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Why High Yield Now?

BlackRock

Quick read

What does the market look like?

Growth and employment remain resilient, while inflation is cooling down.

Are current spread levels justified by fundamentals?

The market has identified the companies/sectors that challenge business models and capital structures.

What is less well understood?

The concept of spread-to-worst vs spread-to-current.

Ammar Malik
Director, European Leveraged Finance Product Strategy

What does the current HY market look like?

We've often heard that European High Yield spreads are tight (currently ~370bps), and that prices need to fall (and yields rise) before the credit cycle can ultimately deteriorate. However, this cycle is resilient due to (i) resilient growth, (ii) strong job creation, and (iii) clear progress on disinflation. In addition, the promise of elevated all-in yields is fuelling demand, creating an exceptionally strong technical for the market. What is clear is that the two primary risks to the European high yield market have receded. Namely, runaway inflation or the prospect of rates remaining at restrictive levels for a multiple-year period which would have created unsustainable stress for levered capital structures and FCF generation.

Do fundamentals justify current spread levels?

Looking at whether fundamentals justify current spread levels, the market has identified the companies and sectors that have challenged business models and capital structures for this environment of higher interest rates and a slowing economy.

These are well-identified situations and are pricing as such: 8-9% of the HY market is trading at distressed levels. From this cohort we expect some sort of default/restructuring process on around 3%, but given current trading levels, we think that this risk is contained and fairly priced and we see upside in several of those situations. The reminder 90%+ of the companies have demonstrated capacity to deleverage, generate cash flow and absorb the cost of financing, and we keep seeing consistent upgrades and improving fundamentals in many sectors (transportation, banking, industrials, etc.).

What is less well understood about HY bonds?

Finally, while the improving quality of the market is well understood (2/3 of the market is BB, and <5% is CCC), what is less understood is the concept of spread-to-worst vs spread-to-current. Currently, 2/3 of European HY bonds are trading below par (while both index duration and average years to maturity are at clear post-GFC lows) therefore the spread is computed to maturity.

However, high yield bonds are not left outstanding until maturity and are often called at least 12 months in advance. If we adjust the workout dates of these bonds to 12-month before maturity, this adds around 70bps of spread at the index level.

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Why European High Yield Now?

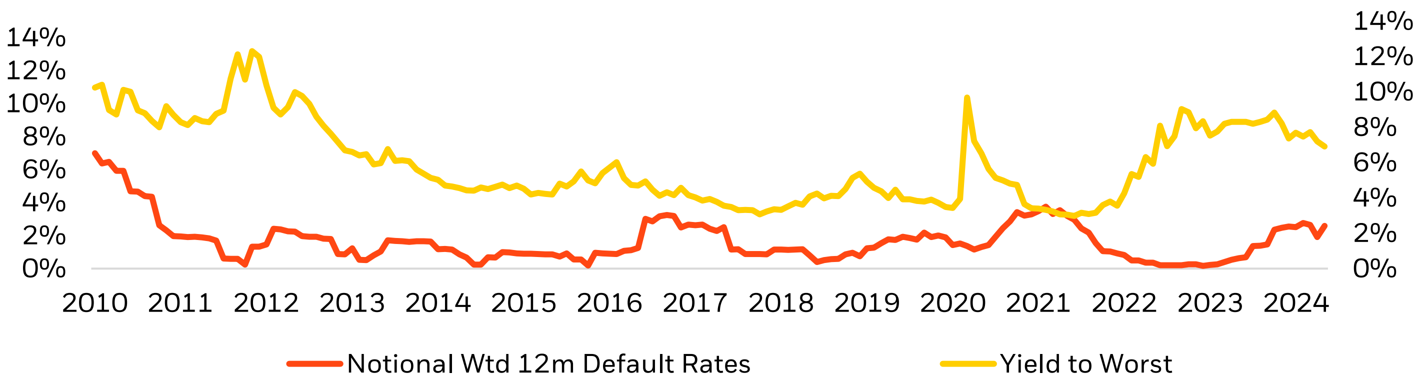
01 Elevated yield increase opportunity cost of not being invested

Yield-to-worst remains over 6% despite the recent rally. This is even more compelling given this yield is earned on the front-end of the curve – a level of yield simply not available in other areas of fixed income. In addition, an average cash price around 95 in a short duration asset class represents near-term capital appreciation potential as bonds get called at par typically 12-24 months ahead of maturity. This frontloaded nature of high yield bond returns when prices are at a discount to par means that you can earn in excess of the yield-to-worst, a feature of the asset class that is not properly understood. This also creates additional alpha opportunities for active high yield managers.

02 Yields are overcompensating investors for default risk

While defaults have increased from virtually zero at the end of 2022, they have remained below average in 2023 (2.5%) and may increase marginally in 2024. However, we see this as a return to the long-term average default rate rather than a default spike. We believe current yields are more than compensating investors for default risk as default candidates are relatively well identified and are already priced at recovery levels, thereby reducing downside risk. The other factor which is important to point out is that we expect many defaults to be "amend and extend" – meaning high to full recoveries for investors with limited impact on total returns.

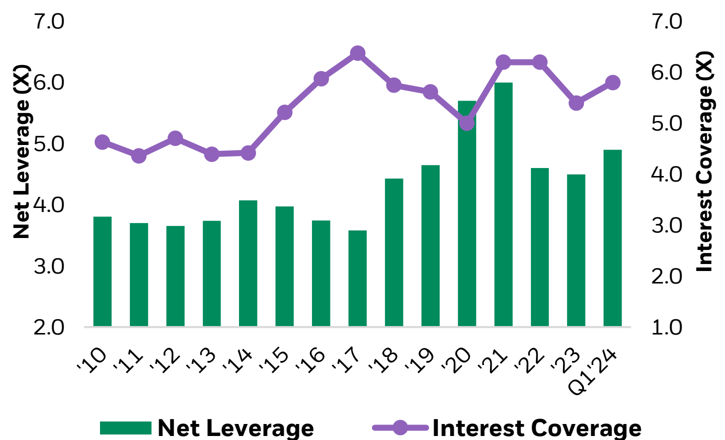
Exhibit 1: Default rates are returning to long-term averages, while yields remain elevated[1]



03 The composition of the market has improved over time making the spread level more attractive

Despite being a backwards looking metric, the fundamentals of HY companies remain relatively robust – interest coverage is elevated while leverage has stabilised back down to pre-COVID levels. The primary risks to credit market have receded – namely, runaway inflation or the prospect of rates remaining at restrictive levels for a multiple-year period which would have created unsustainable stress for levered capital structures and FCF generation. If this assessment is correct, we believe we are entering a highly favourable environment for credit. As rates and equity volatility comes down, credit spreads have room to compress from current levels.

Exhibit 2: Headline leverage has plateaued after trending downward while interest coverage ratios remain at healthy levels[2]



There is no guarantee that any forecasts and forward-looking expectations made will come to pass. For illustrative purpose only. Sources: Barclays, JP Morgan, as of August 31 2024. Yield to Worst is shown for BBG Barclays Pan Euro High Yield 3% Capped index. Indices are unmanaged and one cannot invest directly in an index. 2. J.P. Morgan 30 June 2024

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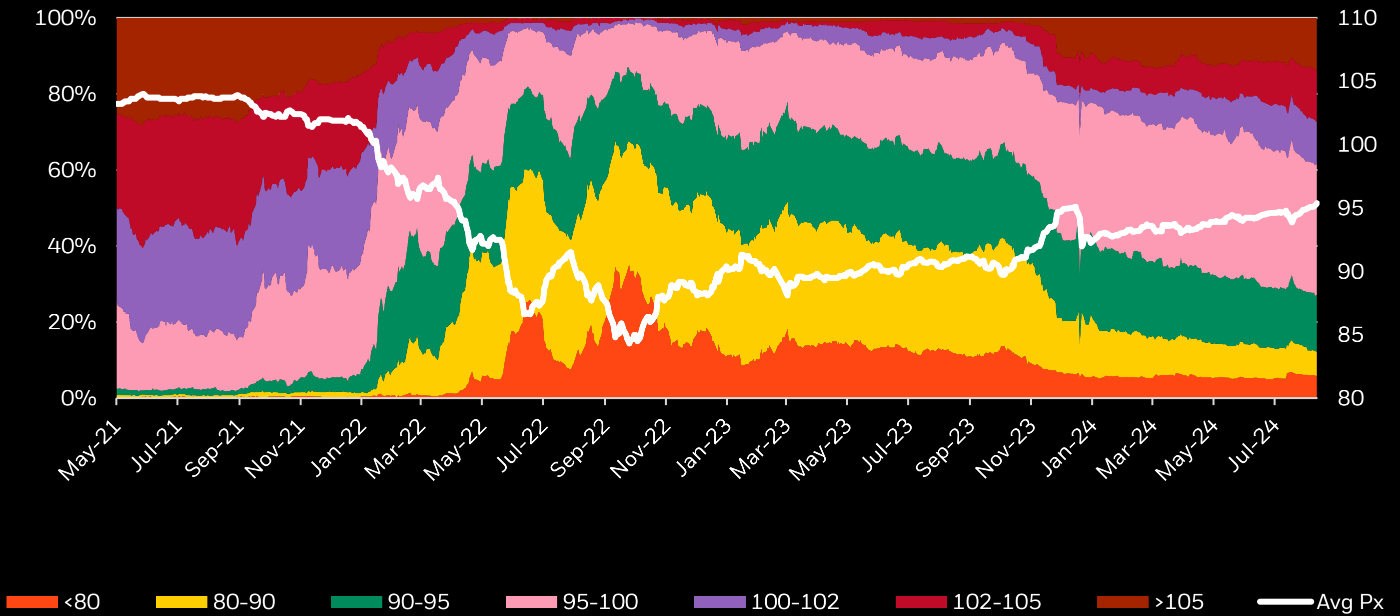
Exhibit 3 – Dispersion and convexity have returned to the European High Yield Market



Sources: Barclays, as of August 31 2024. Prices are shown for BBG Barclays Pan Euro High Yield 3% Capped index. Indices are unmanaged and one cannot invest directly in an index.

Active strategies can provide durable alpha in up and down markets

Given the elevated level of dispersion in the market is creating outsized alpha opportunities for skilled managers with well-resourced teams.

The size, expertise and experience of our high yield team facilitates an unrivalled depth of independent bottom-up analysis which is supplemented by cutting edge proprietary technology which is used to analyse and evaluate competitors, relative value, industry trends, factor analysis to generate unique trade ideas and enables our portfolio managers to take contrarian or high conviction views on specific credits.

As we navigate this downturn, we aim to select the best credits within industry silos (rather than avoid industries altogether) and we have been finding value in select names within out-of-favour cyclical sectors which are well-positioned to survive a downturn due to healthy liquidity profiles and sticky cash flows – which often come from stable long-term contracts or best-in-class pricing power within the sector.

Our approach of building diversified portfolios of cash-generative companies with the financial flexibility to perform resiliently through a cycle lends itself well to the current environment.

The increase in dispersion between sectors and industries creates greater opportunities to generate alpha, and at BlackRock we are confident we have the right team, experience, and investment skill to capture the outsized future return potential the asset class has to offer, while avoiding the market's pitfalls and defaults.

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