August 2023

High Yield Fixed Income Commentary

Fundamentals	Technicals	Valuations
Neutral	Neutral	Neutral

Overview

US HY returned +0.3% in August. Lower-quality bonds continued to outperform. On a total return basis, BB's returned -0.6%, B's +0.4%, and CCC's +1.2%. Sector performance was mixed in August, with labor issues contributing to weakness in metals and mining (-0.6%), automotive (-0.5%) and restaurants (-0.5%). The best-performing sectors were wireless (+2.3%), cable satellite (+1.1%), and independent energy (+1.0%) on idiosyncratic news within communications and higher brent crude prices for independent energy.

Macro & Fundamentals

We upgraded our view on fundamentals to neutral following the Q2 earnings season as results were better-than-feared. Though the HY market saw -2.6% decline in revenue and -1.7% dip in EBITDA Y/Y, margins were roughly flat. High dispersion remained in the market as sectors appear to be in varying stages of the business cycle. Furthermore, issuers' exposure to particular end markets caused variance in earnings performance within sectors. Continued destocking and declining consumer sentiment were key drivers of double-digit Y/Y top-line deterioration in Chemicals and Consumer Products, respectively. Demand for entertainment and travel led to double-digit earnings growth in Leisure and Transportation. HY gross leverage ticked up 0.3x Y/Y to 4.3x and interest coverage declined -0.6x to 4.8x due to softer EBITDA and minimal debt paydown.

The backdrop of compressing margins and lower coverage ratios raises concerns over the impact of refinancing at higher rates. Issuers successfully termed out maturities during 2020-21, which limited the need to issue debt as rates rose and financial conditions tightened, resulting in a gradual creep forward of maturities. As a result, 13% of the high yield market faces maturities through 2025, concentrated in Bs and CCCs. For a theoretical issuer with high leverage where interest expense increases by 30% following a refi wave the next several years, an issuer with 7x leverage and an average coupon of 6.5% would see interest coverage drop from 2x to 1.5x, according to BoA research. Rising interest burdens are a risk factor we are concerned about, particularly for highly levered credits. Looking forward, we expect Q2 to be the trough for most sectors and for upcoming economic recoveries to buoy fundamentals for addressing short-dated maturities.

Technicals

We are downgrading our outlook on technicals to neutral. The technical backdrop in HY has been overwhelmingly positive for the last 1.5y due to lack of issuance, large net rising stars, and manageable outflows. We believe the major technical tailwinds are now behind us. Refinancing related issuance will are set to increase as maturities gradually creep closer, and the bulk of rising stars are behind us (except for one very large capital structure) as rating migration trends have slowed and even reversed within the HY market. In August, HY saw below-average primary issuance of ~$10bn vs the 20y average of ~$12bn.

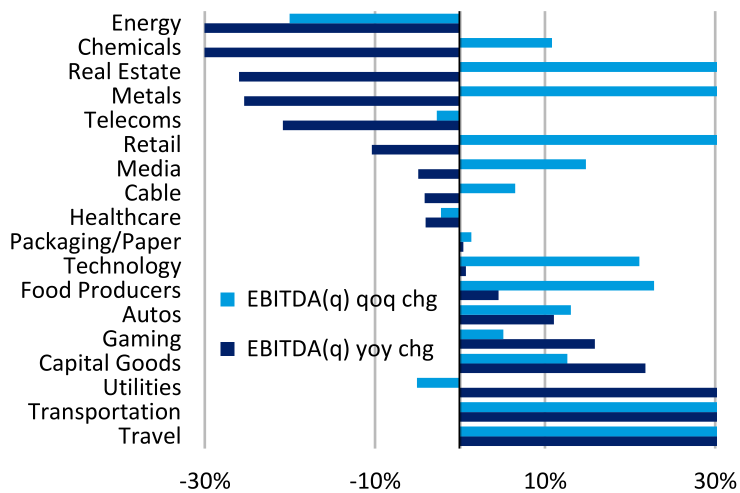
Valuations

We upgrade our view on HY valuations to neutral, in part due to the improved fundamental outlook. HY OAS ended the month at 372bps, ~5bps wider MoM. HY spreads are now in the 36th percentile of the last 30 years with BBs in the 34th percentile, Bs in the 31st percentile, and CCCs in the 52nd percentile. When comparing current OAS to the historical average of ~500bps, we believe a favorable 70bp adjustment should be made to account for the combination of higher quality (50bps) and lower dollar prices (20bps).

Outlook & Positioning

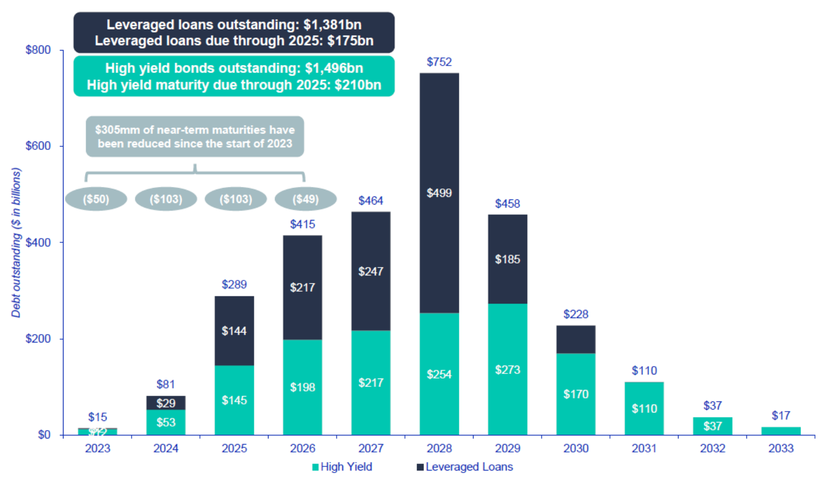
We are neutral overall on the HY market, but continued pressure on several sectors, driven predominantly by capital needs and competitive pressures, presents plenty of idiosyncratic opportunities. We look forward to increased issuance and believe our opportunity set is much improved compared to 2y 1.5y ago when HY was last at current spread levels.

Figure 1: HY saw high dispersion in sector earnings performance during Q2



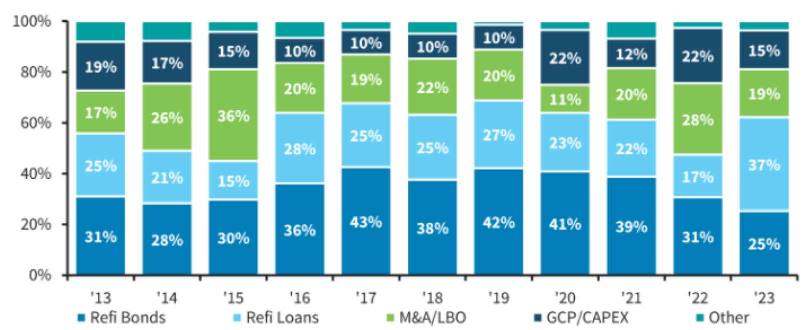
Sources: BofA, Bloomberg

Figure 2: ~13% of the leveraged debt market is set to mature through 2025



Sources: Deutsche Bank, LCD, Bloomberg

Figure 3: HY Use of Proceeds (as a percent of new issue) is primarily composed of refinancings and M&A



Sources: Barclays Research

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