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Polen Capital Credit Perspectives: Mid-Year 2022 Leveraged Credit Review and Outlook

Mid-Year 2022 Leveraged Credit Market Review: "Risk-free reset and risk-off wreak havoc"

To state the obvious, 2022 is off to a tumultuous start. Prices of high yield bonds declined significantly during the first six months of the year. In part, this price decline was in response to heightened inflation, a rise in U.S. Treasury yields, and a dramatic shift in Fed policy. These factors, coupled with the war in Ukraine and growing concerns centered on softening economic activity, resulted in spreads widening considerably from levels observed at the end of 2021. As a result, the performance of the high yield bond market to start the year was the worst on record dating back to 1987. Further, the second quarter of 2022 proved to be the third worst on record, while June 2022 was the seventh worst month of performance ever recorded.

Performance in 2022: High Yield Bonds and Leveraged Loans (%)

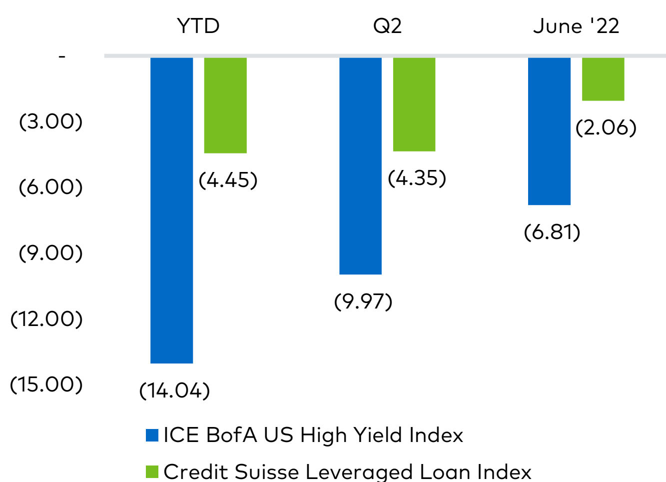


Chart 1: As of June 30, 2022. Source: ICE, Credit Suisse.

Alternatively, given their lower sensitivity to rate increases, leveraged loan performance fared much better. Although not immune to a growing "risk-off" mentality, price declines in the leveraged loan market were less severe. As Chart 1 below shows, the 959 basis points ("bps") of outperformance by loans relative to high yield bonds to start 2022 represents yet another record.

Moreover, as Chart 2 below details, the sell-off to begin the year was at first driven by fears of inflation and rising rates. These fears placed a disproportionate burden on the highest-quality segment of the high yield bond market, which tends to be more susceptible to rate increases. As a result, the less rate-sensitive segments of the market, e.g., "B" and "CCC" rated credits, outperformed. However, while these credits tend to be less vulnerable to changes in rates, given their perceived riskiness, they are usually much more attuned to concerns related to economic growth. Consequently, in Q2 as the macroeconomic climate worsened, these growth-sensitive credits sold off dramatically.

Performance in 2022: High Yield Bonds by Ratings (%)

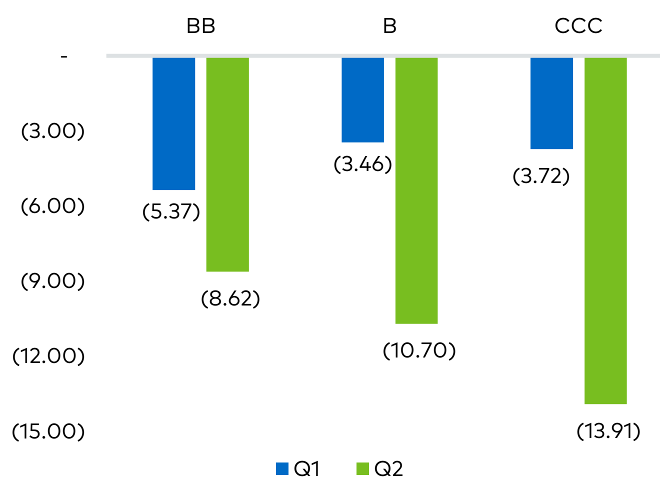


Chart 2: As of June 30, 2022. Source: ICE; reflects performance for the BB, B, and CCC-rated segments of the ICE BofA US High Yield Index.

As Chart 3 below reveals, this "decompression" between ratings cohorts in the high yield bond market was also visible among leveraged loans. However, given that rate increases were the dominant theme in Q1, leveraged loans across the ratings spectrum successfully weathered the initial market turmoil much better than their fixed-rate peers. Despite this relative outperformance, in Q2, even loans could not escape the "risk-off" attitude among market participants with CCC-rated loans being the biggest laggards.

Performance in 2022: Leveraged Loans by Ratings (%)

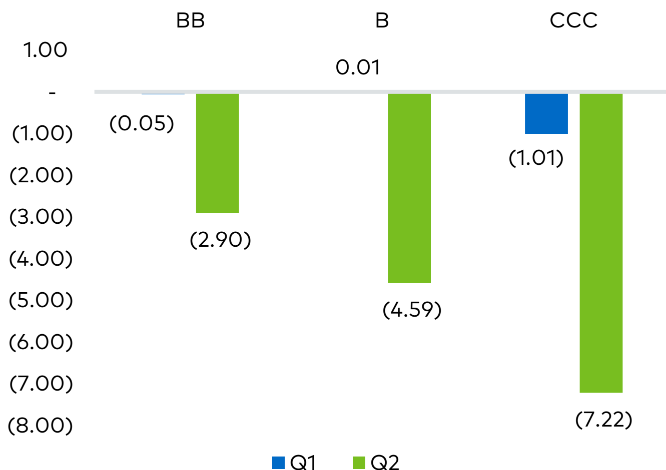


Chart 3: As of June 30, 2022. Source: Credit Suisse; reflects performance for the BB, B, and CCC-rated segments of the Credit Suisse Leveraged Loan Index.

With such a volatile market environment in mind, it should come as no surprise that new issue activity, relative to 2021's record year, was down significantly. For high yield bond issuers, which had spent much of the last two calendar years refinancing debt and pushing out maturities, there was little incentive to issue higher coupon debt via the primary market. Conversely, the new issue market for loans, which had benefited both from 16 consecutive months of mutual fund inflows through April 2022 as well as continued asset growth among CLOs, has remained relatively more active. Nonetheless, according to data from S&P Leveraged Commentary & Data, new issue activity for high yield bonds and leveraged loans, year-over-year, is down 76% and 49%, respectively.

Furthermore, the period of extremely low default activity has begun to turn over. While default rates are still well below their historical averages of approximately 3%, default activity is on the rise. For context, the default rate at the end of 2021 for high yield bonds and leveraged loans stood at 0.3% and 0.5%, respectively. However, as of June 30, 2022, the trailing 12-month default rates for bonds and loans had risen to 0.8% and 0.7%. While this change in rates is not particularly significant on an absolute basis, June's default total was a 20-month high, and default activity in the first six months of 2022 nearly doubled the total from all of last year. Nevertheless, with defaults still below 1%, and spreads materially wider from their level at the start of the year, investors are being well compensated for an increase in default risk.

At Polen Credit, we believe that the current environment presents discerning investors with an opportunity to capitalize on selling pressure brought on by this year's volatility. This increased volatility has created not only a more attractive entry point into the high yield bond market, but also exposed buying opportunities across leveraged credit. In our view, this is one of the most attractive environments in which to invest that we have seen for some time.

Second Half 2022 Thoughts: "One investor's trash is another investor's treasure"

There are several macro-factors that continue to weigh on market sentiment, which we believe will keep volatility elevated in the short term. Most notably, the global economy is still recovering from the shock of the COVID-19 pandemic. In addition, accommodative fiscal and monetary stimulus has injected vast quantities of money into the economy. While this government intervention has increased demand, the absolute supply of goods and services has failed to keep pace.

In the early stages of the pandemic back in 2020, governments worldwide quickly shut down economies to combat the virus. These shutdowns, although painful, were nevertheless fairly easy to institute. However, the ramp-up from those initial shutdowns has proven to be more difficult. Additionally, continued COVID-related closures in certain geographies, as well as shifting consumer preferences, slow down supply chains to this day. All of these challenges have contributed to inflationary pressures.

As a result, the Fed is in the unenviable position of trying to contain rising prices without destroying growth (i.e., orchestrating the so-called "soft landing"). Thus far, the Fed's efforts to fight persistently high inflation have been reactive. However, recent actions, including an increase in the Fed Funds rate by 75 bps in June, have begun to weigh on market sentiment, and numerous indicators of economic activity are pointing to a broader slowdown.

Be that as it may, there are several factors that support our "bullish" view on the leveraged credit markets. Perhaps most critically, within the high yield bond and leveraged loan markets, company fundamentals remain reasonably healthy. For example, aggregate gross and net leverage, as well as interest coverage, remain at or above pre-pandemic levels for bond and loan issuers. In addition, during most of 2020 and all of 2021, accommodative capital market conditions enabled many issuers to extend maturities, thereby pushing out near-term liquidity concerns and lessening the likelihood of a wave of defaults in the near-term (Chart 4). In essence, given the price declines observed during the first half of the year, we believe that these broad measures of market health provide a supportive backdrop to identify attractive risk-reward opportunities.

High Yield Bond and Leveraged Loan Maturity Profile ($ billion)

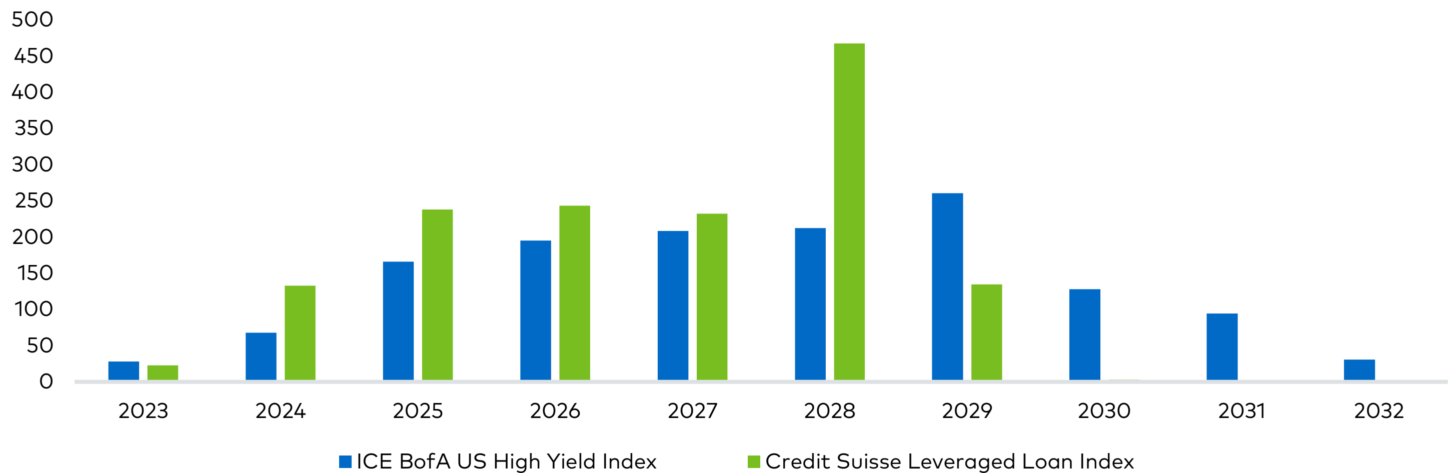
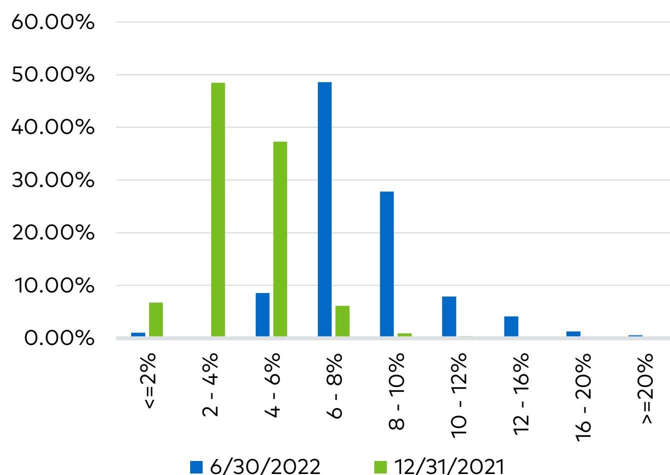


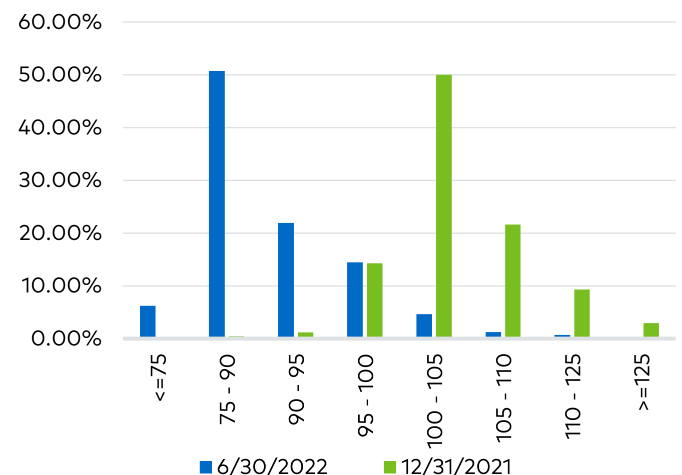
Chart 4: As of June 30, 2022. Source: ICE, Credit Suisse.

Further, across the ratings spectrum, active management, focused on deep fundamental analysis, can uncover competitive businesses that generate high free cash flow. These businesses are often better positioned to withstand periods of economic uncertainty, even if the prices of their bonds or loans decline along with the broader market. Therefore, we believe that the current level of credit spreads and absolute yields more than compensate diligent investors for the corresponding risks, especially over longer holding periods.

Moreover, we believe that most issuers should be able to weather a short-term decline in economic activity and corresponding weakening of fundamentals without otherwise defaulting on their fixed-income debt obligations. In general, issuers in the higher-quality segments of the high yield bond market appear best positioned to survive the next default wave. Following the sell-off in the first half of 2022, the high yield bonds in these segments are offering attractive yields for the risks being assumed (Chart 5 and Chart 6).

The ICE BofA BB/B US High Yield Index: Distributed by Yield and Price





Charts 5 and 6: As of June 30, 2022 and December 31, 2021. Source: ICE.

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For context, as of June 30, 2022, the yield for the ICE BB/B US High Yield Index, which comprises the upper tier of the market, was 8.13%. Even if one assumes a repeat of the worst three-year annualized default rate for this segment of 4.1%, which occurred in the aftermath of the Great Financial Crisis from 2008-2010, default losses of 246 bps per annum would only slightly exceed the market's long-term average of 180 bps.[1] That said, we do not anticipate a default environment akin to 2008-2010, meaning losses from defaults in the next wave are expected to be lower than those described in the above example. For this reason, even in the face of rising defaults (and even if one were to assume
a worst-case default scenario akin to 2008-2010), we view the current yield environment for this higher-quality segment of the high yield market to be very attractive.

Furthermore, relative to their higher rated peers, the CCC-rated segment of the market is offering even more compelling yields (specifically, an average yield of 15% as of June 30, 2022). However, security selection in this area of the market is always of paramount importance, as default rates among this cohort are higher than those experienced with BB/B rated credits. By way of example, the three-year annualized default rate during the aforementioned aftermath of the Great Financial Crisis for CCC-rated bonds of 8.6% was more than two times greater than that of the BB/B rated cohort during the same period. Be that as it may, the current market volatility has created opportunity to buy the debt of companies with a "reason to exist" at attractive prices. That said, this is not the time to promote indiscriminate buying of these often highly leveraged businesses. Rather, it takes experience and patience to sift through the "junk" to find the "gems" (Table 1).

The ICE Bof CCC & Lower US High Yield Index: Select Characteristics

Rating	Yield to Worst	Price	# Issues	% Face	Face ($bn)
CCC1	14.09	80.85	114	47%	82.3
CCC2	13.31	77.23	107	42%	73.8

Table 1: As of June 30, 2022. Source: ICE.

Moreover, as we outlined earlier, leveraged loans have coped with the volatility of the first half of 2022 much better than their fixed-rate peers. Even so, given market participant's "risk-off" mentality, both first lien and second lien loans have seen declines in price. Although we have been more focused on identifying opportunities in the high yield bond market, lower dollar prices (as reflected in Chart 7), coupled with a steep forward curve for base rates, has resulted in an attractive yield profile for leveraged loans. Therefore, we will continue to look for select opportunities to add loans to client portfolios that offer attractive risk-reward profiles.

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Credit Suisse Leveraged Loan Index: Average Price of First and Second Lien Loan Segments

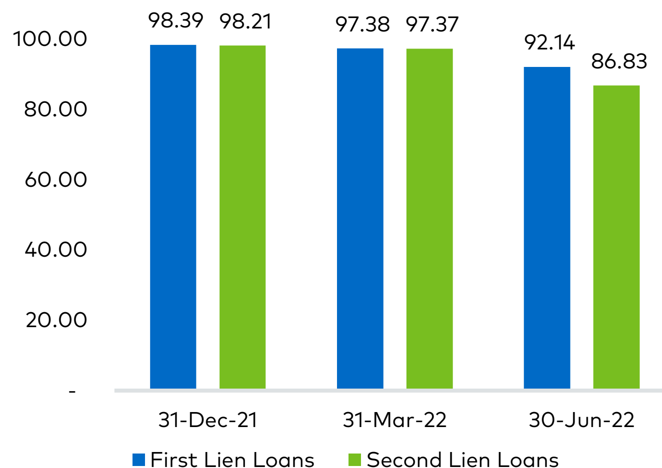

Chart 7: Source: Credit Suisse.

1 Default data has been provided by Bank of America.Default losses of 246 bps assumes an annualized default rate of 4.1% and the long-term average recovery rate of $0.40/dollar invested (i.e., 0.041*(1-0.4)) = 0.0246, or 246 bps. Meanwhile, using the long-term average default rate together with the long-term average recovery rate to calculate default losses results in (0.03*(1-0.4)) = 0.018, or 180 bps.

In summary, the current macroeconomic environment is pressuring the entire leveraged credit market. Thus far in 2022, fixed-income investors have endured a reset in risk-free rates as well as a considerable move wider in credit spreads, as inflation and uncertainty have reigned supreme. As a result, a "risk-off" mentality has created compelling opportunities for discerning investors to uncover value and capture attractive yields. Leveraged credit markets are inefficient, and an environment such as today's creates opportunity to invest in businesses with real competitive advantages at discounted prices. This last point is true among both cyclical businesses as well as those in more defensive sectors. As a result, we believe that exhaustive due diligence is required to identify the best risk-reward opportunities and avoid those situations where the risks do not otherwise justify the potential reward.

At Polen Credit, we construct concentrated portfolios, position-by-position, to provide a yield, or income, advantage compared to that offered by the broader leveraged credit market. In doing so, we are seeking to identify quality businesses that can produce a steady stream of cash flow to service their debt obligations and avoid default. We are patient investors focused on long-term outcomes. In our view, even if spreads widen or yields increase further, today's environment offers a compelling entry point for generating strong long-term returns within the leveraged credit market.

Going Beyond with Polen Capital

Polen Capital is a team of experienced investment industry professionals who share an unwavering commitment to our clients, investors, community, and each other. We have been dedicated to serving investors by providing concentrated portfolios of the highest quality companies for more than three decades. At Polen Capital, we have built a culture of results, and in this, an inherent belief in going beyond what's expected for the people and communities we serve.

We believe that an important part of growing our clients' assets also includes preserving it. To ensure this, we adhere to a time-tested process of researching and analyzing the highest-quality companies around the globe—selecting only the best to build highly concentrated portfolios. Then, we invest for the long haul and with a business owner's mindset—giving these companies time to grow.

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Past performance is not indicative of future results. There can be no assurances that any portfolio characteristics depicted herein shall be replicated in the future.

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Past performance does not guarantee future results and profitable results cannot be guaranteed.

The **ICE BofA U.S. High Yield Index** tracks the performance of US dollar denominated below investment grade corporate debt publicly issued in the US domestic market. Please note that one cannot invest in the index.

The **Credit Suisse Leveraged Loan Index** is designed to mirror the investable universe of USD institutional leveraged loans, including US and international borrowers. Please note that one cannot invest in the index.