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Leveraged Credit Perspectives: 2022 Market Review and 2023 Outlook

2022 Leveraged Credit Market Review

Although it finished with a flourish, 2022 was a turbulent year for leveraged credit markets. Notable influences were dogged inflation and a sharp turn in Fed policy, which combined to send U.S. Treasury yields higher. These issues, when fused with the war in Ukraine and a faltering global economy, resulted in spreads widening meaningfully from levels seen at the end of last year. Subsequently, full-year performance of the high yield bond market in 2022, a loss of 11.22%, was the second worst dating back to 1987, trailing only 2008's loss of 26.4%.

Perhaps not surprisingly, leveraged loans, with their lower sensitivity to rate increases, outperformed their fixed-rate peers. As Chart 1 below details, in 2022 leveraged loans outperformed high yield bonds by 1016 basis points ("bps"), which was the second largest outperformance on record, dating back to the inception of the Credit Suisse Leveraged Loan Index in 1992. While the second half of the year, especially Q4, provided a better environment for both markets, given the volatile environment in 2022, both asset classes generated losses for the year.

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.

2022 Performance: High Yield Bonds and Leveraged Loans

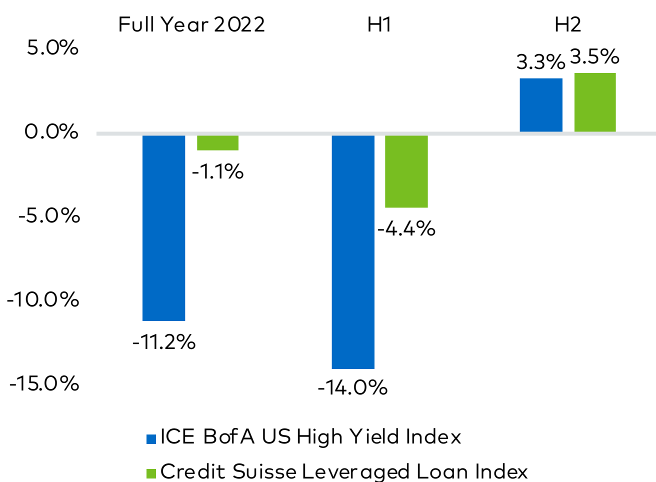

Chart 1: As of December 31, 2022. Source: ICE, Credit Suisse.

2022 Performance: High Yield Bonds by Ratings (%)

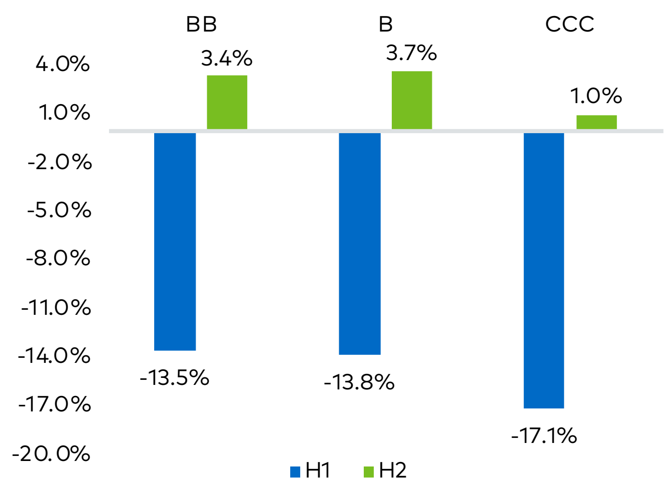

Chart 2: As of December 31, 2022. Source: ICE; reflects performance for the BB, B, and CCC-rated segments of the ICE BofA U.S. High Yield Index.

As Chart 3 below reveals, performance between ratings cohorts in the leveraged loan market further decompressed in the second half of 2022, as higher-rated loans rallied while CCC-rated loans lagged further behind. Given the floating rate nature of the coupons paid by loans and the rapid rise in the base rate used to calculate such coupons, the amount of interest expense paid by loan issuers has increased. Therefore, it is not surprising that these lower-rated, often highly leveraged firms are seeing declines in the price of their loans as investor concerns surrounding the ability of these issuers to support a heavy debt load have grown. While these types of price moves can be difficult for investors to digest, the negative bias against this segment of the market nonetheless can provide opportunity. Generic assessment of risk by market participants can lead to attractive opportunities to enhance the yield and return profile of an actively managed portfolio.

2022 Performance: Leveraged Loans by Ratings (%)

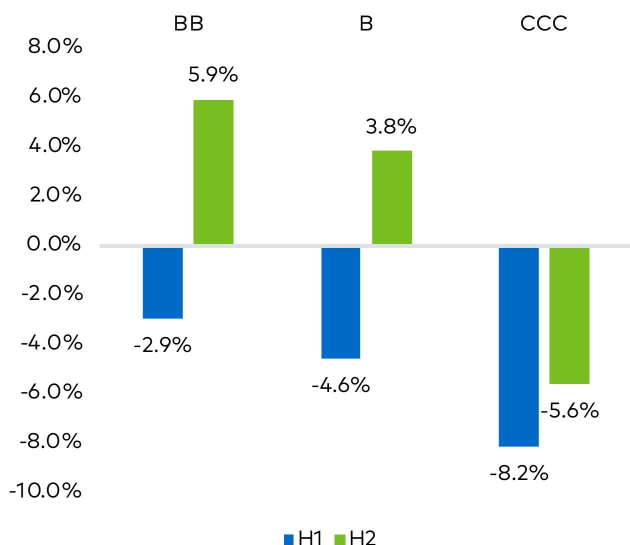

Chart 3: As of December 31, 2022. Source: Credit Suisse; reflects performance for the BB, B, and CCC-rated segments of the Credit Suisse Leveraged Loan Index.

The volatility this year not only negatively affected performance, but also had a meaningful impact on capital market activity for high yield bonds and leveraged loans. Following the record issuance of bonds and loans in 2021, leveraged credit primary market activity slowed considerably in 2022. Given the rapid rise in rates this past year and the steps already taken by issuers to lock in lower coupons and/or extend maturities, companies generally faced no pressing need to refinance or issue new debt in 2022. As a result, high yield bond new issue activity plummeted 78% year-over-year, with fewer high yield bonds issued in 2022 than in any period since 2008. For leveraged loans, the story was similar, as primary market activity declined 70% to levels last seen in the years immediately following the Great Financial Crisis.

Properly functioning capital markets are an important part of the leveraged credit ecosystem. Without them, issuers become more susceptible to default. Combine that with growing concerns of recession and it becomes clear that the default picture, which has been relatively benign, is likely to deteriorate. Over the last two calendar years, defaults have remained well below their long-term averages of 3% for both high yield bonds and leveraged loans. In fact, default rates were sub-1% and sub-2% in 2021 and 2022, respectively. However, over the coming quarters, as more issuers stare down refinancing needs and deteriorating fundamentals, dysfunctional capital markets have the potential to exacerbate an expected rise in defaults.

At Polen Capital, our credit strategies are designed to produce positive outcomes for our clients over a complete cycle. While success or failure is not assessed over quarters or a single calendar year, short-term results can be and oftentimes are influenced by the market environment. While 2022 has posed many challenges, which are likely to continue into 2023, we believe that the current environment presents active managers with compelling opportunities.

2023 Outlook: Thoughts Moving Forward

The macroeconomic picture remains troubling. The global economy is under tremendous pressure, which is expected to persist. A rapid deceleration in monetary and fiscal support will likely lead to a reduction in inflation from current near-historic levels. Moreover, we expect greater clarity from the central bank in 2023 as the Fed seeks to reset rates to a more appropriate, sustainable level sooner rather than later.

Nevertheless, going forward, market participants could face higher inflation compared to the levels experienced in recent decades. Further, this elevated inflation could continue for longer than expected, especially given the disruptions wrought by COVID-19 (including, most recently, China's removal of its "zero-COVID" policies), the costly war in Ukraine, and Europe's energy crisis. Volatility can be expected as we navigate our way through the post-pandemic world and settle into a new normal.

Unfortunately, to arrive at that new normal, we are likely headed to our second recession of the 2020s. Although many indicators are pointing to a meaningful slowdown in economic activity, in October 2022, the yield spread between 10-year U.S. Treasury Notes and 3-month U.S. Treasury Bills turned negative; in other words, the yield curve inverted (Chart 4). Historically, this phenomenon has proven to be a useful leading indicator of a recession. However, while it is true that the yield curve has inverted prior to each U.S. recession dating back to the 1960s without producing a false signal, there appears to be little to no information embedded in this signal as to the timing of the ensuing recession. Admittedly, this missing information is a very important piece.

Inverted Yield Curve and U.S. Recessions

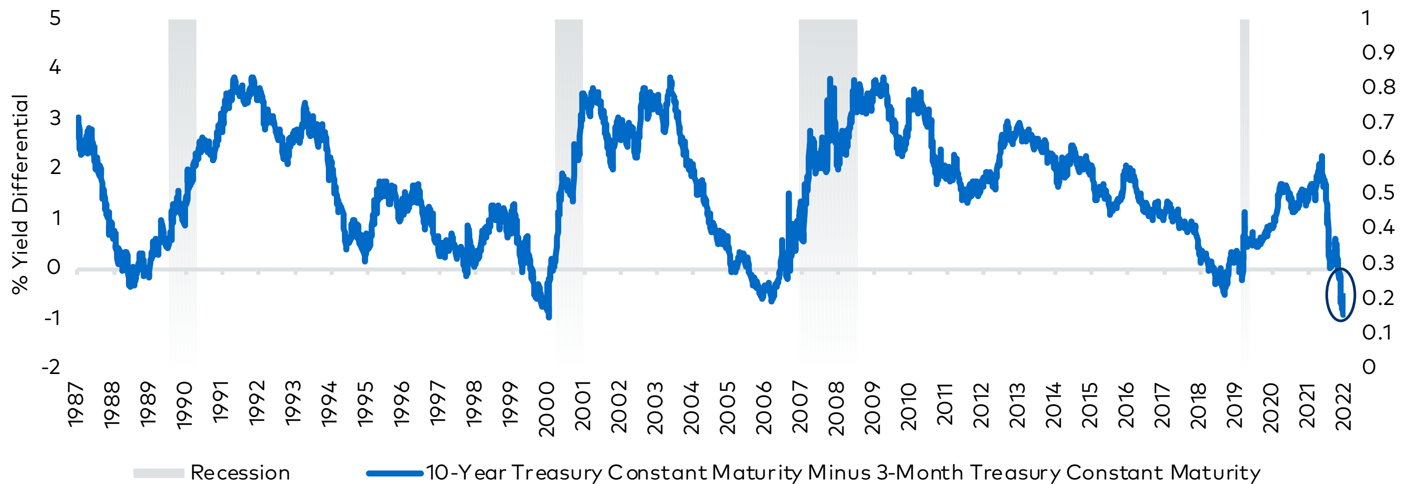

Chart 4: As of December 31, 2022. Source: Federal Reserve Data; St. Louis Federal Reserve.

If the economy is headed for recession, the question becomes, what type of recession? One that is short but deep, or shallow and protracted? These are difficult questions to answer, and, unfortunately, the spread of the high yield market is not providing any clarity. As of this writing, it is hard to say that the high yield market is pointing to an imminent recession. As of December 31, 2022, the option-adjusted spread ("OAS") of the ICE BofA U.S. High Yield Index was 481 bps. For context, based on monthly data between December 1997 and December 2021, the median recessionary and non-recessionary OAS for the index was 824 bps and 455 bps, respectively. Therefore, in the aggregate, the high yield market's spread is suggesting that the likelihood of a recession is very low. However, given there are several indicators flashing a recessionary warning, that forecast seems highly unlikely.

Be that as it may, fundamentals in the high yield market remain in a relatively strong position, which itself could be affecting the predictive power of OAS. That said, if a recession is imminent, issuer fundamentals will likely deteriorate along with the economy. Moreover, fundamentals of loan issuers, which are presently in aggregate weaker than those of high yield bond issuers, face even greater challenges. Rising rates and a greater percentage of the loan market in need of refinancing, with 28% of par outstanding facing maturity between 2023-2025 compared to just 18% for bonds, place greater stress on the loan market.

With this last point in mind, the rational action for companies to take would be to pay down debt with excess cash, especially higher-coupon floating rate debt. Unfortunately, at year-end, we continue to see companies use excess cash to make dividend payments to shareholders, rather than to reduce debt. However, given the uncertain macroeconomic backdrop, equity distributions should give way to more bondholder-friendly uses of excess cash in the coming year.

Moreover, we believe that primary market activity will increase meaningfully from 2022's near-record low levels. Properly functioning capital markets are vital in aiding market participants in assessing risk-reward. Unfortunately, in 2022, capital markets were relatively dysfunctional, with bonds and loans priced with wider spreads and higher yields than during most of the previous two years. In our view, this dysfunction reflected market participants trying to digest the potential success of central bank actions, which were directed at reining in inflation while at the same time not creating a severe economic slowdown. Said another way, the volatility was associated with the market's perceptions of the ability of the Fed to orchestrate a "soft landing."

While primary market functioning should improve, given the evolving capital market conditions, expected economic environment, and deteriorating fundamentals, default rates are set to rise further in 2023 from recent historic lows. Exactly where default rates settle is unknown, but certain data points provide a good foundation for understanding the possibilities.

According to research from BofA, about 85% of all defaults each year come from those high yield bonds trading at distressed levels, defined as those with an OAS greater than or equal to 1000 bps, with the remainder coming from the non-distressed segment of the market. As of December 31, 2022, the distressed segment of the high yield market accounted for 5.3% of such market. Using this data point as a guide, assuming the entire segment defaults and historical data prevails, one could place an estimate of defaults at 4.5% (5.3%*85% = 4.5%). This is just a point-in-time estimate and could fluctuate for various reasons. Regardless, the broader point is that defaults appear headed higher from their previously benign levels.

Further, the Federal Reserve's Senior Loan Officer Opinion Survey on Bank Lending Practices, last released on November 7, 2022, showed a significant tightening in lending standards. Historically the results of this survey have correlated highly with forward default rates. As lending officers curtail the availability of credit, the likelihood of expected defaults increases. Therefore, the results of the most recent release lend further support to the contention that default rates are set to rise, at a minimum, to historical averages.

The Fed's relentless policy tightening, rising risk-free yields, and concerns around economic growth have all resulted in a swift move downward in high yield bond prices during 2022. However, as Chart 5 below shows, such moves are part of the credit cycle's natural rhythm. While there are price declines, including some that will be permanent, the vast majority of such moves are temporary, and ultimately most bonds are paid back, or refinanced, at par or a premium to par pursuant to the terms of the underlying contract.

ICE BofA U.S. High Yield Bond Index: Price by Ratings Category Over Time

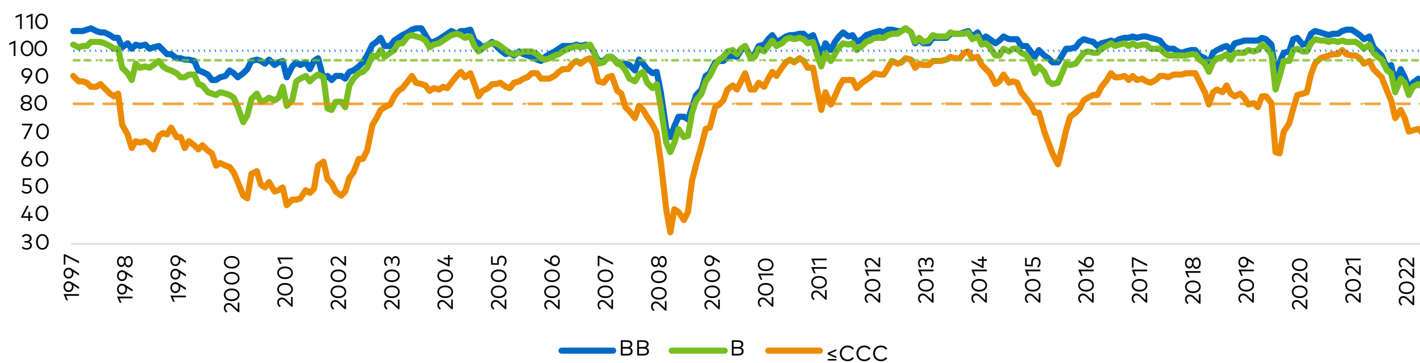

Chart 5: As of December 31, 2022. Source: ICE.

With that in mind, it is important to consider that large declines in price, such as those depicted in the chart above, provide tremendous opportunity for active managers. Our team's investment process is designed to uncover value regardless of the asset class or market segment (i.e., high yield bonds or leveraged loans, BB-rated or CCC-rated). We believe that our focus on deep fundamental analysis enables us to uncover competitive businesses that generate high free cash flow and are often overlooked by market participants. These businesses are well positioned to survive periods of economic uncertainty, even if the prices of their bonds or loans temporarily decline along with the broader market. We believe that the current environment continues to provide the opportunity for active managers to identify those investments that result in a portfolio with a significant yield advantage to the broader market without exposing the portfolio to incremental credit risk.

Moreover, we frequently use the phrase, "History does not repeat itself, but it often rhymes." From our perspective, it is a timeless observation about human behavior, which as we know, dramatically influences markets. The so-called greed and fear cycle pushes and pulls investors into risk-on or risk-off mode. The ebb and flow of these emotions can cause markets to gyrate meaningfully from year to year. However, as Chart 6 below details, on a year-by-year basis, the high yield market has tended to reward investors with positive outcomes.

ICE BofA U.S. High Yield Index: Calendar Year Returns

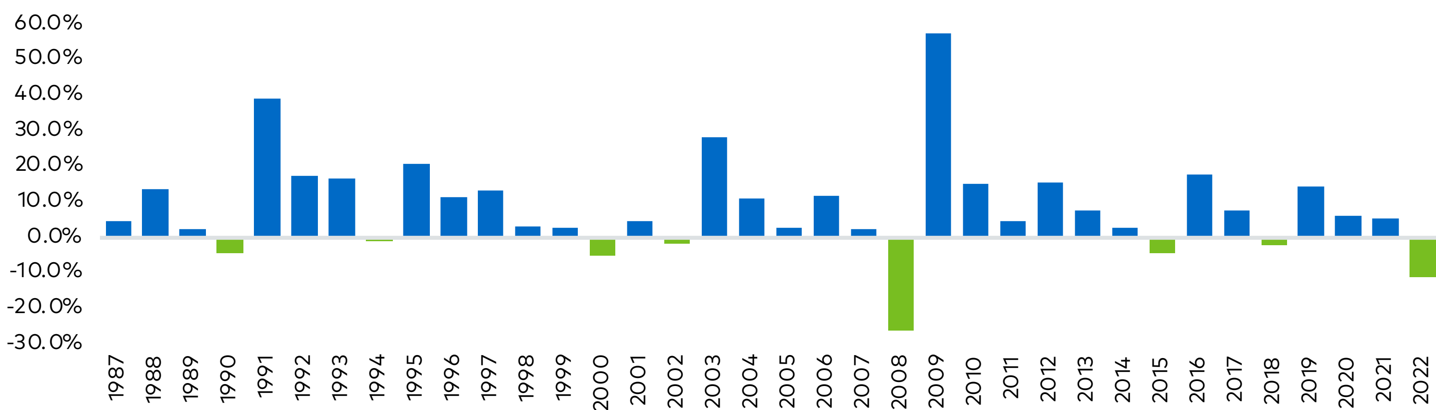

Chart 6: As of December 31, 2022. Source: ICE.

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As one can observe, during the 36 years depicted, the high yield market has only produced a loss in eight of those years while never producing back-to-back losses. This last point could bode well for 2023, even in a challenging environment. While bond and loan prices could fall further, the resulting double-digit return potential created by a further sell-off, particularly given the attractive yields already available today, would certainly attract a slew of buyers, increasing the likelihood of an impressive recovery.

Each year, it is easy to lose sight of one's long-term goals. Fear and greed can cause investors to become undisciplined and make errors in judgment. As chart 6 above shows, the high yield market has produced relatively steady returns year-in and year-out. However, it has earned a reputation as being very risky. The reality is that both high yield bonds and leveraged loans have consistently provided investors with a steady stream of income that allows for relatively durable compounding over time with much less volatility than equities. As Chart 7 outlines, over the last 25 years, total return has been dominated by income, not price, and in fact, price has served as a drag. However, when prices are meaningfully discounted as they are today, a wonderful opportunity is created for active managers to generate compelling performance, both absolute and relative.

The ICE BofA U.S. High Yield Index and Credit Suisse Leveraged Loan Index: 25-year Annualized Return Decomposition

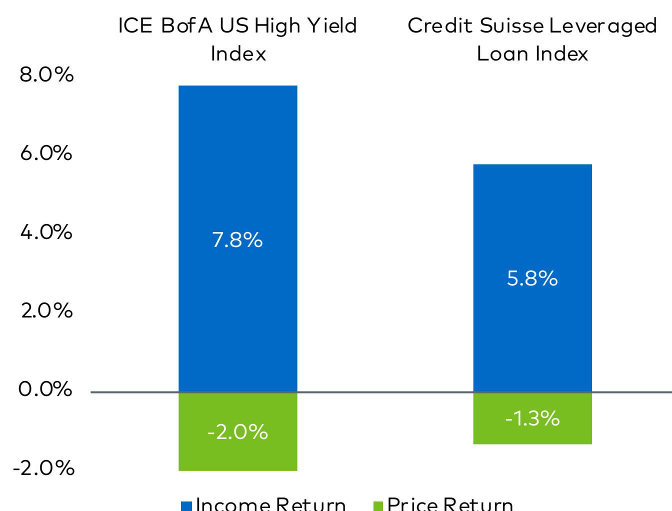

Chart 7: As of December 31, 2022. Source: ICE and Credit Suisse.

In summary, we expect 2023 will provide markets with greater stability and hopefully less volatility. The last three years have represented a period of tremendous uncertainty. Whether markets relax will depend on how quickly participants gain clarity on Fed policy and what appears to be a coming recession. The latter's effect on inflation will likely influence the former. If inflation ebbs, we believe the Fed will complete its rate reset early in 2023, thus calming markets.

Still, we believe 2022's turmoil, while challenging, improved the forward return trajectory for credit. Specifically, high yield now offers compelling absolute yields with stronger fundamentals relative to pre-pandemic conditions. Moreover, 2022's sell-off created attractive opportunities amongst issuers across each segment of the high yield market, resulting in a rich environment for an active manager like Polen Capital to potentially generate significant alpha for its clients.

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 what we believe are 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 pursue this, we adhere to a time-tested process of researching and analyzing the highest-quality companies around the globe—seeking 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.

Connect with Us

For more information on Polen Capital visit **www.polencapital.com** and connect with us on **LinkedIn**.

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