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Global Credit Weekly:

Warranted resilience

BlackRock

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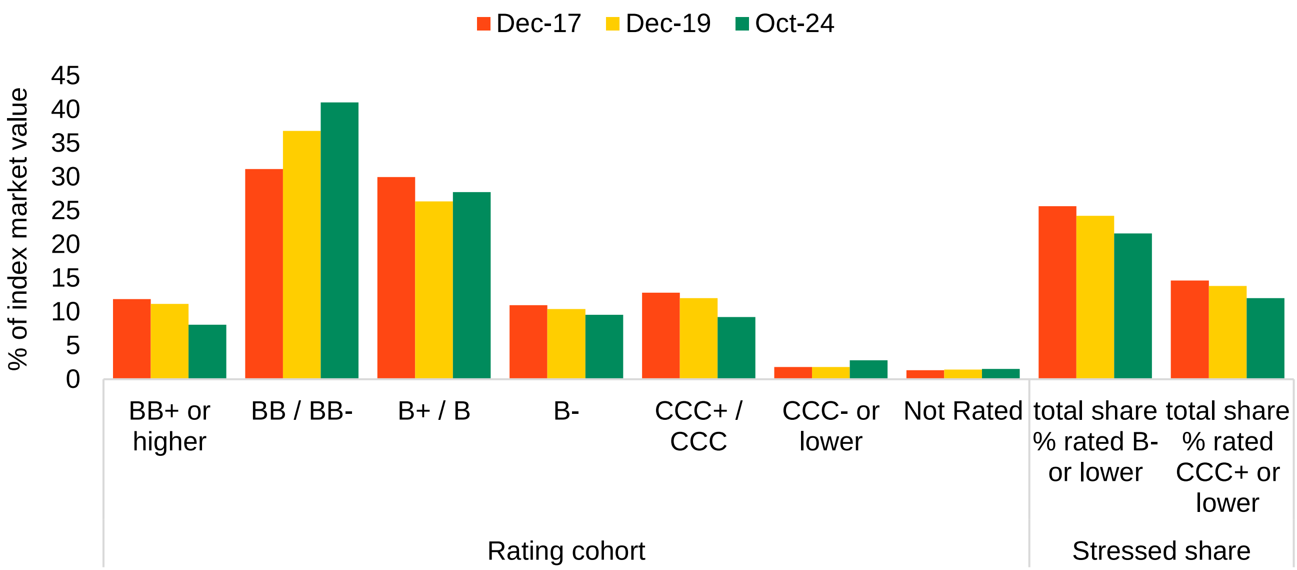
Key takeaways

- Over the course of the last year, many market participants have pointed to HY corporate credit index-level spread measures as a barometer of growth risks and investor sentiment. Outside of the short-lived period of market volatility in early August 2024, index-level spreads for the Bloomberg USD HY Corporate Index have traded well below 340bp for most of this year. On October 16th, the index closed at 287bp – a level at the tight end of the historical range and well below the post-financial crisis average of 455bp.
- Many market participants have expressed a view that the recent range of USD HY spreads offers only minimal compensation for credit risk. In this *Global Credit Weekly*, we explore *why* credit spreads have exhibited such resilience – and why this is, in some respects, warranted. In short, we see several fundamental and technical drivers: (1) a "supportive enough" macroeconomic backdrop; (2) an up-in-quality ratings skew within USD HY; (3) some valuation and fundamental convergence between the high-end of the USD HY rating spectrum (i.e., BBs) and the low-end of the USD IG rating spectrum (i.e., BBBs); (4) support from yield-based demand; (5) limited net issuance which has led to a *shrinking* USD HY market, overall, (6) a higher proportion of secured issuance in recent years, and (7) a technical tailwind from reinvesting higher coupons.
- Looking ahead, we expect many of these factors to persist. As we noted in our 4Q2024 *Global Credit Outlook*, we anticipate some near-term spread volatility around the U.S. election given the various potential paths that may impact corporate issuers: namely, tariffs/trade and taxes. But over the medium term, our base case of supportive growth (especially in the U.S), reduced monetary policy restriction, solid fundamentals, and technical tailwinds (such as the yield-based demand) suggest spreads can likely remain in their narrow (and tight) ranges.

Exhibit 1: The rating distribution of the USD HY index skews higher quality
Market value distribution of the Bloomberg USD HY Corporate Index, by Bloomberg Composite Rating, over time



Source: BlackRock, Bloomberg. As of October 14, 2024.

USD HY spreads: unpacking the recent resilience

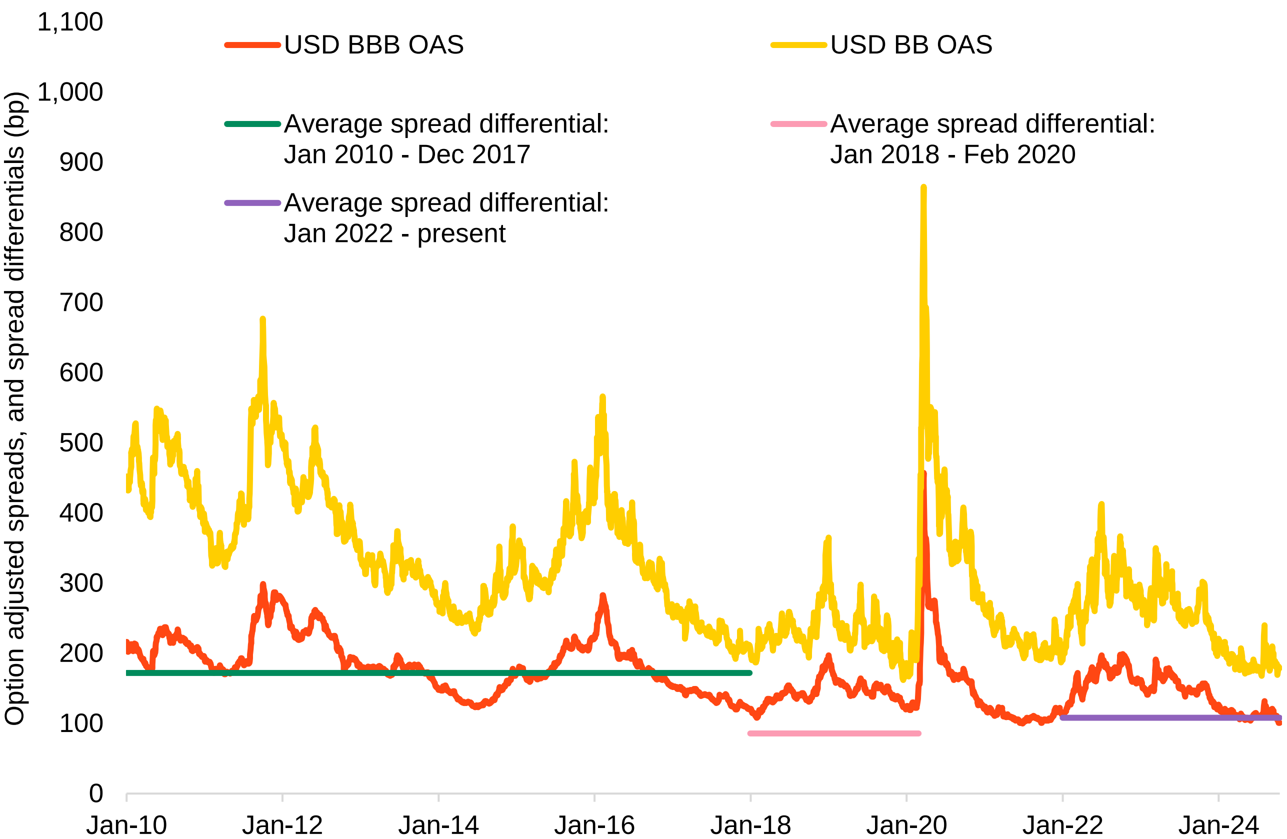
Over the course of the last year, many market participants have pointed to USD IG and HY corporate credit index-level spread measures as a barometer of growth risks and investor sentiment. Of the two, spreads in the USD HY market have been especially closely watched. This is because the USD IG universe has a large weighting toward Banks (22% of market value for the Bloomberg USD IG Corporate Index). It also includes many large-cap, cash-rich companies in the Technology and Pharmaceutical sectors. For this reason, the USD IG universe is viewed as somewhat less sensitive to downside risks to growth, relative to its USD HY peer.

Outside of the short-lived period of market volatility in early August 2024, index-level spreads for the Bloomberg USD HY Corporate Index have traded well below 340bp for most of this year (the average was 313bp). And as of October 16th, the index closed at 287bp – a level at the tight end of the historical range and well below the post-financial crisis average of 455bp (i.e., since January 2010 to present).

Many market participants have expressed a view that these recent USD HY spread levels offer only minimal compensation for credit risk. In this *Global Credit Weekly*, we explore *why* credit spreads have exhibited such resilience. In short, we see several fundamental and technical drivers: (1) a “supportive enough” macroeconomic backdrop; (2) an up-in-quality ratings skew within USD HY; (3) convergence in valuations and fundamentals between the high-end of the USD HY rating spectrum (i.e., BBs) and the low-end of the USD IG rating spectrum (i.e., BBBs); (4) support from yield-based demand; (5) limited net issuance which has led to a *shrinking* USD HY market, overall, (6) a higher proportion of secured issuance, in recent years and (7) a technical tailwind from reinvesting higher coupons.

Exhibit 2: The average index-level spread differential between USD BBs and BBBs has compressed somewhat, vs. several years ago

Historical index-level option adjusted spreads for the Bloomberg USD BB and BBB Corporate indices, and the average spread differentials at different points in time (excluding the pandemic period of March 2020 - December 2021, due to the unique nature of the shock)



Source: Bloomberg, BlackRock. As of October 14, 2024. Excludes debt that is not index eligible. **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.

Growth remains paramount for corporate credit

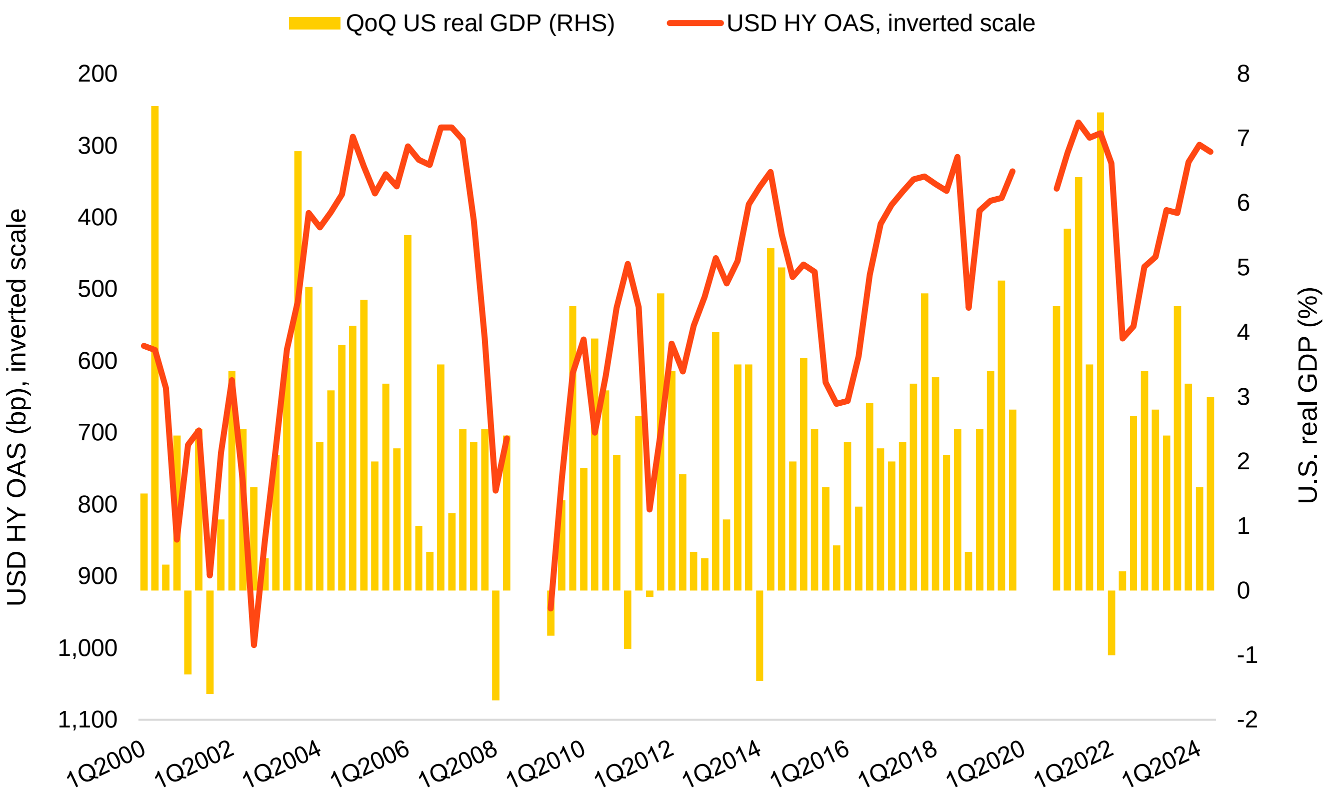
One of our key investing themes over the past few quarters has been “dispersion but not widespread disruption.” This phrase reflects our view that, while the higher cost of capital environment of the past two years has been a headwind for *subsets* of the corporate credit universe, by and large, most corporations found ways to adapt. But the resilience of credit spreads despite higher interest rates can also be attributed to a supportive growth backdrop. For example, above trend GDP in the U.S. was a powerful mitigant to higher debt servicing costs.

Looking ahead to 4Q2024 and 2025, we expect the growth backdrop will continue to be important for investors’ sentiment towards corporate credit risk – especially for the HY, leveraged loan, and private debt universes – which tend to be more economically sensitive relative to their IG peers.

That said, again using the USD HY market as an example, the borrowers in this universe are far from uniformly stressed. On the contrary, the financially stressed cohort of the USD HY market is quite limited. Exhibit 1 illustrates this by capturing the percentage of the Bloomberg USD HY Corporate Index at the low end of the rating spectrum, which we define as B- or below. A narrower definition of “stress” – focused on the cohort rated CCC+ and lower – tells an even more encouraging story. And importantly, Exhibit 1 also illustrates how this share of stressed firms has declined over the past several years.

Indeed, 49% of the Bloomberg USD HY Corporate Index is rated BB- or higher (again, Exhibit 1). And as Exhibit 2 highlights, the spread differential between the high-end of the USD HY ratings spectrum (i.e., BBs) and the low-end of the USD IG ratings spectrum (i.e., BBBs) has narrowed somewhat, relative to several years ago.

Exhibit 3: The USD HY index has responded to the pace of U.S. growth, over time
Average index-level option adjusted spreads (OAS) for the Bloomberg USD HY Corporate Index at each quarter-end (inverted on axis), and quarter-over-quarter (QoQ) U.S. real GDP (seasonally adjusted at an annualized rate), RHS; Excludes 3Q2008 – 1Q2009 and 1Q2020 – 3Q2020.



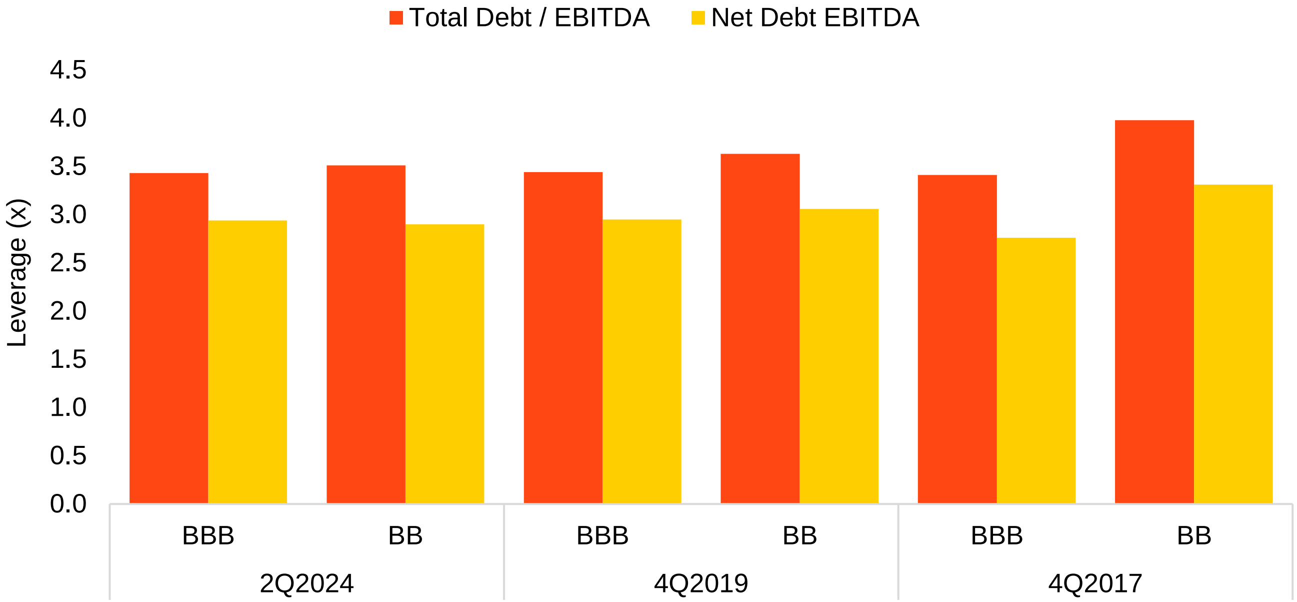
Source: Bloomberg, BlackRock. For ease of visualization purposes in the chart, we exclude three quarterly periods during the Global Financial Crisis (3Q2008 – 1Q2009) and the COVID-19 pandemic (1Q2020 – 3Q2020). For context, the associated spread and GDP figures for each period were: 3Q2008: 1,020bp / -2.1%; 4Q2008: 1,662bp / -8.5%; 4Q2008: 1,514bp / -4.5%; 1Q2020: 880bp / -5.5%; 2Q2020: 626bp / -28.1%; 3Q2020: 517bp / +35.2%. **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.

BBs vs. BBBs: a narrowing “fundamentals gap”

The USD IG and HY markets are distinctly different asset classes in terms of investor participation and market conventions (trading, issuance, documentation). That said, we see a greater degree of fluidity between the two markets in recent years, as several large capital structures have moved from IG to HY, and back again (note: many of the initial “fallen angel” downgrades to HY occurred following the immediate onset of the pandemic).

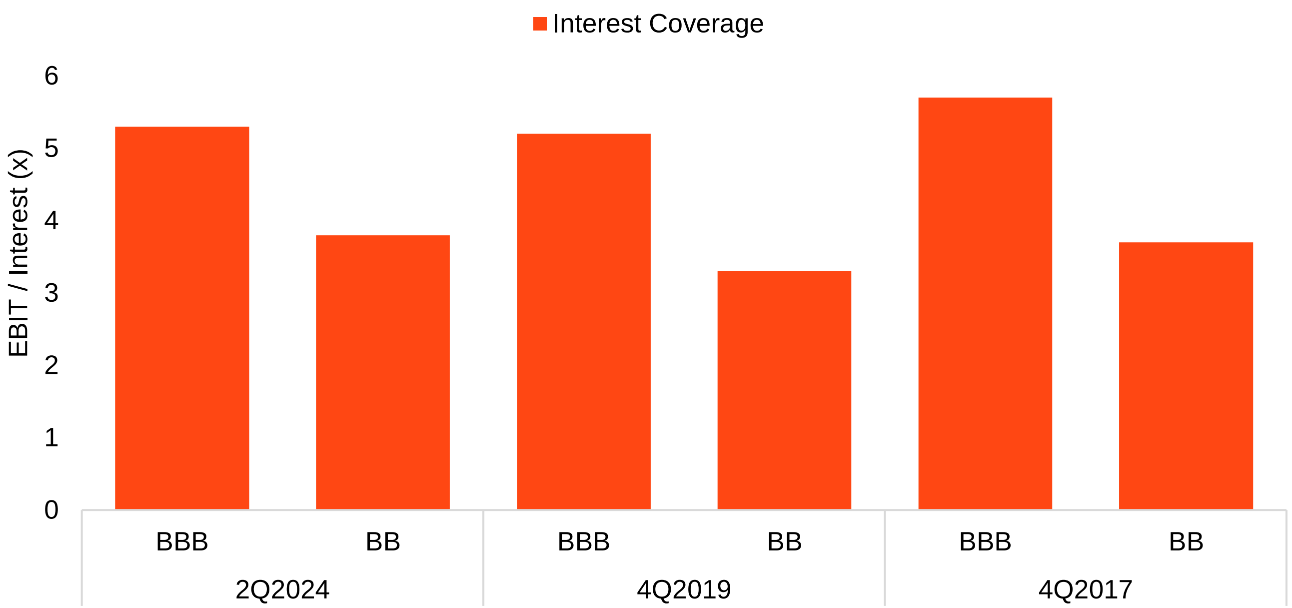
Indeed, even some of the average fundamental metrics between the BB and BBB universes have converged somewhat, as illustrated in Exhibits 4 through 6. For context, the BBB universe represents 46% of the $7.0 trillion Bloomberg USD IG Corporate Index (as of October 17th, 2024).

Exhibit 4: Average leverage metrics are very similar for the BB and BBB cohorts, as of 2Q2024
Trimmed mean (excludes top / bottom 10%) leverage metrics, for the last twelve months ended 2Q2024, 4Q2019, and 4Q2017. Captures issuers in the Bloomberg USD BB and BBB Corporate indices.



Source: Bloomberg, BlackRock. Excludes issuers which are not index-eligible. As of October 16, 2024.

Exhibit 5: Interest coverage metrics have also moved closer together, over time
Trimmed mean (excludes top / bottom 10%) interest coverage metrics, for the last twelve months ended 2Q2024, 4Q2019, and 4Q2017. Captures issuers in the Bloomberg USD BB and BBB Corporate indices.



Source: Bloomberg, BlackRock. Excludes issuers which are not index-eligible. As of October 16, 2024.

Leverage, coverage, margins and liquidity: spotting the differences

Exhibit 4 uses trimmed mean (i.e., a form of an average, which excludes outliers) gross and net leverage metrics, as captured by Bloomberg data (for the universe of issuers in the USD BB and BBB Corporate indices). Notably, net leverage is the same (2.9x) for the BB and BBB cohorts, as of 2Q2024. As of late 2017, there was a more meaningful gap (3.3x for BB vs. 2.8x for BBB). Gross leverage for BBs of 3.5x as of 2Q2024 was slightly higher than for BBBs (3.4x). But here too, the "fundamentals gap" has narrowed vs. late 2017 (4.0x for BBs vs. 3.4x for BBBs).

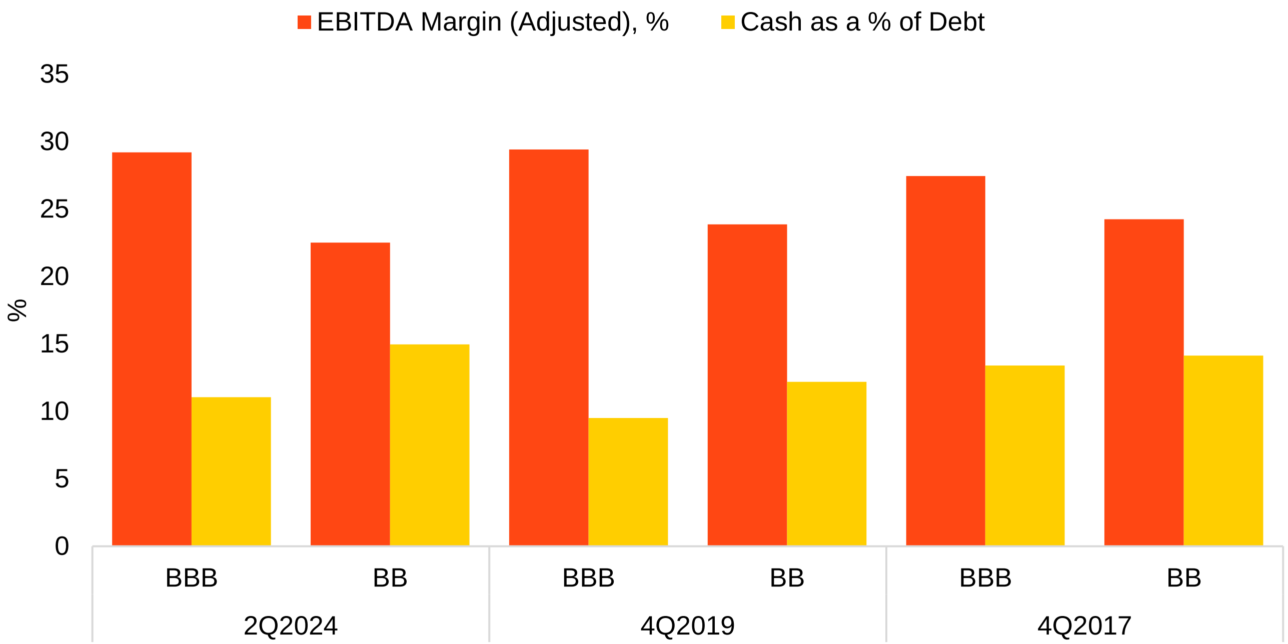
Exhibit 5 uses the same comparison across rating and time dimensions, this time using interest coverage. As of 2Q2024, the average interest coverage for the BB cohort was 3.8x, compared to 5.3x for BBBs. While this is a somewhat more notable differential vs. the leverage metrics above, the trend of a "narrowing fundamentals gap" over the past several years has also been evident. Indeed, as of late 2017, these average interest coverage metrics were 3.7x for BBs and 5.7x for BBBs.

Finally, we turn to Exhibit 6 for incremental statistics on margins and liquidity. On average, BB issuers currently have lower EBITDA margins vs. their BBB peers (22.5% vs. 29.2%). In fact, the 6.7 percentage point differential as of 2Q2024 is larger than the differential that existed as of late 2017 (3.2 percentage points).

That said, BB issuers appear to hold more liquidity relative to debt (again, on average). For example, cash as a percentage of total debt was 15.0% for BB issuers as of 2Q2024, compared to 11.1% for BBB firms, on average. As of late 2017, these average metrics were more closely aligned: 14.1% for BBs and 13.4% for BBBs. This indication of modestly higher balance sheet conservatism among BBs is likely a residual impact of the pandemic, in our view, when the leveraged finance debt capital markets were somewhat inaccessible for a brief period. Corporate Treasurers and CFOs likely realized the value of "excess" liquidity at that time and may have adjusted capital management approaches, as a result. Holding excess cash has also been a more compelling value proposition in recent years, given the elevated interest rate backdrop (i.e., it now generates a return). We also believe the higher liquidity among BBs reflects the significant amount of proactive pre-funding and refinancing that has occurred in 2024 (some of this cash may be kept on balance sheet, pending an upcoming maturity). We discuss this later.

Exhibit 6: On average, USD BB issuers have lower EBITDA margins than their BBB peers, but hold more cash relative to debt

Trimmed mean (excludes top / bottom 10%) EBITDA margin and liquidity metrics, as of 2Q2024, 4Q2019, and 4Q2017. Captures issuers in the Bloomberg USD BB and BBB Corporate indices.



Source: Bloomberg, BlackRock. Excludes issuers which are not index-eligible. As of October 16, 2024.

We see some additional scope for valuation convergence

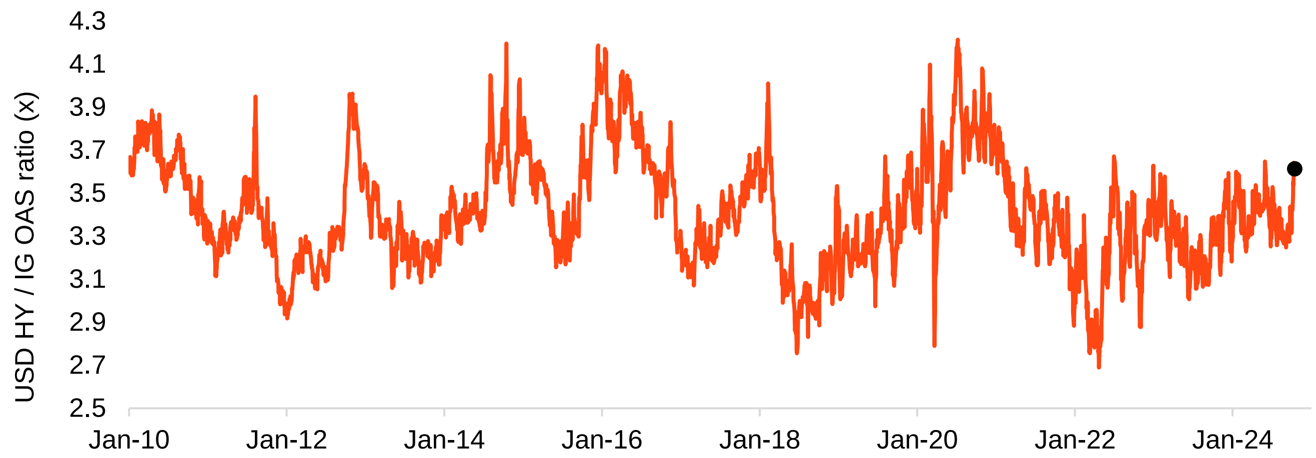
Given this fundamental backdrop, it begs the question: what is priced into valuations, currently? We approach this question from two perspectives: (1) the broad, HY vs. IG index-level spreads, and (2) the USD BB vs. BBB spreads.

Starting with the broad indices, Exhibit 7 illustrates that the current relationship between USD HY and IG index-level spreads is towards the middle of the historical range (i.e., HY spreads are 3.6x their IG peers, on average). Over the medium term, we see some modest scope for this to compress (again, with the important caveat that we anticipate some *near-term* volatility around the November 5^{th} U.S. election).

That said, *significant* additional compression in the USD HY market (relative to IG) is likely to be fueled by the highly idiosyncratic CCC cohort, which still trades somewhat wide (average OAS of 598bp) relative to what the HY index-level OAS would suggest. Supportive economic growth is critical, in our view, for sustained outperformance of CCCs, and active credit selection is key in this highly-levered group.

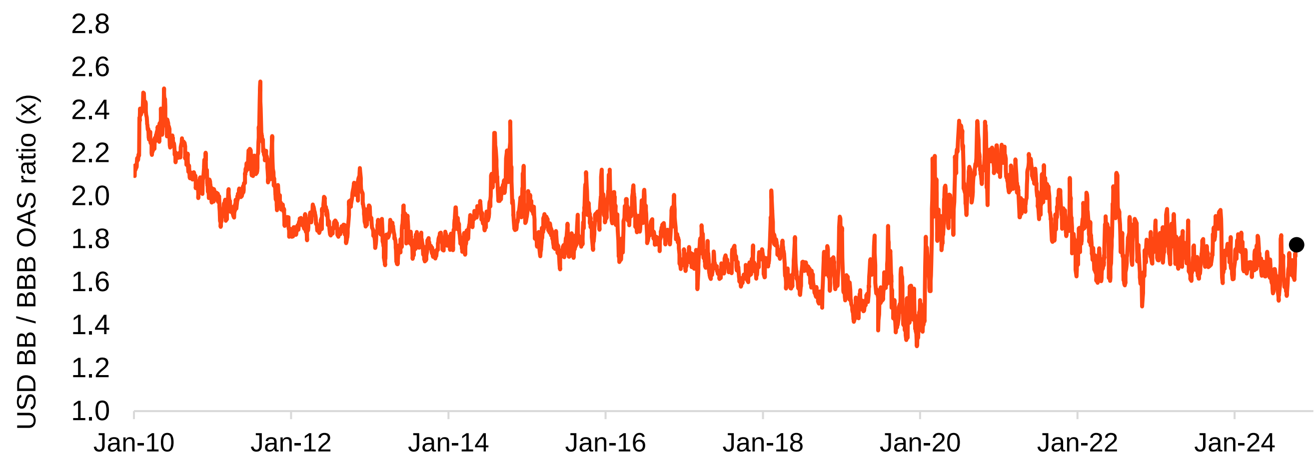
Exhibit 8 illustrates that BB spreads have (somewhat consistently) compressed vs. BBBs over the past few years. Here too, we see some scope for additional compression – although it is likely to be more limited vs. what might be possible at the index level, given current valuations.

Exhibit 7: We see additional room for HY spreads to compress relative to their IG peers
USD HY / IG option adjusted spread (OAS) ratio (x), for the Bloomberg USD Corporate indices



Source: Bloomberg, BlackRock. As of October 14, 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: We also see some scope for BBs to tighten relative to BBBs
USD BB / BBB option adjusted spread (OAS) ratio, for the Bloomberg USD Corporate indices



Source: Bloomberg, BlackRock. As of October 14, 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.

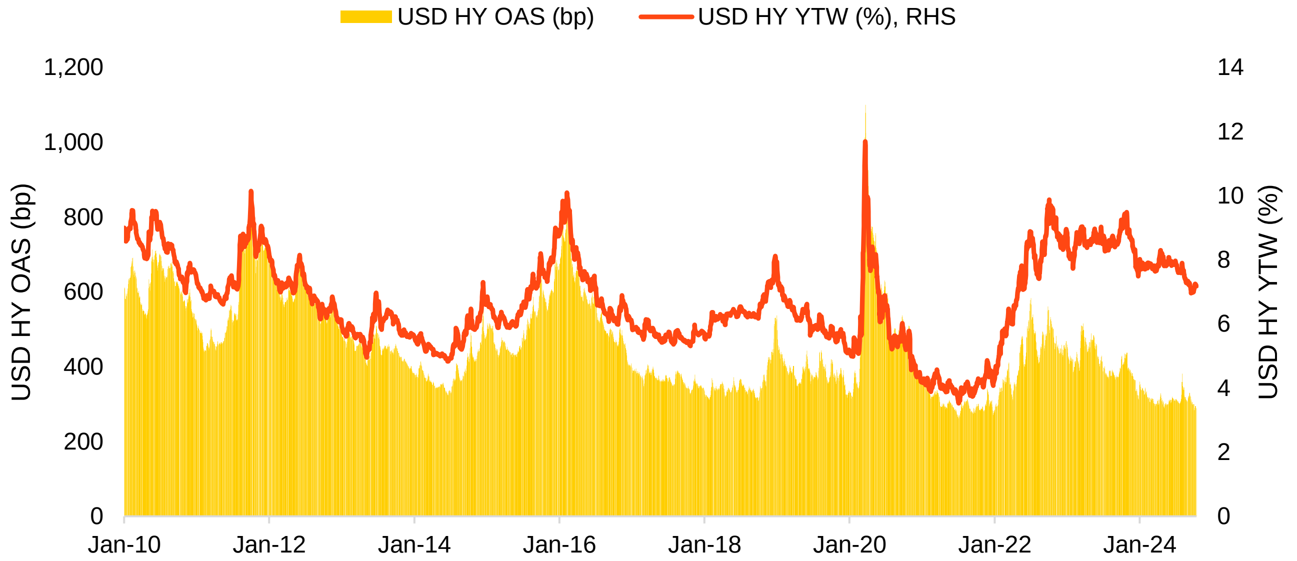
Technical tailwinds

Beyond the fundamental impact on valuations, the technical backdrop has also been uniquely supportive on a few fronts. First, the all-in yields available in the USD HY market have been boosted by the risk-free rate and screen as attractive in the context of the post-financial crisis era (Exhibit 9). We believe this has kept spreads in a tight range, as capital is deployed into the asset class by yield-based buyers.

Second, the share of refinancing activity is at a post-financial crisis high, meaning only limited net supply is coming into the USD HY market (Exhibit 10).

Exhibit 9: The elevated all-in yield backdrop of the past few years has kept spreads tight, in our view

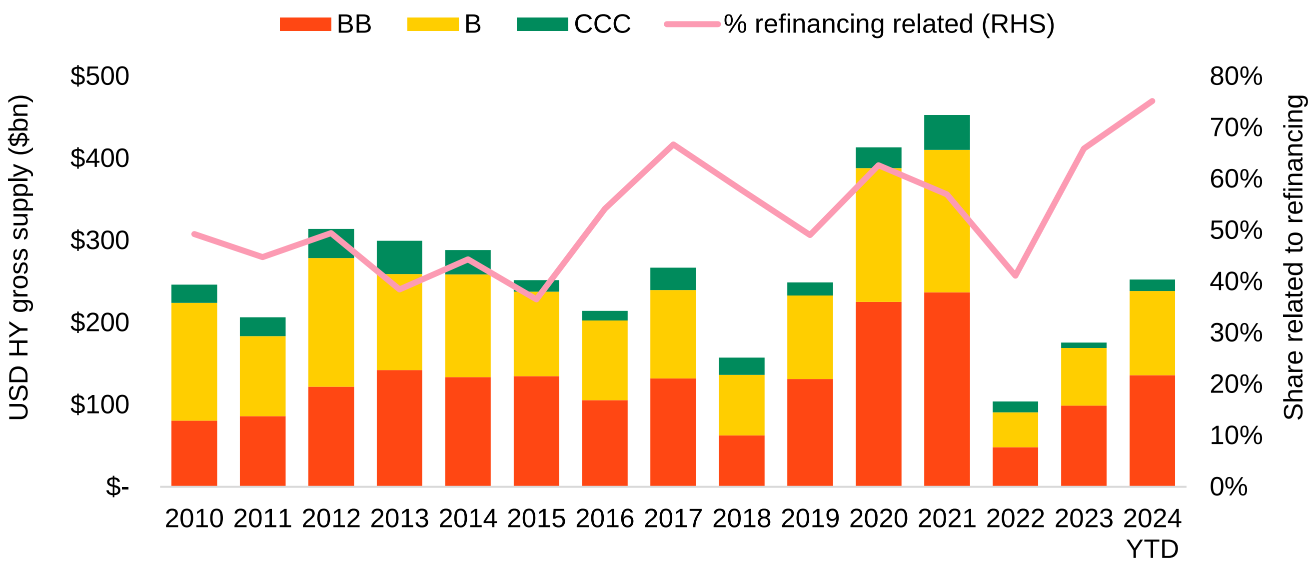
Index-level option adjusted spread (OAS) and yield-to-worst (YTW) measures, for the Bloomberg USD HY Corporate Index



Source: Bloomberg, BlackRock. As of October 14, 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 10: This year's USD HY gross supply has been primarily earmarked for debt repayment and refinancing

USD HY gross supply by Dealogic Effective Rating at Launch, and the share of gross issuance earmarked for debt repayment or refinancing (as captured by Dealogic's "primary use of proceeds"), RHS



Source: Dealogic (ION Analytics), BlackRock. As of October 16, 2024.

A larger refinancing share, and more secured supply

Indeed, while gross issuance in the USD HY market has been elevated vs. the past two years, 75% of this activity has been earmarked for debt repayment or refinancing, according to data compiled by Dealogic (again, Exhibit 10). This is the highest share of any annual period in the post-financial crisis era and has been an important technical consideration for investors, in our view.

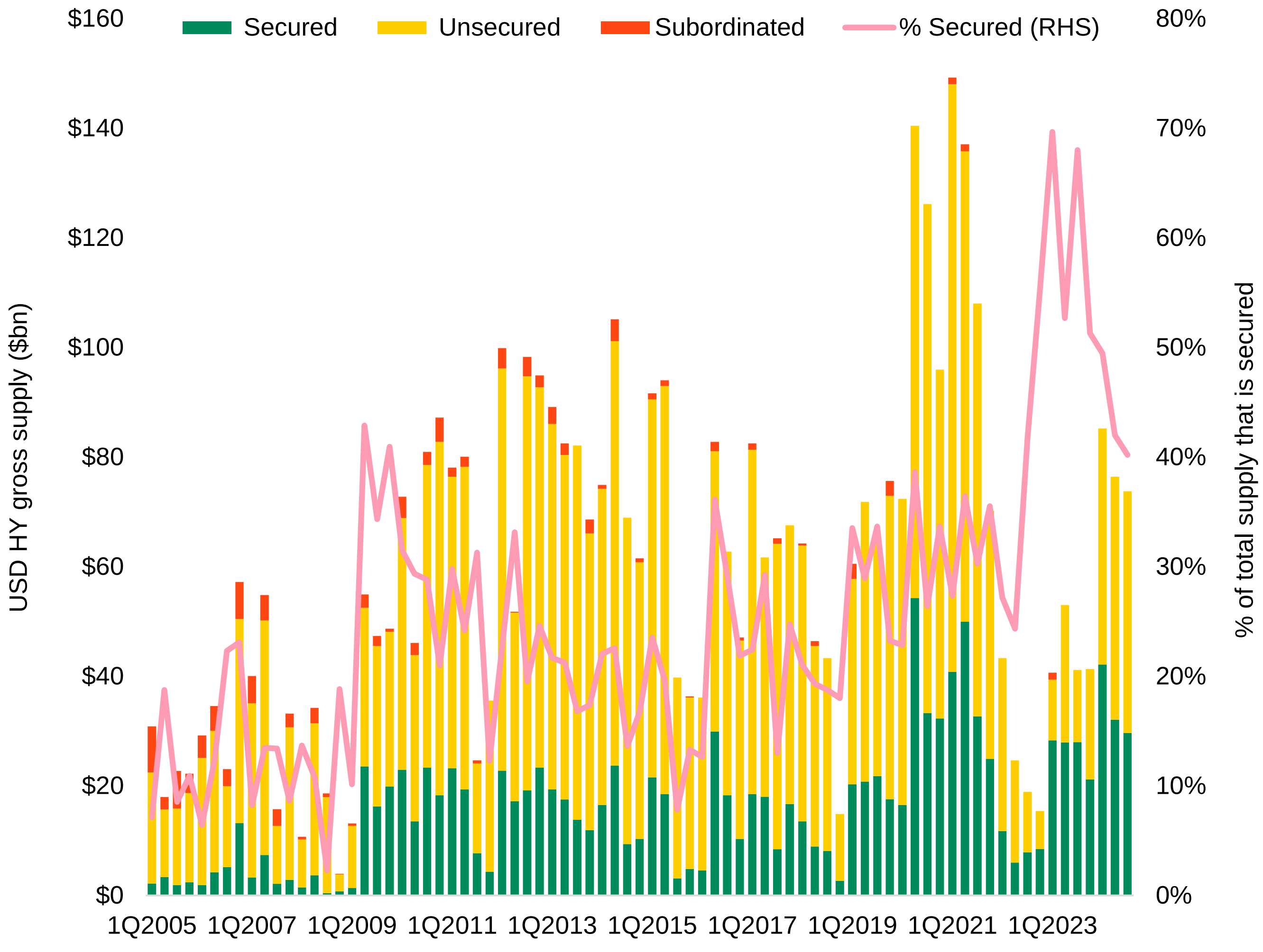
Additionally, debt issued in recent years has been more heavily skewed towards secured supply (Exhibit 11) – which sits higher in the capital structure relative to unsecured debt. This has also likely contributed to resilient spread valuations, in our view. Another notable takeaway from Exhibit 11: subordinated issuance is also less common, relative to 10-15 years ago. This is another example of how the USD HY market has evolved.

Lower net supply has (unsurprisingly) had an impact on the size of the USD HY market. In fact, the notional (par) amount outstanding for the Bloomberg USD HY Corporate Index has *declined* 13% since year-end 2021 ($1.57 trillion). As shown in Exhibit 12, at $1.37 trillion as of October 2024, the index is only slightly above where it stood in 2015 ($1.32 trillion). This compares to the Bloomberg USD IG Corporate Index, which has *grown* 18% since year-end 2021 (from $6.2 trillion, to $7.3 trillion; again, Exhibit 12).

This technical tailwind (regarding the size of the USD HY market) has likely been further exacerbated by the reinvestment of higher USD HY coupons in recent years, on an ongoing basis (Exhibit 13). Finally, for reference, we provide a snapshot of how sector weightings have evolved for the USD HY market in Exhibit 14.

Exhibit 11: More secured USD HY supply in recent years

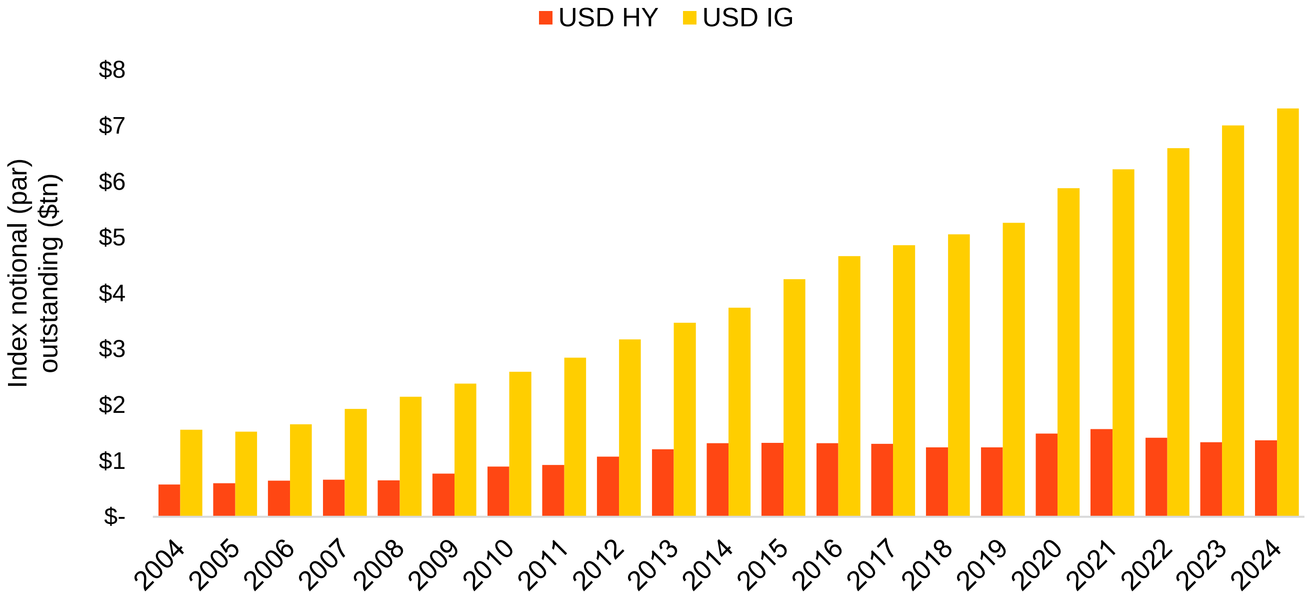
USD HY quarterly gross supply by capital structure positioning, and the share of total supply that is secured



Source: Pitchbook LCD, BlackRock. Captures data through 3Q2024, as of October 16, 2024.

Exhibit 12: The USD HY index has declined 13% since year-end 2021, while USD IG has grown 18%

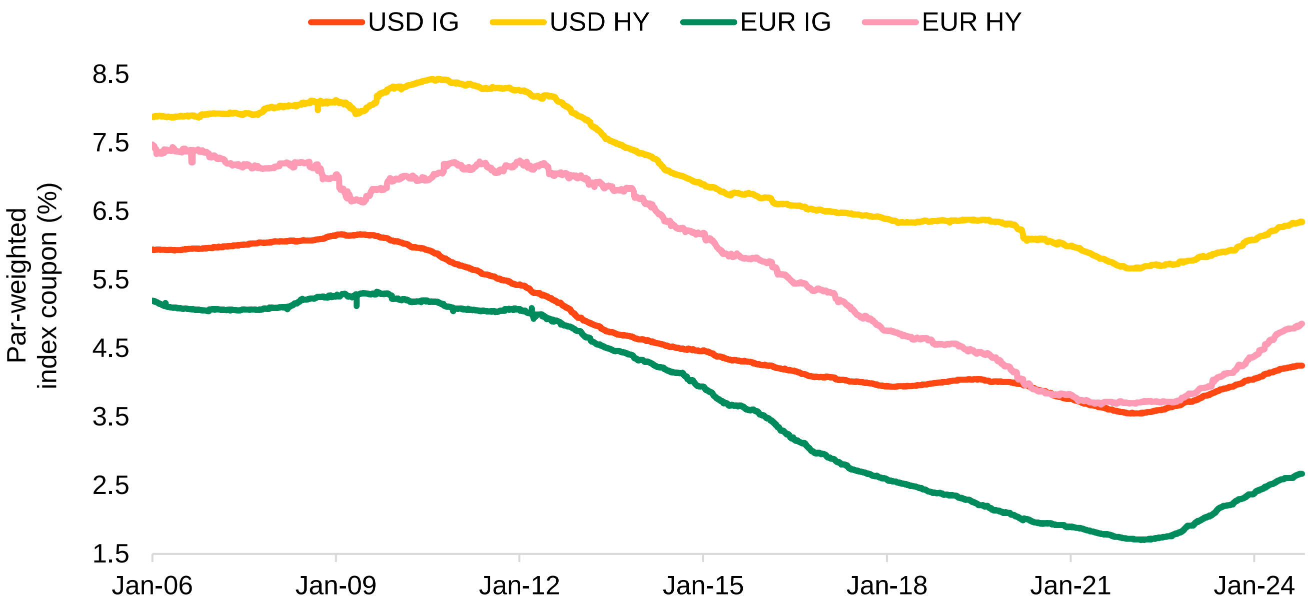
Notional (par) amount outstandings ($tn) for the Bloomberg USD HY and USD IG Corporate indices



Source: Bloomberg, BlackRock. As of each calendar year-end from 2004 to 2023, and as of October 15, 2024. Excludes debt that is not index eligible.

Exhibit 13: Reinvestment of higher USD HY coupons is occurring against backdrop of a shrinking USD HY market – another technical tailwind

Average par-weighted coupon for the Bloomberg USD and Pan-Euro IG and HY Corporate indices



Source: Bloomberg, BlackRock. As of October 15, 2024.

Exhibit 14: A shifting sector mix in USD HY

Sector-level weights (%, by market value outstanding) for the Bloomberg USD HY Corporate Index

	Dec-17	Dec-19	Oct-24
Energy	13.9	11.6	11.7
Technology	7.2	6.7	7.5
Cable Satellite	7.2	8.0	6.3
Healthcare	6.9	6.1	5.5
Retailers	2.8	2.5	4.9
Finance Companies	2.9	2.6	3.7
Gaming	3.0	3.6	3.4
Media Entertainment	4.1	4.8	3.4
Leisure	0.9	1.0	3.3
Consumer Cyc Services	2.0	2.8	3.3
Wirelines	3.8	3.6	3.2
Insurance	1.6	2.4	2.8
Utility	2.7	2.4	2.7
Chemicals	2.6	2.3	2.5
Metals and Mining	4.5	3.3	2.5
Packaging	2.6	2.8	2.5
Building Materials	1.5	1.6	2.3
REITs	0.7	1.4	2.2
Automotive	2.3	2.2	2.2
Aerospace/Defense	2.0	2.6	2.1
Food and Beverage	1.9	2.6	2.0
Diversified Manufacturing	1.0	1.2	1.9
Pharmaceuticals	2.4	2.4	1.6
Airlines	0.4	0.4	1.5
Wireless	4.9	4.5	1.5
Consumer Products	1.2	1.9	1.5
Restaurants	1.1	1.2	1.3
Construction Machinery	1.2	1.2	1.3
Other Industrial	1.3	1.2	1.2
Other Financial	0.9	1.0	1.1
Home Construction	2.4	2.3	1.1
Lodging	0.4	0.9	1.0
Transportation Services	1.0	1.0	1.0
Brokerage Asset managers Exchanges	0.4	0.4	0.9
Banking	2.7	2.0	0.9
Environmental	0.3	0.5	0.7
Supermarkets	0.7	0.5	0.6
Paper	0.5	0.5	0.5
Railroads	0.0	0.0	0.2
Tobacco	0.1	0.2	0.1

Source: Bloomberg, BlackRock. As of October 14, 2024.

Unless otherwise stated, all reference to $ are in USD.

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