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 ticked higher sequentially to 2.3% in August. The default rate had its cyclical peak of 6.8% at year-end 2020. Moody's expects that the default rate will rise to 2.9% by December 2022.
- Near-term maturities remain low given the magnitude of recent refinancings taking advantage of last year's low interest rate environment and the technical tailwind provided by the Fed's financial initiatives.
- EBITDA rebounded significantly in 2021 and is now beginning to exhibit significant margin pressure in 2022 due to cost pressures.
- Coverage levels remain resilient at current EBITDA levels as companies retire borrowings used to shore up liquidity in 2020.

Technicals

- HY fund flows were -$5.3B in August, returning to the negative trend seen in most of 2022. In July, the HY market had a flows respite at +$3.7B compared with -$3.8B in June and -$3.8B in May. Flow totals in 2021 were -$13B.
- The HY market reversed course again in August posting a -2.40% return compared with July's +6.02% return, June's -6.81% return and May's +0.25% return. Much of August's weakness occurred in the back half of the month on investors renewed Federal Reserve policy fears.
- Most HY sectors were negative in August with Healthcare the biggest decliner at (-4.85%), followed by Cable (-4.03%), Environmental (-3.75%), Broadcasting (-3.73%) and Restaurants (-3.50%). Only four sectors posted positive returns, indeed, marginally. Steel was the best performer (+0.83%).
- Curiously, performance by rating favored lower quality bonds. CCCs returned a marginally positive +0.31% return, Bs posted a -2.34% return, and BBs returned -3.00%.
- Primary market issuance continues to be anemic totaling just $8.0B in August compared with $1.8B in July, $11.0B in June and $2.95B in May. Full-year 2021 issuance was $490.7B, up from $479.8B in 2020.
- Issuance proceeds since April 2020 have been destined primarily for enhancing liquidity and refinancing, but issuance has subsequently fallen off sharply in 2022 due to the increase in all-in yields and cash outflows.

Valuations

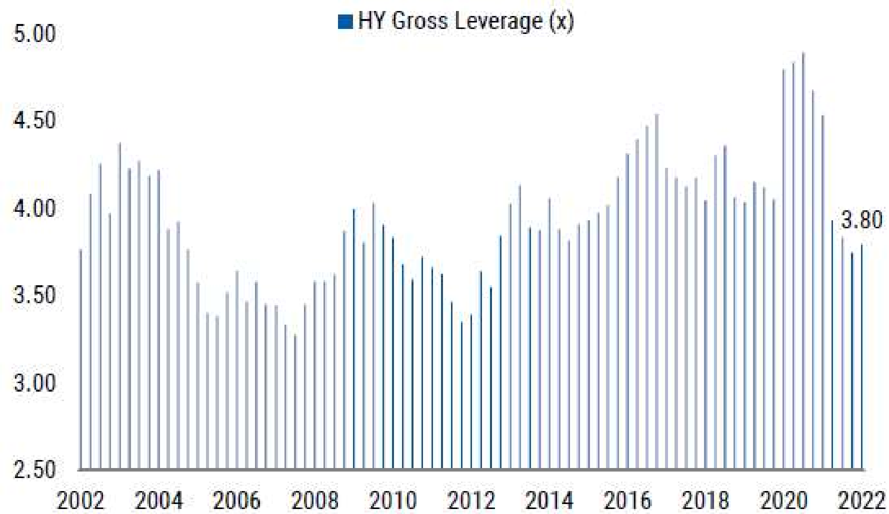
- Credit quality has materially improved reflecting the positive impacts of stimulus programs and the COVID vaccine rollout on economic activity.
- HY spreads going forward will likely widen given higher interest rate concerns and more credit risk in lower rated credits.
- Given still-low absolute Treasury yields, higher-quality carry remains at attractive relative levels on a risk/reward basis.
- Risk/reward for CCCs will continue to be volatile as spreads widen further.

Macro

- High yield returns will remain susceptible to an increasing interest rate outlook and any adverse impacts resulting from the Russian invasion.
- 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.

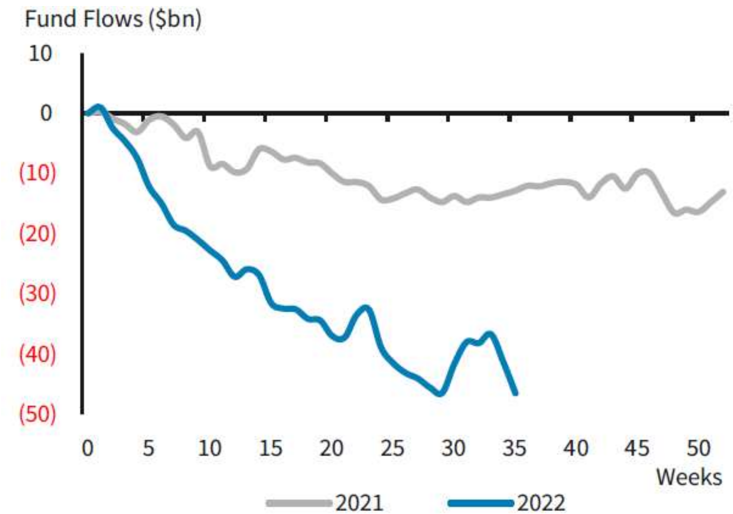
The Case for High Yield

Fundamentals: Although Leverage Increased Moderately in August with Economic Activity Deteriorating, Levels Remain Well Below Earlier Periods



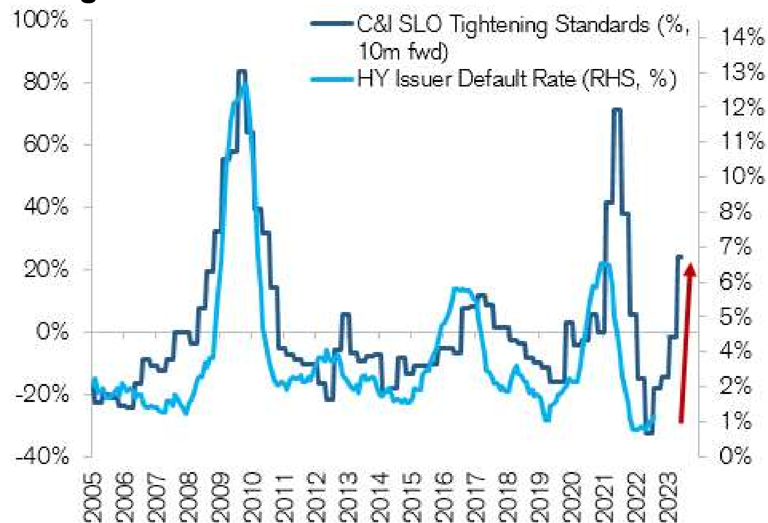
Source: Morgan Stanley Research, Bloomberg, S&P Capital IQ, *9/1/2022*

Technicals: August Saw a Reacceleration of Weekly Retail Cash Outflows Totaling -$5.2B on Rising Interest Rate Concerns Bringing YTD Outflows to -$36.2B



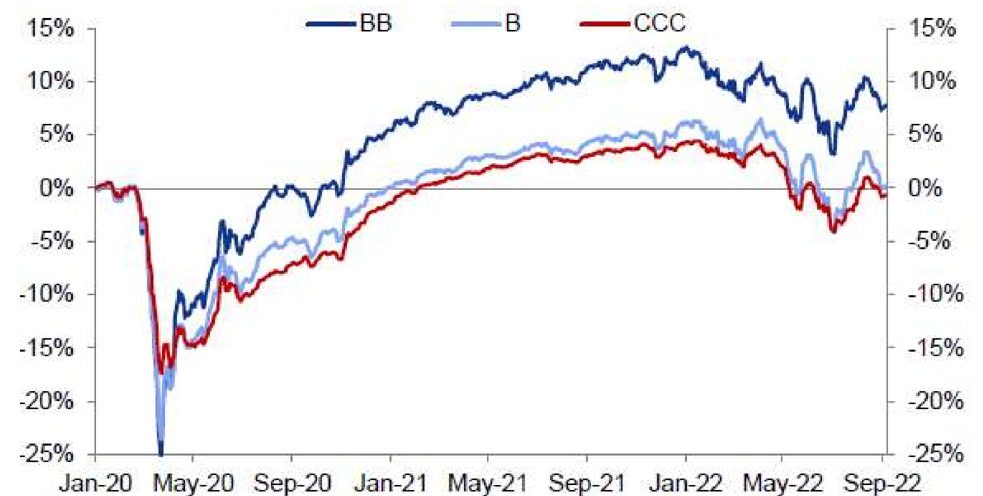
Source: Lipper, Barclays Research 9/9/2022

Macro: HY Defaults are Rising as Banks Tighten Lending Standards but Projected to Remain Benign and Well Below Average Historical Levels



Source: Credit Suisse *9/7/2022*

Valuation: HY BBs Continue to Outperform On a Beta Adjusted Basis



Source: Bloomberg-Barclays, Goldman Sachs 9/8/2022

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Senior Secured Bank Loan Observations

Fundamentals

- The par-weighted default rate for leveraged loans was 0.81% in August compared with 0.66% in July, 0.68% in June and 0.67% in May. By comparison, the default rate began 2021 at 3.95%.
- Loans are seeing an increase in distressed names lately given declining market liquidity and economic outlook, 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.
- 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 in recent quarters.

Technicals

- Leveraged loans posted a 1.51% return in August compared with +1.93% return in July, -1.93% in June and a -2.33% return in May.
- B-rated loans posted the highest return in August at +1.80%, Split B/CCC-rated loans returned +1.60% and BB-rated loans returned +1.24%.
- Leveraged loans significantly outperformed bonds in August. The best-performing sectors were Housing (+2.67%), Automotive (+2.20%) and Metals/Mining (+2.17%).
- Loan retail outflows in August were -$2.6B compared with July's -$4.1B outflow, June's -$4.1B outflow and May's outflow of -$3.0B. These four back-to-back-to-back-to-back negative months are a big reversal for the Loan Market that had not seen a negative month since October 2020.
- Gross loan issuance in August was $12.1B versus July's $3.5B, which was the lowest since January 2010, and compares with June's $16.3B and $17.3B in May. Gross loan issuance for all of 2021 amounted to $835.1B, up 98% year-over-year.

Valuations

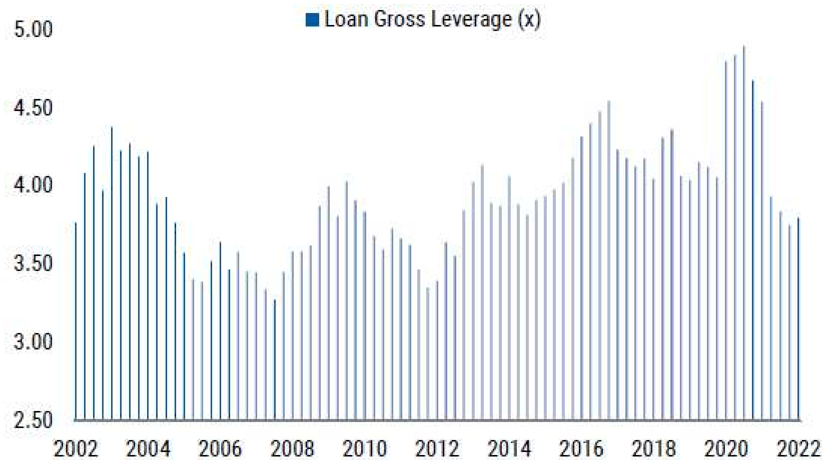
- The average loan price was 94.66 at the end of August compared with 93.76 a month earlier, and up from 92.45 at the end of June.
- The spread to the 3-year takeout widened +66bp to 673bp.
- At the end of August, the yield to the 3-year takeout widened +37bp to 9.32%.
- Loan volatility continues to be significantly lower when compared to HY bonds as loans are higher in the cap structure, have higher recovery levels, and float with LIBOR and SOFR.

Macro

- Loans, due to their negative convexity and short duration, provide one of the most compelling asset classes.
- Highly liquid, quality loans trading close to par will offer an attractive carry trade while providing upside as interest rates rise.
- 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 are likely to remain volatile in 2022 with interest rates expected to rise reflecting inflationary pressures due to supply disruptions as well as labor tightness offset by rising credit concerns of lower quality loans.
- CLOs issuance has moderated in 2022 with CLO AAA spreads tracking IG spreads wider negatively impacting arbitrage.

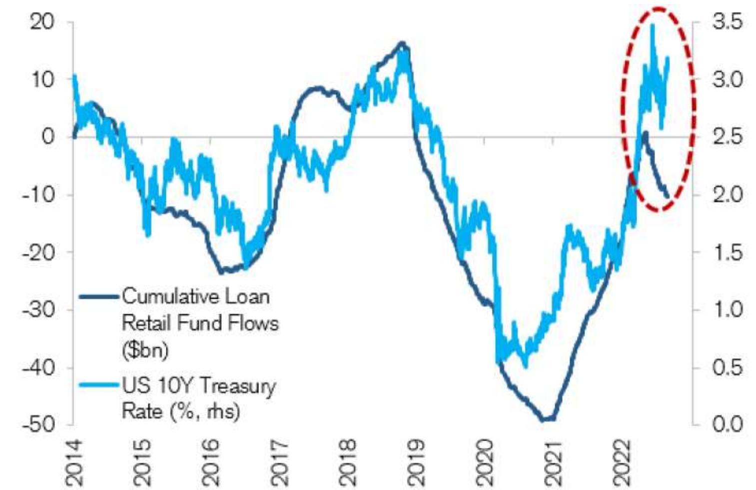
The Case for Senior Secured Bank Loans

Fundamentals: Although Leverage Increased Moderately in August with Economic Activity Deteriorating, Levels Remain Well Below Earlier Periods



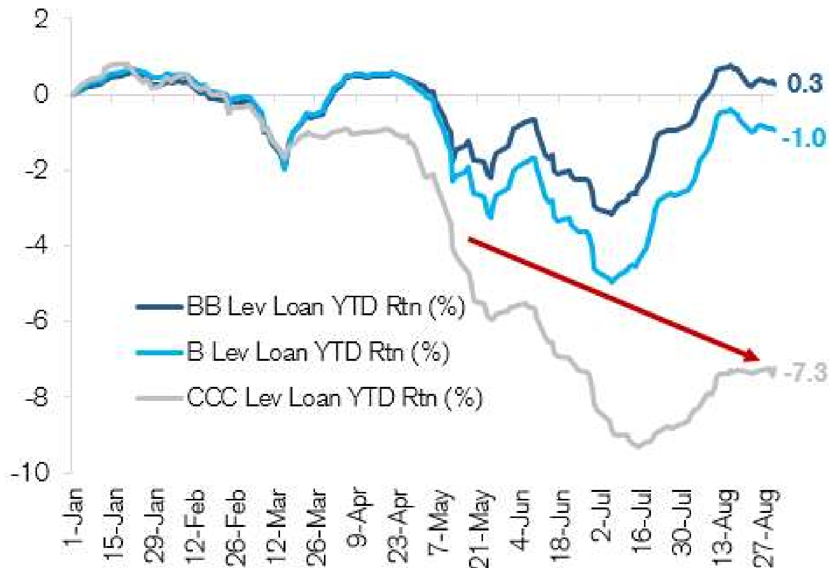
Source: Morgan Stanley Research, Bloomberg, S&P Capital IQ, *9/1/2022*

Technicals: Asset Class Posted Fourth Consecutive Outflow As Investor Concerns on Lower Quality Issuers' Ability to Service Cash Flows More Than Offset Rising Coupon Payments as Treasury Rates Rise



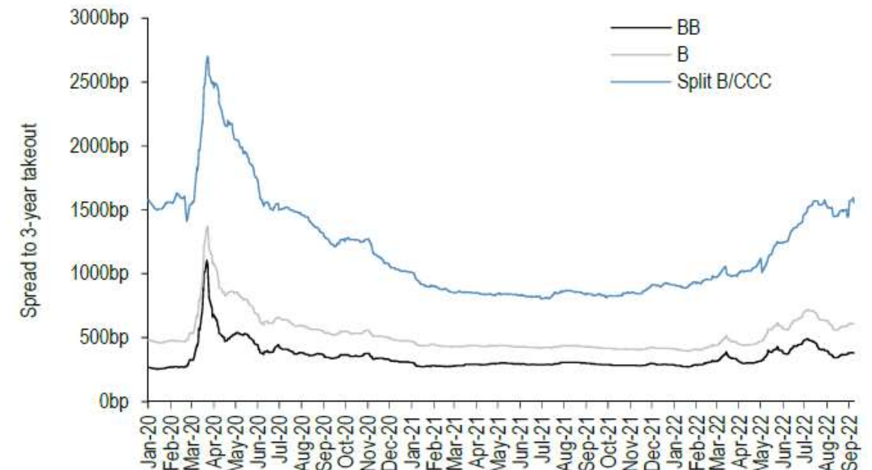
Source: Credit Suisse, EPFR 9/8/2022

Macro: Higher Quality Loans Continue to Outperform YTD



Source: Credit Suisse 9/8/2022

Valuation: Higher Quality Loan Spreads Relatively Stable as CCCs Widen in Volatile Rates Environment



Source: J.P. Morgan; IHS Markit *9/9/2022*

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