February 29, 2024

Global Credit Weekly:

Unpacking the resilience of spreads

BlackRock

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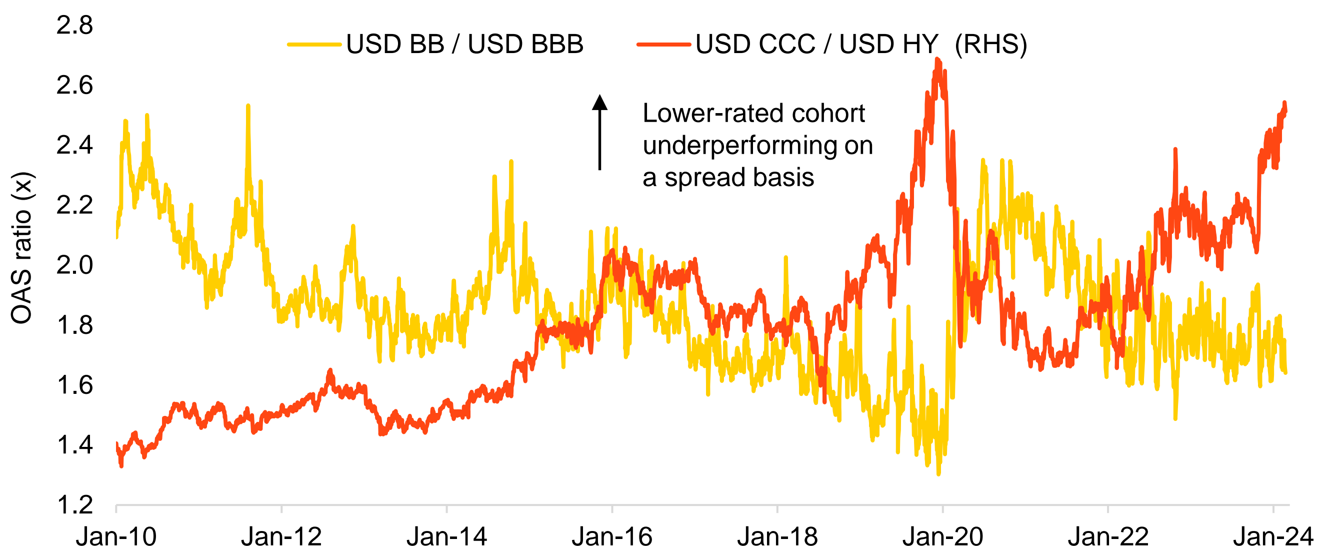
Key takeaways

- Since the end of January, USD investment grade (IG) and high yield (HY) index-level corporate credit spreads have generally been on a one-way journey tighter. Moreover, they have been largely uninterrupted by the market's recalibration of the timing (later) of Federal Reserve (Fed) rate cuts and the move (higher) in intermediate and long-end interest rates. In fact, both IG and HY spreads now stand at the very low end of their post-global financial crisis (GFC) era ranges – although still somewhat above the mid-2021 local troughs (Exhibits 2 and 3).
- Three main factors have contributed to the resilience of corporate credit spreads, in our view: 1) an attractive all-in yield opportunity for yield-based buyers, boosted by the elevated risk-free rate, 2) a supportive growth/monetary policy mix in the U.S., which has been especially important for speculative grade issuers, and 3) the recent success of the lowest-rated borrowers' ability to access debt capital markets for refinancing. Presuming all three forces remain intact, we see potential for spreads to revisit their summer of 2021 lows. That said, the bar for significant spread compression is likely to be high given current valuations, ongoing geopolitical risks and recent strength in inflation data.
- Importantly for corporate credit investors, the tone has not been uniformly "risk-on". As Exhibit 1 illustrates, CCC spreads continue to lag the broader USD HY market (extending the trend since late 2023), even as BB spreads are modestly outperforming their higher-rated BBB peers. This likely reflects some lingering concern about a portion of this (highly idiosyncratic) CCC-rated segment's ability to address its upcoming refinancing needs, or its ability to navigate a "high-for-longer" cost of capital environment. We expect this bifurcation to continue.

Exhibit 1: CCC spreads are lagging the broader HY market, even as BBs outperform BBBs

Option adjusted spread (OAS) ratios using the Bloomberg Corporate indices: USD BB / USD BBB and USD CCC / USD HY



Source: BlackRock, Bloomberg. As of February 28, 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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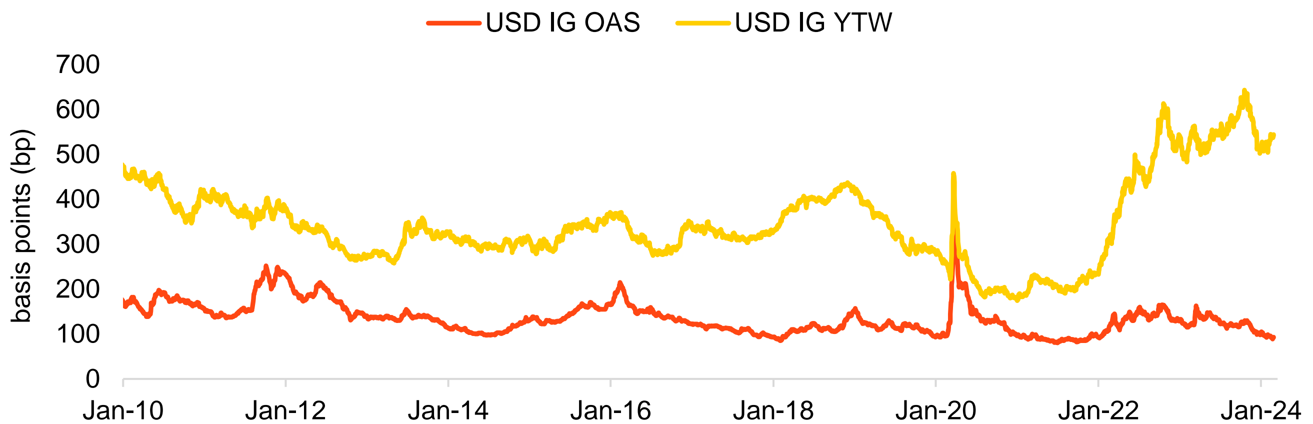
The spread vs. yield "tug-of-war" remains a theme

Since the end of January, USD IG and HY spreads have generally been on a one-way journey tighter – largely uninterrupted by the market's recalibration of the timing (later) of Fed rate cuts and the move (higher) in intermediate and long-end interest rates. In fact, both IG and HY spreads now stand at the very low end of their post-global financial crisis (GFC) era ranges – although still somewhat above the mid-2021 local troughs (Exhibits 2 and 3).

Three main factors have contributed to the resilience of spreads, in our view: 1) an attractive all-in yield opportunity for yield-based buyers, 2) a supportive growth/monetary policy mix in the U.S., and 3) recent success of the lowest-rated issuers' ability to access debt capital markets for refinancing. Presuming all three forces remain intact, we see potential for spreads to revisit their summer of 2021 lows.

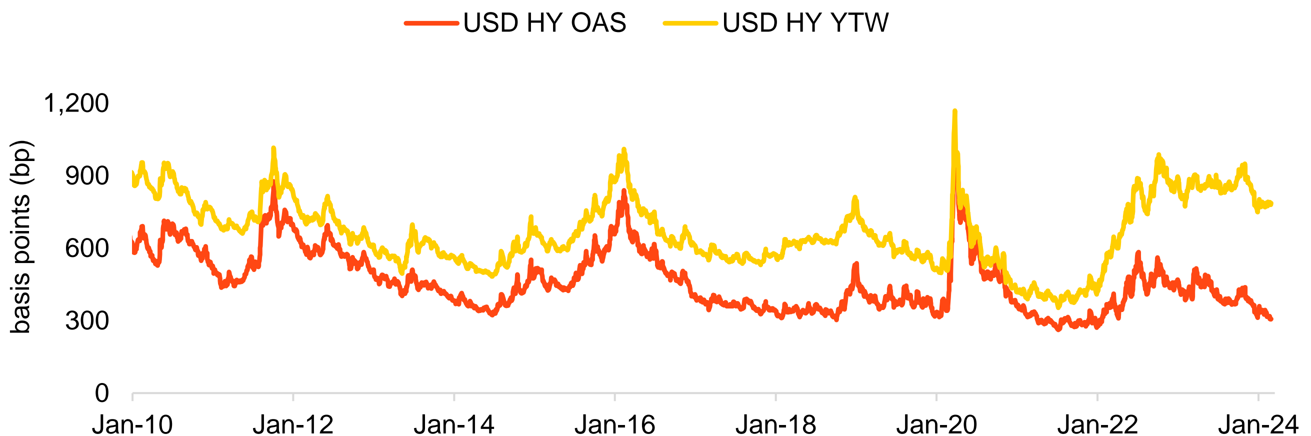
The yield-to-worst levels offered by the USD IG and USD HY indices, in aggregate, remain compelling by historical standards, owing to a still elevated risk-free rate (again, Exhibits 2 and 3). This has driven ongoing demand from yield-based buyers – a pattern we expect to persist over the medium term.

Exhibit 2: USD IG spreads of 92bp are close to the post-GFC tights of 80bp
Historical average option adjusted spread (OAS) and yield-to-worst (YTW) for the Bloomberg USD IG Corporate Index



Source: BlackRock, Bloomberg. As of February 28, 2024.

Exhibit 3: USD HY spreads of 307bp are also close to the mid-2021 tights of 262bp
Historical average option adjusted spread (OAS) and yield-to-worst (YTW) for the Bloomberg USD HY Corporate Index



Source: BlackRock, Bloomberg. As of February 28, 2024.
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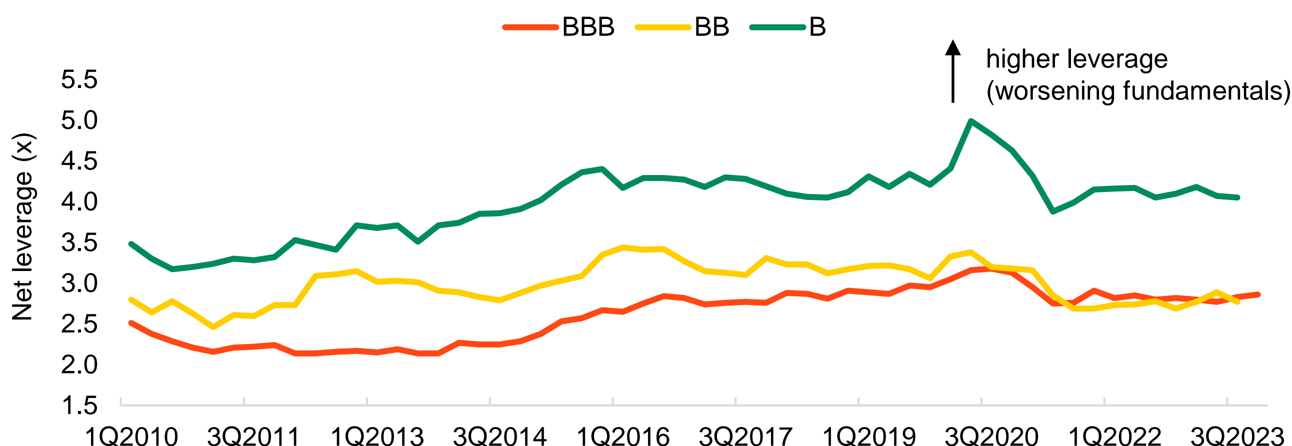
A supportive growth/monetary policy mix

The second driver of credit spread resilience, in our view, is the favorable growth/monetary policy mix in the U.S. The Fed's December FOMC press conference was notable, as Chair Powell indicated a willingness to cut rates in response to declining inflation – as opposed to waiting for a downturn in growth to emerge. Such a proactive stance on monetary policy is supportive for risk assets, even if those rate cuts emerge later in the year. As discussed previously, 2H2024 remains our base case for the first Fed rate cut, with risks skewed towards the beginning of that timeframe.

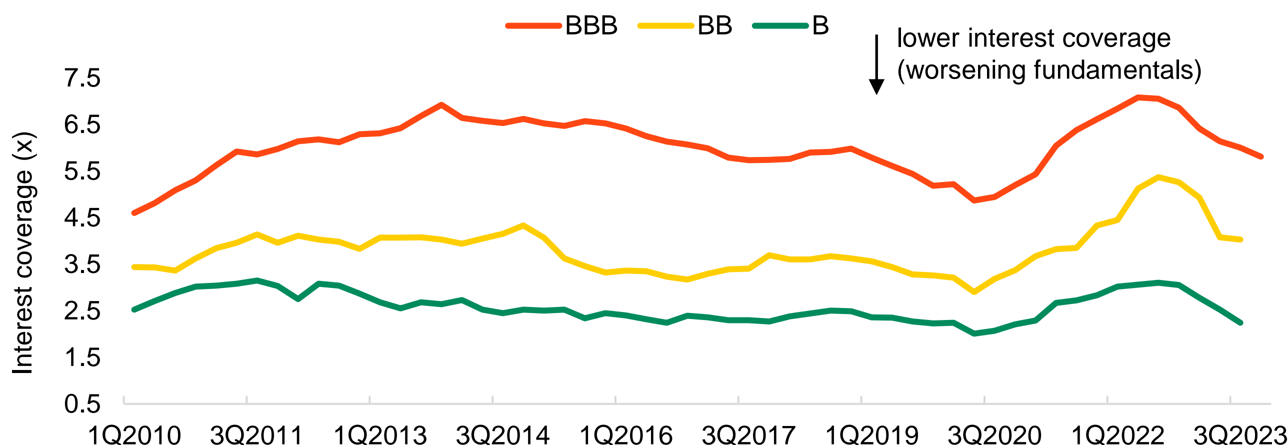
Furthermore, this proactive stance on monetary policy has coincided with resilience in U.S. economic growth: 3Q2023 real GDP was 4.9% (quarter-on-quarter, annualized), and 4Q2023 was a solid 3.2%. A supportive growth backdrop is especially important for economically-sensitive asset classes, such as the USD HY bond and leveraged loan markets. It has also helped corporates keep EBITDA margins stable (and leverage metrics range-bound) over recent quarters, even as higher interest costs have weighed on interest coverage ratios (Exhibits 4 and 5). The key risk, in our view, is a *sustained* reacceleration in inflation, which may cause the Fed to reconsider its proactive stance towards normalizing monetary policy (this is not our base case, however).

Exhibit 4: Net leverage in recent quarters has remained somewhat consistent, in aggregate
Trimmed mean (excludes the bottom 10% and top 10%) net leverage for BBB, BB and B rated issuers in the Bloomberg USD Corporate Indices



Source: BlackRock, Bloomberg. Net leverage is defined as: ((Debt - Cash) / LTM EBITDA). Captures most recent data available as of February 28, 2024.

Exhibit 5: Interest coverage has declined in recent quarters, as the Fed hiked rates
Trimmed mean (excludes the bottom 10% and top 10%) interest coverage for BBB, BB and B rated issuers in the Bloomberg USD Corporate Indices



Source: BlackRock, Bloomberg. Interest coverage is defined as LTM EBIT / LTM Interest Expense. Captures most recent data available as of February 28, 2024.

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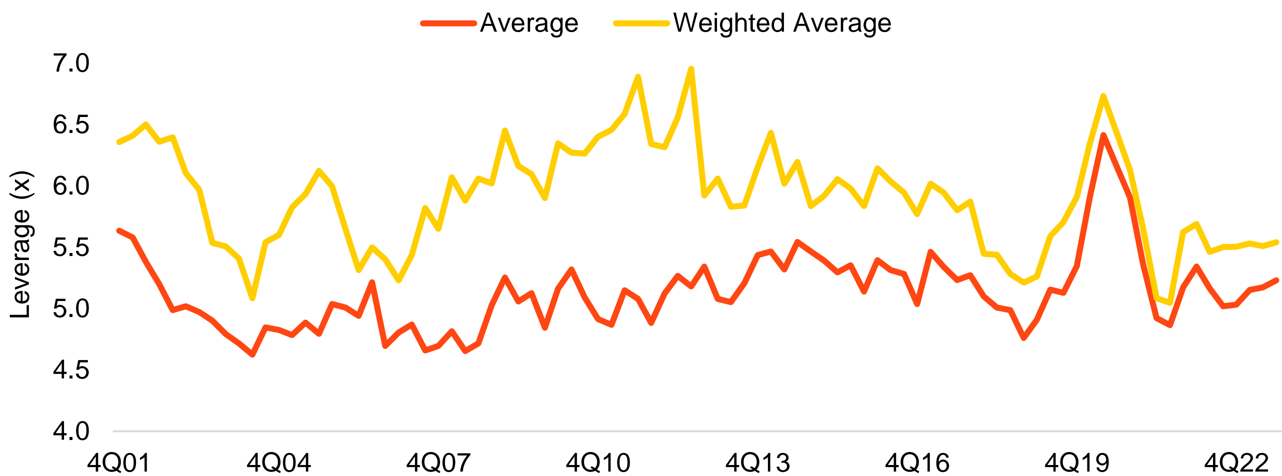
Similar fundamental trends are visible in the USD leveraged loan market, as illustrated in Exhibits 6 and 7. With the important caveat that this analysis includes only those issuers in the Morningstar/LSTA USD Leveraged Loan Index with publicly available financials, the exhibits show that leverage ratios have remained relatively range-bound since the start of the Fed's rate hiking cycle (March 2022), while interest coverage metrics have declined.

The deterioration in interest coverage metrics in the USD leveraged loan market is more pronounced (relative to the fixed rate USD HY bond market) given loans' floating rate structures. Unless a leveraged loan issuer chooses to hedge, its interest rates will generally move in tandem (higher) with Fed rate hikes – and have done so over the course of 2022 and 1H2023. By contrast, fixed rate borrowers encounter higher interest costs if and when they choose to refinance into a higher cost of capital environment.

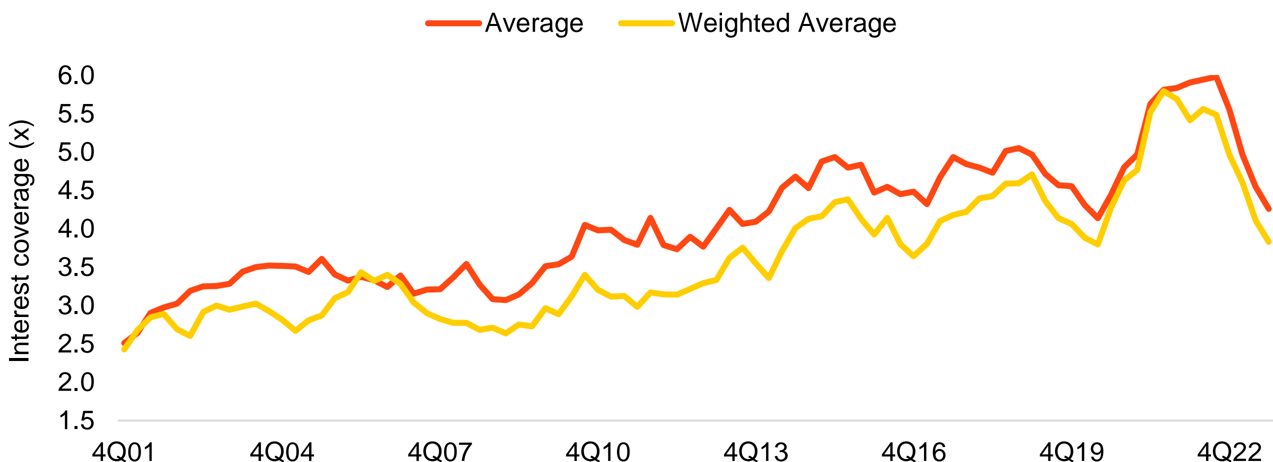
While neither universe (HY nor loans) is immune from a higher cost of debt, they *are* impacted on different timelines. They are also affected at different parts of the curve. For example, borrowing costs for floating rate issuers are more closely aligned with the Secured Overnight Financing Rate (SOFR), which tracks the Federal Funds Rate over time. Fixed rate HY issuers, by contrast, are more sensitive to points further out the curve (the 5-year U.S. Treasury, for example).

Exhibit 6: Range-bound leverage in the USD syndicated loan market since mid-2022...
Gross leverage statistics (debt/EBITDA) for loans (issuers with publicly available financials only) in the Morningstar/LSTA USD Leveraged Loan Index



Source: BlackRock, Morningstar/LSTA, Pitchbook LCD. As of 3Q2023 (most recent).

Exhibit 7: ...but declining interest coverage metrics for USD syndicated loan issuers
Interest coverage statistics (EBITDA/interest expense) for loans (issuers with publicly available financials only) in the Morningstar/LSTA USD Leveraged Loan Index



Source: BlackRock, Morningstar/LSTA, Pitchbook LCD. As of 3Q2023 (most recent).

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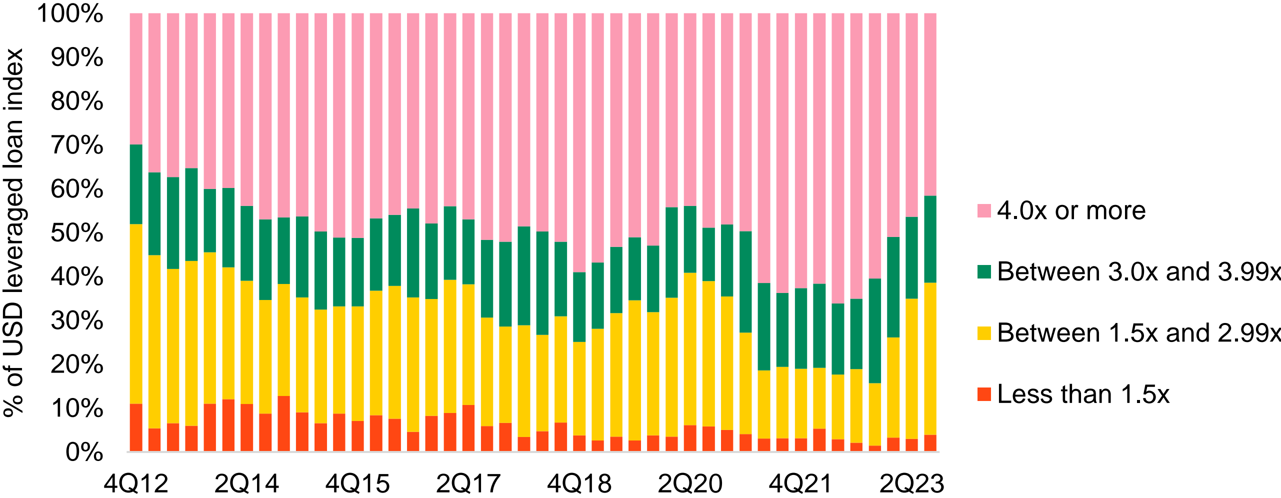
Exhibit 8 illustrates the impact that higher interest rates have had on the overall distribution of interest coverage metrics within that same universe of index eligible leveraged loans (again, using only those issuers with public financials). The share of public loan issuers with strong interest coverage metrics (of 4.0x or higher) has declined from 66% in 2Q2022 to 42% as of 3Q2023 (most recent available).

That said, the bulk of the headwind from the Fed's rate hiking cycle is likely behind us at this point, considering the last 25bp rate hike was delivered in July 2023 (and the last 75bp rate hike was delivered in November 2022). As long as the growth backdrop remains supportive, we expect the USD leveraged loan default rate to show signs of plateauing soon (Exhibit 9). While tentative, the USD HY bond market has already demonstrated signs of potentially peaking defaults.

It is important to note that defaults have not been a strong driver of index-level performance in recent years. Case in point: USD leveraged loans led USD HY bonds in terms of defaults last year, per Moody's data (again, Exhibit 9). But the Morningstar/LSTA USD Leveraged Loan Index generated a 13.3% total return – the highest since 2009 and in-line with that of the Bloomberg USD HY Corporate Index (13.4%), owing to loans' higher carry / yield profile (in part, a function of the inverted yield curve).

Exhibit 8: The distribution of loan issuers' interest coverage metrics has deteriorated

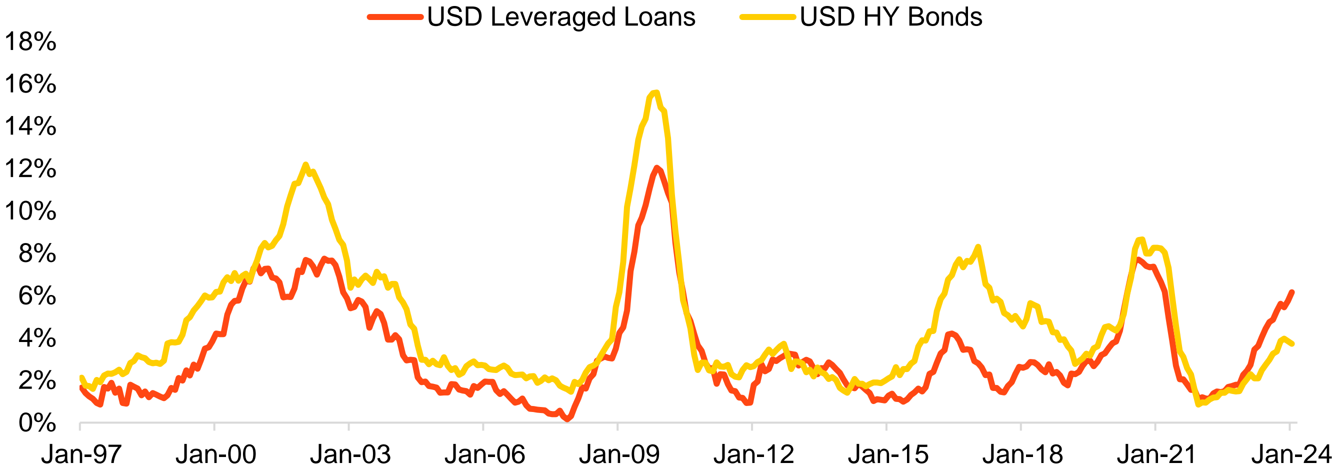
Interest coverage (EBITDA/interest) distribution of loans (issuers with publicly available financials only) in the Morningstar/LSTA USD Leveraged Loan Index, based on issuer count.



Source: BlackRock, Morningstar/LSTA, Pitchbook LCD. As of 3Q2023 (most recent available).

Exhibit 9: The USD HY default rate has shown early signs of plateauing in recent months

Trailing 12-month, issuer-weighted default rates for the universe of USD HY bonds and USD leveraged loans tracked by Moody's



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

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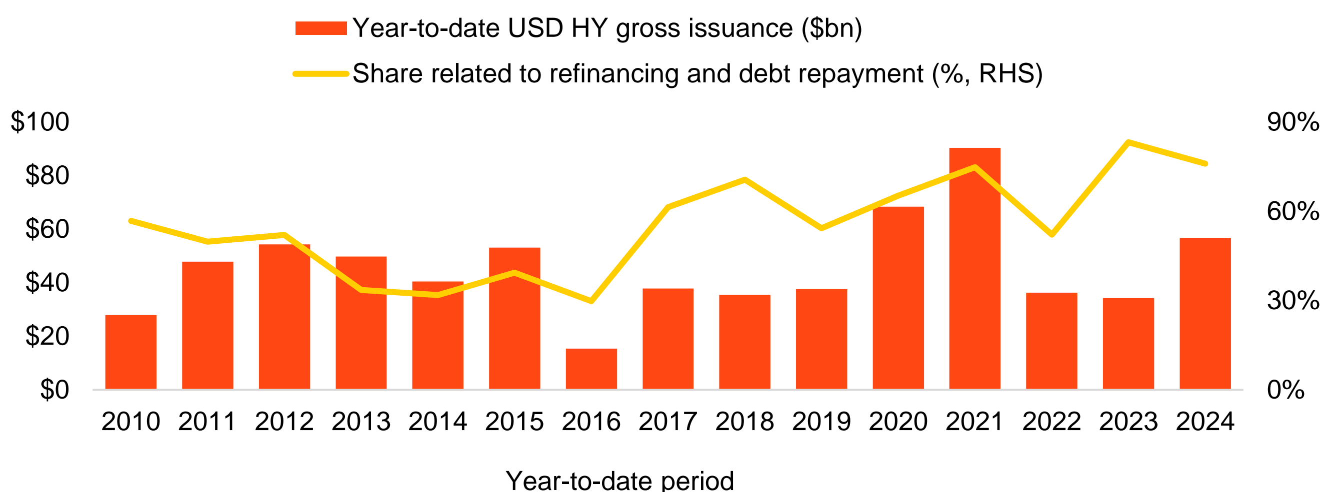
Primary markets remain receptive to lower-rated borrowers

The third driver of the risk-on tone, in our view, has been the supportive backdrop for new issue activity – especially for the lowest-rated issuers. As shown in Exhibit 10, USD HY gross issuance is off to a strong start in 2024, trailing only the record shattering pandemic-era years of 2020 and 2021.

More importantly, in our view, has been the recent success of the lowest-rated issuers (B- and CCC+/CCC/CCC-) to access the debt markets for refinancing (Exhibit 11). After an extended lull from this cohort in 2H2023, this is an encouraging sign for these firms' ability to address their upcoming maturities (Exhibit 12).

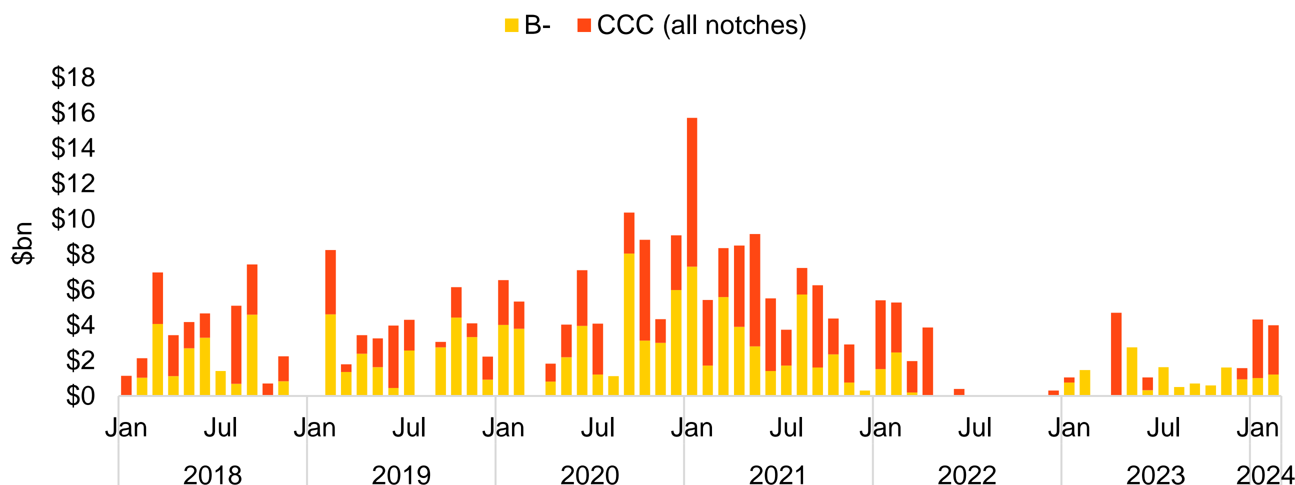
That said, as Exhibit 1 illustrates, CCC spreads continue to lag the broader USD HY market, even as BB rated firms modestly outperform their higher-rated BBB peers. This likely reflects some lingering concern about a portion of this (highly idiosyncratic) CCC-rated segment's ability to address its upcoming refinancing needs, or its ability to navigate a "high-for-longer" cost of capital environment. We expect this bifurcation to continue.

Exhibit 10: USD HY supply is off to a strong start, driven by refinancing-related activity
USD HY gross issuance by year-to-date period, and the share of issuance earmarked for debt repayment or refinancing (per Dealogic's primary use of proceeds)



Source: BlackRock, Dealogic. Previous year-to-date periods are as of February 28th. As of February 28, 2024.

Exhibit 11: After a lull in 2H2023, CCC issuers have returned to the USD HY primary market
Monthly USD HY gross issuance by Dealogic Effective Rating at Launch (only captures B- and CCC+/CCC/CCC- rated issuance)



Source: BlackRock, Dealogic. As of February 28, 2024.

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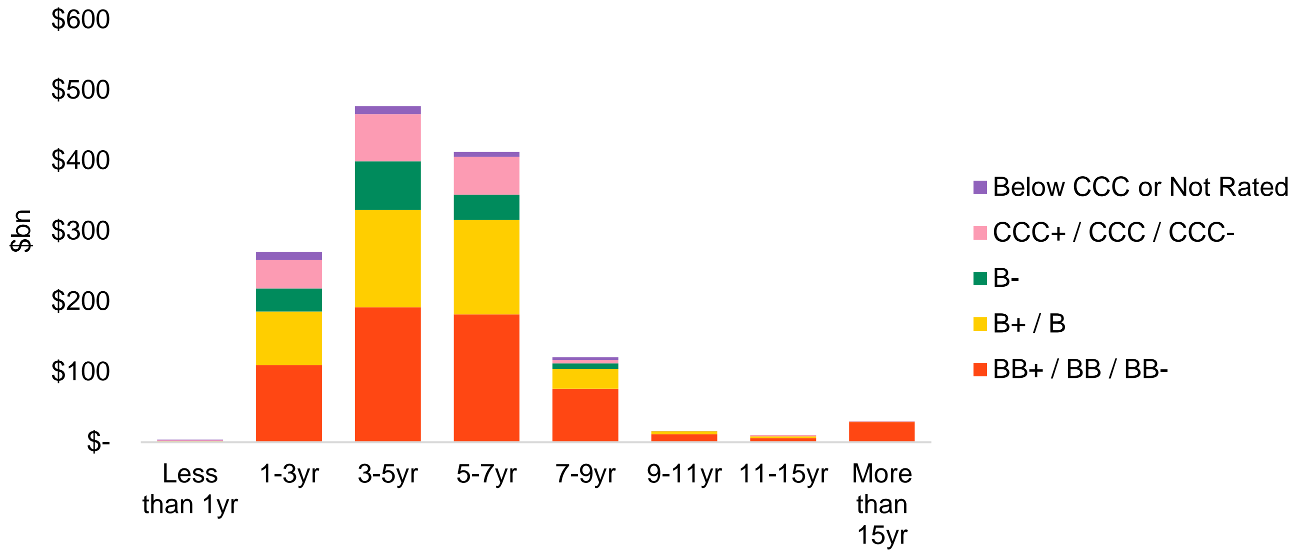
Exhibit 12: Lower-rated HY issuers have refinancing needs in upcoming years
Maturity breakdown (by rating) of bonds in the Bloomberg USD HY Corporate Index



Source: BlackRock, Bloomberg. As of February 28, 2024.

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