Global Credit Weekly:

HY bonds vs. leveraged loans

BlackRock

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Market insights contributors

Amanda Lynam, CPA

Head of Macro Credit Research, Portfolio Management Group

Dominique Bly

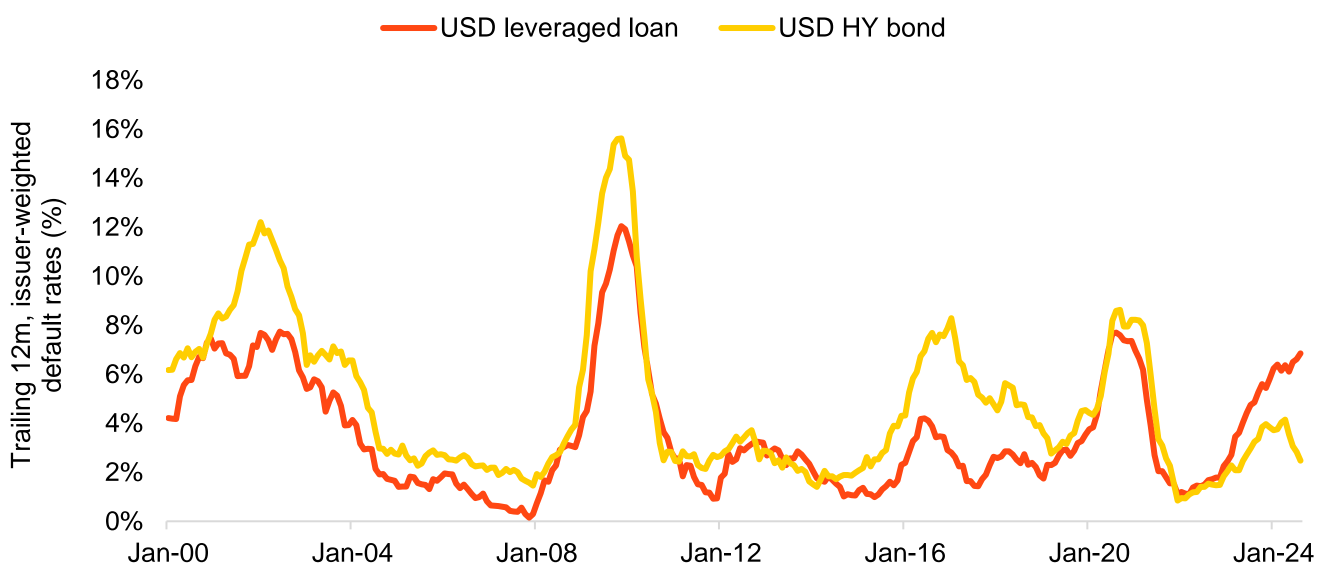
Macro Credit Research Strategist, Portfolio Management Group

Key takeaways

- Stronger than expected economic data over the past two weeks catalyzed a repricing of market expectations for Federal Reserve (Fed) rate cuts (Exhibit 3). As of October 9th, Fed Funds futures implied 45bp of total rate cuts in 4Q2024, and a terminal rate of approximately 3.4%. As recently as October 1st, market pricing called for 71bp of rate cuts in 4Q2024, and a 2.9% terminal rate.
- For corporate credit investors, the *drivers* of monetary policy are more important than *depth* of the anticipated cutting cycle, in our view. For example, a backdrop of fewer (or more gradual) Fed rate cuts because of robust economic activity is still supportive for credit – especially for subsets that are especially growth sensitive, such as speculative grade liquid credit and private credit. By contrast, if fewer rate cuts are delivered because of persistently elevated (or re-accelerating) inflation (this is not our base case), that would be less supportive for corporate credit, in our view.
- Looking ahead, we expect monetary policy *normalization*, as opposed to *easing*. We see scope for the Fed to cut rates into the 3.5% context (or slightly higher) through early 2025. But once that level is reached, additional granularity on the neutral rate will become more critical. With 3Q2024 U.S. real GDP estimated at an above trend pace of 3.2% (per the Atlanta Fed's GDPNow, as of October 9th), we struggle to see a strong rationale for the Fed to *ease* policy rates quickly.
- The back-up in U.S. Treasury yields (Exhibit 4) has moved the fixed vs. floating rate asset allocation decision (i.e., navigating the dynamics between carry and duration) back to center stage. In this *Global Credit Weekly*, we take stock of the relative value and fundamental differences between the USD HY bond and leveraged loan markets. For floating rate borrowers in liquid and private credit, incremental rate cuts should provide some benefit to fundamentals (i.e., default rates, coverage ratios) – especially if growth remains supportive. We expect the USD leveraged loan default rate - which has decoupled from HY - to plateau over the next few months.

Exhibit 1: The USD leveraged loan and HY default rates have further decoupled

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



Source: BlackRock, Moody's. As of August 31, 2024 (most recent available as of October 9, 2024). Includes distressed exchanges.

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Focus on the *drivers* of rate cuts, less on the *depth*

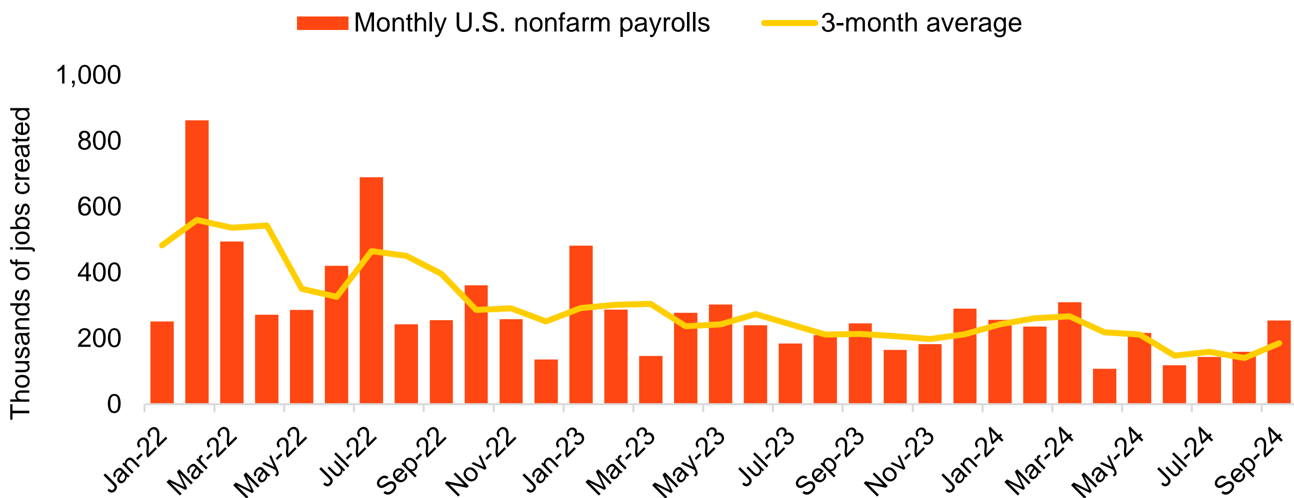
Perhaps the most notable data release over the past several days was the September non-farm payrolls (NFP) report, released on October 4th. It was strong on multiple fronts. Not only were September payroll gains well above consensus estimates (+254k vs. forecasts for +151k), the July and August months were revised higher by a combined total of 72k. This, combined with a 430k gain in household employment and stable labor force participation, pushed the unemployment rate *lower*, to 4.1% (from 4.2%).

(Note: looking ahead, upcoming labor market data may be noisy. For example, the October NFP report, which will be published on November 1st (just ahead of the November 5th U.S. election and the November 6th-7th FOMC), will include an ongoing labor strike and recent weather-related disruptions).

These recent encouraging signals in the labor market, coupled with the positive data revisions to U.S. consumer spending and the savings rate in late September, led to a repricing of market expectations for Fed rate cuts (Exhibit 3). For example, as of October 9th, Fed Funds futures implied 45bp of total rate cuts in 4Q2024, and a terminal rate of approximately 3.4%. As recently as October 1st, market pricing called for 71bp of rate cuts in 4Q2024, and a 2.9% terminal rate.

Exhibit 2: The September NFP report was above consensus expectations

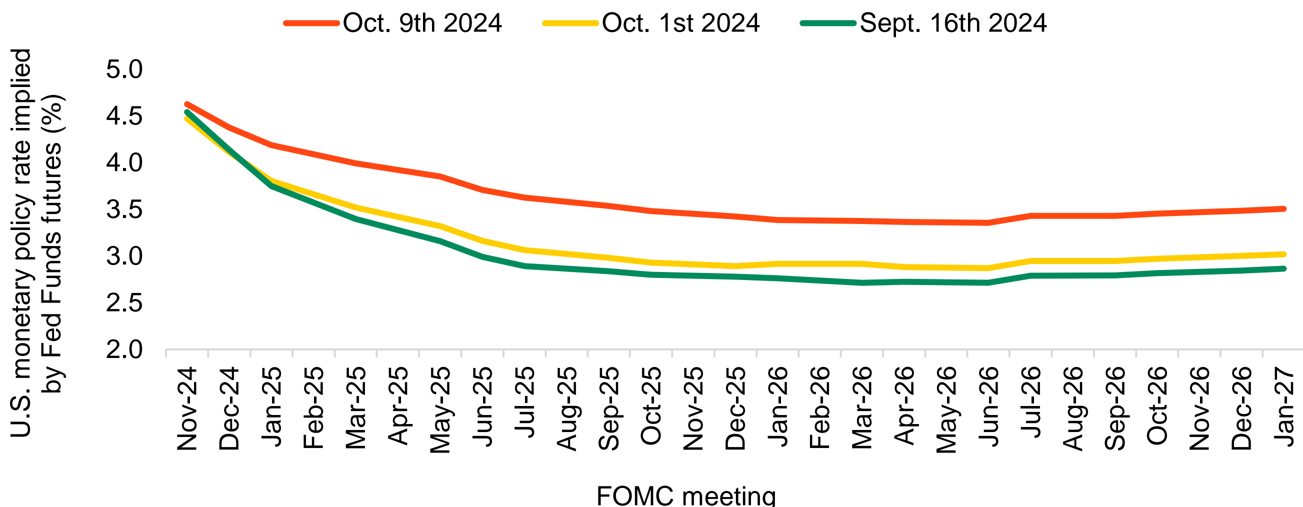
Monthly change in U.S. nonfarm payrolls and the three-month moving average pace of job creation



Source: BlackRock, Bloomberg, Bureau of Labor Statistics. Captures data through September 30, 2024 (most recent available). Data does not include the preliminary benchmark QCEW revisions, released August 21, 2024.

Exhibit 3: The strong September NFP report repriced market expectations for Fed rate cuts

The U.S. monetary policy rate implied by Fed Funds futures (at each upcoming FOMC meeting date), through early 2027; As of October 9th, October 1st, and September 16th, 2024.



Source: Bloomberg, BlackRock. As of October 9, 2024. **There is no guarantee any forecasts may come to pass.**

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“Easing” vs. “normalizing” monetary policy

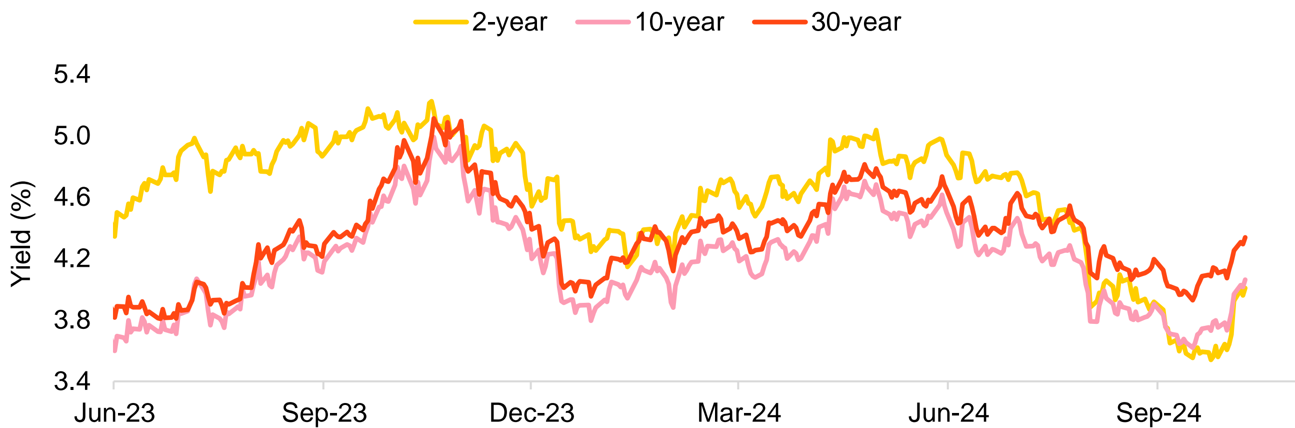
For corporate credit investors, the *drivers* of monetary policy are more important than the *depth* of the anticipated rate cutting cycle, in our view. For example, a backdrop of fewer (or more gradual) Fed rate cuts because of robust economic activity is still supportive for credit – especially for subsets that are especially growth sensitive, such as speculative grade liquid credit (HY and leveraged loans) and private credit. By contrast, if fewer rate cuts are delivered because of persistently elevated (or re-accelerating) inflation (this is not our base case), that would be less supportive for corporate credit, in our view.

Looking ahead, we expect monetary policy *normalization*, as opposed to *easing*. We see scope for the Fed to cut rates into the 3.5% context (or slightly higher) through early 2025. But once that level is reached, additional granularity on the neutral rate will become more critical. With 3Q2024 U.S. real GDP estimated at an above trend pace of 3.2% (per the Atlanta Fed’s GDPNow, as of October 9th), we struggle to see a strong rationale for the Fed to *ease* policy rates quickly. The minutes of the September FOMC meeting also pointed to a gradual “recalibration” of policy – in part because of uncertainty related to the neutral rate of interest (and the degree of restrictiveness embedded in the current monetary policy stance).

As we noted in our *4Q2024 Global Credit Outlook*, we expect additional steepening in the U.S. Treasury curve (Exhibit 5). The drivers of this are two-fold. First, as the Fed continues to normalize monetary policy, the 2-year yield (which is sensitive to the policy rate) should move lower alongside Fed Funds. Second, at the long-end of the curve, concerns surrounding the deficit overhang have the potential to increase the “term premium” – or the compensation investors demand for holding long-term U.S. Treasuries.

Exhibit 4: U.S. Treasury yields have risen across the curve in recent weeks

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 October 9, 2024.

Exhibit 5: We expect the U.S. Treasury yield curve will continue to steepen

2s10s U.S. Treasury yield curve (bp): 10-year yield minus 2-year yield

Source: BlackRock, Bloomberg. As of October 9, 2024.

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The floating vs. fixed rate allocation decision

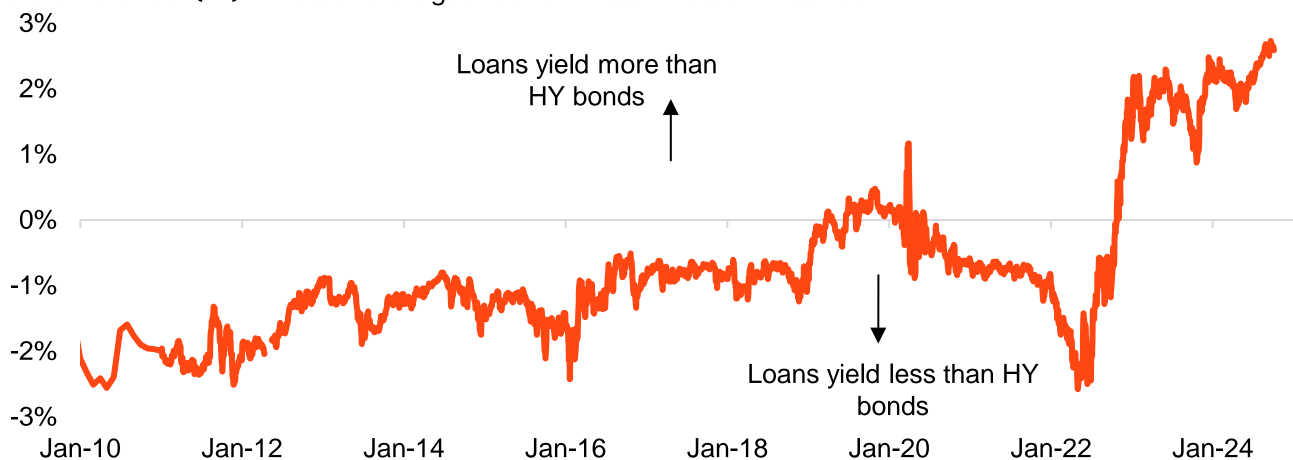
The back-up in U.S. Treasury yields (Exhibit 4) has moved the fixed vs. floating rate asset allocation decision (i.e., navigating the dynamics between carry and duration) back to center stage. In this *Global Credit Weekly*, we take stock of the relative value and fundamental differences between the USD HY bond and leveraged loan markets.

Starting with relative value, Exhibit 6 illustrates that the yield "pick-up" offered by leveraged loans is again near the high end of the historical range. And while the 3Q2024 rally in U.S. Treasury yields (again, Exhibit 4) previously provided a tailwind for fixed-rate credit total returns (Exhibit 7), the recent move higher in the risk-free rate has been a modest headwind. That said, the robust all-in yield opportunity in corporate credit is keeping demand from yield-based investors intact. This has been a key ingredient to the resilience of corporate credit spreads, in our view.

For floating rate borrowers in liquid and private credit, incremental rate cuts should provide some benefit to fundamentals (i.e., default rates, coverage ratios) – especially if growth remains supportive. We expect the USD leveraged loan default rate - which has decoupled from HY - to plateau over the next few months.

Exhibit 6: The yield "pick-up" offered by leveraged loans is at the high-end of the range

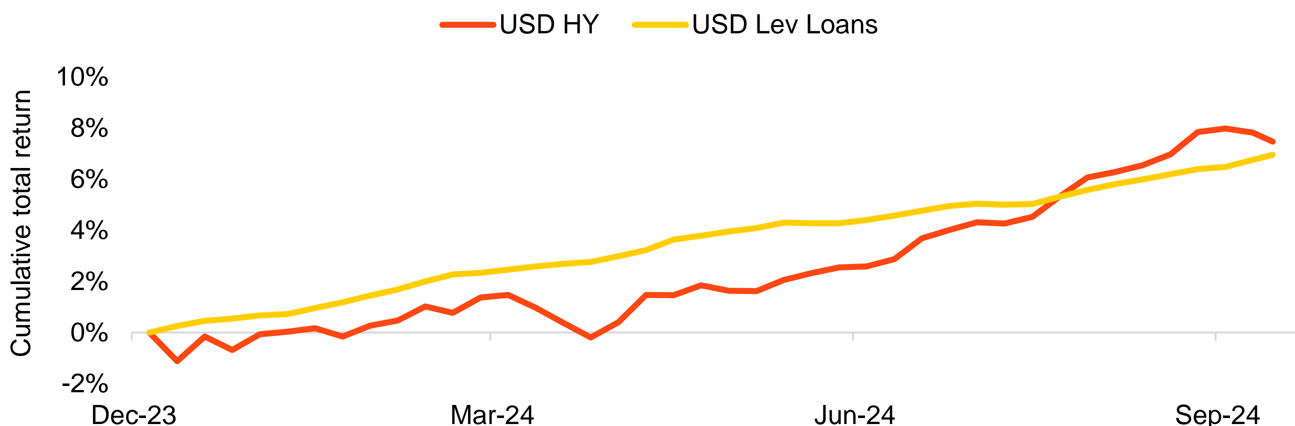
Yield differential (%): B-rated leveraged loans minus B-rated HY bonds



Source: Pitchbook LCD, BlackRock, Morningstar/LSTA, ICE-BAML. October 3, 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 7: The recent rate sell-off has been a modest headwind to fixed rate total returns

Cumulative year-to-date total returns for the Bloomberg USD HY Corporate Index and the Morningstar/LSTA USD Leveraged Loan Index



Source: Bloomberg, Morningstar/LSTA, BlackRock. As of October 9, 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. Uses weekly returns.

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Leveraged loans vs. HY bonds: the fundamental differences

Beyond the mechanical relative value considerations due to the fixed vs. floating rate structures, there are also fundamental differences between the two markets. One of the most important, in our view, is the difference in sector composition. Exhibit 8 illustrates this using the Bloomberg USD HY Corporate and Morningstar/LSTA USD Leveraged Loan indices.

For example, the USD HY Index has a much larger weight towards commodity related sectors, such as Energy and Metals & Mining. It also has larger exposure to Cable Satellite, Financials, Gaming and Manufacturing. By contrast, the USD Leveraged Loan Index has a more significant weight towards Technology, Healthcare, Professional Services and Construction.

While these are some of the more prominent sector differentials between the two, there is fair amount of differentiation across a wide range of sectors, as shown below.

With potential policy shifts related to trade/tariffs and taxes on the horizon in the U.S. election, such differences in sector weightings – across a wide range of industries – may be increasingly relevant.

Exhibit 8: The sector composition of the USD HY and Leveraged Loan markets is not uniform
Sector index weights (%) for the Bloomberg USD HY Corporate and Morningstar / LSTA USD Leveraged Loan indices

	USD HY	USD Lev Loans
Energy	11.7	3.3
Technology / Software / Semis / IT Services / Equipment	7.5	18.4
Cable Satellite	6.3	0.0
Leisure / Lodging / Restaurants	5.6	6.4
Healthcare / Providers / Life Sciences / Tools / Equipment	5.5	9.9
Retailers	4.9	3.2
Finance Companies / Consumer Finance	3.7	0.1
Gaming	3.4	0.0
Media / Entertainment	3.4	5.9
Consumer Cyclicals / Household Durables	3.3	2.5
Wirelines / Telecom / Communications Equipment	3.2	4.0
Diversified Manufacturing / Industrial	3.1	0.0
Paper / Packaging / Containers	3.0	2.3
Insurance (Life / P&C / Health)	2.8	3.6
Utilities	2.7	4.7
Chemicals	2.5	3.9
Metals and Mining	2.5	0.7
Building Materials / Products	2.3	1.5
REITs	2.2	0.8
Automotive	2.2	1.8
Food / Beverage / Tobacco	2.1	1.9
Aerospace / Defense	2.1	1.4
Banking / Financial Services	2.0	0.5
Pharmaceuticals and Biotech	1.6	1.5
Airlines / Air Freight	1.5	1.6
Wireless	1.5	0.4
Consumer Products / Staples	1.5	0.8
Construction Machinery / Engineering	1.3	5.9
Transportation Services / Rails	1.2	1.5
Home Construction	1.1	0.0
Brokerage / Asset Mgrs. / Exchanges / Capital Mkts.	0.9	3.7
Environmental	0.7	0.0
Supermarkets	0.6	0.0
Professional and Commercial Services	0.0	7.7

Source: Bloomberg, Morningstar / LSTA, Pitchbook LCD, BlackRock. As of October 9, 2024.

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The rating distribution skews lower for leveraged loans

In addition to sector compositional considerations, there is also a notable difference in the distribution of ratings between the HY and leveraged loan markets. As shown in Exhibit 9, the USD Leveraged Loan Index tends to skew towards a lower rating, overall.

Indeed, roughly 30% of the Morningstar/LSTA USD Leveraged Loan Index is rated B- or lower, compared to approximately 22% for the Bloomberg USD HY Corporate Index. And 49% of the USD HY Corporate Index is rated BB+/BB/BB-, compared to 28% for the USD Leveraged Loan Index.

The lower rating distribution of the USD Leveraged Loan Index can be a technical headwind in certain risk-off market environments (such as 2H2023, when many market participants were more concerned about the potential for the U.S. economy to fall into a recession). This technical headwind arises because the largest buyers of broadly syndicated leveraged loans – collateralized loan obligations (CLOs) – are limited in the amount of CCC-rated loans they can hold within typical CLO portfolios (for a typical structure, this is usually capped at 7.5%, per the market convention). In volatile market environments or periods where perceived downside risks are greater, CLOs tend to behave more selectively toward CCC-rated loans *and* B- loans (which are just one notch above CCC territory).

That said, the technical related to CLO creation has been unquestionably positive so far this year. In fact, using data compiled by Pitchbook LCD, year-to-date CLO creation of $145 billion is up 71% vs. this time last year, and is on track to rival the prior record set in 2021 ($187 billion).

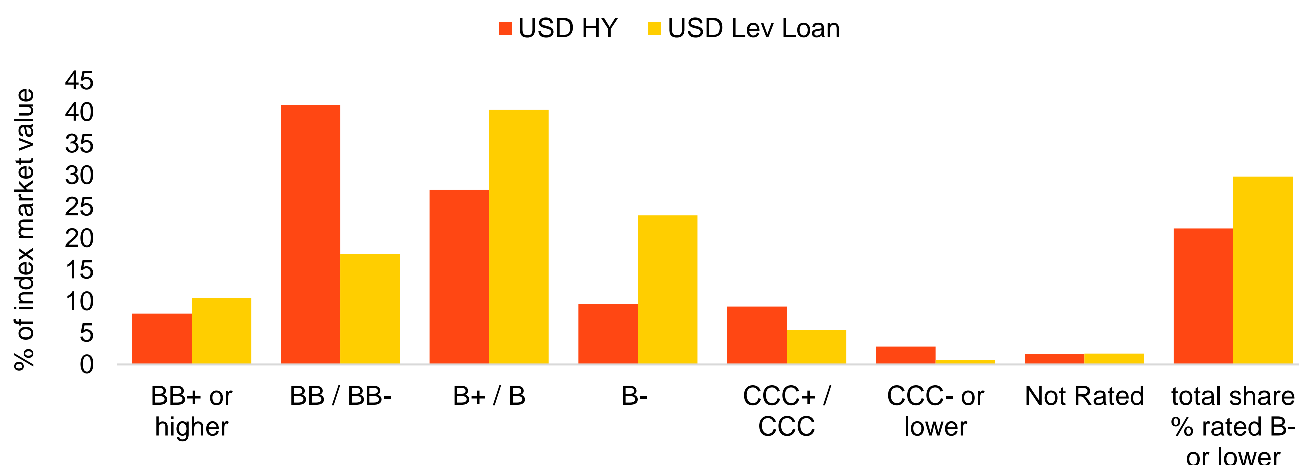
Defaults have also diverged

As shown in Exhibit 9, the default patterns have also further decoupled between the two asset classes. For example, using the issuer-weighted, trailing 12-month default data tracked by Moody's (which includes distressed exchanges as a default), the default rate for USD leveraged loans continues to increase and stood at 6.9% as of August 31st (most recent). This is well above the 2.5% default rate for USD HY bonds, which has been declining since May 2024 (again, Exhibit 1).

One key reason for the divergence between the two rates, in our view, is the swifter transmission of the Fed's interest rate hikes (which began in March 2022) to floating rate borrowers. In contrast to their fixed rate peers, floating rate borrowers encountered higher debt costs immediately.

Somewhat encouragingly, recovery rates have been steadily increasing in *both* asset classes (again using the Moody's data). After tracking below the longer-term historical trends in late 2023 and early 2024, recovery rates are now closer to the historical averages: $40.5 for unsecured HY bonds and $63.1 for first-lien leveraged loans, both for the trailing 12-months as of August 31st.

Exhibit 9: The rating distribution of the USD Leveraged Loan Index is lower vs. its HY peer
Share of index market value (for the Bloomberg USD HY Corporate and Morningstar/LSTA USD Leveraged Loan indices) allocated to each rating cohort



Source: Bloomberg, Morningstar/LSTA, Pitchbook LCD, BlackRock. As of October 7, 2024.

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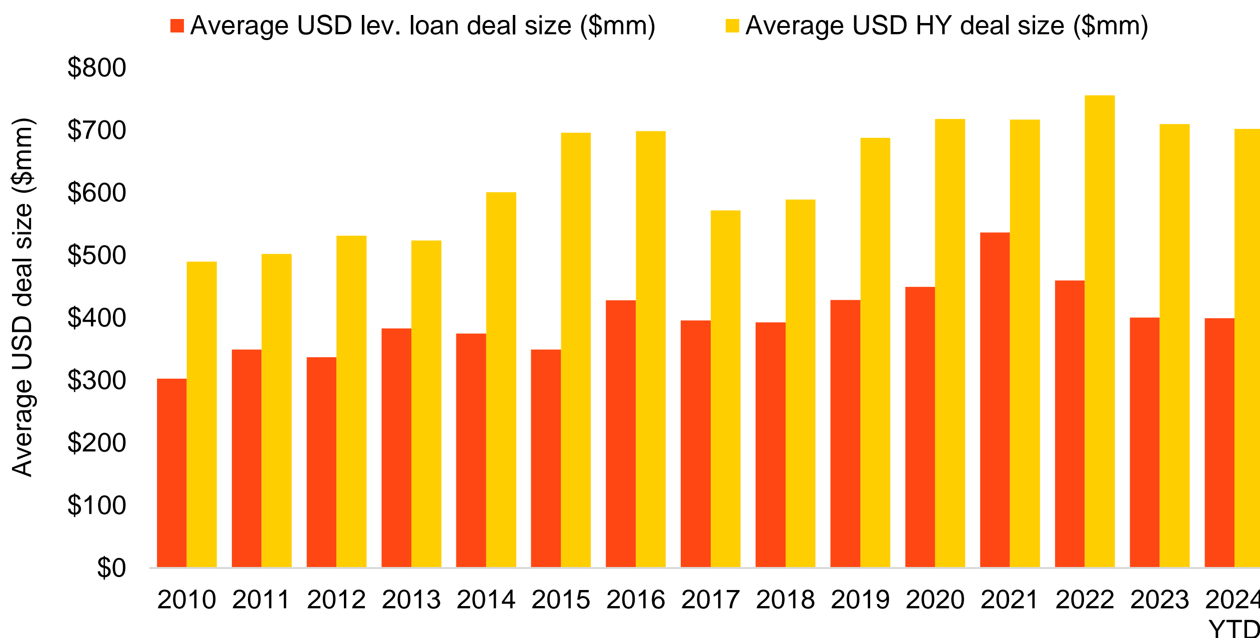
Other structural distinctions between the two markets are outlined below.

- **Borrower size:** Using average deal size as a proxy for capital structure and company sizing: we believe larger borrowers generally seek financing from the HY market. For example, the average USD HY deal size, according to Dealogic, has averaged $721 million for the past five years, vs. $449 million for the USD leveraged loan market, according to data from Pitchbook LCD (Exhibit 10). Smaller borrowers can often be subject to lower credit ratings because they (for a variety of factors) may tend to have less diversification (product, geography, customer, etc.), thinner financial cushions, and fewer economies of scale than their larger peers – all of which can make smaller businesses more vulnerable in certain macroeconomic environments.
- **Private equity (PE) ownership:** PE-backed borrowers generally opt to issue debt in the leveraged loan market due to the term flexibility available (vs. in the HY market). According to Pitchbook LCD, 60% of year-to-date (YTD) issuance is associated with a PE sponsor, vs. only 22% in the HY market.
- **Flexibility in terms:** The leveraged loan market is generally associated with more flexible terms, and this flexibility is often compelling to borrowers that may benefit from it, such as PE-backed borrowers or smaller borrowers. HY issuers, on the other hand, are generally subject to tighter terms.
- **Call protections:** The HY market generally has more stringent call protections, meaning that there is a sustained period following issuance in which an issuer may not buy back their bonds. Call protections in leveraged loan agreements tend to be less stringent, attracting borrowers seeking flexibility.

Exhibit 10: HY tends to finance larger deals, on average, than the leveraged loan market
Average USD HY deal size and average USD leveraged loan deal size by calendar year (both in $ millions); new institutional money shown for each category



Source: BlackRock, Dealogic (ION Analytics), Pitchbook LCD. 2024 is as of August 20, 2024.

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