May 30, 2024

Global Credit Weekly:

Meaningful rate relief is unlikely

BlackRock

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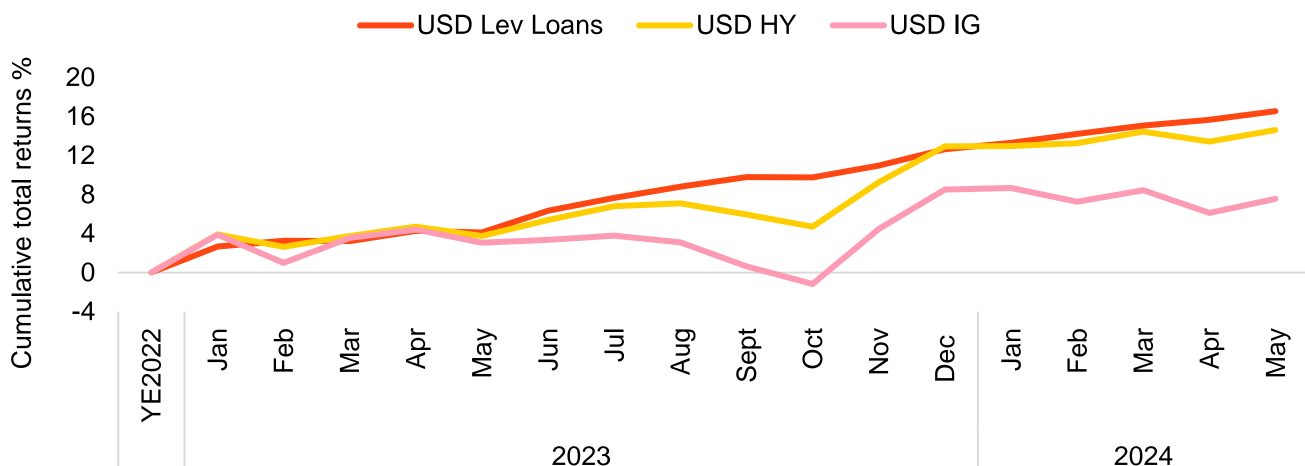
Key takeaways

- We are not expecting significant, near-term interest rate relief in the form of Federal Reserve rate cuts. Rather, we believe a “shallow” rate cutting cycle (once it eventually begins) is more likely. Federal Reserve officials have publicly referenced uncertainty related to the “degree of restrictiveness” of the current monetary policy stance, due in part to resilient U.S. growth. Absent a sharp and unexpected deterioration in the U.S. labor market (which is not our base case), we struggle to identify a sense of urgency for the Federal Reserve to cut rates significantly.
- This “high for longer” interest rate environment – at least relative to the post-financial crisis era – has two implications for USD corporate credit investors. First and foremost, capital allocated to USD corporate credit should primarily be based on income and yield, not total return. The second implication is that dispersion will remain elevated – a theme we have emphasized over the past few quarters.
- Separately, two weeks ago, we highlighted the ongoing *decline* in covenant defaults rates in the private credit market, despite a persistently high cost of capital environment. Indeed, after declining (improving) for four consecutive quarters (through 1Q2024), the covenant default rate for the Lincoln International Proprietary Private Market Index now stands at 2.7% (a level below the average 4.3% rate of the past four years).
- Recently released 1Q2024 data for a separate universe – the 15,600 directly originated U.S. middle market loans included in the Cliffwater Direct Lending Index (CDLI) – illustrates a similarly encouraging trend. Realized losses for the CDLI were 23bp in 1Q2024, bringing the trailing 12-month realized loss rate to 85bp. This realized loss rate is modest in the context of the interest income generation of the asset class and remains below the long-term average.

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 May 29, 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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Upward pressure on U.S. interest rates

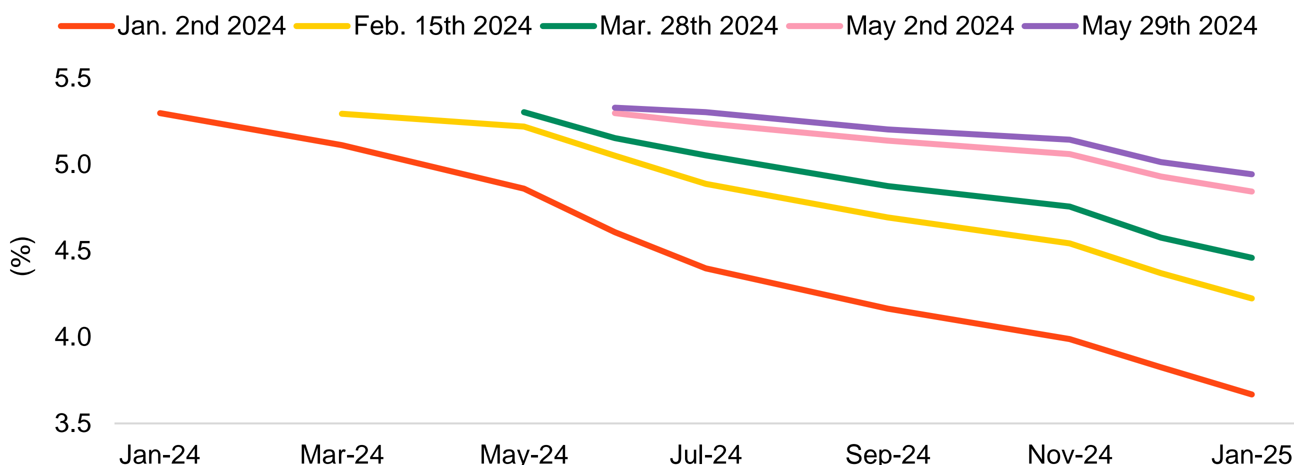
The U.S. Treasury market was in focus this week, as three separate debt auctions (2-year, 5-year and 7-year maturities) priced at higher-than-anticipated yields. These so-called auction "tails," alongside instances of low bid-to-cover ratios and elevated shares allocated to primary dealers, were collectively reflective of tepid investor demand for the government debt sales in recent days.

Auctions have been increasingly tracked by many market participants over the past several months given the U.S. Treasury's ongoing borrowing needs to fund the budget deficit, which totaled $1.7 trillion for fiscal year 2023. While government deficits are not a new concept – nor are they specific to the U.S. – investor attention on the trajectory of the U.S. deficit has nonetheless been heightened. One catalyst for this was Fitch's downgrade of the U.S. sovereign rating (from AAA to AA+) in August 2023, which cited "expected fiscal deterioration."

The investor focus on the U.S. deficit also exists against a backdrop of persistently high interest rates, which makes servicing this deficit more costly (a topic addressed in the February 2024 projections from the Congressional Budget Office). Indeed, prospects for Federal Reserve rate cuts continue to be delayed - a development captured by market pricing of Fed Funds futures (Exhibit 2).

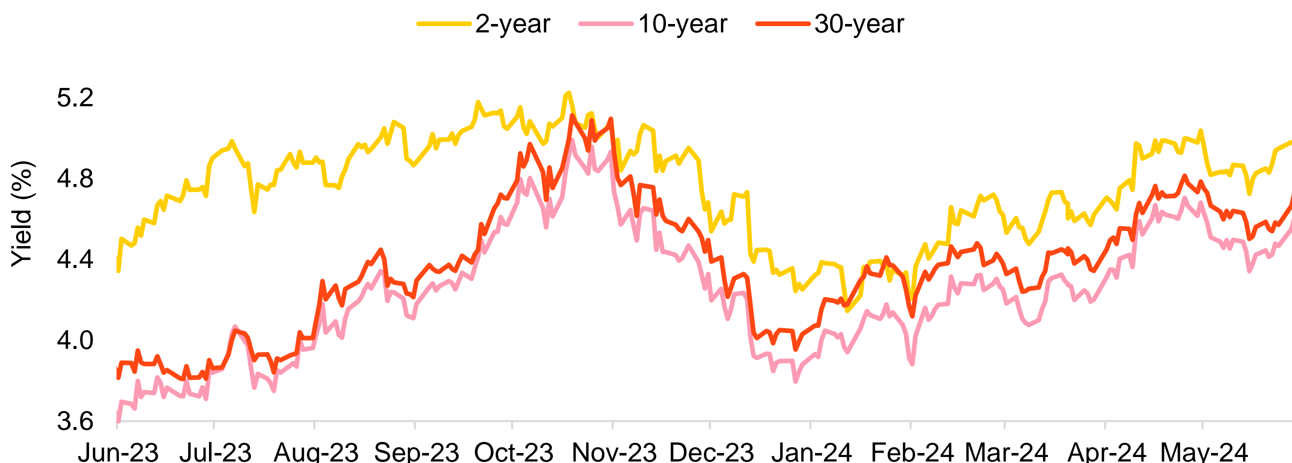
These auction developments, combined with some hawkish Fed speak, placed upward pressure on U.S. interest rates across the Treasury curve this past week (through May 29; Exhibit 3).

Exhibit 2: Fed Funds futures are now pricing only minimal rate cuts through early 2025
The U.S. policy rate implied by Fed Funds futures, through early 2025



Source: BlackRock, Bloomberg. As of May 29, 2024.

Exhibit 3: U.S. Treasury yields have moved higher in recent sessions
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 May 29, 2024.

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Material U.S. interest rate relief is unlikely, in our view

We are not expecting significant, near-term interest rate relief in the form of Federal Reserve rate cuts. Rather, we believe a "shallow" rate cutting cycle (once it eventually begins) is more likely. For example, Federal Reserve officials have publicly referenced uncertainty related to the "degree of restrictiveness" of the current monetary policy stance, due in part to resilient U.S. growth. Absent a sharp and unexpected deterioration in the U.S. labor market (which is not our base case), we struggle to identify a sense of urgency for the Federal Reserve to cut rates significantly.

This "high for longer" interest rate environment – at least relative to the post-financial crisis era – has two implications for USD corporate credit investors. First and foremost, capital allocated to USD corporate credit should primarily be based on income and yield, not total return. Material declines in interest rates (at the policy-sensitive front-end, as well as at the long-end) are not our base case, due to the interaction of growth, inflation, monetary policy and fiscal considerations. Similarly, given the current valuations of spreads (Exhibit 4), we are not expecting significant spread tightening from here. Both factors limit the scope for sizable absolute total returns. But there is still an attractive opportunity for yield-based buyers to capture attractive all-in yields (Exhibit 5).

Exhibit 4: USD IG and HY spreads are tight, but still slightly wide to the mid-2021 levels
Option adjusted spreads (OAS, bp) for the Bloomberg USD IG and HY Corporate indices

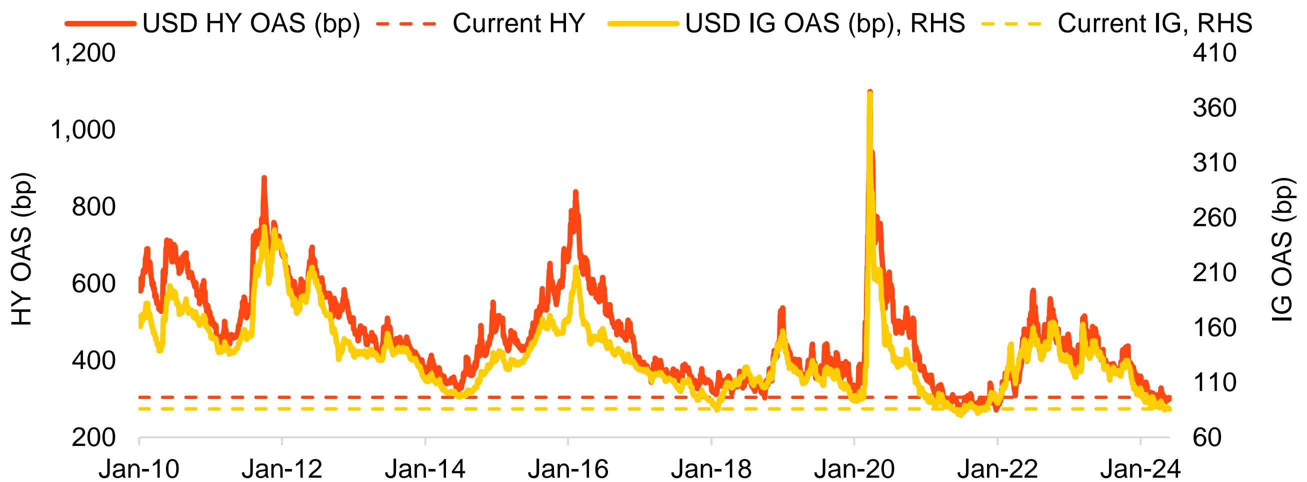
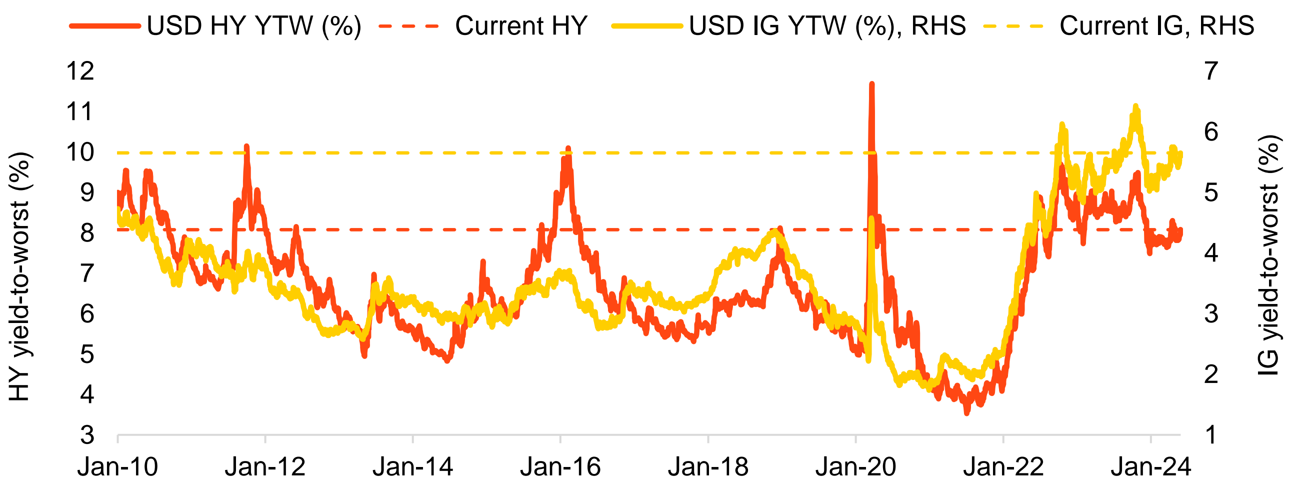


Exhibit 5: All-in yields are attractive by historical standards, due to the elevated risk-free rate
Yield-to-worst (%) for the Bloomberg USD IG and HY Corporate indices



Source for both charts: BlackRock, Bloomberg. As of May 29, 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 role of duration

Higher U.S. Treasury yields, if they materialize, may attract additional yield-based demand for USD corporate credit. That said, using the Fall 2023 market movements as a guide, we believe the velocity of any move higher in Treasury yields will need to remain somewhat contained for that to be the case. A sharp and "disorderly" sell-off in rates (i.e., higher yields) may disincentivize capital deployment in corporate credit, due to the scope for duration underperformance.

Exhibit 1 illustrates the meaningful role that duration has played in total return performance across three main liquid corporate credit indices in the USD market. For example, the Bloomberg USD IG index (which has an average duration of 6.8 years), outperformed in late 2023 as Treasury yields fell (again, Exhibit 3). But with a -1.96% total return so far this year, USD IG has lagged its shorter-duration HY peer (3.1 years), which generated a 1.38% total return (as of May 29th). Meanwhile, the Morningstar/LSTA USD Leveraged Loan Index (a floating rate asset class) outperformed both, generating a 3.97% total return so far this year.

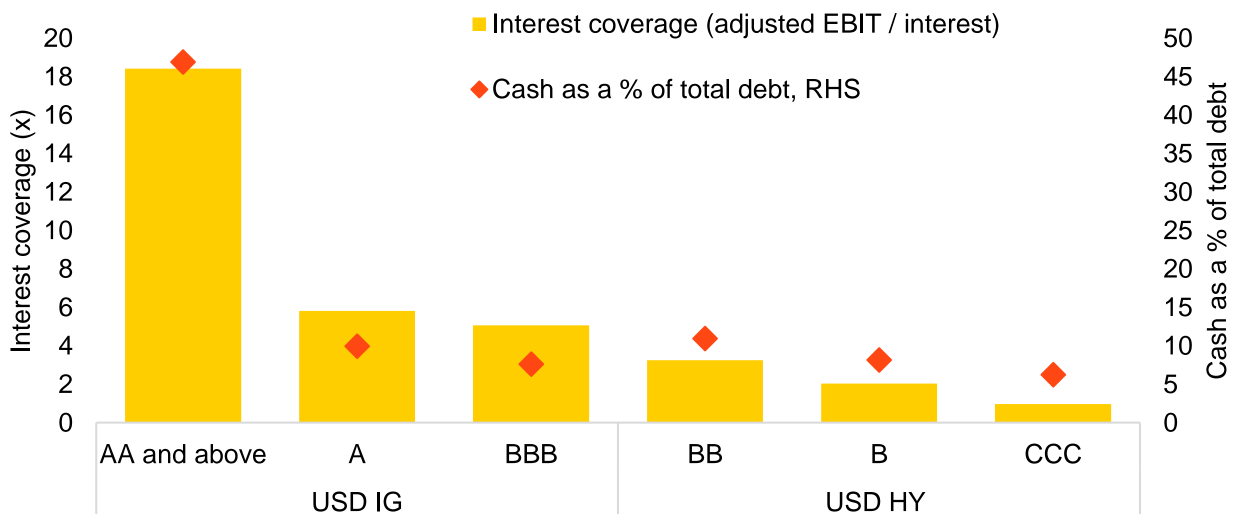
Dispersion, but not disruption

The second implication from the "high for longer" backdrop is that dispersion will remain elevated – a theme we have emphasized over the past few quarters. Indeed, performance dispersion has already been evident across the broader market. As we noted a few weeks ago, CCCs have lagged the overall spread tightening at the USD HY index level.

Performance dispersion is also visible across sectors, as we highlight in the Appendix (Exhibits 8 through 13). And as Exhibit 6 illustrates, fundamental dispersion is clear across the various rating cohorts in the USD IG and USD HY markets. While ratings are an imperfect proxy for fundamental strength (as they can "react" to both positive and negative developments with a time lag), the directional trend is nonetheless informative: the lowest rated borrowers in the USD HY market (i.e., CCCs) already have minimal financial cushions (i.e., interest coverage is 0.98x).

Within USD IG, we favor BBB-rated credit over its higher-rated (and tighter-trading) A and AA peer groups. Within USD HY, we view B-rated credit as the most attractive relative value, as many BB-rated credits trade *well inside* the index level spread (which, as discussed earlier, is already quite tight). BBs also tend to be more duration sensitive, relative to Bs. We expect ongoing relative underperformance among CCCs, although we acknowledge this is a highly idiosyncratic group, which may lend itself to very selective "credit picking."

Exhibit 6: Fundamental divergence across rating cohorts
Median fundamental credit statistics as of 1Q2024 (coverage and liquidity ratios), for the companies included in each rating-specific cohort of the Bloomberg USD IG and HY Corporate indices



Source: BlackRock, Bloomberg. Income statement metrics such as interest coverage ratios are shown for the trailing 12-months ended 1Q2024. Balance sheet metrics such as cash / total debt are shown as of 1Q2024.

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Private credit: another encouraging fundamental datapoint

Two weeks ago, we highlighted the continuation of a somewhat counterintuitive trend in the eyes of many market participants: the ongoing *decline* in covenant default rates in the private credit market, despite the persistently high cost of capital environment. Indeed, after declining for four consecutive quarters (through 1Q2024) the covenant default rate for the Lincoln International Proprietary Private Market Index now stands at 2.7% (a level below the average 4.3% rate of the past four years).

Recently released 1Q2024 data for a separate universe – the directly originated U.S. middle market loans included in the Cliffwater Direct Lending Index (CDLI) – illustrates a similarly encouraging trend. Specifically, realized losses for the CDLI were 23bp in 1Q2024, bringing the trailing 12-month realized loss rate to 85bp. This is below the approximate 1.0% historical long-term average realized loss rate since the inception of the CDLI and is also very modest in the context of the interest income generation of the index (12.29% for the trailing 12-months ended 1Q2024; Exhibit 7).

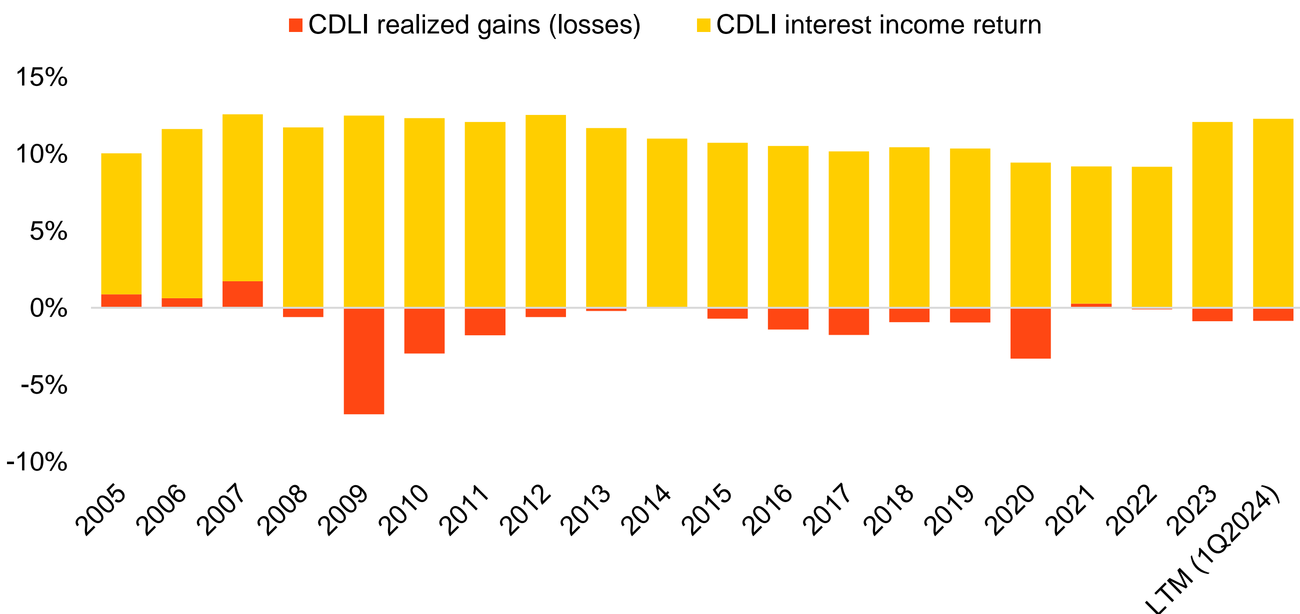
For context, the CDLI is an index of private U.S. middle market loans that was launched in 2015 and reconstructed (and back-tested) to 2004 using the SEC filings of business development companies. The CDLI tracks the U.S. direct lending market and captured roughly 15,600 directly originated middle market loans totaling $337 billion (as of March 31, 2024).

While these trends on covenant defaults and realized losses may seem counterintuitive at first glance, we view them as representative of two important characteristics of the private debt asset class (both of which were outlined in our November 2023 *Private Debt Primer*):

- the flexibility inherent in the long-term relationship between the lender and borrower, and
- the focus on structural protections (including covenants), underwriting and granular credit selection

Exhibit 7: Realized losses for a widely tracked U.S. direct lending index remained modest in 1Q2024

Cliffwater Direct Lending Index (CDLI) realized gains (losses) and interest income return, by annual period (2005 - 1Q2024)



Source: BlackRock, Cliffwater. As of March 31, 2024. Excludes unrealized gains and losses. Realized gains can be driven by equity stubs, warrants, and gains on exited investments. These were more common in 2005-2007, when second lien and mezzanine loans were a greater portion of the CDLI. **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.

Appendix – Part 1 (corporate bond indices)

Note: Exhibits 8 through 11 show performance attribution using the Bloomberg USD and EUR Corporate indices (IG and HY). Performance attribution represents the contribution of each sector – which is a function of the sector's index weighting – to the overall index total return, as of May 28th.

Exhibit 8: Technology and Utility have underperformed in USD IG, while Banks outperformed
Sector contributions to the USD IG Bloomberg Corporate Index YTD total return of -1.21%

	YTD Index Total Return (%)
USD IG Index	-1.21

	Sector contribution to YTD Index Total Return (%)
Banking	0.12
Finance Companies	0.01
Automotive	0.01
Airlines	0.01
Gaming	0.00
Home Construction	0.00
Tobacco	0.00
Lodging	0.00
Other Financial	0.00
Packaging	0.00
Supermarkets	0.00
Consumer Cyc Services	0.00
Building Materials	0.00
Paper	0.00
Brokerage Asset Managers Exchanges	-0.01
Environmental	-0.01
Construction Machinery	-0.01
REITs	-0.01
Other Industrial	-0.01
Metals and Mining	-0.01
Transportation Services	-0.01
Restaurants	-0.02
Consumer Products	-0.02
Chemicals	-0.02
Wireless	-0.02
Diversified Manufacturing	-0.03
Media Entertainment	-0.05
Railroads	-0.05
Cable Satellite	-0.06
Wirelines	-0.06
Energy	-0.07
Aerospace/Defense	-0.07
Healthcare	-0.07
Food and Beverage	-0.08
Retailers	-0.08
Insurance	-0.09
Pharmaceuticals	-0.13
Utility	-0.17
Technology	-0.19

Source: BlackRock, Bloomberg. As of May 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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Exhibit 9: As in USD IG, Banking materially outperformed other sectors in EUR IG
Sector contributions to the EUR IG Bloomberg Corporate Index YTD total return of 0.19%

	YTD Index Total Return (%)
EUR IG Index	0.19

	Sector contribution to YTD Index Total Return (%)
Banking	0.31
Other Financial	0.07
Insurance	0.07
Automotive	0.01
Media Entertainment	0.01
Tobacco	0.01
REITs	0.01
Aerospace/Defense	0.00
Airlines	0.00
Brokerage Asset Managers Exchanges	0.00
Cable Satellite	0.00
Construction Machinery	0.00
Environmental	0.00
Finance Companies	0.00
Gaming	0.00
Health Insurance	0.00
Home Construction	0.00
Leisure	0.00
Lodging	0.00
Metals and Mining	0.00
Packaging	0.00
Paper	0.00
Railroads	0.00
Restaurants	0.00
Supermarkets	0.00
Energy	0.00
Building Materials	-0.01
Chemicals	-0.01
Consumer Cyc Services	-0.01
Consumer Products	-0.01
Diversified Manufacturing	-0.01
Other Industrial	-0.01
Retailers	-0.01
Transportation Services	-0.01
Wireless	-0.01
Healthcare	-0.02
Technology	-0.02
Wirelines	-0.03
Pharmaceuticals	-0.04
Utility	-0.04
Food and Beverage	-0.06

Source: BlackRock, Bloomberg. As of May 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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Exhibit 10: In USD HY, Energy has materially outperformed while Cable & Satellite has notably underperformed

Sector contributions to the USD HY Bloomberg Corporate Index YTD total return of 1.64%

	YTD Index Total Return (%)
USD HY Index	1.64

	Sector contribution to YTD Index Total Return (%)
Energy	0.39
Retailers	0.23
Healthcare	0.20
Pharmaceuticals	0.16
Technology	0.16
Leisure	0.10
Gaming	0.09
Chemicals	0.08
Finance Companies	0.08
Consumer Cyc Services	0.08
Other Industrial	0.05
Automotive	0.05
Diversified Manufacturing	0.05
Metals and Mining	0.05
Building Materials	0.05
Aerospace/Defense	0.05
Airlines	0.05
Other Financial	0.04
Brokerage Asset Managers Exchanges	0.04
REITs	0.04
Insurance	0.04
Consumer Products	0.03
Banking	0.03
Food and Beverage	0.02
Paper	0.02
Home Construction	0.02
Environmental	0.01
Transportation Services	0.01
Utility	0.01
Restaurants	0.01
Lodging	0.01
Packaging	0.01
Construction Machinery	0.01
Supermarkets	0.01
Tobacco	0.01
Railroads	0.00
Wirelines	-0.01
Media Entertainment	-0.08
Wireless	-0.12
Cable Satellite	-0.42

Source: BlackRock, Bloomberg. As of May 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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Exhibit 11: Banking and Other Financial sectors contributed meaningfully to the EUR HY index total return

Sector contributions to the EUR HY Bloomberg Corporate Index YTD total return of 2.76%

	YTD Index Total Return (%)
EUR HY Index	2.76

	Sector contribution to YTD Index Total Return (%)
Banking	0.50
Other Financial	0.46
Wirelines	0.19
Retailers	0.17
Automotive	0.16
Supermarkets	0.16
Chemicals	0.13
Consumer Cyc Services	0.12
Leisure	0.10
Transportation Services	0.08
Healthcare	0.07
Other Industrial	0.07
Energy	0.07
REITs	0.07
Diversified Manufacturing	0.06
Gaming	0.06
Media Entertainment	0.06
Pharmaceuticals	0.06
Insurance	0.06
Food and Beverage	0.05
Utility	0.05
Restaurants	0.04
Tobacco	0.04
Construction Machinery	0.03
Consumer Products	0.03
Finance Companies	0.03
Airlines	0.02
Home Construction	0.02
Lodging	0.02
Metals and Mining	0.02
Paper	0.02
Aerospace/Defense	0.01
Brokerage Asset Managers Exchanges	0.01
Environmental	0.01
Building Materials	0.00
Railroads	0.00
Cable Satellite	-0.01
Packaging	-0.05
Wireless	-0.09
Technology	-0.15

Source: BlackRock, Bloomberg. As of May 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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Appendix – Part 2 (leveraged loan indices)

Note: Exhibits 12 and 13 show total returns by sector for the Morningstar USD and EUR Leveraged Loan indices, as of May 24th. These are absolute total returns by sector (unadjusted by sector weightings) – not contributions by sector, as shown for the corporate bond indices. The difference in presentation between the corporate bond and leveraged loan indices is due to data availability and variations in presentation by third-party data providers.

Exhibit 12: Telecom underperformed all other sectors YTD in the USD Leveraged Loan Index
Index and sector YTD returns for the Morningstar/LSTA USD Leveraged Loan Index

	YTD Index Total Return (%)
USD LL Index	3.90

	YTD Sector Total Return (%)
Health Care Equipment & Services	5.47
Automobiles & Components	5.30
Household & Personal Products	4.97
Pharmaceuticals, Biotechnology & Life Sciences	4.67
Utilities	4.56
Materials	4.54
Commercial & Professional Services	4.16
Capital Goods	4.12
Retailing	4.09
Energy	4.06
Diversified Financials	4.03
Food & Staples Retailing	4.03
Technology Hardware & Equipment	3.96
Insurance	3.89
Consumer Services	3.88
Consumer Durables & Apparel	3.85
Real Estate	3.79
Software & Services	3.72
Transportation	3.66
Semiconductors & Semiconductor Equipment	3.57
Food, Beverage & Tobacco	2.97
Media & Entertainment	2.53
Telecommunication Services	-0.18

Source: BlackRock, LCD. As of May 24, 2024 (latest 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.

Exhibit 13: While underperformance of certain sectors in the European Leveraged Loan Index is evident, YTD returns across all sectors remain positive in absolute terms
Index and sector YTD returns for the Morningstar European Leveraged Loan Index

	YTD Index Total Return (%)
EUR LL Index	4.69

	YTD Sector Total Return (%)
Building Products	7.22
Aerospace & Defense	7.13
Specialty Retail	6.28
Food Products	6.03
Chemicals	5.76
Health Care Providers & Services	5.67
IT Services	5.37
Machinery	5.21
Professional Services	4.97
Household Durables	4.95
Trading Companies & Distributors	4.91
Software	4.88
Hotels, Restaurants & Leisure	4.74
Interactive Media & Services	4.64
Pharmaceuticals	4.62
Health Care Equipment & Supplies	4.51
Diversified Consumer Services	4.37
Containers & Packaging	4.35
Entertainment	4.33
Life Sciences Tools & Services	3.89
Media	3.87
Auto Components	3.66
Commercial Services & Supplies	3.20
Diversified Telecommunication Services	1.13

Source: BlackRock, LCD. As of May 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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