HIGH YIELD SPREAD WIDENING: WAITING FOR GODOT

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The elusive Godot and the absurdity of waiting: after being told, time and again, of his pending arrival, he never appears. This should be familiar to high yield investors as they continue to wait for the magical spread of +600, +700, +800 and beyond.

Index	Date	Price	Yield to Worst (seasonally adjusted)	OAS
ICE BofA U.S. High Yield Index	12/31/2021	103.31	4.32	310
ICE BofA U.S. High Yield Index	12/31/2022	85.88	8.98	481
ICE BofA U.S. High Yield Index	12/31/2023	92.86	7.69	339
ICE BofA BB U.S. High Yield Index	12/31/2021	105.51	3.4	211
ICE BofA BB U.S. High Yield Index	12/31/2022	89.25	7.26	308
ICE BofA BB U.S. High Yield Index	12/31/2023	95.38	6.37	205
ICE BofA Single-B U.S. High Yield Index	12/31/2021	102.25	4.69	351
ICE BofA Single-B U.S. High Yield Index	12/31/2022	87.04	9.34	515
ICE BofA Single-B U.S. High Yield Index	12/31/2023	94.28	7.76	341
ICE BofA CCC & Lower U.S. High Yield Index	12/31/2021	96.21	7.81	678
ICE BofA CCC & Lower U.S. High Yield Index	12/31/2022	70.05	15.69	1170
ICE BofA CCC & Lower U.S. High Yield Index	12/31/2023	79.66	13.03	902

Source: Bloomberg LP, Seix Investment Advisors. As of December 31, 2023. **Past performance is no guarantee of future results.**

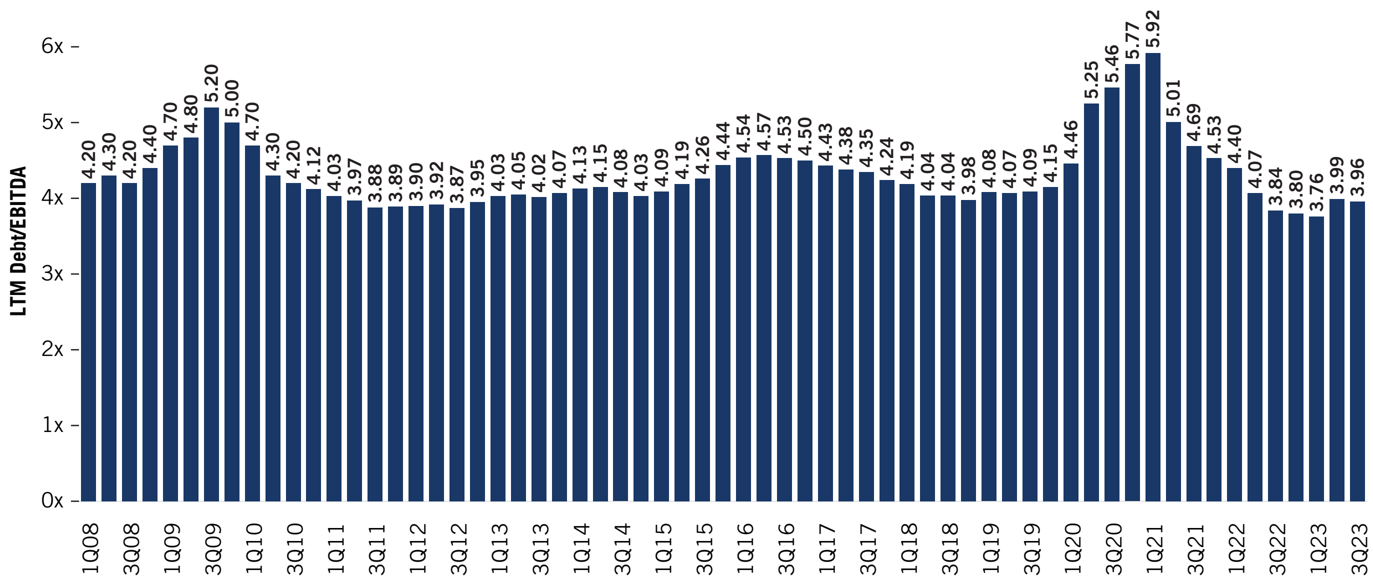
In 2023, many investors sat idle waiting for spreads to widen. However, the heightened quality of the high yield space has made spread widening to the above levels less likely. With yields earlier in 4Q23 in the 9.50% range, and given historical returns when yields have reached those levels, it was clear that grabbing the coupon and locking in the higher payout, regardless of spread, was the correct execution. However, fewer investors took advantage of the +13.46 returns in high yield (as represented by the ICE BofA US High Yield Index), as outflows continued in 2023 (-$7.9 billion) after seeing outflows of -$48.9 billion in 2022.

We ended 2023 having witnessed an interesting juxtaposition in high yield between recessionary fears on the one hand and tighter credit spreads on the other. High yield OAS spreads began the year at +481 basis points (bps), with BBs at +308, single-Bs at +515, and CCCs at +1170. As of 12/31/23, the high yield OAS spread was +339, with BBs at +205, single-Bs at +341, and CCCs at +902. Interest rates (U.S. Treasury 10-year rate) were flat for 2023 (3.88% as of 12/31/23 vs 3.88% as of 12/31/22) and were actually down 110 bps from the high of 4.98% as of 10/19/23.

Given higher recessionary expectations, why are spreads tightening in the high yield markets? For one, a decreasing universe of high yield securities has created a solid technical picture for the space. As clients reach for yield, there is a higher percentage of money going after fewer securities. Additionally, as mentioned above, the strength of issuer fundamentals continues to foster comfort (perhaps even complacency?) with investors.

Leverage continues to track below long-term averages for high yield issuers. Leverage for high yield companies as of 3Q 2023 sat at 3.96x—well below the long-term average of 4.92x and where it stood in 1Q21 of 5.92x.

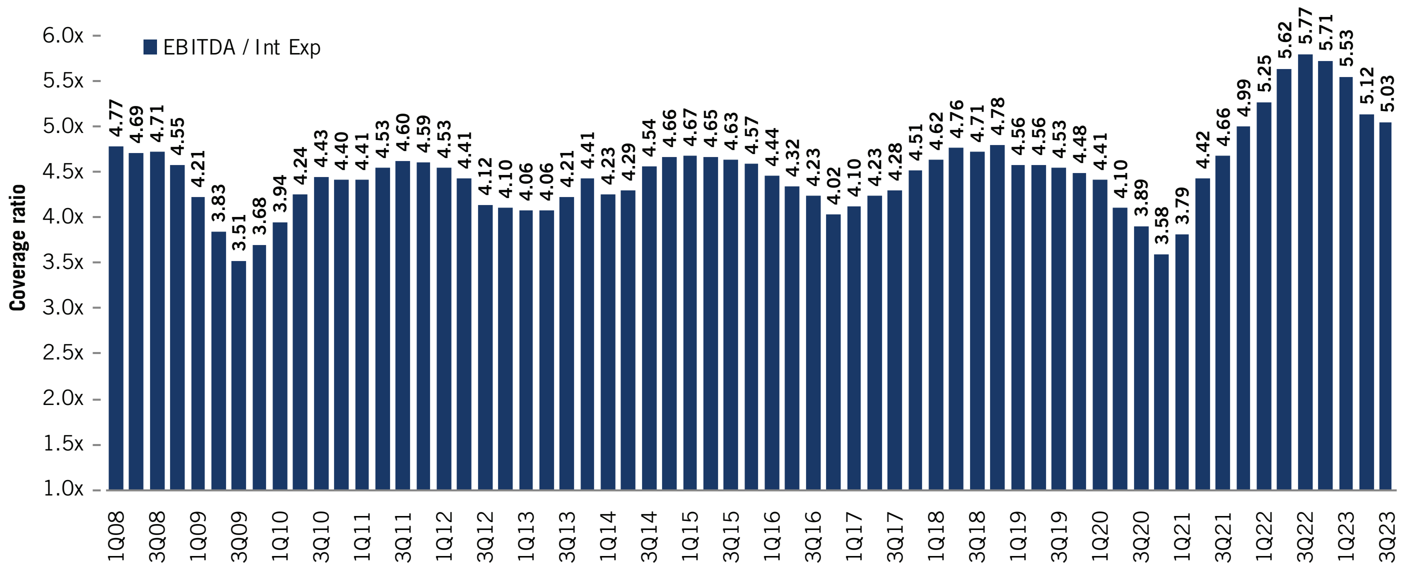
CHART 1: LEVERAGE RATIOS DECREASED MODESTLY IN 3Q 2023, BUT REMAIN HIGHER YEAR-OVER-YEAR



Source: J.P.Morgan, S&P Capital IQ. As of December 12, 2023.

However, some slight weakness in interest coverage was seen in 3Q, due to higher interest expense and margin deterioration caused by cost-side inflation remaining stickier than the revenue side. At 5.03x for 3Q23, it was still on the stronger side; in fact, the high yield sector has now witnessed seven straight quarters of interest coverage above 5x. Prior to this, the high yield market never saw 5x or greater since records for this information began in 2008.

CHART 2: COVERAGE RATIOS FOR HIGH YIELD COMPANIES DECREASED FOR A FOURTH CONSECUTIVE QUARTER TO A SEVEN-QUARTER LOW



Source: J.P.Morgan, S&P Capital IQ. As of December 12, 2023.

There are several reasons for interest coverage decreasing over the last few quarters—growth in interest expense is one of them. Many issuers of fixed rate high yield securities also have bank loans that are floating rate.

According to J.P. Morgan's 3Q23 High Yield Credit Fundamentals report from December 12, "Specifically, HY companies with at least 50% of their debt load in floating rate loans experienced a median increase in interest expense across the last four quarters of +28% quarter-over-quarter (q/q), while those with loans as a percent of total debt between 25% and 50% experienced a median q/q increase in interest expense of +25%, those with loans as a percent of total debt between 0%

and 25% experienced a median q/q increase in interest expense of +16%, and those companies with no loans in their debt load saw an interest expense increase of only +6% q/q." Additionally, over the last two years, approximately 10% of the high yield universe became rising stars and moved into investment grade, taking their stronger balance sheets and higher interest coverage with them.

Is the Market Partying Like It's 1999?

From 12/31/96 through 12/31/99, the median yield for the High Yield Index was 9.44%, with a median spread of +330 bps (meaning the average Treasury yield, given the same duration as the index, was 6.14%). As of 12/31/23, the yield for high yield was 7.69%, with a spread of +339. So, are spreads historically tight or is the market repricing risk to more normal levels? It appears that over roughly the past 10 years, wider spreads coincided with significantly lower yields, so spreads helped compensate for a "lower for longer" environment. With yields having adjusted upward, so has potential total return and the risk/reward benefit of owning high yield.

CHART 3: BB YIELD EXCEEDS S&P 500® INDEX EARNINGS YIELD

Difference Between S&P 500® Earnings Yield and BB Yield

Past performance is not indicative of future results. Source: Standard & Poor's; ICE BofA U.S. High Yield BB Rated Index YTW.

As equity valuations continue to be stretched and BB yields continue to exceed that of the S&P 500® Index, we need to keep in mind that high yield is not only an equity substitute, but that historically it has offered potential downside mitigation, which may result in equity-like returns with significantly lower volatility.

CHART 4: HIGH YIELD MAY OFFER DOWNSIDE MITIGATION VERSUS EQUITIES WHILE ALLOWING INVESTORS TO POTENTIALLY STILL CAPTURE MUCH OF THE UPSIDE

High Yield versus Equity Markets (7/1/83–12/31/23)						
	Annualized Return	Standard Deviation	Return Per Unit of Risk	Rolling 3-Year Periods		
				Best	Worst	% Negative
High Yield Bonds	8.24%	8.37%	1.0	26.4%	-7.6%	5%
Large Cap Equity	11.17%	15.20%	0.7	33.3%	-16.1%	13%
Small Cap Equity	8.78%	19.62%	0.4	32.0%	-17.8%	10%

Past performance is not indicative of future results.

The High Yield, Large Cap Equity, and Small Cap Equity Markets are represented by the Bloomberg U.S. Corporate High Yield Bond Index, S&P 500® Index, and Russell 2000® Index, respectively. Returns were calculated using monthly data and begin with the inception of the Bloomberg High Yield Credit Index on 7/1/83. Source: Standard & Poor's, FTSE Russell, Bloomberg.

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A **Basis Point (bp)** is equal to 0.01%. The **option-adjusted spread (OAS)** is the measurement of the spread of a fixed-income security rate and the risk-free rate of return, which is adjusted to take into account an embedded option. Typically, an analyst uses the Treasury securities' yield for the risk-free rate.

The **ICE BofA U.S. High Yield Index (H0A0)** tracks the performance of U.S. dollar denominated below investment grade rated corporate debt publicly issued in the U.S. domestic market. To qualify for inclusion in the index, securities must have a below investment grade rating and an investment grade rated country of risk. The **ICE BofA BB U.S. High Yield Index (H0A1)** is a subset of the ICE BofA U.S. High Yield Master II Index and includes all securities with a given investment grade rating BB. The **ICE BofA Single-B U.S. High Yield Index (H0A2)** subset includes all securities with a given investment grade rating B. The indexes are unmanaged, their returns do not reflect any fees, expenses, or sales charges, and are not available for direct investment. The **ICE BofA CCC & Lower U.S. High Yield Index (H0A3)** subset includes all securities with a given investment grade rating CCC or below. The **Bloomberg U.S. Corporate High Yield Index** is an unmanaged, U.S. dollar– denominated, nonconvertible, non-investment-grade debt index. The index consists of domestic and corporate bonds rated Ba and below with a minimum outstanding amount of $150 million. The **S&P 500® Index** is a free-float market-capitalization weighted index of 500 of the largest U.S. companies that measures the performance of the large-cap segment of the market. The index is calculated on a total return basis with dividends reinvested. The **Russell 2000® Index** is a market capitalization-weighted index of the 2,000 smallest companies in the Russell universe, which comprises the 3,000 largest U.S. companies. The index is calculated on a total return basis with dividends reinvested. The indexes are calculated on a total return basis, are unmanaged, and are not available for direct investment.

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High Yield Fixed Income Securities: There is a greater risk of issuer default, less liquidity, and increased price volatility related to high yield securities than investment grade securities.

Investing is subject to risk, including the risk of possible loss of principal. Past performance is no guarantee of future results.

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