The Nuanced Opportunity in SMID Credits

"Rising interest costs will crowd out other possible uses of government resources, and then also pose a risk to our economic stability" in the coming decade, CBO director Phillip Swagel told the budget committee at a hearing on Capitol Hill on February 7, 2025.

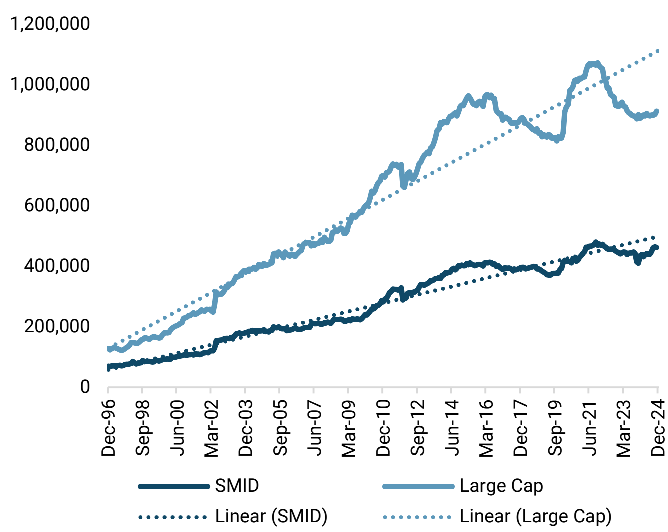
The CBO report projected that the yearly U.S. budget deficit would grow by an estimated $1 trillion over the next 10 years. The deficit, which is expected to total $1.6 trillion in fiscal year 2024, will grow to $2.6 trillion in 2034, according to the analysis.

Sobering warnings for fixed income investors concerned that US Treasury issuance used to fund the CBO's potential deficits will increasingly put pressure on long duration fixed income exposures. In this note, we take a long look back to evaluate some of the pertinent changes in the High Yield (HY) universe. Credit improvement and shorter duration are some of the trends and these factors can potentially help fixed income investors insulate their holdings from the aforementioned concerns.

Size Considerations

To start, the market size of HY has materially increased over the last quarter-century. **Chart 1** demonstrates that we have seen a steady increase in the asset class over a long period. The chart bifurcates the market into Large Cap and Small and Medium size (SMID) issuers, based on the average issuer size within the HY universe. Issuer level metrics are used because it is the company level unit in the market. This measure includes all bond and loan amounts issued by an individual firm and accumulates the totals for all issuers in the below investment grade debt markets. The mean of this issuer measure provides breakpoint for the two baskets in this market study.

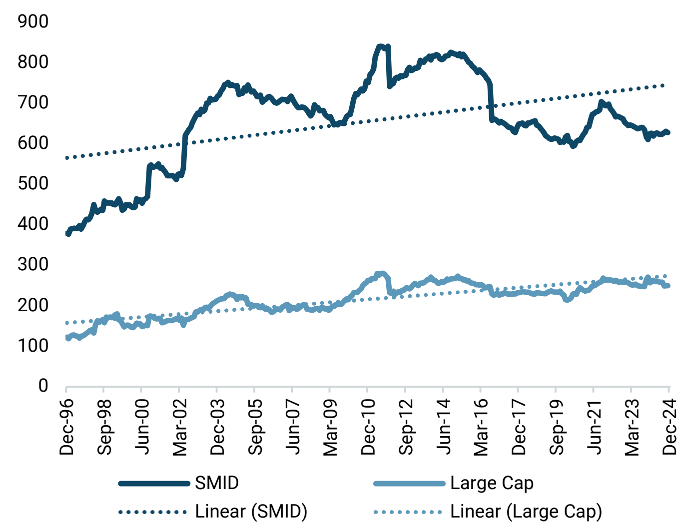
Chart 1: HY Face Value Outstanding
As of November 30, 2024



Over the period from December 1996 to December 2024, the par amount of debt outstanding has grown at constant average growth rate of 6.9% for SMIDs and 7.3% for Large Cap HY. To put context on these growth rates, in 1996, the average SMID issuer had a $188 million debt outstanding, and the average Large Cap had a little over $1 billion out. Today, the average SMID issuer has nearly $750 million outstanding while the average Large Cap has nearly $3.7 billion.

Interestingly, the number of issuers in the market, depending on the bucket, has grown at a much slower rate compared to the respective total debt outstanding growth rates. **Chart 2** details the number of issuers in the HY market, by segment, over the period.

Chart 2: Issuer Count - SMID vs Large Cap
As of November 30, 2024



The SMID issuer count has grown at approximately 1.8% over the last 28 years. For Large Caps, the constant growth rate has been approximately 2.6%. Most of the growth for both segments occurred in the period leading to the Global Financial Crisis (GFC). Since that period, several technical factors such as increases in private debt, bank debt only balance sheet structures have siphoned issuers out of the public HY bond market. Nonetheless, both segments have grown significantly since the early years. In 1996, there were 378 SMID issuers and 122 Large Cap Issuers. Today, there are 627 SMID and 249 Large Cap issuers. This relatively significant issuer growth means that there are plenty of name-level opportunities for investors in today's HY universe.

Quality

Quality has improved over nearly three decades. **Chart 3** and **Chart 4** detail the rating composition of the HY SMID and Large Cap market over the past 28 years.

Both markets have benefited from an increase in higher quality content over the period as lower quality issuers have been siphoned into new markets. In both cases, BB increases have mostly been offset by declines in the single B percentage within each market segment. The proportion within the BB category has increased by 5% for both SMIDs and Large Caps over that period. The single B market appears to have borne the brunt of the new market disintermediation where we have witnessed an 8% and 14% decline in single B issuers as a percentage of the SMID and Large Cap segments of the HY market, respectively.

With that said, it is noteworthy that over the long history, we have witnessed an increase in the CCC proportion within both segments of the HY market. The GFC represented the peak CCC proportion of 19% and 26% for SMID and Large Cap HY, respectively. Both markets shed CCC content over the subsequent periods. More recently, SMIDs and Large Caps have taken slightly different paths. SMIDs have maintained a 6-8% range, while Large Caps have increased from an 8-9% range just after COVID to the current level of 13%.

We like what we characterize as the bar-belled quality improvement in HY over the past decade. On the higher quality side, we see the improved rating migration of both SMID and Large Cap as affording us more potential opportunities for full-cycle credit underwriting, what we call core names. Here, both SMID and Large Caps of a high single B and low double B seek to offer resilient opportunities that could serve as compounding value propositions in the portfolio. On the lower quality side, we also see value in two areas that frankly require a more tactical approach because their fundamentals are less certain, as reflected in the rating. The first area is straight down the fairway SMID credits with bad balance sheets, but good businesses and prospects. The second area is secured opportunities in both SMIDs and Large Cap bonds and loans, typically in out of favor sectors or issuers facing what we consider as idiosyncratic conditions that their business fundamentals should enable them to weather. This category tends to fall into the basket of credits we consider high risk, but high reward. If our view of these names proves correct, these issues tend to migrate into core credits over time.

Chart 3: SMID Rating Quality Trends, As % of Total SMID Market
As of November 30, 2024

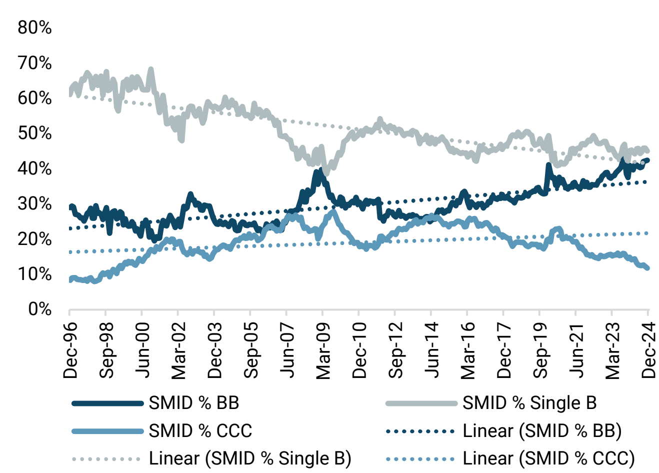
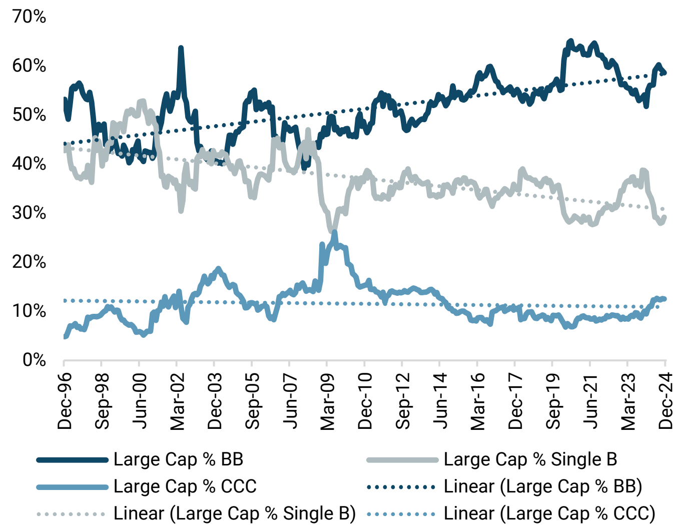
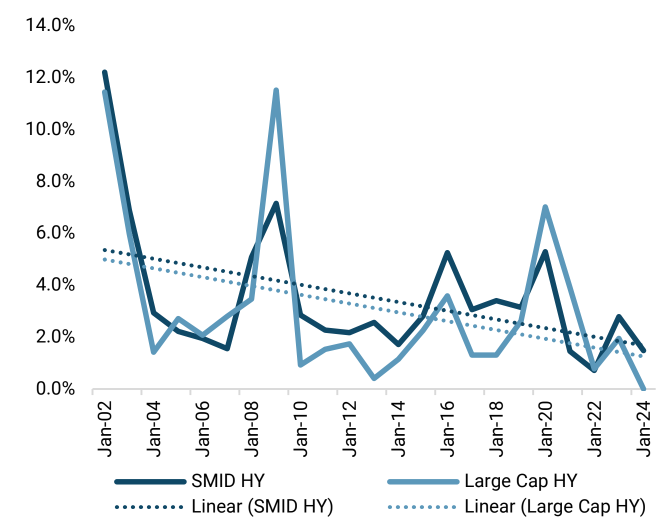


Chart 4: Large Cap HY Quality Trends
As of November 30, 2024



The improved rating composition trend has translated into much lower defaults over the past 25 years (data availability shortened the horizon). **Chart 5** details the impressive declines in HY issuer-level credit defaults. The mean issuer default rate for SMID and Large Caps over the period is 3.5% and 3.1%, respectively. The median default rates are 2.8% and 2.1%, respectively. For the past 10 years, the mean default risk has been lower by 0.7% for both SMID and Large Caps (Median unchanged). This recent trend is probably most attributable to the accelerated credit improvement within the broad HY market as riskier content in single B and CCC was diverted to the private debt and bank debt only issuer market.

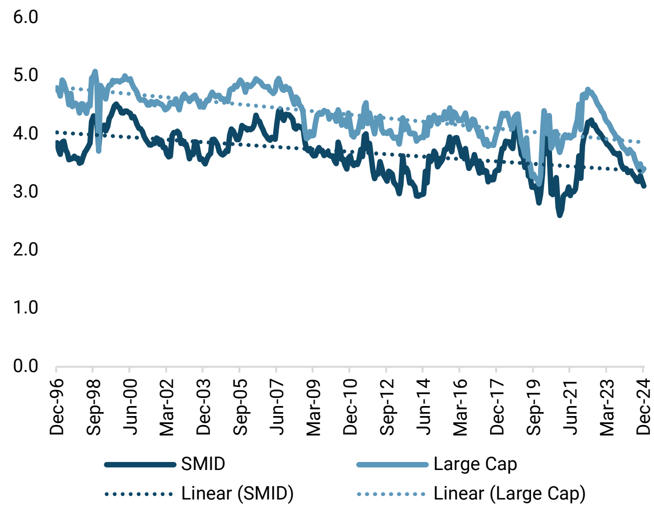
Chart 5: Issuer Default Rates: SMID vs Large Caps
As of December 31, 2024



Duration

Another interesting trend in the HY market is the decline in duration over time. HY has always been a shorter duration fixed income market. **Chart 6** shows duration for SMID and Large Cap HY over the past 28-years. Aside from the broad declines over time, there is a clear differentiation between the two market segments with SMIDs exhibiting nearly uniform shorter duration over the period. Only recently, as the duration declined in both markets with Fed rate increases, the difference between the two markets narrowed. By the end of 2024, SMID and Large Cap duration was approximately 3.1 and 3.4 years, respectively demonstrating a clear bias toward the larger HY credits.

Chart 6: SMID and Large Cap Duration
As of December 31, 2024

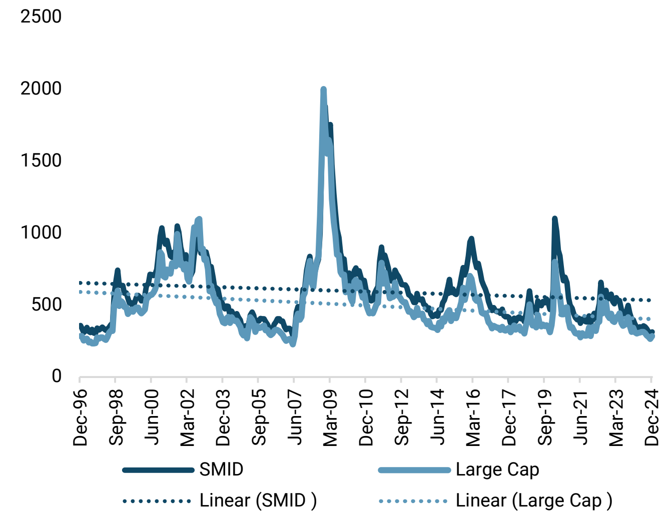


For context, we compared the duration of HY with its close comparable, namely investment grade corporate bonds (IG). In contrast to the broad declines in duration found in HY over the past, IG corporates have exhibited a very different path. In the markets leading up to the GFC, IG bonds exhibited durations that consistently ranged between 1.5-2.0-years longer than Large Cap HY. After the GFC, IG durations started to climb while the HY market started to gradually decline. The peak difference occurred during Covid when the IG duration swelled to nearly 5-years longer than HY. Since COVID, durations in both markets have trended lower. Today, IG duration of about 6.5-years which makes it over 2X as sensitive to rate changes compared to HY and even more so for the shorter duration SMID market.

Valuation

The long perspective of valuation is interesting. **Chart 7** presents the Option Adjusted Spread (OAS) for the SMID and Large Cap market over a 28-year period. Here, we see the cyclical expansion and contraction in spreads tied to the business cycle and intermarket events. As a rule of thumb, the OAS tends to exceed 1000 bps in recessionary periods, driven mainly by concurrent increases in defaults. Since the GFC, we have seen non-recessionary periods that push spreads to near recessionary levels. The 2015-2016 period was probably the best example where a highly focused set of circumstances in the Mining, Metals, and Energy sectors created very difficult localized conditions that produced abnormally high defaults rates in those sectors and led to contagion in the broader HY market. To us, these non-recessionary spread widening events offer great potential opportunities for investors to move from a strategic position in HY by adding a tactical overweight in HY.

Chart 7: SMID and Large Cap Option Adjusted Spread
As of December 31, 2024



Today's markets are much more quiescent with spreads at relatively tight levels in both SMID and Large Cap HY. This is consistent with the supportive fundamental and technical forces in the markets that we have experienced over the last several years. We too are waiting for something to develop that will push spreads wider. Nothing is obvious on the horizon aside from the concerns about government financing cited at the beginning of this article.

Putting It All Together

Our HY strategy incorporates the above historical perspective insofar as it is constructed with our confidence that the state of HY remains solid as indicated by the long run trends. The improved quality and low default environment over the past decade are especially noteworthy. Looking forward, we think HY's low interest sensitivity combined with the high relative carry makes it an ideal structural allocation for asset allocators. However, recognizing the valuation tightness, we are maintaining a below market duration, above market carry and centering our quality orientation in what we believe is the sweet spot of HY – single B credits. As for SMIDs vs Large Cap HY, SMIDs still offer value compared with Large Caps, it is just a more nuanced opportunity as reflected in our slimmed down overweight compared to the broad market and our historical orientation. Overall, our current strategy is consistent with a somewhat defensive position, which is intended to fortify the strategy against rate volatility. This approach also helps gird against the knock-off volatility induced by fundamental and technical contagion.

Data source: Charts 1-7: JPMorgan, H&W; ICE BofA Index

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