How Low Can Credit Spreads Go?

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Credit spreads on high yield bonds continue to tighten in June despite a more hawkish than expected outcome of the recent Federal Open Market Committee (FOMC) meeting and increased equity volatility. Following the Federal Reserve’s 16 June press conference, Treasury yields initially traded higher but quickly reversed course and rallied, with the 10-year yield again moving below 1.5%.

The combination of tighter spreads and lower Treasury rates has led to a strong total return for the high yield asset class this month. There is now a negligible difference in year-to-date performance between bank loans and high yield, as both asset classes have returned more than 3% so far.

With yields and spreads at or near post-crisis tights, forward-looking return expectations have become more muted. High yield has performed relatively well in recent periods despite significant outflows from retail mutual funds and exchange-traded funds (ETFs). We expect outflows to continue given subdued return expectations and the potential for more hawkish Fed comments and Treasury rate volatility.

While we are still finding attractively priced credits in both markets, we have grown to prefer bank loans and collateralized loan obligation (CLO) debt over high yield, as the former stands to benefit from the rate backdrop and retail fund flows.

The following sections reflect the investment team’s views on the relative attractiveness of the various segments of below-investment-grade corporate credit. Conviction scores (CS) are assigned on a scale from 1 to 5, with 1 being the highest conviction.

US Leveraged Loans

Kevin Wolfson, Portfolio Manager, US Leveraged Loans

2.8 (unchanged)

Fundamentals: For publicly reporting loan issuers (roughly 13% of performing loans), first-quarter EBITDA increased roughly 16% year-over-year (y/y), and expectations are that second-quarter gains will be even greater given the weak results of last year’s comparable period (PineBridge Investments as of 18 June). As expected, the last-12-month (LTM) default rate by amount outstanding continues to decline, with the May month-end figure coming in at 1.73% (S&P/LSTA as of 31 May). There have been no defaults within the S&P/LSTA Leveraged Loan Index month-to-date (MTD), and with eight defaults from June 2020 about to roll off, the LTM default rate at the end of June 2021 will almost certainly take another step down (S&P/LSTA through 15 June). With ample liquidity still available to issuers, we expect the loan default rate to stay below its long-term historical average over the near to medium term.

Valuations: The spread-to-maturity (STM) for the S&P/LSTA Leveraged Loan Index tightened five basis points (bps) from 18 May through 15 June; it now stands at Libor +400. Over the same period, BB and single-B STMs have tightened by 3 and 5 bps, respectively, while the STM on CCC rated loans has tightened 10 bps. The STM for the S&P/LSTA Index has compressed 43 bps year-to-date (YTD), while the nominal spread has tightened only 4 bps to L+371 (as of 15 June). The weighted-
average bid of performing loans is at its highest level since 2018, leaving little room for market price appreciation. Single-B loans still look relatively attractive on a risk-adjusted basis.

Technical: Retail inflows have continued through the first half of June, and the market remains on pace to experience its seventh consecutive month of positive fund flows. In addition, CLO formation remains strong and YTD new issuance exceeded $70 billion, well ahead of 2020 levels (S&P/LSTA as of 14 June). Despite the continued strong demand for loans from CLOs, retail funds, and institutional buyers, a recent increase in new-issue supply has left the market more in balance. Greater new-issue volume is a result, largely, of increased leveraged buyouts and mergers and acquisitions (M&A) activity, although refinancings continue.

US High Yield

John Yovanovic, CFA, Head of High Yield Portfolio Management

2.8 (unchanged)

Fundamentals: The picture remains bright. Commodity prices, which have more than recovered to reach new highs, continue to propel the reopening economy, and particularly industrial sectors. The upgrade/downgrade ratio remains positive for the fifth consecutive month.

Valuations: Over the past few weeks, the surprise decline in Treasury yields spurred a credit spread melt-up (from admittedly tight levels). This move broke spreads out of their range, propelling them toward our target option-adjusted spread (OAS) of 270. Currently at 281 OAS (Bloomberg Barclays US Corporate High Yield Index as of 17 June), spreads are fair near term, though the view on 2021 is that total returns will be positive on an absolute basis and still attractive relative to other options. More duration-sensitive BB/B credits still look attractive versus CCCs. When spreads reach our target, we would look at ways to take some risk out of portfolios.

Technical: Primary issuance continues at a steady pace, falling off a bit. As M&A picks up, BAML is now predicting $500 million in high yield (HY) issuance this year, a record level that would exceed our expectations (BAML Research as of 11 June). CCC issuance continues to be relatively muted. Fund outflows continue, and even the rates rally couldn’t stanch the weekly drainage; outflows now total $12.6 billion YTD (JP Morgan as of 11 June). Technicals remain positive at the margin, with periodic weakness due to issuance bulges and rates fears. We expect interest rates to rise from here so have kept our score unchanged despite the recent rally.

US CLO Tranches

Laila Kollmorgen, CFA, Portfolio Manager, CLO Tranche

3.0 (unchanged)

Fundamentals: CLO fundamentals continue to improve across all metrics, and with lower anticipated defaults in the US, combined with active management and good credit selection, we expect this trend to continue.

Valuations: BBBs are at 290 to 425, BBs at 600 to 900, and single-Bs at 900 to 1,275. BBB rated CLOs are cheap compared to BB rated HY (at 220) and BB rated leveraged loans (295). BB rated CLOs are trading wide of single-B HY (at 315) and leveraged loans (at 430) on an OAS basis. The three-month cross-currency Japan yen/US dollar basis is approximately -6.0 bps as of 19 May, 1.5 bps more expensive over the month, with longer-term cross-currency hedges also modestly more expensive over the month. US dollar assets remain attractive when hedged on any term. (Valuations based on Bloomberg and S&P/LSTA data as of 15 June.)

Technical: Demand remains good despite heavy new issue and refi/reset volumes, with spreads softening over the month. Supply will weigh on spreads as we go into the July payment date. We anticipate supply to be more measured in July and August, which should support spreads.

European Leveraged Loans

Evangeline Lim, Portfolio Manager, European Leveraged Finance

2.7 (unchanged)

Fundamentals: The euro area economy is finally rebounding as progress on vaccinations encourages private consumption and demand for industrial goods picks up. The recovery will be boosted by a hefty fiscal stimulus package from Brussels. The rebound in economic activity is driven by noticeable growth in the services sector. Capacity constraints both in terms of supply-chain bottlenecks and difficulties in taking on new staff are currently among the key risks to the rate of recovery.

Valuations: Rates insulation/protection from inflation and low default expectations call for fair value in loans despite spreads grinding tighter. Recent outperformance in bonds makes loans look relatively attractive, especially in the BB rating bracket.

Technical: Loan issuance continues at a steady pace and supply appears to be well absorbed by the market, with new-issue spreads tightening slightly and most new issues trading above issuance price in the secondary market. Overall, the secondary loan market is range-bound. The proportion of loans bid at or above issue price declined marginally, reflecting the impact of ongoing refinancing activities. Some loans trading in the low 90s migrated into the mid-90s, signaling positive investor sentiment on the fundamental outlook. Demand for loans continues to come from new CLO issuances and CLO warehouse formation and the need to replace repayments.

European High Yield

Evangeline Lim, Portfolio Manager, European Leveraged Finance

2.8 (-0.2)

Fundamentals: The euro area economy is finally rebounding as progress on vaccinations encourages private consumption and demand for industrial goods picks up. The recovery will be boosted by a hefty fiscal stimulus package from Brussels. The rebound in economic activity is driven by noticeable growth in the services sector. Capacity constraints both in terms of supply-chain bottlenecks and difficulties in taking on new staff are
currently among the key risks to the rate of recovery.

**Valuations:** The low default environment and improving fundamental outlook continue to be the main justifications for staying in European HY.

**Technicals:** The market’s tone firmed in May and continued into June amid a moderating pace of issuance. New bond supply is being well absorbed, reflected in oversubscription levels in new issues and prices moving up in the secondary market.

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**European CLO Tranches**

Laila Kollmorgen, CFA, Portfolio Manager, CLO Tranche

3.0 (unchanged)

**Fundamentals:** As in the US, European CLO fundamentals improved month-over-month. Active CLO management combined with good credit selection continue to provide positive tailwinds for CLO fundamentals.

**Valuations:** BBBs are at 285 to 360, BBs at 515 to 675, and single-Bs at 850 to 920. BBB rated CLOs are cheap to BB rated HY and leveraged loans, while BB rated CLOs are cheap to European HY and leveraged loan single-Bs. European CLOs benefit from a Euribor floor of zero, which adds around 55 bps to the yield of European CLOs. The current euro/US dollar three-month swap at approximately 4 bps means that while European and US BBB CLOs are roughly the same on a spread basis, the benefit of the Euribor floor highlights the relative value of European CLO tranches. In contrast, US BB and B rated tranches are cheap, even when the Euribor floor is added to European BB/B tranche spreads. (Valuations data based on Bloomberg and S&P/LCD data as of 15 June.)

**Technicals:** Similar to the US, there is strong demand (particularly from entities such as banks and insurance companies that fund in Euribor) for the AAA rated tranche. Given high levels of supply throughout June, we anticipate spreads softening before turning tighter in July and August.

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**Global Emerging Markets Corporates**

Steven Cook, Co-Head of Emerging Markets Fixed Income

2.6 (-0.1)

**Fundamentals:** We see improvements in HY fundamentals on expectations that deleveraging will continue on the back of first-quarter results. Thus far, we have seen 24% and 63% y/y increases in revenue and EBITDA, respectively. Net leverage is expected to decline to 1.4x (down 0.6x) on the back of a 34% y/y increase in EBITDA and a 4% y/y reduction in net debt. HY is expected to outperform investment grade (IG) given regional and sector components, with net leverage declining 0.9x to 1.9x, the lowest level since 2011, and IG declining 0.5x to 1.2x (JP Morgan as of 3 June).

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