CONCISE CAPITAL

March 2023 High Yield Market Insights

- HY spreads have not risen with rates, suggesting credit stress is not currently a concern
- HY firms that issued fixed rate debt when rates were low:
  - insulated themselves against higher rates
  - are perhaps the largest beneficiaries of an inflationary environment
  - could be funded through a potential recession when rates could be lower
- With improved fundamentals and record interest coverage, HY may be a haven and a buying opportunity

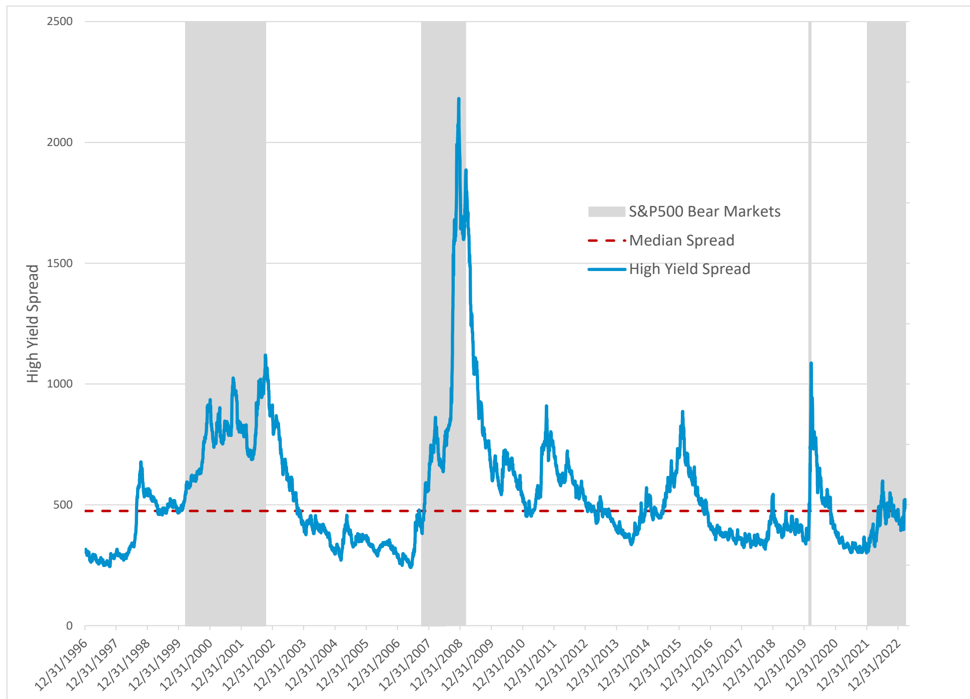
The Federal Reserve has been raising the Fed funds rate for over a year. Treasury yields are much higher as a result. High yield (HY) bond yields have followed along with treasuries. The S&P500 fell into a bear market, a 20% decline from its peak, in June 2022. It remains in bear market territory. Two large regional banks, Silicon Valley Bank and Signature Bank of NY, have failed. Despite all that, HY bond spreads, the yield premium for taking on the risk of lower rated debt, have not exploded higher as they did in every other equity bear market.

Figure 1: High Yield Bond Index Yield to Worst

Source: FRED, Concise Capital

The HY spread currently resides at the 54th percentile, just above its median spread since 1996. Many market participants are awaiting the day that spreads widen, as they feel they should, as they have so often before. Perhaps they are right, but perhaps something else is going on.

Figure 2: High Yield Spread with Median Line



Source: FRED, Concise Capital

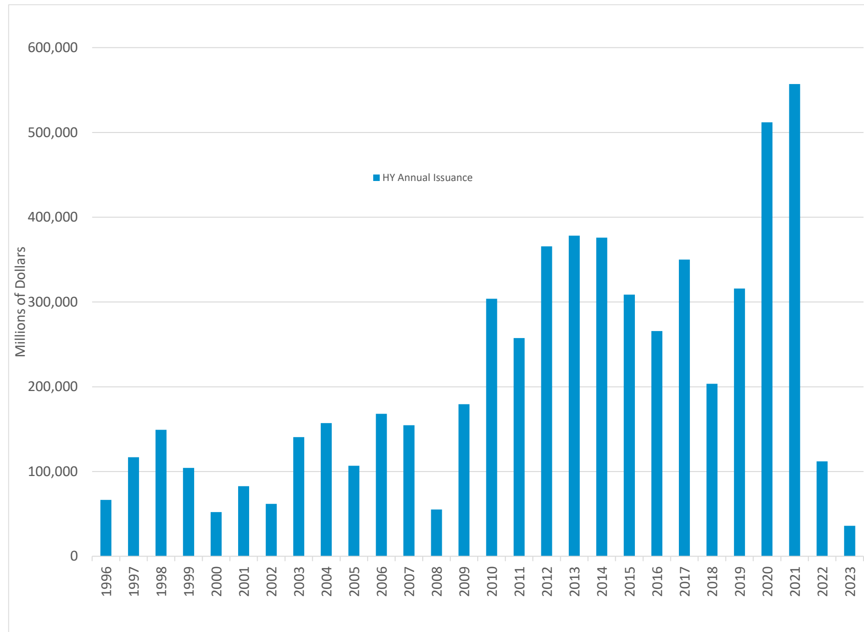
In a world where the Fed is raising rates, who gets hurt? We have found out, so far, that one set of victims is banks that invested short term deposits in long term, interest rate sensitive, treasuries and mortgages. Such instruments have suffered greatly as rates moved upward at a magnitude not seen in forty years. When their deposits ran, Silicon Valley Bank and Signature Bank effectively became bankrupt and were seized by the FDIC.

HY firms are not like banks. They issue fixed rate debt. HY firms are insulated from rate rises until they need to refinance. We lived in a world of historically low rates until a year ago. The question is whether HY companies took advantage of those rates. The answer is they did by issuing record amounts of fixed rate debt in both 2020 and 2021.

1111 Brickell Avenue, Suite 1525 ● Miami, FL 33131 ● Office: +1 (305) 371-4578 Ext. 1014 ● Email: ir@concisecapital.com

CONCISE CAPITAL

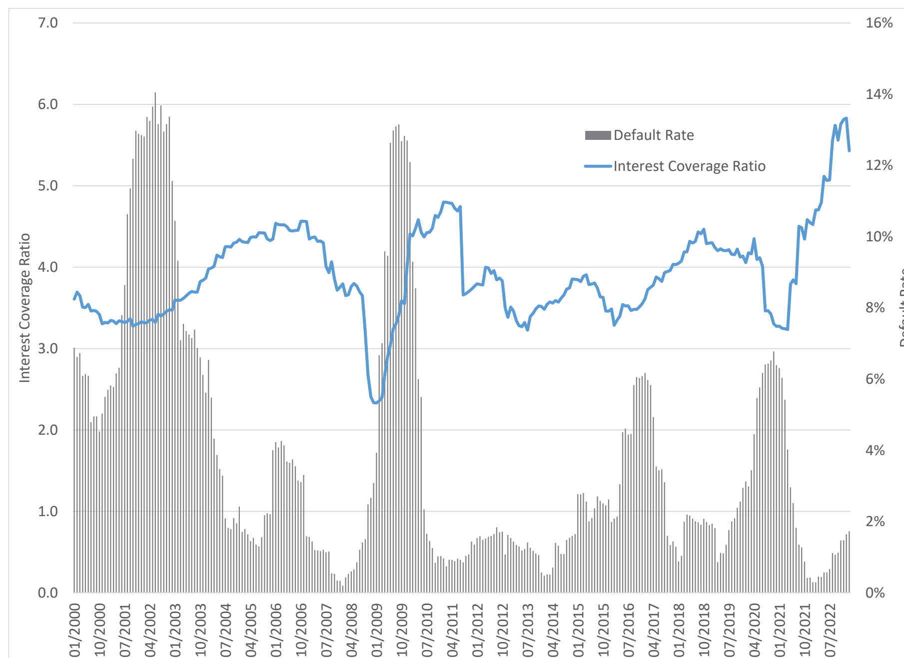
Figure 3: High Yield Bonds Annual Issuance



Source: BAML. 2023 issuance is through February.

HY firms are highly leveraged by definition. Their higher interest costs are a relatively higher proportion of their costs than those of less levered firms. When inflation is high, as it is now, these companies benefit disproportionately as their debt burden is inflated away in real terms. That is exactly what has been happening. Meanwhile, revenues and earnings have kept up with inflation.

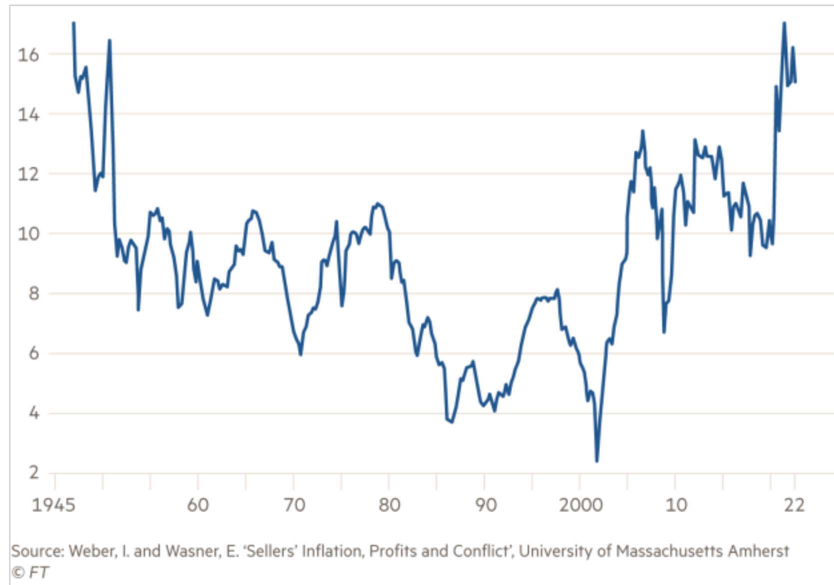
Figure 4: High Yield Firms' Interest Coverage Ratio and Defaults



Source: BAML

Companies have set prices to reflect the increased costs that they face from inflation, plus a little bit more. Having prioritized cost reduction and efficiencies during Covid, margins have expanded. Interest coverage, defined roughly as EBITDA relative to interest, has risen to 5.5x, far higher than typical. Defaults have risen slightly from historic lows but remain relatively muted. The fundamentals suggest they should remain below average.

Figure 5: After-tax profit margins of US non-financial corporates



Source: Financial Times

Levered companies are well funded as a group until 2025. If a recession is to occur between now and then, it is a real possibility that by the time HY companies need to issue more debt, both inflation and interest rates will be lower.

This implies that we are looking at an opportunity to lock in high yields with the chance that a default cycle is postponed and/or mitigated by the differential impact of inflation on revenues versus fixed funding costs. It will be interesting to see if HY bonds can function as a kind of safe haven given this combination of circumstances.