Public Credit

High yield bond yields and spreads rose to 9.86% and 575 basis points at quarter-end. And while yields are well above their previous year-to-date high on 6/30 of 9.2%, spreads remain 63 basis points below their wide of 637 basis points with only CCC spreads reaching their 2022 wides. The average high bond is now down -19pts (+4% coupon) for roughly a -15% YTD cumulative return. Overall, investor sentiment worsened in September with high yield spreads increasing by the third most since August 2011 (+115 basis points) and retail fund outflows accelerating reaching $53.6bn year-to-date.

Spreads Across Corporate Credit, by Index and Rating (2022)

	(In Basis Points)					
	High Yield	**IG**	**BBB**	**BB**	**B**	**CCC**
9/30/2022	575	167	203	373	593	1320
2022 High	637	171	207	439	682	1320
2022 Low	370	94	115	248	399	718
12M Average	456	125	154	308	483	914
US Recession Average	971	252	355	561	925	2149
US Non-Recession Average	519	117	172	332	521	1054

Source: J.P. Morgan

Given the market backdrop, high yield corporates have avoided coming to market and a mere $9 billion of high yield bonds and $8.4 billion of institutional loans priced in September and overall capital market activity for the third quarter – $18.9 billion for high yield and $24 billion for leveraged loans was the lightest since the first quarter of 2009 and 2010 respectively.

Default/distressed volume in the third quarter totaled $23.4 billion, up from $10.4 billion in the second quarter and $8.6 billion in the first quarter. Year to date, a total of 15 companies have defaulted totaling $25.8 billion in bonds ($12.2 billion) and loans ($13.6 billion). Including distressed exchanges, both the US high yield bond and loan default rates have ticked up to 1.6%. Despite the modest rise in default rates, credit fundamentals remain generally strong. While real GDP growth is slowing, high inflation is sustaining nominal GDP growth – and debt interest is paid in nominal dollars. Moreover, during the past couple of years of extremely low rates, many companies borrowed to build their cash balances and extend out their maturities. As a result, much of the refinancing for US high yield debt, for example, won't be due until 2025, with only 8% maturing before then. Hence, we expect default rates to remain low for the foreseeable future not dissimilar to what we experienced in the late 1990s and early 2000s.

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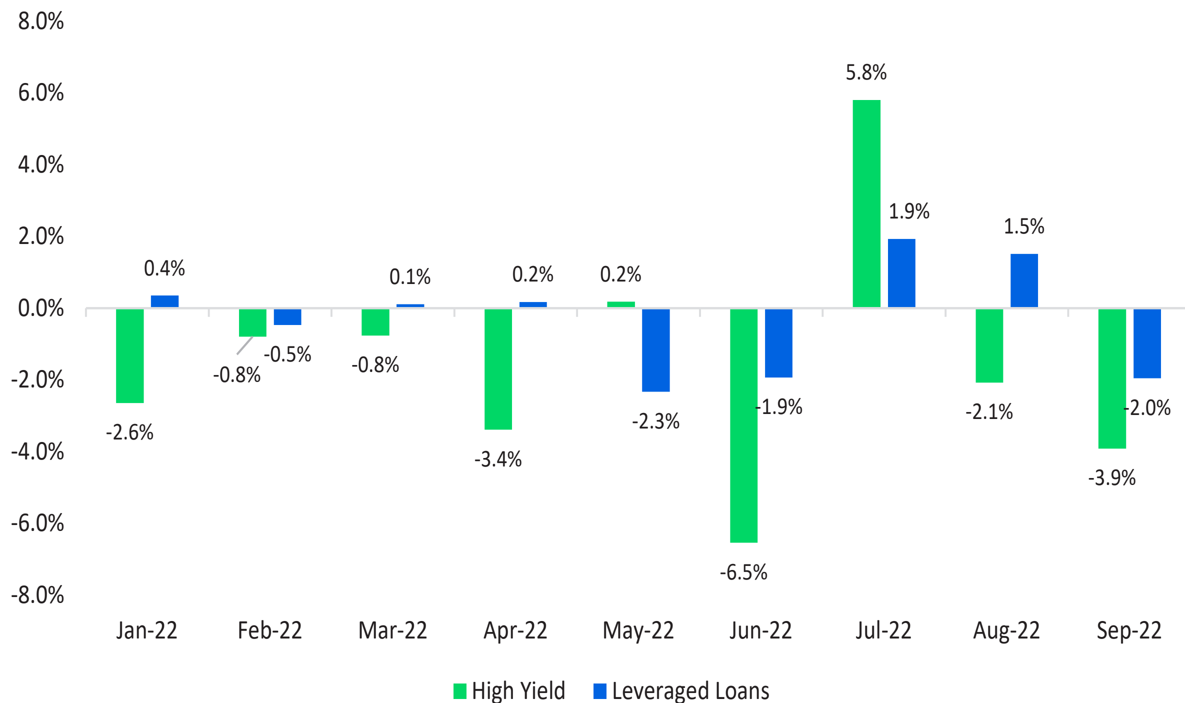
Leveraged Loans Continue to Outperform High Yield so far in 2022



Source: Bloomberg

As you can see above, one of the brighter spots in the fixed income market this year has been leveraged loans which have been the most resilient fixed income asset class down only 2.7% on a year-to-date basis. This outperformance is mostly due to lower sensitivity to interest rates than other fixed income asset classes as well as the general supply/demand dynamics in the loan market. Similar to high yield, new issuance for the year has been down significantly, but demand has remained robust as investors sought protection from rising interest rates. However, as economic growth is slowing, the question now turns to whether loan issuers can continue to service higher debt payments especially as borrower fundamentals weaken. In fact, investors are becoming more concerned with leveraged loans beginning to see outflows with September's $4.8 billion outflow representing the 10th largest on record.

Emerging Market Debt:
An Opportunity?

Emerging markets debt are on track for their worst performance since 2008. Consequently, investors are reevaluating trends that underpinned investment in emerging markets over the last two decades. Until 2020, many EM countries enjoyed (a) declining interest rates, which often approached the levels seen in developed markets; (b) robust economic growth; (c) strong capital inflows; and (d) the benefits of globalization. These trends enabled these countries and companies to accumulate substantial amounts of debt.

However, many of these trends now appear to be weakening or reversing entirely. Moreover, be it in investment grade sovereigns that continue to face headwinds from continued Fed hikes or high yield sovereigns which face significant credit issues largely stemming from a stronger dollar, there is literally no place to hide.

We remain cautious about the near-term outlook for the asset class, as the combination of massive debt burdens and tightening global financial conditions can further exacerbate the situation.