

# High Yield Credit - Update

## Some breathing room thanks to rate cuts?

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FLASH NOTE

### SUMMARY

- US and euro corporate bonds have been performing well year-to-date, helped by tightening credit spreads and a comfortable carry. US HY bond yields remain above 7% on average (according to the ICE Bank of America index on 12 September). While profit margins showed signs of coming under pressure, Q2 earnings reports painted an overall picture of stable leverage ratios. In addition, the US HY bond default rate fell to a relatively low 2.8% in July. We would expect the upcoming Fed rate cuts to provide some breathing room to indebted companies with noninvestment-grade ratings.
- The highest-quality segment (BB-rated names) has increased its share of the US HY bond universe, while the share of the riskiest segment (CCC-rated) remains relatively low and stable. Our improved stance on US HY (we have moved from underweight to neutral) also stems from the divergence we see between spreads on the riskiest segment—which are close to distressed levels (above 1000 bps) and which we avoid—and the tighter spreads on bonds with a much lower probability of default. We further believe that upcoming Fed rate cuts and the resilience of the US economy will help US HY's prospects.

### SOLID RETURNS FOR HIGH-YIELD CORPORATE BONDS YEAR-TO-DATE

US and euro corporate bonds have been performing well year-to-date, helped by tightening credit spreads and a comfortable carry. US investment-grade (IG) corporate bonds have returned 5.6% year-to-date in USD (to 11 September), while their high-yield (HY) counterparts have returned 6.6%, according to ICE Bank of America indices. Total return performances have been lower in euro credit, standing at only 3.3% for euro IG and 5.6% in euro HY.

Although credit spreads have tightened slightly year-to-date (except in US HY), most of the total return in credit has come from elevated coupons and the fall in

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sovereign bond yields. Returns in excess of sovereign bonds range from 1.1% for US IG to a whopping 4.2% for euro HY, according to our calculations.

**Chart 1: US and euro corporate bond yields**



Source: Pictet Wealth Management, FactSet, 12.09.2024

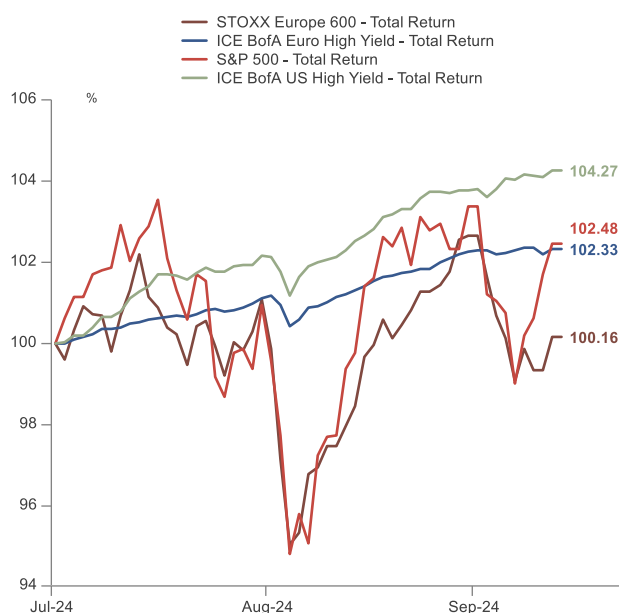
Although yields have fallen steeply over the last 12 months, they remain at historically attractive levels, at 7.5% for US HY and at 6.3% for euro HY (on 12 September, see chart 1). Such elevated coupons offer a significant margin of safety and have actually made HY bonds less volatile. On top of that, the overall duration of HY credits has fallen, reducing the impact of yield movements on total returns.

This relative resilience of US and euro HY bond indices was thrown into sharp relief during the two most recent equity sell-offs, in early August and early September (see chart 2). Spreads widened but only briefly came close to 400 bps while the 500bps threshold that we consider as stressed remained far off (see chart 3).

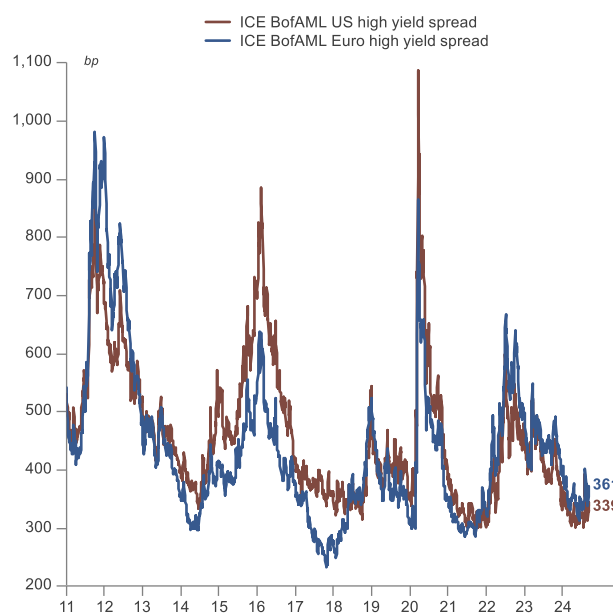
Still-elevated coupons and central bank rate cuts should, we believe, continue to boost bonds' prospects. This is why we have moved from a neutral to overweight position on fixed income in general. We are overweight sovereign bonds given the risk asymmetry that we see in central bank policy (see [Upcoming rate cuts should boost bonds' appeal](#)).

We have also moved from underweight to neutral on US HY bonds, as part of our bid to move up the capital structure of companies, which also involves transitioning from US and global equities. The performance of equities is at risk from multiple compression and over-ambitious earnings targets, while US HY bonds could continue to benefit from tailwinds.

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**Chart 2: Equity and bonds indices total return since 1<sup>st</sup> of July**

Source: Pictet Wealth Management, FactSet, 12.09.2024

**Chart 3: US and euro high-yield corporate bond spreads**

Source: Pictet Wealth Management, FactSet, 12.09.2024

## TAILWINDS STILL BLOWING IN FAVOUR OF US HY BONDS

We have identified several tailwinds for US HY bonds that underpin our more constructive stance on this segment and the downward revision of our year-end spread forecast from 400bps to 350bps (only slightly wider than the 339 bps at which it currently trades (*see chart 3*)).

First the highest-quality segment (BB-rated names) has increased its share of the US HY bond universe (to 52% of the ICE Bank of America US High Yield index), while the share of the riskiest segment (CCC-rated) remains relatively low and stable (at 15%). Our improved stance on US HY also stems from the divergence we see between credit spreads on the riskiest segment, which are close to distressed levels (above 1000 bps) and which we avoid, and the tighter spreads on bonds with a much lower probability of default (*see chart 4*).

We further believe that upcoming US Federal Reserve (Fed) rate cuts and the resilience of the US economy will help US HY's prospects. While profit margins have come under pressure, Q2 earnings report paint a picture of stable leverage and interest coverage ratios, while the US HY bond default rate fell to a relatively low 2.8% in July. As we would expect the upcoming Fed rate cuts to provide some breathing room to indebted companies with noninvestment-grade ratings, the peak in the US HY bond default rate was possibly reached in April (at 4.2%).

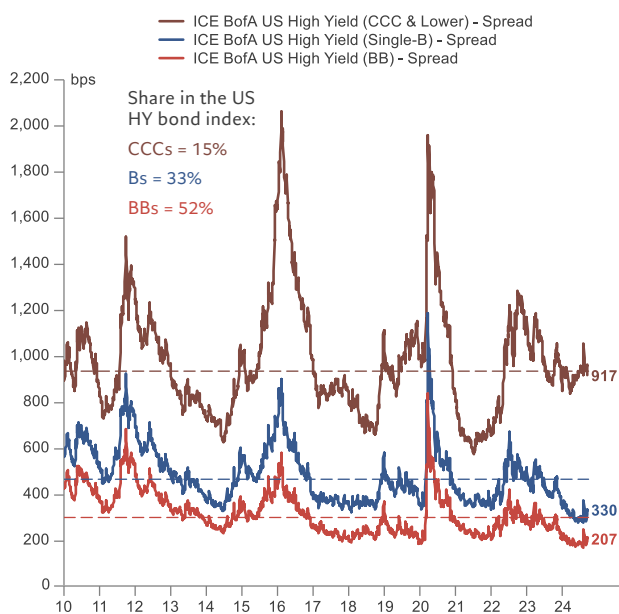
This is low compared to previous default cycles and can be explained both by the resilience of companies' profits thanks to robust nominal US GDP growth, and by the fact that some of the riskiest issuers have moved away of the HY bond market into the syndicated loans and private credit market. Illustrating this point is the

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sharp increase in the size of the syndicated loans market between 2021 and 2023, while the US HY bond market shrunk over the same period (see chart 5). The default rate for US syndicated loans is much higher (6.4% in July) and has not yet come down because loans are floating-rate instruments and as such are directly linked to the Fed’s policy rate. (Of note, 37% of HY bonds issuers also have syndicated loans in their capital structure.)

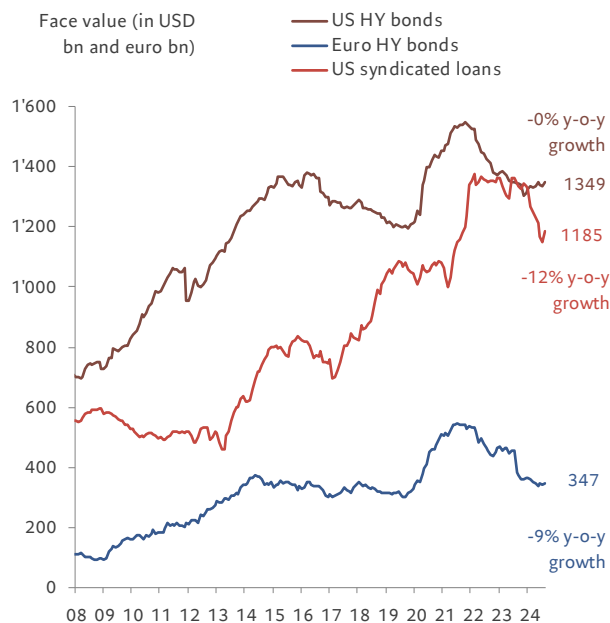
Moreover, around 70% of gross US HY bond issuance year-to-date has been used for refinancing purposes. This means that even though yields are at historically attractive levels for investors, limited net issuance over the last few years has made them scarcer.

Chart 4: US high-yield spreads by rating



Source: Pictet Wealth Management, FactSet, 12.09.2024

Chart 5: Market size of high-yield bonds and loans



Source: Pictet Wealth Management, FactSet, 12.09.2024

**BEWARE THE RECESSION RISK**

Since the downside surprise in the US employment report for July, market participants have perceived a greater risk of recession in the US. A look at the option market for Secured Overnight Financing Rate (which is closely linked to the Fed funds rate) suggests the market currently (on 12 September) sees a 53% probability that the Fed’s main policy rate falls below 3% by December 2025, up from 18% in May. This would be consistent with the Fed having to reverse its restrictive policy rapidly to deal with a potential recession in our view.

Although US HY credit spreads remain tight (at 339 bps on 12 September) and as such do not suggest that a recession is priced in, cyclical sectors have underperformed defensive ones since July. Credits in the automotive, energy, metals & mining and retail sectors have all posted negative excess returns (in excess of sovereign bonds, on 12 September). This sector rotation suggests some concern among investors about the US economic slowdown.

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US HY energy spreads were very tight by historical standard, so it is not surprising that they have reacted strongly to the recent fall in the oil price. Because the energy sector makes up 12% of the ICE Bank of America US HY bond index, a further fall in the oil price could lead to more HY spread widening.

US HY credit spreads could be vulnerable to significant widening (potentially by as much as 500 bps) should the risk of a US recession increase further and the US labour market plummet. Although we do not dismiss the recession risk (to which we assign a 30% probability), we believe that elevated coupons and the improved quality of the US HY bond universe should enable investors to weather the storm until the Fed rate cuts give the most indebted issuers sufficient breathing room.

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