

May 2023

# Sector Fixed Income Commentary

Fundamentals	Technicals	Valuations
Negative	Neutral	Neutral

## Overview

US HY returned -0.9% in May, but most of the negative return was driven by higher risk-free rates as HY excess returns were only -0.2%. CCC's saw marginal underperformance in May but remain the best performing quality bucket year to date at +6% (+4% excess return) while BBs have underperformed at +2.5% (+0.8% excess return).

## Macro & Fundamentals

90% of HY companies have reported 1Q23 earnings. EBITDA grew 5% YoY but softened on a sequential basis. Debt levels were flat sequentially, and gross leverage moved up slightly to 4.0x. Interest coverage ratios remained healthy at 1.25x for CCCs, 3.7x for Bs, 8.2x for BBs, and 5.2x for HY overall. While backward looking fundamentals have been supportive, our forward view is more cautious. The May LTM par-weighted HY default rate ticked up to 2.3% with 6 issuers defaulting in May (all ~\$1B or smaller).

The ratings quality of the HY index has declined since the start of 2022, almost entirely driven by shrinkage in BB face value. Rising stars have been by far the largest contributor, but ratings migration patterns within HY have also started to deteriorate. HY face value has seen 12% net downgrades over the last 12 months, and 21% over the last 3 months (vs ~20% net upgrades just over 1y ago). Downgrades have been most severe in Telecom and Cable sectors. As a result, BB's represent 48% of index face value, down from 54% in early 2022.

During the loose financing period of 2021, issuers were able to term out their maturities. However, over the last 1.5 years, refinancings have been light and maturities have crept closer. As a result, 8% of HY bond market and 10% of loan market maturities occur in the next two years. Of the sectors with highest distress ratios, Telecom is the only one with above-average near-term maturity concentration. Except for Telecom, there is a negative correlation between maturity wall and distress ratio.

## Technicals

We have downgraded our technical outlook on the back of expected supply and several large rising stars that are now behind us. The HY market saw ~\$22bn of primary issuance in May – the largest month since January 2022. Private equity-backed bond sales propelled last month's issuance, making up ~1/3<sup>rd</sup> of volume versus the typical 5-10%. Several new deals priced with large concessions vs secondary bonds yet most re-priced existing bonds rather than tightening themselves.

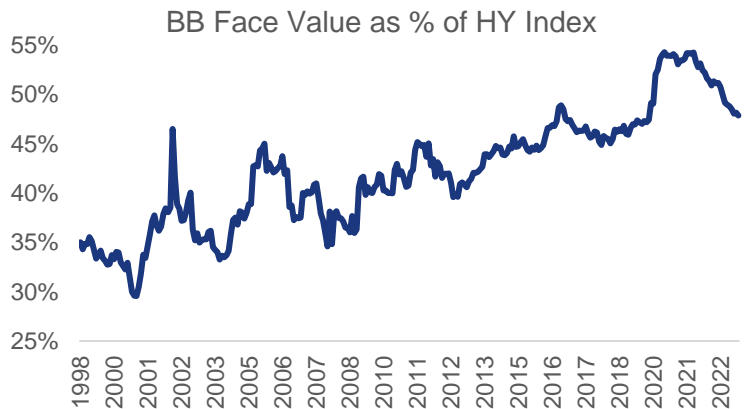
## Valuations

HY OAS ended May at roughly unchanged at 459bps which is the 54<sup>th</sup> percentile of trailing 30-years. All ratings buckets have seen spread tightening in 2023 except BB's, but that is partly driven by rising star upgrades. We believe current valuations compensate investors for a period of average default rates after adjusting for quality of the index.

## Outlook & Positioning

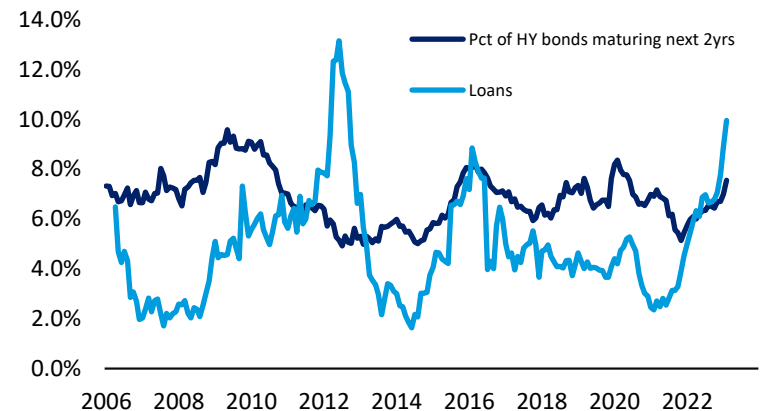
Our outlook remains largely unchanged. We believe issuer fundamentals will become more challenged, the technical picture has begun a phase of gradually weakening, and valuations are broadly unexciting with pockets of value.

**Figure 1: HY rating quality has deteriorated due to rising stars and the more recent trend of net downgrades**



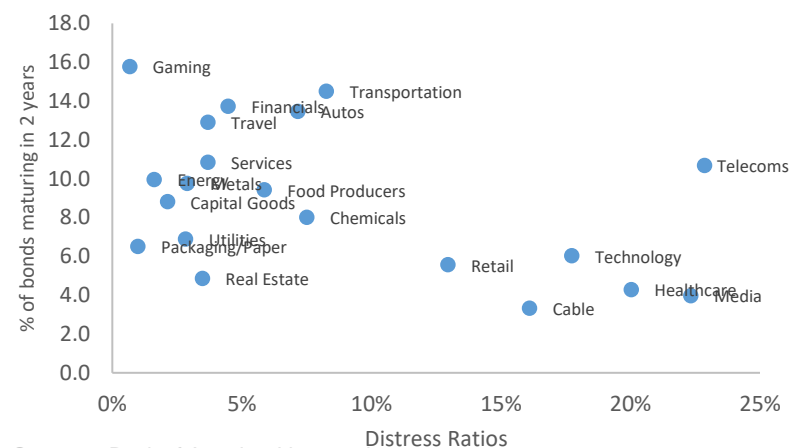
Sources: Bank of America, Vanguard

**Figure 2: Debt maturing within the next two years is increasing particularly within bank loans.**



Sources: Bank of America

**Figure 3: % of HY bonds maturing within two years. Telecoms is the outlier compared to other industries.**



Sources: Bank of America, Vanguard

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