Private Markets

April 25, 2024

Global Credit Weekly:

Bifurcation

BlackRock

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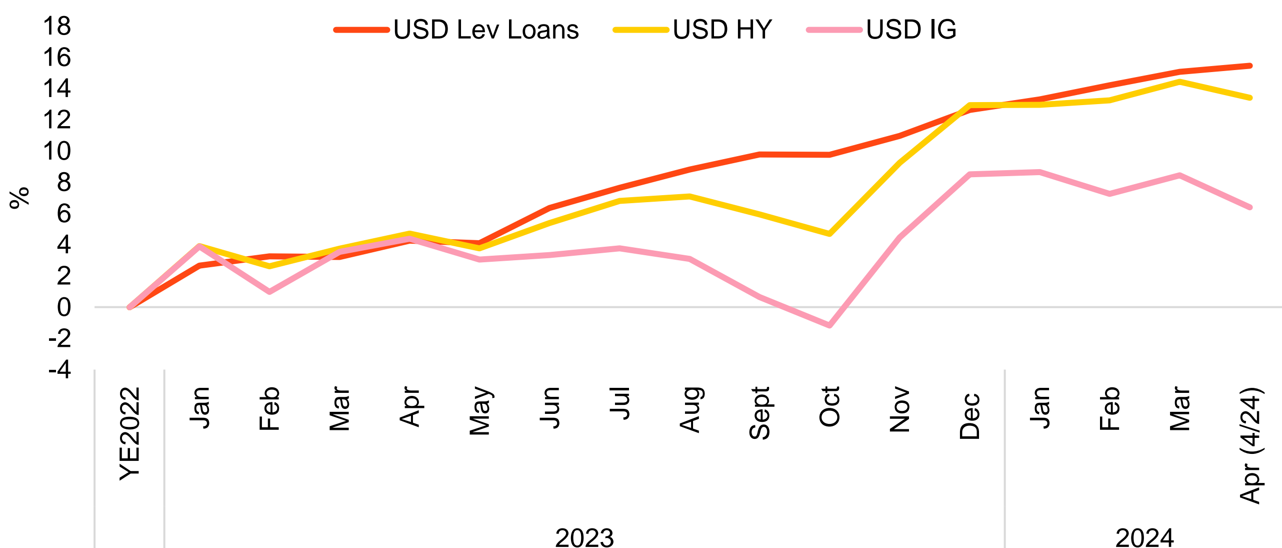
Key takeaways

- After modest widening in mid-April, USD corporate credit spreads have largely retraced those moves over the past few sessions (through April 24th). We attribute the resilience of spreads to two factors: (1) ongoing strength in U.S. economic activity , and (2) the attractive all-in yield backdrop. While we see limited scope for material tightening at current levels, we expect spreads to remain supported and range-bound through 2Q2024.
- So long as U.S. growth remains resilient, we expect *most* pockets of USD corporate credit will be able to navigate a "high for longer" cost of capital. That said, the relative underperformance of CCCs is likely to persist, in our view. We also continue to see a case for tactical allocations to floating rate and front-end exposures in corporate credit, given the interest rate backdrop.
- While many market participants are focused on the start (*timing*) of the Federal Reserve rate cutting cycle, we are more concerned with the *reason* for it. Policy normalization in response to improved inflation is a more supportive backdrop for credit than policy easing in response to a sharp economic downturn. By the same token, an extended delay (beyond 2024) for rate cuts because of strength in U.S. economic activity would likely be more easily digested by credit, in our view, versus a postponement of rate cuts because of a *sustained* reacceleration of inflation.
- A *sustained* reacceleration of inflation is a key downside risk to corporate credit valuations. But not because we view a 25bp or 50bp rate cut as material for leveraged finance borrowers. Rather, such a scenario is negative, in our view, as it would likely interject significant uncertainty related to the path of U.S. monetary policy (as it may lend more credence to the potential for *rate hikes*).

Exhibit 1: Leveraged loans have been outperforming, while longer duration credit has lagged
Cumulative monthly total returns (%) for the Morningstar/LSTA USD Leveraged Loan Index, the ICE-BAML USD HY Corporate Index, and the ICE-BAML USD IG Corporate Index



Source: BlackRock, Morningstar/LSTA, Pitchbook LCD, ICE-BAML, Bloomberg. Captures data through April 24, 2024. **The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results.** Index performance returns do not reflect any management fees, transaction costs or expenses. Indices are unmanaged and one cannot invest directly in an index.

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Short-lived weakness in USD corporate credit spreads

After some very modest widening in mid-April, USD corporate credit spreads have largely retraced those moves over the past few trading sessions. At 90bp for USD IG and 307bp for USD HY, index-level spreads (for the Bloomberg USD Corporate indices) are now hovering just above the local tights of mid-2021 (80bp and 262bp, respectively).

The culprit for the recent widening, in our view, was a combination of (1) the release of stronger than anticipated March U.S. CPI data, which caused the market to (once again) temper expectations for near-term interest rate cuts; (2) an escalation in geopolitical tensions; and (3) mixed earnings from U.S. banks, ahead of seasonally heavy new issue supply from the sector.

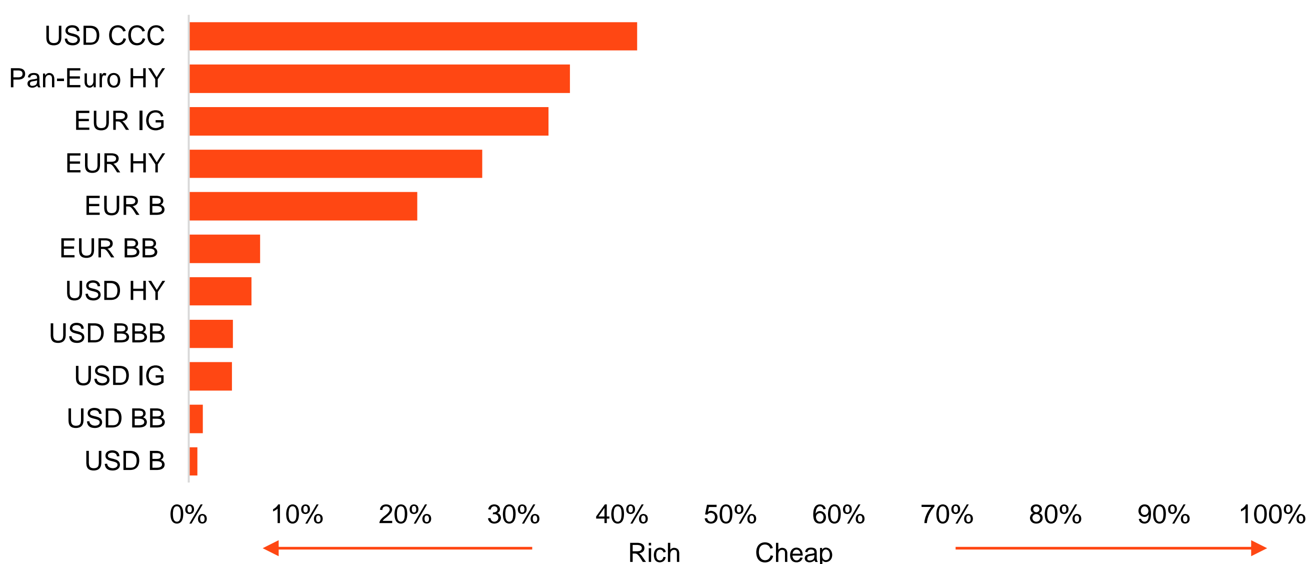
While none of these factors have been "reversed", corporate credit spreads have managed to hold in well. With the important exception of USD CCCs, USD IG and HY spreads – across most rating cohorts – are trading at the tight end of the post-financial crisis range (Exhibit 2).

We attribute this ongoing resilience to two primary factors. First and foremost, U.S. growth has remained strong. 1Q2024 U.S. real GDP is tracking at 2.7% per the Atlanta Fed's GDPNow tracker (as of April 24th), which is key for the underlying health of credit fundamentals – especially for speculative grade issuers in growth sensitive asset classes such as HY and leveraged loans. (Note: the 1Q U.S. GDP print released on April 25th showed a more moderate pace of growth, of 1.6%, though this may have been driven by some timing considerations in volatile categories such as inventories and net exports).

So long as U.S. growth remains resilient, we expect most (but not all) pockets of the USD corporate credit universe will be able to navigate a "high for longer" cost of capital environment. That said, as we discuss later, the relative underperformance of CCCs is likely to persist, in our view. This is consistent with the backdrop we outlined in our *2Q2024 Global Credit Outlook*, which was one of elevated dispersion, but not widespread market disruption.

The second driver of the relative resilience of credit spreads relates to the well-telegraphed all-in yield opportunity in USD corporate credit. These entry points remain compelling by historical standards, as highlighted in Exhibit 3. This has likely encouraged capital deployment in corporate credit from yield-based buyers, despite spreads that screen as optically tight.

Exhibit 2: USD corporate credit spreads remain tight...
Percentile rank of daily index-level corporate bond spreads since January 1, 2010



Source: BlackRock, Bloomberg, ICE-BAML. Captures option adjusted spread data through April 24, 2024. **The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results.** Index performance returns do not reflect any management fees, transaction costs or expenses. Indices are unmanaged and one cannot invest directly in an index. We exclude EUR CCC due to its small market size.

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The *reason* for Fed rate cuts (or a potential delay) is key

With corporate debt supply poised to accelerate as companies exit earnings-related blackout periods and geopolitical tensions remaining an overhang, the scope for material spread tightening is likely limited, in our view. That said, we expect the all-in yield backdrop will keep spreads range bound as a material widening in spreads (in most instances) would likely be met with meaningful demand from the marginal credit buyer.

As we outlined last week, while we still expect the first Federal Reserve rate cut to arrive in 2H2024, we no longer view the risks to that (admittedly wide) timeframe as skewed towards the earlier side. And as we noted, we also see scope for a "transatlantic divergence," as the ECB looks poised to cut rates in June.

More important than the start (timing) of the Federal Reserve rate cutting cycle, however, is the *reason* for it. For example, policy normalization in response to improved inflation (which over the past three months has been somewhat elusive) is a more supportive backdrop for corporate credit than policy easing in response to a sharp deterioration in U.S. economic growth.

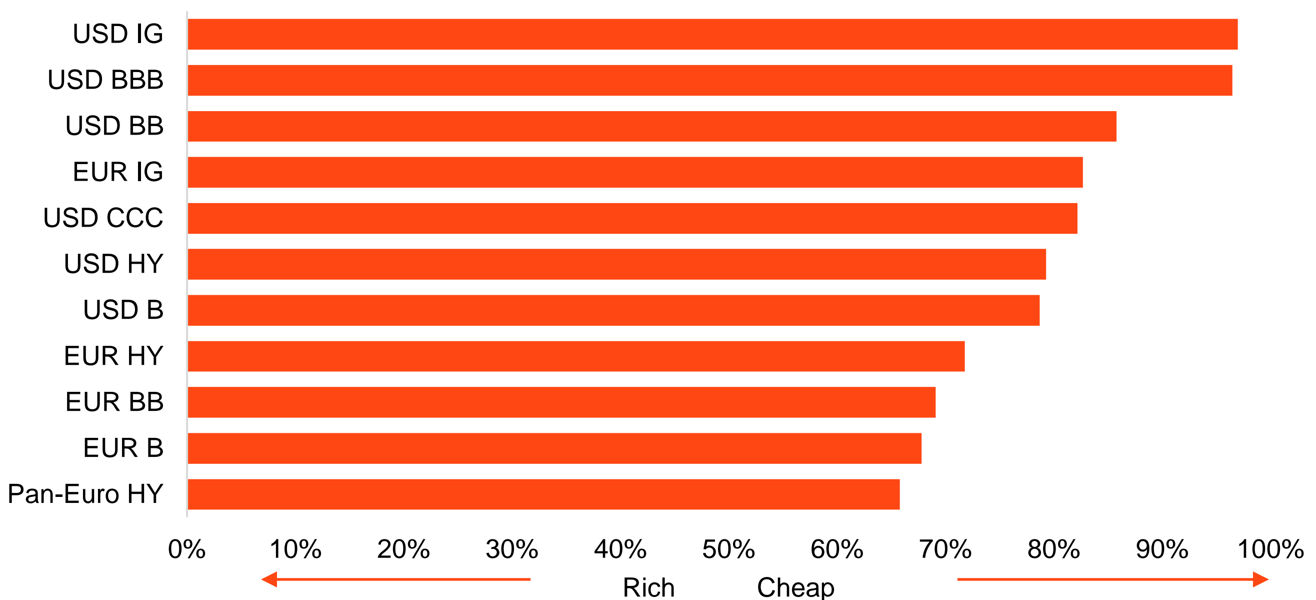
By the same token, an extended delay (beyond 2024) for rate cuts because of ongoing strength in U.S. economic activity would likely be more easily digested by corporate credit, in our view, versus a postponement of rate cuts because of a *sustained* reacceleration of inflation.

Indeed, as we noted in the *2Q2024 Global Credit Outlook*, a *sustained* reacceleration of inflation is a key downside risk to corporate credit valuations. But not because we view a 25bp or 50bp rate cut as material for floating rate leveraged finance borrowers in corporate credit. Rather, such a scenario is negative, in our view, as it would likely interject significant uncertainty related to the forward path of U.S. monetary policy (as it may lend more credence to the potential for *rate hikes*).

Moreover, once the U.S. rate cutting cycle does (eventually) start, it is likely to be shallow. The Federal Reserve's March 2024 Summary of Economic Projections pointed to a long-term Fed Funds rate of 2.6% from the median participant – well above the "zero lower bound" which prevailed for much of the post-financial crisis era. As a result, corporate credit investors should brace for a "high for longer" backdrop.

Exhibit 3: ...but all-in yields are attractive

Percentile rank of daily index-level corporate bond yields since January 1, 2010



Source: BlackRock, Bloomberg, ICE-BAML. Captures yield-to-worst data through April 24, 2024. **The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results.** Index performance returns do not reflect any management fees, transaction costs or expenses. Indices are unmanaged and one cannot invest directly in an index. We exclude EUR CCC due to its small market size.

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Ongoing resilience from floating rate credit

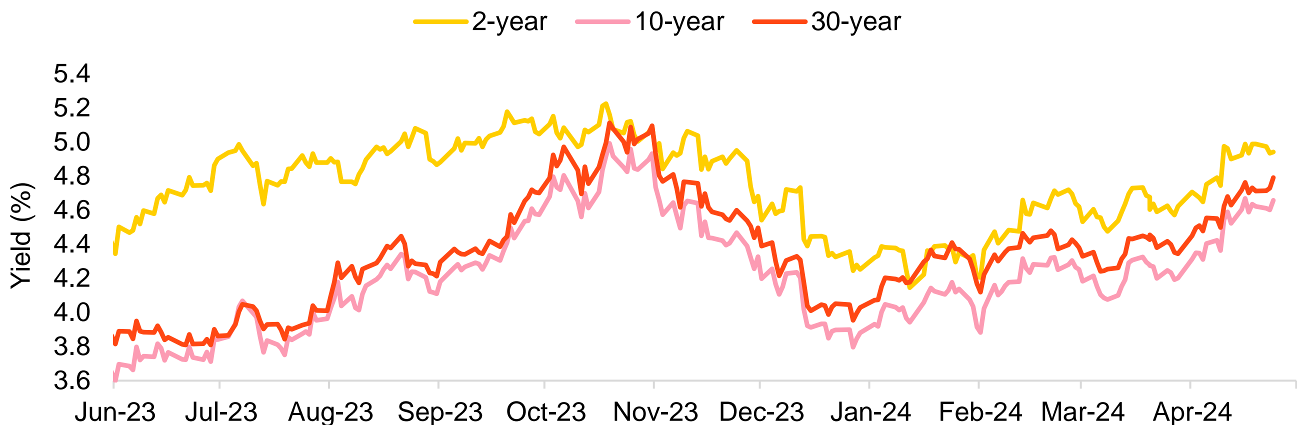
In the USD corporate credit market, two relative value themes stand out to us in the first few months of 2024 – both of which we expect to persist through 2Q2024. These include: (1) the relative outperformance of floating rate syndicated leveraged loans, relative to their fixed rate peers (especially vs. long duration IG; Exhibit 1); and (2) the underperformance of the CCC-rated cohort of the leveraged finance universe (in both syndicated leveraged loans and HY bonds).

The relative underperformance of duration in the USD corporate credit market is, of course, due to the sell-off in U.S. Treasury yields over the past few months (Exhibit 4). Absent a sharp escalation in geopolitical tensions, we do not foresee a sustained rally in long-end U.S. Treasury yields.

In our *2Q2024 Global Credit Outlook*, we outlined a tactical case for front-end and/or floating rate credit exposures. Since that time, public commentary from a range of Federal Reserve officials has pointed to a further delay in the start of the rate cutting cycle in the U.S., further supporting this allocation view.

Floating rate exposure could take a variety of forms, including IG floating rate notes, leveraged loans, collateralized loan obligations (CLOs), and portions of private credit such as direct lending. And on the fixed rate bond side, given that the U.S. Treasury curve remains inverted (Exhibit 5), we see the most compelling case for income and carry in the front and intermediate portions of corporate credit curves, as opposed to the long-end.

Exhibit 4: Higher U.S. Treasury yields have weighed on fixed rate credit's total returns
Yield-to-worst of the 2-year, 10-year and 30-year U.S. Treasuries (on-the-run securities, mid levels)



Source: BlackRock, Bloomberg. As of April 24, 2024.

Exhibit 5: The U.S. Treasury yield curve remains inverted
U.S. Treasury yield curve: on-the-run 10-year minus on-the-run 2-year yield (bp)

Source: BlackRock, Bloomberg. As of April 24, 2024.

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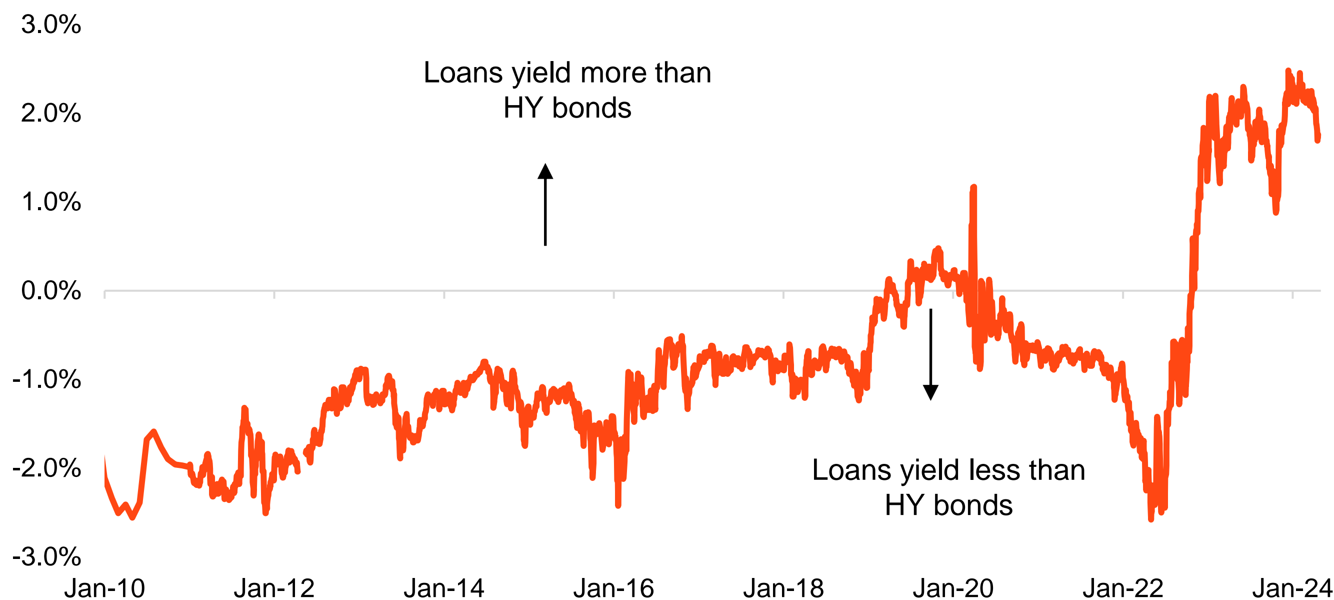
Exhibit 6 illustrates the carry differential for one closely tracked relative value relationship: USD leveraged loans vs. USD HY bonds. As shown below, the yield "pick up" offered by B-rated loans (compared to B-rated HY bonds) remains at the high-end of the historical range. While there are sector composition considerations between the two asset classes, the key takeaway, in our view, is that the relative value relationship currently skews in favor of loans. That said, sector and credit selection will remain paramount, as not every floating rate issuer is equipped to navigate a "high for longer" backdrop.

Exhibit 6: Leveraged loans continue to offer a carry "pickup" vs. HY bonds
Yield differential (%): B-rated leveraged loans minus B-rated HY bonds



Source: BlackRock, Pitchbook LCD. Morningstar/LSTA, ICE-BAML. As of April 19, 2024 (most recent available). **The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results.** Index performance returns do not reflect any management fees, transaction costs or expenses. Indices are unmanaged and one cannot invest directly in an index.

CCCs have yet to close their underperformance gap

Another notable relative value theme so far in 2024 has been the episodic underperformance of CCC-rated bonds. While CCCs are an incredibly idiosyncratic cohort (often with unique company/sector-specific challenges), we nonetheless view the directional trend of aggregated data as informative.

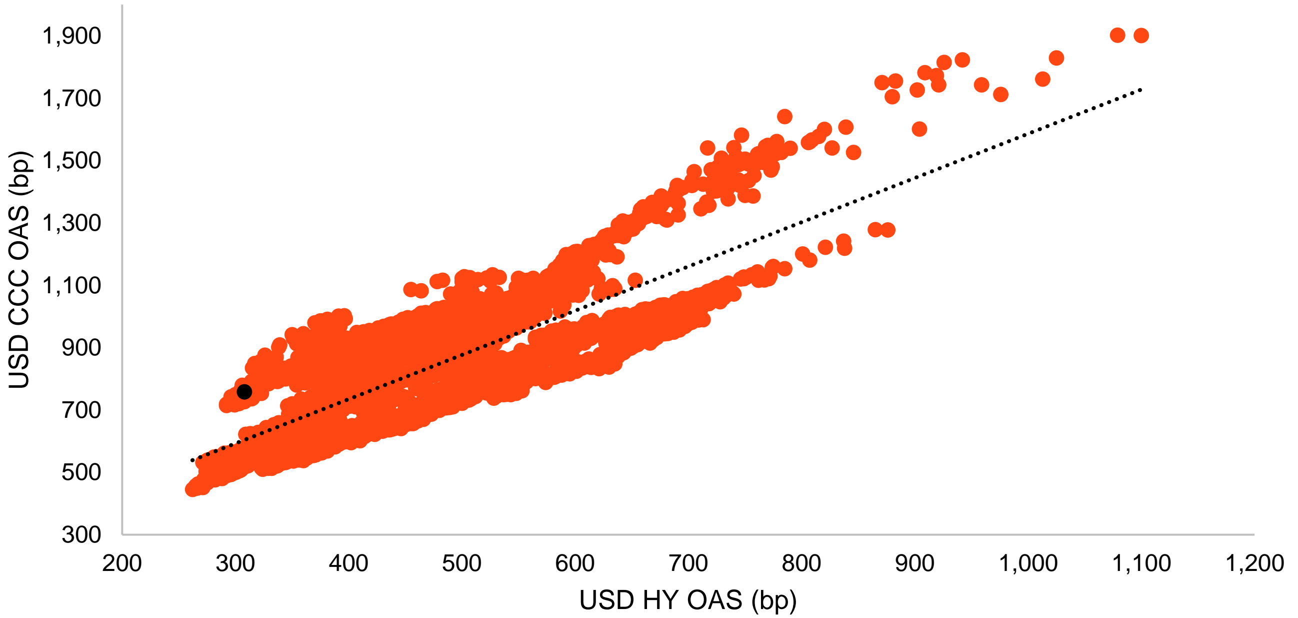
Exhibit 7 captures a regression of daily spreads for two Bloomberg USD Corporate indices: the broad HY universe and the CCC-specific group. As the scatter plot illustrates, the current HY index-level option adjusted spread (OAS) of 307bp implies an average CCC spread of approximately 600bp. This compares to the actual OAS of the CCC subindex of 749bp (black dot in Exhibit 7).

Exhibit 8 illustrates this yet another way, using OAS ratios. While a somewhat noisy series, the takeaway from Exhibit 8 is that CCC spreads have yet to close the underperformance gap (vs. the broader USD HY index) which opened in late 2023.

In our view, the underperformance of CCC-rated bonds reflects this group's limited financial flexibility in the context of a "high for longer" interest rate environment. For context, data complied by Bloomberg places trimmed mean interest coverage for USD CCC-rated issuers at just 1.1x as of 4Q2023 (on a trailing 12-month basis). This compares to 2.3x for USD B-rated issuers and 3.9x for USD BB-rated issuers.

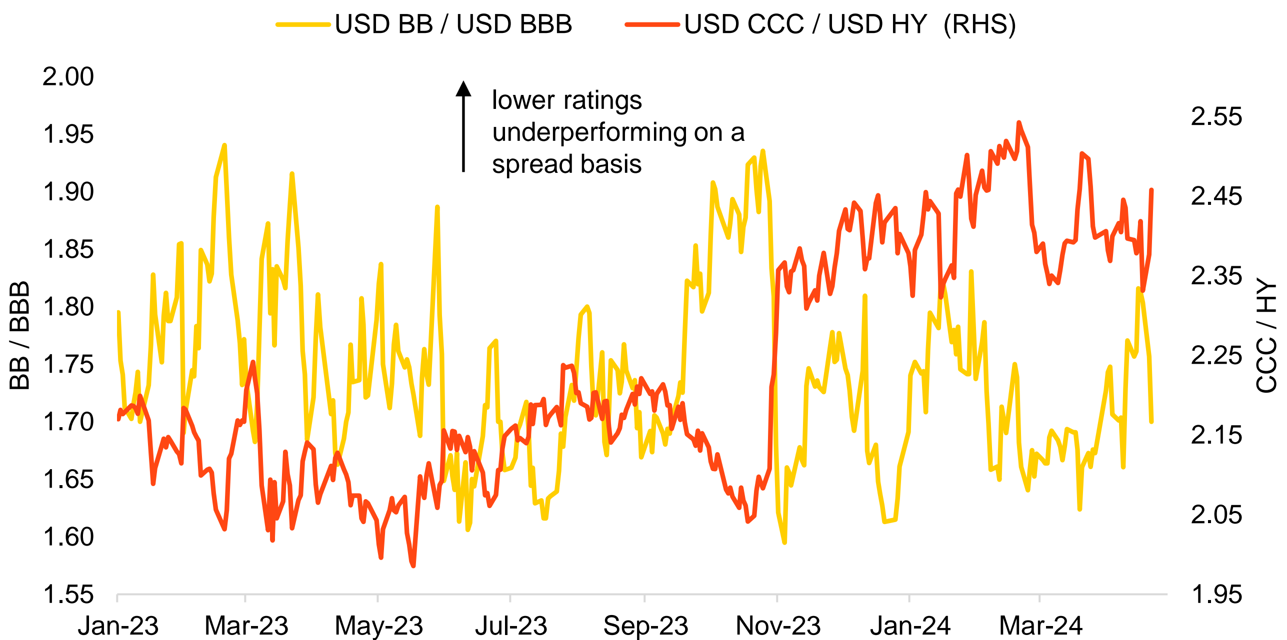
Given this limited financial flexibility, we expect that CCCs will continue to lag the broader HY market on a spread basis. A sharp deterioration in economic data, or a lack of receptivity of the capital markets to finance lower-rated borrowers, could spark more material underperformance, in our view.

Exhibit 7: CCCs have lagged the tightening in overall USD HY index-level spreads
Daily observations of option adjusted spreads for the Bloomberg USD HY and CCC rated corporate indices, since January 2010



Source: BlackRock, Bloomberg. As of April 24, 2024.**The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results.** Index performance returns do not reflect any management fees, transaction costs or expenses. Indices are unmanaged and one cannot invest directly in an index.

Exhibit 8: CCCs have not closed the "underperformance gap" which opened in late 2023
Option adjusted spread ratios using the Bloomberg Corporate indices: USD BB / USD BBB and USD CCC / USD HY (RHS)



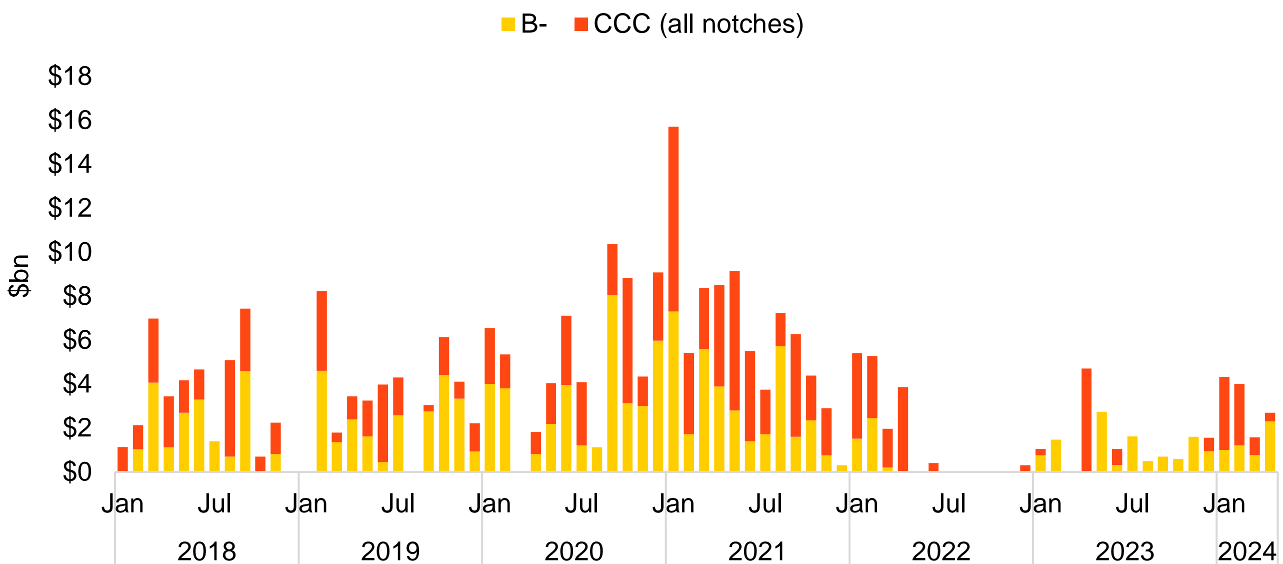
Source: BlackRock, Bloomberg. As of April 24, 2024. **The figures shown relate to past performance. Past performance is not a reliable indicator of current or future result.** Index performance returns do not reflect any management fees, transaction costs or expenses. Indices are unmanaged and one cannot invest directly in an index.

After an extended drought of activity in 2H2023, the USD HY bond primary market has been receptive to these lower-rated issuers in recent months (Exhibit 9). The syndicated leveraged loan market has also been wide open for refinancing related activity in the first few months of 2024 – boosted in part by strong demand from robust CLO creation (which purchase leveraged loans).

Amend-and-extend activity in the syndicated leveraged loan market has also been running well above the historical pattern per data from Pitchbook LCD, as issuers chip away at their 2025-2027 maturities.

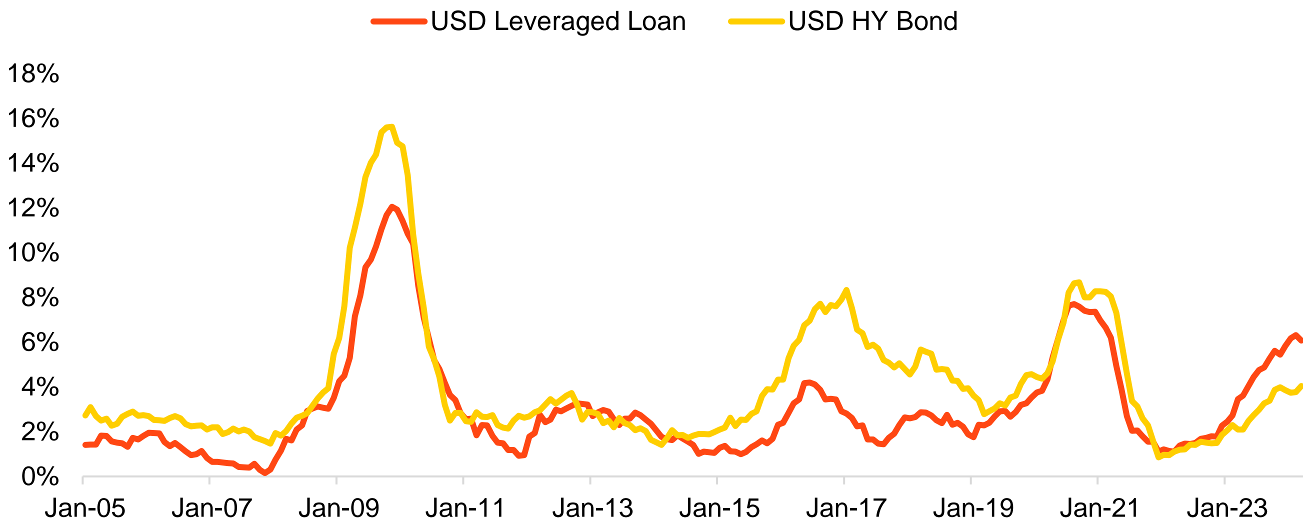
The general receptivity of debt capital markets – coupled with above-trend U.S. economic growth – has helped to keep the corporate default rate relatively contained (Exhibit 10), despite the swift rate hiking cycle in the U.S. (which began in March 2022) and the well-documented tightening in bank lending standards.

Exhibit 9: The USD HY bond market remains open to lower-rated issuers
Monthly USD HY gross issuance by Dealogic Effective Rating at Launch (only captures B- and CCC+/CCC/CCC- rated issuance)



Source: BlackRock, Dealogic (ION Analytics). As of April 24, 2024. Excludes private placements not reported to Dealogic.

Exhibit 10: Tentative signs of peaking in USD corporate default rates
Trailing 12-month, issuer-weighted default rates (%) for the universe of USD HY bonds and leveraged loans tracked by Moody's



Source: BlackRock, Moody's. As of March 31, 2024 (most recent available).

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Investors are optimistic about performance of syndicated loan markets

A few weeks ago, we outlined investor expectations related to the private credit market (allocations, performance, etc.). In this *Global Credit Weekly*, we do the same for the syndicated leveraged loan market using Pitchbook LCD's U.S. Leveraged Finance Survey.

The survey, which was most recently conducted in 1Q2024, gathers perspectives from U.S. sell-side, buy-side, and advisory accounts about their outlook for syndicated markets in the coming months. Half of the respondents came from the sell-side, 30% from the buy-side and the remaining 20% were a mix of advisors (for example, debt advisors). All respondents are clients of Pitchbook LCD.

Shifting rate-cut expectations make leveraged loans more attractive

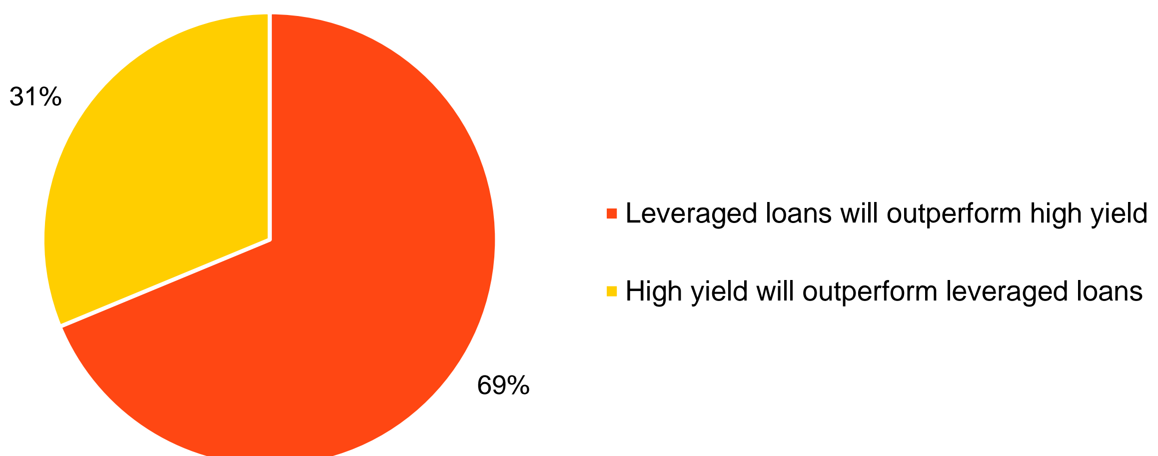
As a reminder, market pricing entering 2024 suggested meaningful odds for the first cut in March 2024, and implied more than six 25bp rate cuts for the year. By late-March, when the survey was conducted, that expectation had been reduced to just over three 25bp cuts beginning in July 2024. Today, rate cut expectations are further delayed, with the first full rate cut priced in by November 2024, per Bloomberg.

For some investors, delayed rate cuts increase the attractiveness of floating-rate debt instruments, because of the opportunity to earn an elevated cash yield (versus fixed-rate instruments), for a longer period. Exhibit 11 illustrates this preference, with 69% of respondents expecting leveraged loans (floating rate) to outperform high yield bonds (fixed rate) in the next six months. In 4Q2023, 61% of respondents favored leveraged loans. We believe the incremental increase was influenced by the expectation of fewer rate cuts this year, alongside the aforementioned upward pressure on long-end U.S. Treasury yields and the inverted curve.

The shift in performance expectations also extends to investors' allocation plans. 72% of respondents expect increased allocations to broadly syndicated loans ("BSL") in the next six months, up from 31% in the fourth quarter (Exhibit 12).

However, the expected increase in allocations to BSL does not come at the expense of high yield allocations. 84% of respondents expected allocations to high yield bonds to either increase or remain the same over the next six months. In our view, this reflects the relative fundamental resilience of USD corporate credit in the leveraged finance market – despite the swift rate hiking cycle of the past two years. (Please see our *2Q2024 Global Credit Outlook* for further detail on this theme).

Exhibit 11: Respondents believe leveraged loans will outperform HY in the next six months
Respondents were asked: "Will leveraged loans or high yield bonds outperform in the next six months?"



Source: BlackRock, Pitchbook LCD U.S. Leveraged Finance Survey. As of March 22, 2024.

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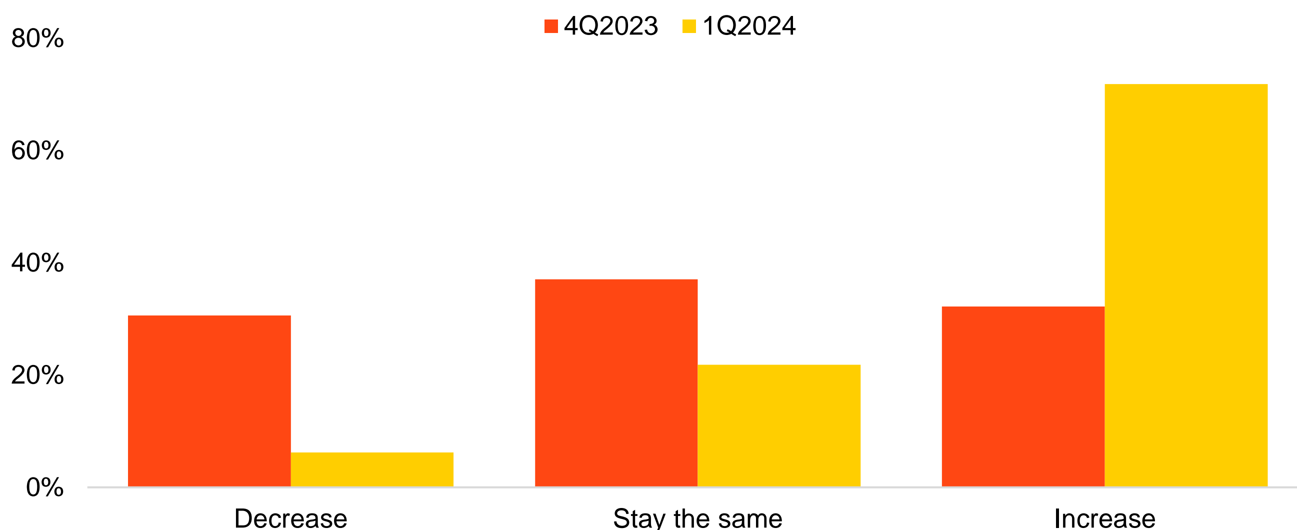
Exhibit 12: Respondents expect allocations to BSL to increase over the next six months
Respondents were asked: "What do you expect allocations to broadly syndicated loans will do in the next six months?"

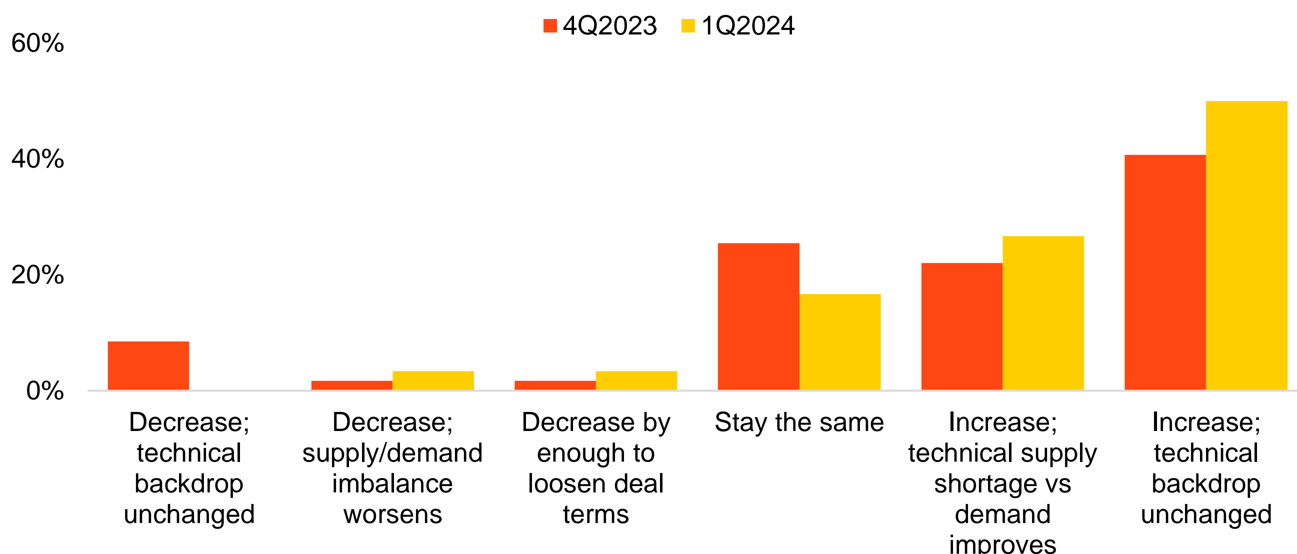


Source: BlackRock, Pitchbook LCD U.S. Leveraged Finance Survey. As of March 22, 2024.

Respondents expect new-money M&A volume to increase for BSL

Despite sentiment that rate cuts may be scarce in 2024, respondents are confident that new-money merger and acquisition (M&A)-related BSL issuance will return, with 77% of respondents expecting volumes to increase in 2024 (Exhibit 13). Half of the respondents expect the increase in supply will not be enough to offset existing demand (noted by "increase; technical backdrop unchanged"). The remaining 27% of respondents that expect M&A to increase (noted by "increase; technical supply shortage vs demand improves"), expect volumes to increase enough to improve existing supply shortages. Versus 4Q2023, more respondents (by percentage) expect M&A volumes to increase, and fewer (by percentage) expect M&A volumes to decrease or stay at the same level. We believe additional clarity on the macroeconomic landscape may be fueling the expected increase in new-money M&A volume, alongside increased optimism that the U.S. will be able to avert a sharp downturn in economic activity.

Exhibit 13: Respondents expect an increase in BSL M&A issuance volume
Respondents were asked: "Regarding M&A-related issuance [volume] via broadly syndicated loans in 2024, which do you expect?"



Source: BlackRock, Pitchbook LCD U.S. Leveraged Finance Survey. As of March 22, 2024.

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The first quarter brought additional clarity on performance drivers

Looking forward, respondents view (1) the interest rate environment and (2) defaults and restructuring as the most likely factors to impact portfolio performance over the next six months, two factors that are connected by the common theme of debt service costs (Exhibit 14). Both factors were also ranked highest in 4Q2023, though the interest rate environment experienced a meaningful increase (+7 percentage points) quarter-over-quarter (QoQ) while defaults and restructuring remained relatively stable.

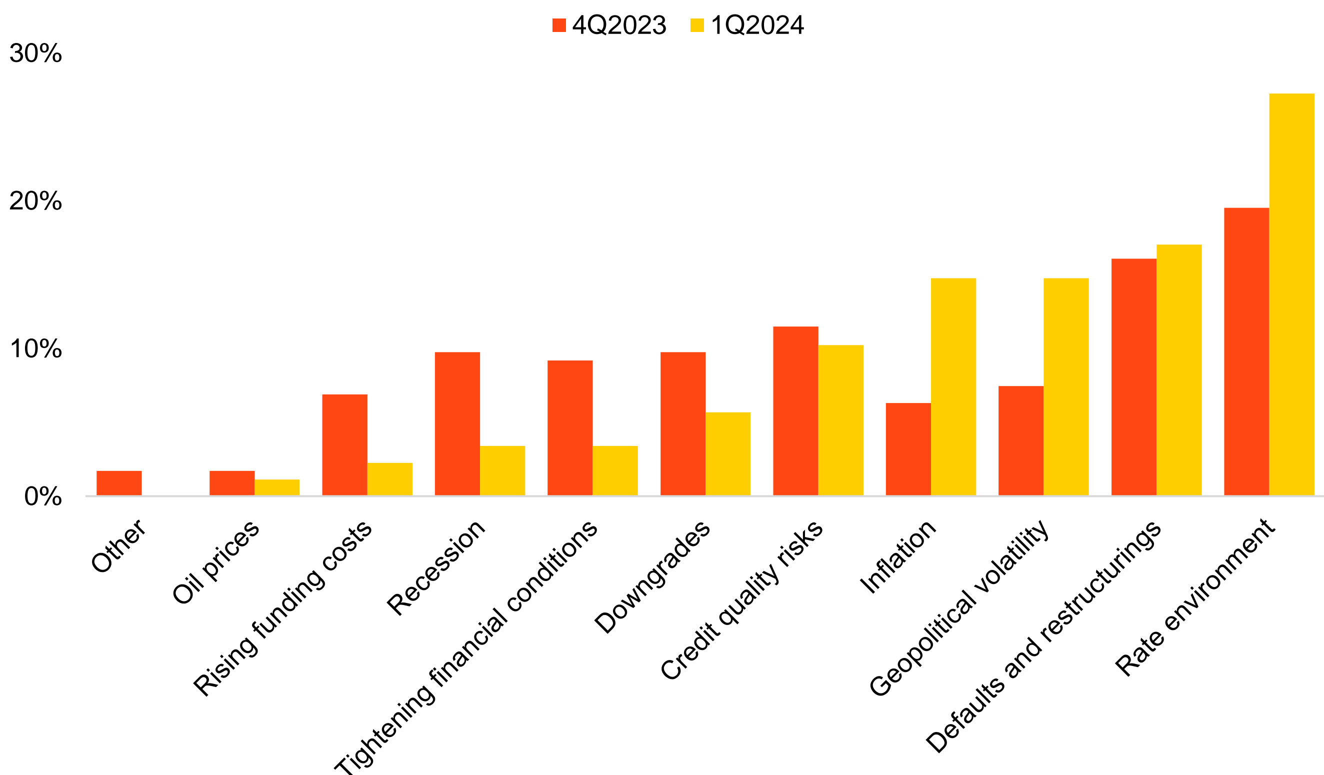
Respondent concerns in 1Q2024 were more concentrated, with the top four factors accounting for 74% of all responses, versus just 57% in 4Q2023. The narrower scope suggests that the first quarter provided investors with additional visibility into what concerns are *most likely* to impact their portfolio in the near term. The decreased percentages relative to funding costs and financial conditions also likely reflect Federal Reserve officials' recent public comments that we are likely at peak U.S. policy rates for this cycle (barring a sustained reacceleration in inflation).

Default expectations ease

Nine months after the last increase in the Federal Funds Rate (in July 2023), investors have also gained confidence in the resilience of credit performance in a high-rate environment. We believe that this, coupled with the previously referenced revival of syndicated markets late last year and through 1Q2024, has boosted investor confidence about default expectations one year out. Indeed, one-year out default rate expectations from 1Q2024 proved more optimistic than 4Q2023, skewing heavily to a more benign default environment (Exhibit 15).

In addition to investor confidence vis-à-vis credit performance, we believe this may also indicate that investors expect defaults to peak before 1Q2025.

Exhibit 14: Respondents concerns narrowed in 1Q2024
Respondents were asked: "Which of the following will most likely impact leveraged credit performance over the next six months?"



Source: BlackRock, Pitchbook LCD U.S. Leveraged Finance Survey. As of March 22, 2024.

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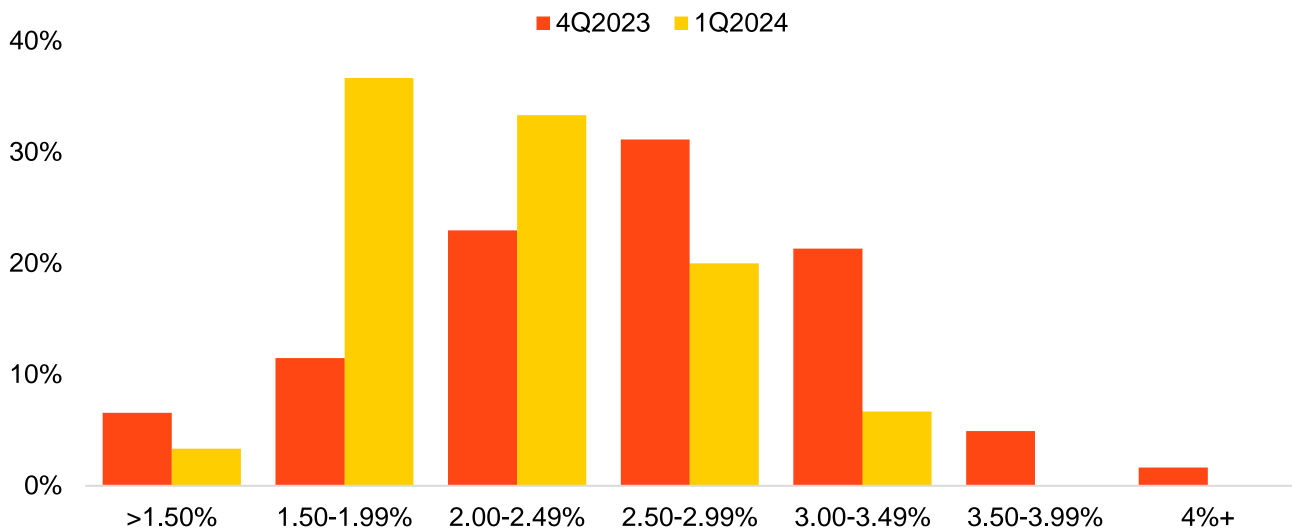
Exhibit 15: Respondents' expectations of U.S. loan default rates one year from now fell QoQ
Respondents were asked: "What do you predict the U.S. loan default rate will be one year from now?"



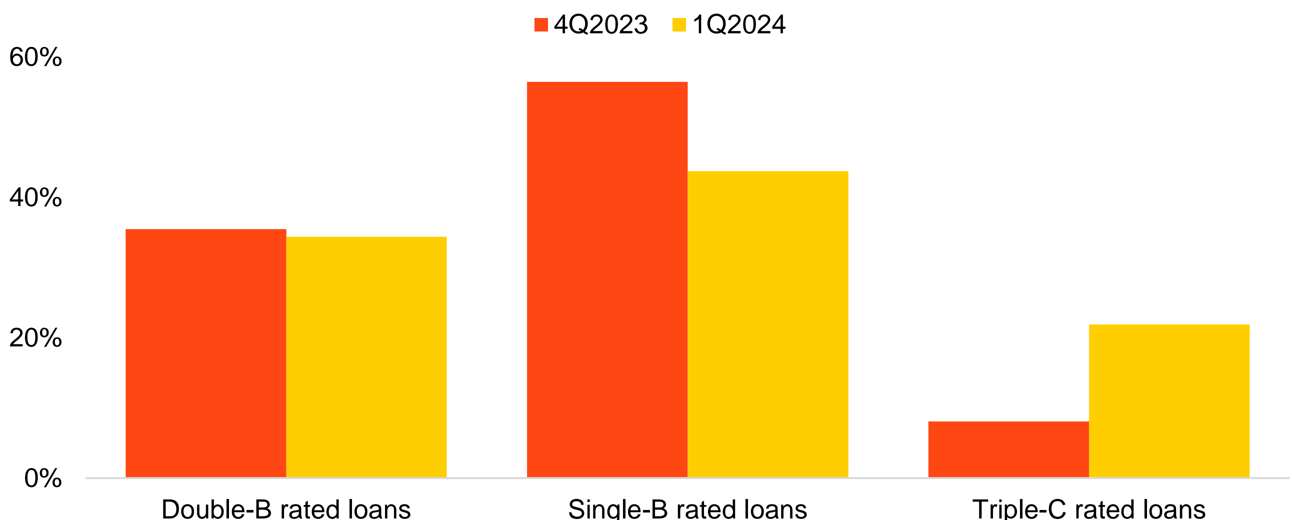
Source: BlackRock, Pitchbook LCD U.S. Leveraged Finance Survey. As of March 22, 2024.

Investor confidence leads to more interest in lower-rated borrowers

Another trend indicating investor confidence in credit performance and the macroeconomic environment is increased interest in lower-rated borrowers. In 1Q2024, 22% of survey respondents voted that they expect the CCC-rated cohort will outperform in the next six months, up from 8% in 4Q2023 (Exhibit 16). This shift comes in the wake of strong issuance volumes in the first quarter, including the demonstrated ability of the lowest-rated firms to access the public debt markets for their refinancing activities (for most of 2H2023, market receptivity for CCC-rated refinancing had been largely untested).

Still, investor expectations of outperformance in 1Q2024 skew toward higher quality loans, including single-B and double-B, suggesting that investors have more confidence in the credit fundamentals of higher-rated borrowers to weather a still uncertain economic outlook.

Exhibit 16: Respondents gain some confidence in lower-quality loans
Respondents were asked: "Which ratings bracket do you expect will outperform in the next six months for leveraged loans?"



Source: BlackRock, Pitchbook LCD U.S. Leveraged Finance Survey. As of March 22, 2024.

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