spreads were also low, loans were an attractive way to fund companies. A decade and a half of near zero rates fueled the tendency to borrow at floating rates. Just as some regional banks did not hedge against the possibility rates would rise and sink their assets, many companies did not hedge against the possibility rates would rise, increase their borrowing costs, and hurting their profitability.

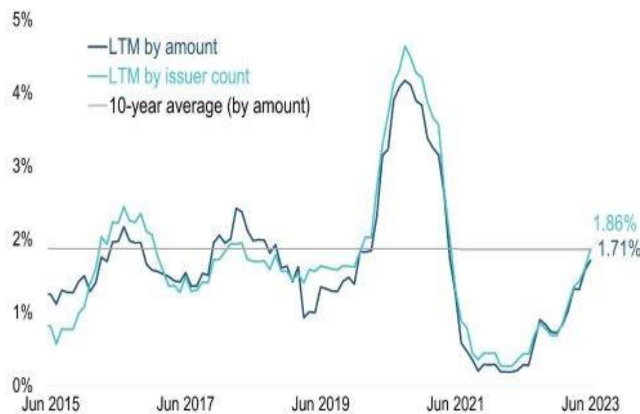
Figure 2: Loan Funded Firms Hurt by Higher Rates



As shown in Figure 2, HY bond yields are higher too, but bonds are fixed rate. They do not represent costs that must be paid today. Fixed rate funding gives firms the gifts of time and certainty, time before they need to refund and certainty about what they will be paying until the bonds mature. If inflation comes under control before their bonds mature, bond issuers could escape this rate cycle unscathed.

For floating rate issuers, distress is on the rise. Bankruptcies have risen; they are back at their ten-year average. This Fed rate cycle has hit hard and swiftly. Expect more bankruptcies and restructurings amongst the floating rate crowd.

Figure 3: Loan Bankruptcies Are at Their 10 Year Average



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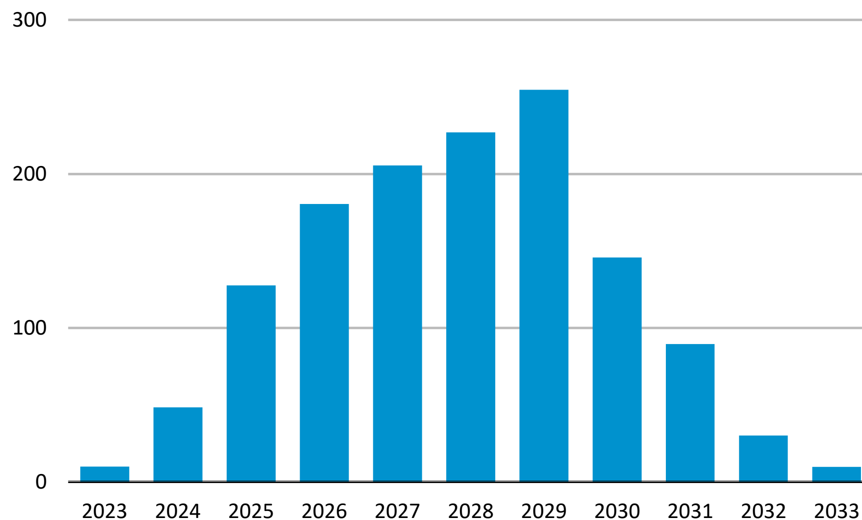
The lesson to be drawn here is some corporate managements became complacent over the last fifteen years. Inflation was supine. Economic growth was modest. The Fed kept rates near zero to encourage risk taking in the hope economic growth would follow. Instead of hedging the potential costs of higher rates via fixed rate funding, i.e. issuing bonds, firms chose to maximize short term profits by funding with low loan rates.

Inflation surged post-Covid, and the Fed tightened rapidly. This rapid tightening has raised funding costs and squeezed profitability for floating rate issuers.

Fixed rate issuers are more insulated from margin pressure than their floating rate peers. They are not completely insulated if they have current maturities or the inability to pass on inflated costs. Still, on balance, the need for refinancing will not be salient for the HY market overall until at least 2025.

Figure 4: HY Maturities Are Light This Year and Next



HY yields are up with loan rates, but higher fixed rate bond yields do not affect issuers without near term maturities in the way they affect floating rate issuers. Those yields are available to invest in the secondary market, while their issuers will be paying low rates for the next few years. This offers an opportunity to buy into the short end of the HY market and to earn high yields for the next two to three years. High yields, combined with the potential to ride out the tightening cycle before they need to refinance, seem like an opportunity.