High Yield Bond and Senior Secured Bank Loan Outlook

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High Yield Observations

Fundamentals

- The Moody's global speculative grade default rate remained flat in February at 2.8%. Rising corporate fundamental headwinds due to a weakening economic environment and tightening lending standards combined with restrictive rates are expected to cause default rates to rise. Moody's expects that the default rate will rise to 4.3% by December 2023. This default rate compares to its most recent cyclical peak of 6.8% at year-end 2020 and a long-term average of 4.1%.
- Maturities during the 2023-2034 period are low given the magnitude of recent refinancings which took advantage of low interest rates and the technical tailwind provided by the Fed's earlier financial initiatives.
- EBITDA rebounded significantly in 2021 but began to exhibit margin pressure in 2H22, which is projected to intensify in 2023 due to cost and recessionary pressures.
- Coverage levels going into the recessionary environment are starting strong at current EBITDA levels but are projected to decline going forward.

Technicals

- HY fund flows in February were a negative -$9.6B compared with a negative -$756M in January. For all of 2022, HY funds flows were -$33.3B, the largest outflow since 2018.
- In February, the HY market gave back quite a bit of the prior month's gains with a -1.29% return compared with a strong +3.91% return in January. February's performance reflected higher concerns for a more hawkish Federal Reserve. The HY market's full year 2022 performance was -11.22%.
- February's reversal was led by Telecommunication (-2.85%), Cable TV (-2.83%), and Railroads (-2.56%).
- February's returns by ratings reflected a risk off environment despite CCCs scratching out a positive +0.24%, while BBs, the most sensitive to rates,
- declined -1.84% and Bs declined -1.02%.
- Primary market issuance was $14.3B in February, down from $19.3B in January, but up from an anemic $2.3B in December. Total 2022 issuance was just $125.8B, Full-year 2021 issuance was $490.7B.

Valuations

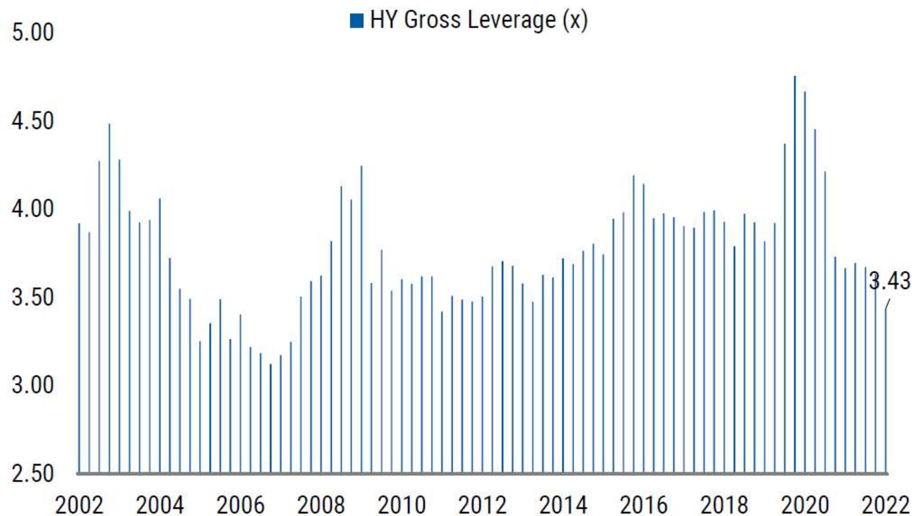
- Credit quality going into a recession remains resilient reflecting the positive impacts of stimulus programs and the COVID vaccine rollout on economic activity during and following the pandemic.
- HY spreads going forward will likely widen given higher interest rate concerns and more credit risk in lower rated credits although technical tailwinds reflecting the low level of new issuance and carry should remain supportive near term.
- Given still-low absolute Treasury yields, higher-quality carry remains attractive on a risk/reward basis.
- Risk/reward for CCCs will continue to be volatile as spreads widen further in a declining economic environment and stricter lending requirements.

Macro

- High yield returns will remain susceptible to an increasing interest rate outlook, declining economic environment, and any adverse impacts resulting from the Russian invasion and rising geopolitical tensions with China.
- KDP believes that higher-quality credits will continue to offer attractive risk/return opportunities compared to other fixed income classes given their:
  - Resilient high credit metrics
  - Significant spread advantages
  - Relative shorter duration
  - Lower correlation to rising interest rates
- KDP reiterates and maintains its up-in-quality preference with a focus on senior secured bonds.

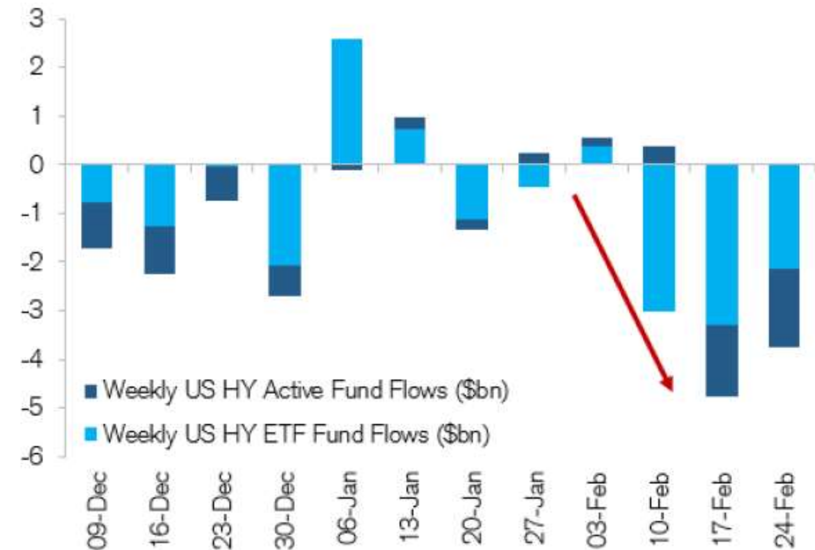
The Case for High Yield

Fundamentals: Leverage Remains Moderate in February, Well Below Earlier Periods Levels. A Deteriorating Economic Environment May Limit Access to Capital Markets By Lower Tier Credits Causing Increased Default Levels.



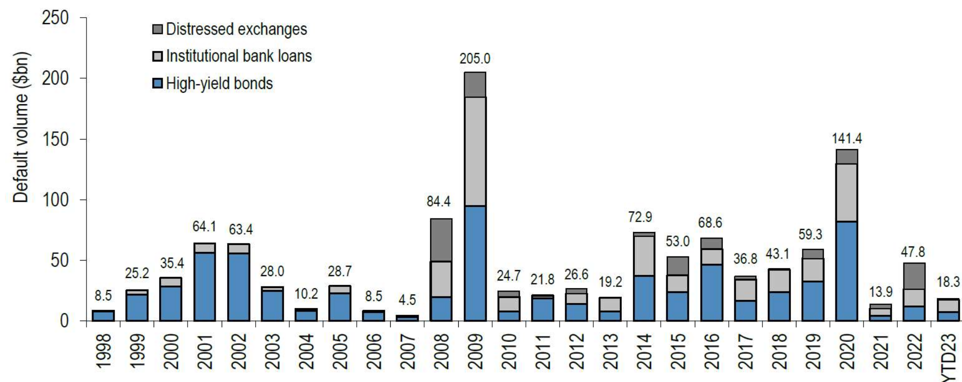
Source: Morgan Stanley Research, Bloomberg, S&P Capital IQ *3/2/2023*

Technicals: HY Funds In February Recorded Their Second Largest Outflow In The Last Year Totaling -$9.3B. ETFs Reported Their Largest Monthly Outflow Totaling -$7.9B.



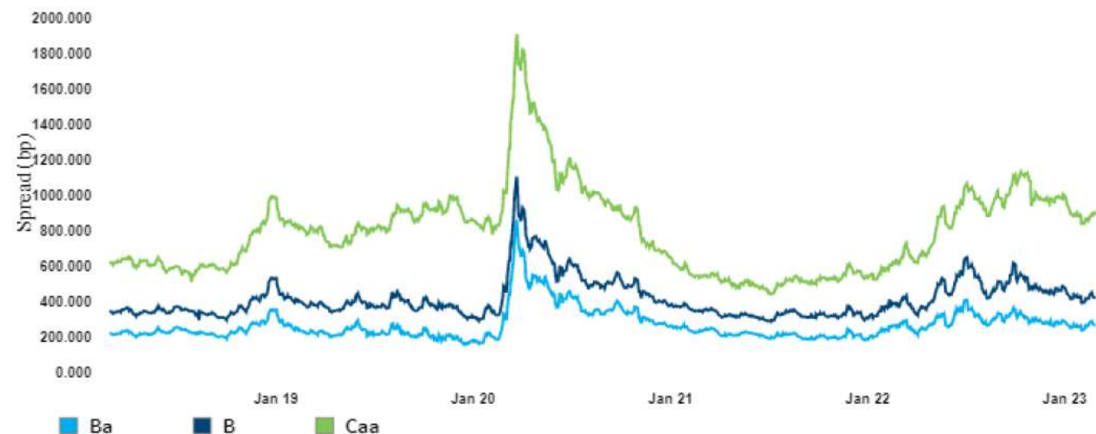
Source: Credit Suisse, EPFR *3/1/2023*

Macro: The Rise in Interest Rates and Stricter Lending Standards Will Lead to Rising Distress Typically Leading To Higher Default Levels.



Source: J.P. Morgan *3/1/2023*

Valuation: Less Volatile BB Credits Will Continue To Offer Best Beta-Adjusted Returns Near Term Given Their Increase in Carry and Lower Volatility In An Increasing Distressed/Default Outlook.



Source: Bloomberg Indices, Barclays 3/1/2023

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Senior Secured Bank Loan Observations

Fundamentals

- The default rate for leveraged loans was 1.66% in February, up 49bp from 1.17% in January.
- Loans are seeing an increase in distressed names as the loan market, primarily single-B rated, faces declining market liquidity and economic outlook, combined with the spike in interest rates which is indicative of an increasing pace of rating downgrades and defaults going forward.
- No near-term maturity concerns reflect the recent record levels of refinancing/repricing. Bond for loan takeout transactions have increased significantly in 2023.
- Overall, the leverage spike and coverage decline in 2020 that was due to the takedown of debt as companies sought to raise cash to enhance liquidity and maturity runways have significantly improved. The trend going forward is deteriorating reflecting margin pressures and tightening financial conditions.

Technicals

- Leveraged loans posted a +0.59% return in February compared with a +2.58% return in January. Full year 2022 returned a modest +0.06%. February's performance reflected a significant outperformance versus HY bonds in light of a rising forward curve and improved capital markets access.
- CCC-rated loans posted the highest return in February at +2.33%, followed by Bs at +0.65% and BBs at +0.07%. For all of 2022, returns by rating highlighted investor preference for higher quality loans. Indeed, all of the positive returns for the asset class were in BB-rated loans. For 2022, BBs posted returns of +3.24% compared with Bs at -0.74% and Split B/CCC at -13.55%.
- February's positive performance was broad based with the best-performing sectors being Energy with a +1.07% gain, Housing with a 0.89% return and Industrials with a +0.85% return. For all of 2022, the best performing sectors were Energy (+7.4%), Utilities (+5.2%) and Transportation (+3.4%).
- Loan retail flows continued to be negative in February at -$2.2B compared with -$1.1B in January.
- Loan issuance (ex-refi) was weak again in February at $6.4B compared with $13.7B in January and $5.5B in December. For reference, loan issuance in January 2022 was $50.9B before beginning to decline. Indeed, total 2022 loan issuance (ex-refi) totaled $163.1B compared to $385.6B in 2021.
- CLO issuance was $15.2B in February up from a weak $6.8B in January and an anemic $4.7B in December. On a positive note, CLOs are most of the buyer base and continue to be a stable source of loan demand and stability.

Valuations

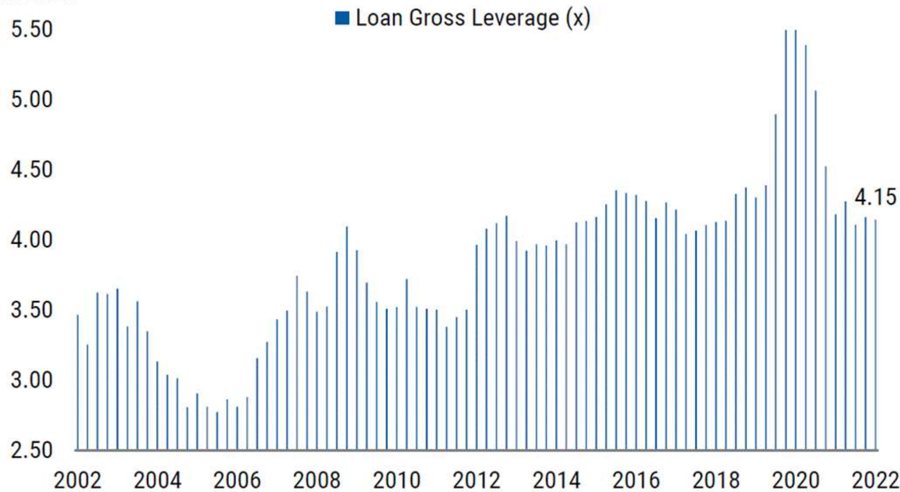
- The average loan price at the end of February was $94.52, a decrease of $0.03 month over month.
- The spread to the 3-year takeout widened +5bp to 545bp.
- At the end of February, the yield to the 3-year takeout widened +63bp to 9.78%.
- Loan volatility continues to be significantly lower when compared to HY bonds as loans are higher in the cap structure, have higher recovery levels, and most importantly, float with rising LIBOR/SOFR.

Macro

- Loans, due to their negative convexity and short duration, provide one of the most compelling asset classes given their higher base rates.
- Highly liquid, quality loans trading below par will offer an attractive carry trade while providing upside as interest rates rise or loans mature.
- High-quality secured floating-rate bank loans are compelling given the attractive risk/reward adjusted returns, and portfolio diversification benefits.
- The floating-rate nature of bank loans traditionally provide a natural hedge to interest rates, low duration risk, and have low correlation to other asset classes.
- Retail flows likely to remain very volatile in 2023 vacillating between higher floating rates and rising credit concerns of lower quality loans given the loan is primarily single-B rated.
- Although CLOs issuance declined significantly in 2022 from 2021 levels with CLO AAA spreads tracking IG spreads wider negatively impacting arbitrage, it was the second busiest year on record. CLO equity arbitrage thus far in 2023 is attractive providing a significant tail wind.

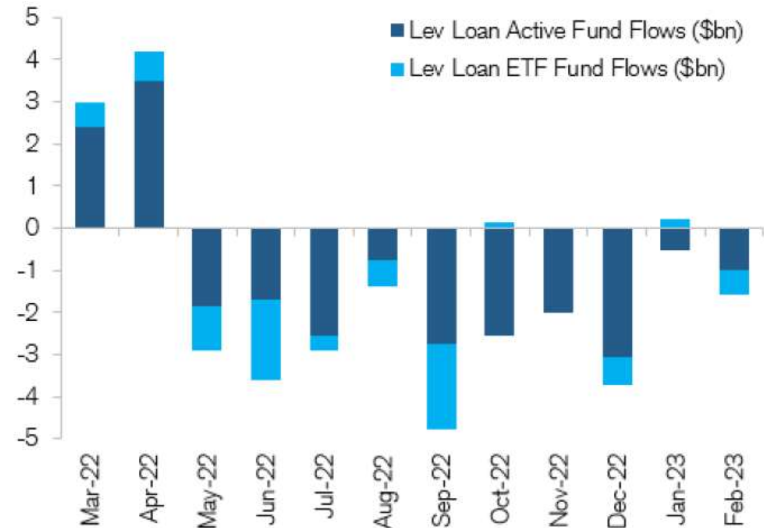
The Case for Senior Secured Bank Loans

Fundamentals: Leverage Levels Remain Relatively Low From Pandemic Highs. A Deteriorating Economic Environment And Rise In Interest Rates Will Limit Lower Tier Credits' Access To Capital Markets.



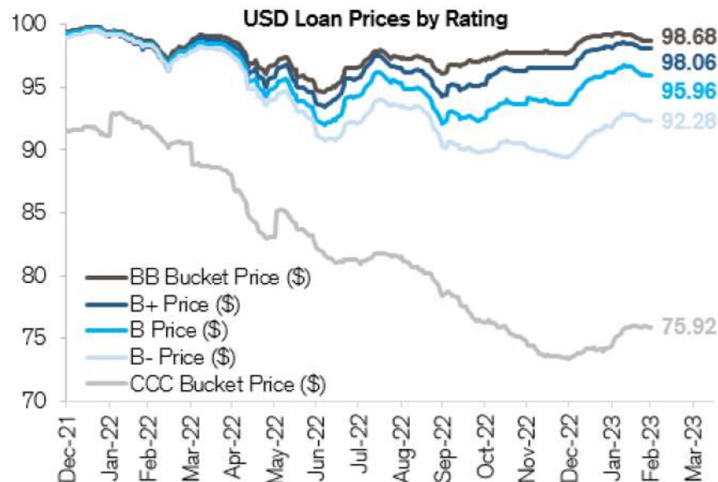
Source: Morgan Stanley Research, Bloomberg, PitchBook LCD, S&P Capital IQ *3/2/2023*

Technicals: Loan Outflows Picked Up in February Totaling -$2.2B. Although Modest Compared To Last Year This Was The Tenth Consecutive Outflow On Continuing Credit Concerns.



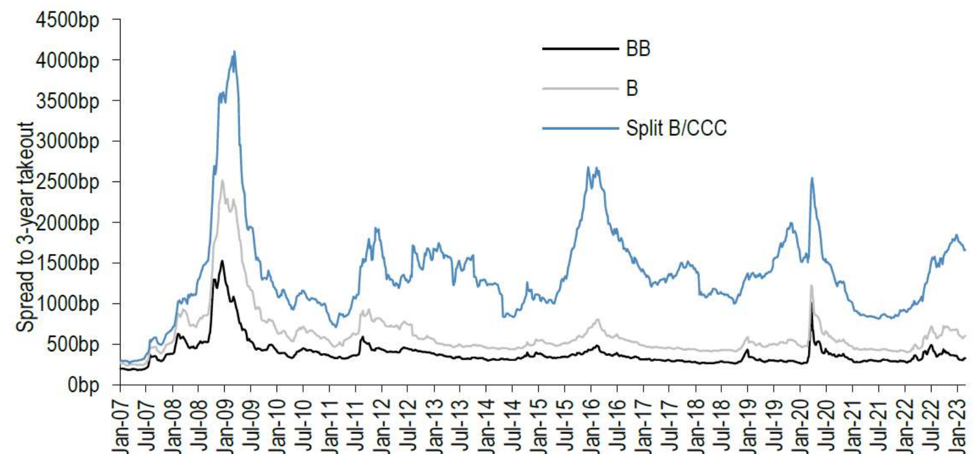
Source: Credit Suisse, EPFR, 3/1/2023

Macro: Although The Upside In Higher Quality Loans Is Limited, Their Outperformance Reflects The Deteriorating Fundamental Backdrop For Loan Issuers, As Ratings Momentum Deeply Negative.



Source: Credit Suisse 3/1/2023

Valuation: Higher Quality Loan Spreads Have Been Relatively Stable In Recent Months Compared with Rise in B/CCCs Spreads with Investor Concerns on Loan-Only Lower Rated Issuers.



Source: J.P. Morgan; IHS Markit, 3/1/*2023*

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