WHEN THE TECHNICAL BECOMES FUNDAMENTAL

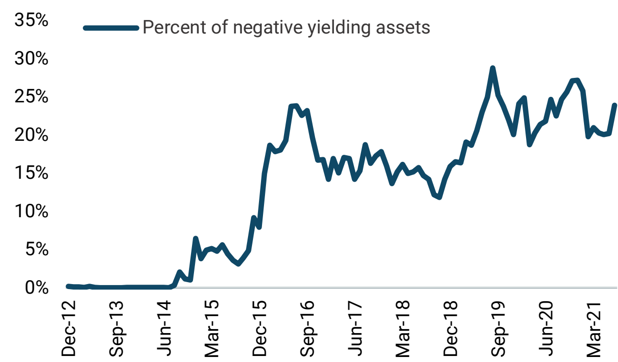
Factors like fund flows, issuance supply, issuance patterns, and nuances associated with specific issuance details combine to make up what are considered the technical aspects of the high yield (HY) debt markets. Historically, these factors have really been second-order considerations compared to valuation and fundamental factors like economic performance, corporate earnings, and defaults. Monetary policy considerations have always been important, but usually in response to the fundamentals and typically applied to a relatively narrow corridor of influence for the nominal level of risk-free rates.

Why do we care if technical factors are second-order influences? First, the technical aspects of the market provide a view of how the market is allocating capital. Is it rational and/or predicated on something that if changed would lead to a significant reallocation of capital? Second, we can compare past periods to current trends to assess whether patterns in relative capital allocations provide us with conclusions about the stability or instability of the current market.

Post Global Financial Crisis Technical Underpinning: Low rates and the search for yield.

The Quantitative Easing (QE) model was established by Japan in 2001 to confront deflation and falling growth. The Fed and other Central Banks turned to QE and other forms of policy stimulus during the Global Financial Crisis (GFC) in the hope that they would augment the traditional monetary policy tool kit and restart their respective economies. The byproduct of the persistent application of these unconventional policies over the past ten years has been that these technical factors have become fundamental factors. It is our view that QE has had an important consequence for the HY market. Namely, it has coincided with low and even negative bond yields across broad swaths of developed markets. In turn, large incremental amounts of capital have been driven into higher-yielding markets such as Investment Grade (IG) and Below Investment Grade HY debt markets.

Chart 1. Percent of Global Bond Market with Negative Yielding Assets



Source: BofA Global Research; ICE BofAML Indices

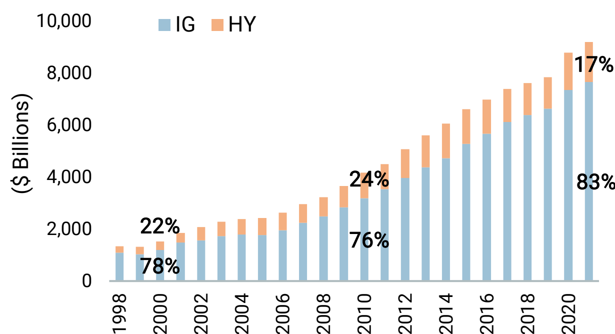
Chart 1 shows that, on average, 19% of the developed bond markets have had a negative yield since 2016 (based on the BofA Global Fixed Income Index). For perspective, this index contains 26,000 developed and emerging market IG and HY debt issues across the domestic and Eurobond markets, including sovereign, quasi-government, corporate, securitized, and collateralized, totaling $68 trillion in market value. For the past two years, over 23% of the world's public debt markets have been generating negative yields.

Loose monetary policy, multiple variations on QE, fiscal deficit spending, and a variety of corporate issuance programs have led to an explosion in debt issuance over the last five years. In January of 2016, just when the percentage of world public debt that had negative yields began to surge, the face value of the global public bond debt stood

at $42 trillion. Today, that number is 52% higher after growing nearly 9% per year over the last five years.

US IG and HY debt have also grown over the past five years. The face value of US IG debt has grown by 47% over the period. Interestingly, the face value of US HY debt has only grown by 15% over that period. As can be seen in Chart 2, IG credit has been an engine of growth for the combined IG and HY debt markets. However, these aggregates mask a significant nuance within US corporate debt markets.

Chart 2. Value of Total US Corporate Credit Markets



Source: BofA Global Research; ICE BofAML Indices

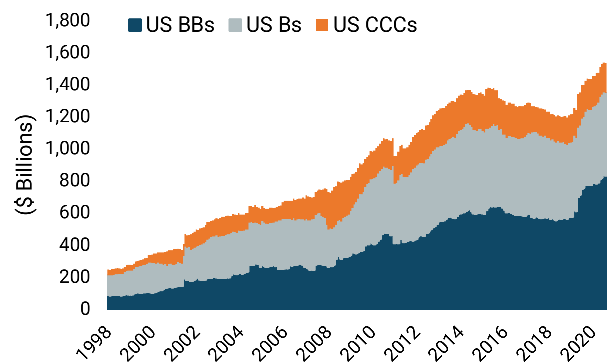
Middle-tier Credit Quality Growth is the Key Development Over the Past Five Years.

Over the past five years, the face value of BBB and BB-rated corporate debt has grown by 60% and 40%, respectively. The combined face value of these credit tiers has grown by 56%. In effect, the growth of the middle credit quality tiers of the US corporate debt market has significantly outpaced the global debt surge over the past five years. Our sense is that these middle credit tier markets have been a direct beneficiary of the persistent accommodative policies and the low interest rate environment.

As the various central banks execute QE with no regard for the economics of their open market purchases, they effectively crowd out institutional and retail investors pursuing positive yielding investments. This has created a robust demand and supply environment in the middle credit quality tier in the US corporate markets. While this environment creates a potential for negative credit migration from BBB, it does not create a particularly concerning default build-up within the HY market.

Chart 3 underpins the point that nearly all the growth in HY debt over the past five years has been in the BB-quality tier of the market.

Chart 3. Face Value of High Yield by Credit Quality



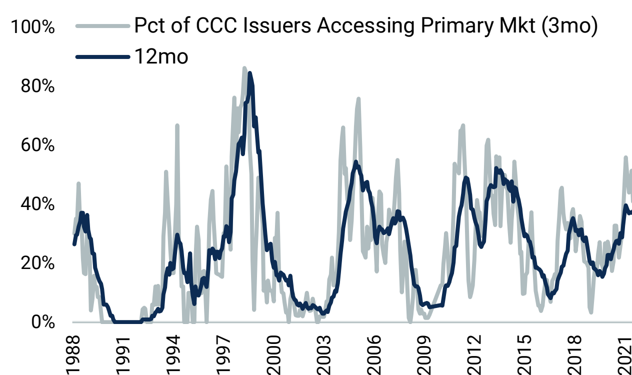
Source: BofA Global Research; ICE BofAML Indices

Historically, it is the surges in low-quality credit tiers that have preceded some form of a credit bubble. The Telecom, Technology and Media (TMT) credit crisis of the early 2000s was preceded by a surge in lower-quality high yield paper. From 1998 to 2002, CCC content in the HY market surged by 189%, mainly supporting TMT credit issuers. The warning sign of surges in low-quality issuance was also apparent in the lead-up to the GFC. From late 2004 until the end of 2008, CCC content in the HY market grew by 124%, led by LBO and mortgage-related issuance. Today's HY market shows no obvious surge in low-quality issuance. On a rolling four-year basis, like the TMT and GFC periods described previously, CCC content has actually declined by 7%. At 12% of the broad HY market, CCC content is at its lowest level in 20 years.

That said, new issue activity precedes content in the composition of the HY market. Chart 4 underscores a dimension of low-quality issuance that is instructive. It portrays the HY market's appetite for low-quality issuers to tap the market (defined as the % of benchmarked split B/CCC and CCC issuers who access the market).

Observe the somewhat countercyclical nature of the low-quality issuers' access to the HY.

Chart 4. HY Use of Proceeds that are Rated Below Single-B



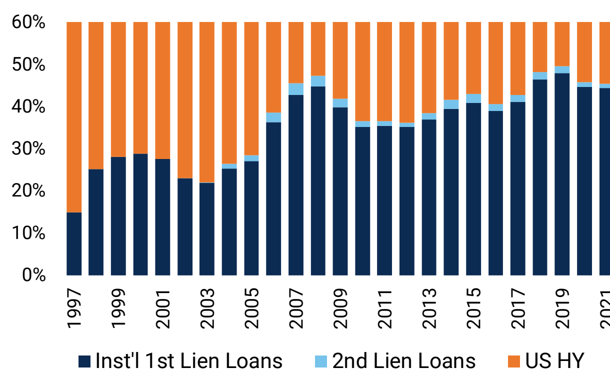
Source: BofA Global Research; ICE BofAML Indices

When times are good, we see a surge in lower-tier issuance by existing low-quality issuers. When times are bad, e.g., recession or other economic dislocation, we see the opposite with lower-tier issuance collapsing. Over the past two years, lower-tier issuers have come back to the market, but for understandable reasons. Most of the 2020 lower-tier issuance was tied to bolstering liquidity in response to the pandemic. For 2021, lower-tier issuance has mainly been about refinancing. In our opinion, neither the 2020 nor 2021 lower-tier issuance increases represent warning signals of any unhealthy build-up in lower-tier issuance that preceded the TMT and GFC periods of massive capital reallocation. Indeed, the average volume of low-tier issuance as a percentage of all annual new issues stands at 14%, consistent with the 10-year average.

Loans Become Important.

Another technical at work in the HY market is the prevalence of leveraged loans. As can be seen on Chart 5, leveraged loans have increasingly become a mainstay in the overall leveraged finance toolbox for investors.

Chart 5. Loans as a Percentage of the Total HY Finance Market by Principal Amount



Source: BofA Global Research; ICE BofAML Indices

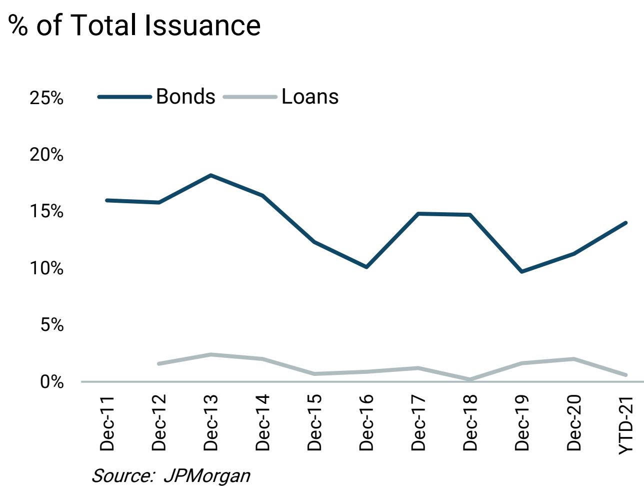
Over the past two decades, the market for loans has grown in standardization, liquidity, and magnitude to account for over 40% of the $2.8 trillion leveraged finance segment of the debt markets. Why is this important? Loans compete with HY bonds for issuer and investor attention. From an issuer's perspective, leveraged loans have two positive attributes. First, they are floating rate and cash-pay coupons based on spreads of short-dated benchmarks (typically a 3-month LIBOR equivalent). Since the most prevalent term structure for rates is upward sloping with maturity, this short-dated fixing of the coupon typically improves overall issuer cost of capital. Second, leveraged loans are typically callable any time at low or no call premium providing issuers with significant financial flexibility.

For investors, the leveraged loan is a pure carry instrument. Unless purchased below par, the leveraged loan offers virtually no total return beyond the coupon. That said, leveraged loans are typically structured as first lien or secured instruments, significantly improving the loan investor's claim in a restructuring. As a result, the combination of better claim and virtually no interest rate duration makes loans attractive either unleveraged or leveraged carry instruments. These positive investor perspective attributes explain the increased use of loans in leveraged structures like collateralized loan obligations and business development companies.

Because of the intertwined nature of HY loans and bonds, we need to consider the credit quality of leveraged loan issuance patterns to appreciate the potential for lower quality risk build-ups. Chart 6 shows that lower-quality issuance (defined as split rated B/CCC or CCC) has not exhibited any unhealthy low-quality trends. Neither HY loans or bonds are at or above their 10-year averages as a percentage of total new issue proceeds.

Chart 6. Low Quality HY Issuance: Bonds and Loans

% of Total Issuance

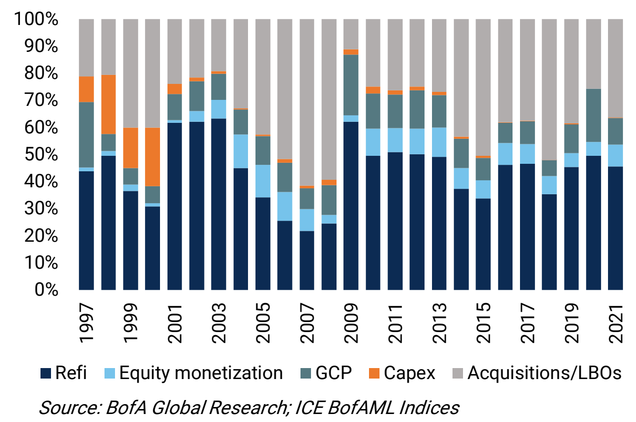


Source: JPMorgan

Use of Proceeds.

Beyond an absence of low-quality issuance build-up, what other technical aspects of the HY market can be assessed? Historically, we've found that the new issue use of proceeds data is useful in assessing capital allocation trends. In some cases, new issue use of proceeds can correlate with credit quality. For example, in Chart 7 we see a surge in capital expenditure as a percentage of bond and loan new issuance in the late 1990s. That coincided with a significant increase in lower-quality TMT financing. A similar lower quality Acquisitions/LBO bulge in bond and loan new issuance occurred in the lead-up to the GFC.

Chart 7. HY and Loan New Issue Uses of Proceeds



Source: BofA Global Research; ICE BofAML Indices

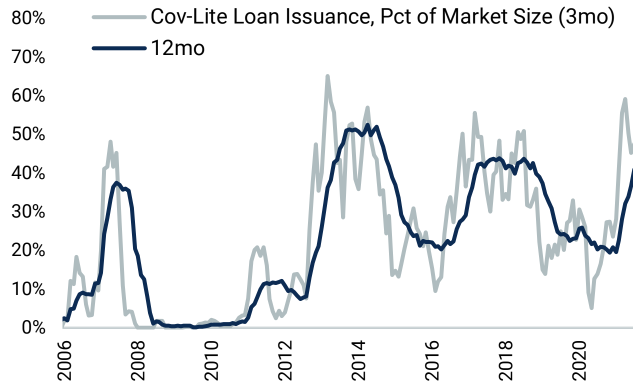
Like quality, today's HY bond and loan markets offer little evidence of any unhealthy capital allocation trends.

Covenant-lite Structures.

Frankly, the only trend that can be considered concerning is the loosening of covenant constraints in the leveraged loan market. Covenant-lite structures are loan documents that include flexible financial constraints resulting in diminished protection for loan investors. Practically, covenant-lite structures are more closely aligned with HY bond covenants than traditional leveraged loan protections.

Chart 8 demonstrates that covenant-lite structures have begun to move up as a percentage of the overall leveraged loan new issuance market.

Chart 8. Loan Use of Proceeds that Include Covenant Lite Structures



Source: BofA Global Research; ICE BofAML Indices

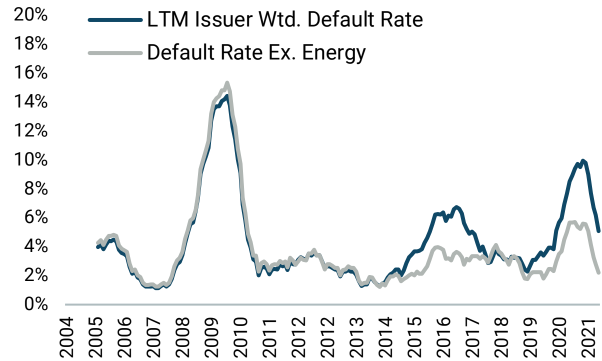
Compared with the 10-year average of 31%, the recent reading of 41% of the loan new issuance market including covenant-lite structures represents a material deterioration in loan investor protection. Since loans are a modest portion of our HY strategy, we do not see this as a particularly troublesome issue at the present. Nevertheless, it does represent a growing hazard in the leveraged loan market.

Fundamental Backdrop.

The fundamental backdrop for HY, in some ways, is mirroring the relatively benign technical assessment. Chart 9 shows that HY defaults have collapsed post the surge in the pandemic-related volatility of 2020.

Whether you evaluate the entire market or adjust to exclude the extremely volatile energy sector, HY defaults have (x-Energy) or appear to (including Energy) to be reverting to modest levels associated with supportive fundamentals.

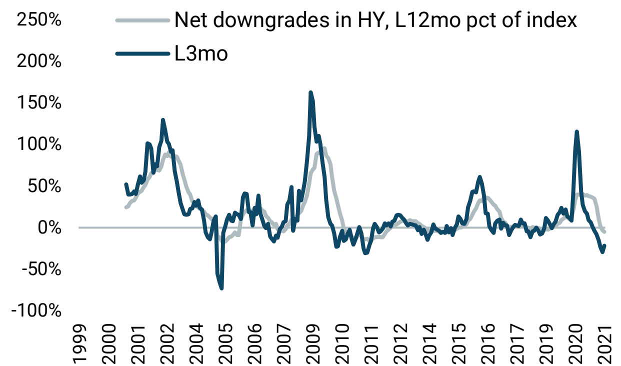
Chart 9. HY LTM Par Default Rates



Source: BofA Global Research; ICE BofAML Indices

Chart 10 echoes the improving default trend through the lens of downgrades. As a percentage of the overall market, downgrades have plummeted. Like the default data, the pandemic contraction in 2020 produced massive credit quality disruptions.

Chart 10. Net HY Rating Activity, Net Downgrades as % Index Face Value



Source: BofA Global Research; ICE BofAML Indices

Conclusion: Constructive Fundamentals and Solid Technical Conditions.

Persistently easy global central bank policy has facilitated a boom in global debt financing over the past decade. Low and even negative rates have pushed investors further afield in search for yield. This has translated into a surge in the middle credit quality tier of corporate issuance in the US (BBB/BB). Unlike prior periods leading up to dislocations/recessions, the technical

indicators in the US leveraged finance market appear relatively healthy. None of the usual suspects like low quality or risky use of proceed vehicles have shown any material build-up. The only trend that may lead to trouble down the road is the increasing prevalence of diminished protections in the leveraged loan market as represented by the number of covenant-lite structures in the new issue market.

So why not pound the table for HY? One word: Valuation. No matter how you slice absolute risk-reward, HY valuations are tight. Spreads, albeit 75-100 bps wide to the all-time lows, are hovering near 10-year lows.

For Hotchkis & Wiley's HY strategy, we view this environment as well suited for higher-than-average liquidity, credit quality, and market capitalization positioning. Given potential uncertainties with inflation and the timing of QE tapering, we also believe the near-term orientation should skew below benchmark in duration. What's more, we are including an above-average allocation to well-structured bank debt. We think this blend of conservatively structured carry is the best way to navigate current HY market conditions.

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