NORTHERN TRUST
ASSET MANAGEMENT

FINDING VALUE IN HIGH-YIELD BONDS AND CREDIT MARKETS

Since mid-2023, experts have been increasingly optimistic about U.S. economic growth, which has continued to exceed expectations. Meanwhile, although inflation, as measured by the Consumer Price Index (CPI), is coming down, it hasn't fallen enough for the market to feel confident about its future direction. In our view, the combination of strong growth and a stall in inflation improvement suggests the market no longer expects interest rate cuts in the near term.

What does this mean for public and private credit markets? In the April edition of the *What's the Market Missing?* webinar series, Eric Williams, head of Northern Trust Asset Management (NTAM) Capital Structure Group and lead portfolio manager of our high-yield strategies, along with Bob Morgan, managing director of the NTAM Alternative Investments platform, share their insights.

IDENTIFYING POCKETS OF VALUE

Recent market volatility has been fueled by concern of unchecked inflation and a potential recession, neither of which appear likely at this point. According to Williams, the volatility creates unique opportunities for high-yield investors.

"There has been material repricing in the 10-year Treasury both in nominal and real terms. The dollar continues to strengthen, and we've seen volatility in the commodities market — all of which leads to questions around credits' ability to trade at current valuations and remain resilient amidst these potential headwinds."

He added that, historically, spreads have been able to withstand these macroeconomic pressures when economic growth is strong. "And recently," he said, "spreads have performed quite well because of that growth." Against this backdrop, we think the market is potentially missing some terrific opportunities in certain segments of the market, including the high-yield credit market."

What it is

We provide an in-depth analysis of high-yield bonds and credit markets, highlighting their current performance and identifying opportunities.

Why it matters

High-yield bonds and credit markets present potential opportunities for income generation and portfolio diversification in a volatile economic environment.

Where it's going

As economic growth continues, and inflation steadies, high-yield bonds and credit markets are well-positioned for sustained resilience, offering potential value for investors.

A FUNDAMENTALLY ATTRACTIVE BACKDROP

The current credit market environment presents attractive reasons for investors to consider high-yield bonds.

- **Low volatility:** High-yield spreads have exhibited low volatility year-to-date and have hovered at the tighter end of the spread range vs. higher-quality Treasuries over the last couple of years. This low volatility combined with consistent income generation and discount to par value are characteristics driving more investment in the high-yield market.
- **Increased dispersion:** In 2024, we've seen a wider range of performance (dispersion) among individual high-yield bonds. This dispersion at the security level allows investors to add more value by carefully selecting individual bonds rather than just looking at high-level categories like credit ratings or sectors. We're particularly noticing dispersion in the transportation sector, certain segments of finance, and the energy sector, pointing to potential opportunities.
- **Attractive CCC-rated bond yields:** CCC-rated bond yields remain attractive compared to higher-quality bonds. Looking at spreads since 2021, CCC-rated bonds are near the median level even after their returns outperformed all other rating segments YTD. In contrast, BB and B high-yield bonds seem overvalued relative to higher-quality investment grade comparisons. While there are ample opportunities across different bond ratings, careful research and active management are essential to make the most of these investments.
- **Moderating supply and steady rates:** New high-yield bond issuance in the first quarter of 2024 was the highest in two years. We're not overly concerned that increased supply will be a headwind. A record 83% of high-yield issuance year-to-date has been for refinancing activity. The amount of new debt coming to the market is relatively sparse and, we believe, can easily be absorbed in this environment where investors are allocating more into high-yield credit markets.
- **Resilient corporate earnings and guidance:** More companies are increasing their forecasts for future earnings, revenue, and other financial metrics and fewer are talking about inflation as a headwind.
- **Low distress levels:** Distress levels, which indicate how close companies are to financial trouble or default, remain low. Treasurers and management teams are effectively managing upcoming debt payments and other financial obligations, and most companies, except the least creditworthy, are finding a market for their debt offerings. This suggests a low risk of a rising default rate in the near term.

PRIVATE CREDIT: A LONGER-TERM OPPORTUNITY

The private credit market includes a wide array of strategies, positions in the capital structure, and underlying borrower types. It deals in debt securities that are privately traded, making them less liquid than the public high-yield market.

"In this space you can lend to either non-sponsor or sponsor-backed companies, which are effectively owned by a private equity firm," said Morgan.

"Our philosophy is that alpha is created by avoiding losses. We believe private equity sponsorship provides downside support in difficult market environments and protects the senior lenders to help them avoid those losses."

So, what's the market missing?

Morgan notes that some investors may question whether the market can continue to absorb the recent level of capital inflows and still generate attractive yields and risk/return profiles.

"We believe it can," said Morgan. "The market is driven by private equity fundraising and deal flow. A private equity firm buying a business is going to fund the purchase with about 50% equity capital and 50% debt capital. There is a lot of private equity capital sitting on the sidelines." He added that once markets begin to pick up, firms may need to finance those businesses, which will potentially create a large take-up from private credit providers.

Highlighting that valuations in this market differ from the public debt markets, Morgan offered, "In a relatively illiquid asset class like private credit, there isn't a daily buyer and seller of assets. Valuations and private credit are dictated by company performance and moving interest rates. At the end of the day, you're looking for repayment of capital and avoiding losses on those credits."

Morgan points to two key considerations for a potential private credit investor. The first is risk tolerance: the risk of loss of capital and loss of investment liquidity. The other is a level of experience and expertise. It's important to understand the experience, tenure, and results of the manager you choose and whether they can create a strong portfolio for you. Given the strong inflow of capital into the private credit markets and the rising number of firms raising capital, it has become more important to perform due diligence on their ability to work out of poor credits. Many of today's firms did not exist during the last severe credit cycle in 2008–2009.

CONCLUSION

High-yield bonds and private credit present compelling opportunities in today's credit markets. Deciding whether these investments are right for you requires you to understand your risk tolerance, the potential impact of current market volatility, and the economic backdrop. Choosing a credit manager that has been tested in many market cycles can help you successfully navigate the dynamic landscape of high-yield bonds and private credit.

ABOUT NORTHERN TRUST ASSET MANAGEMENT

Northern Trust Asset Management is a global investment manager that helps investors navigate changing market environments in efforts to realize their long-term objectives.

Entrusted with nearly $1.2 trillion in assets,* we understand that investing ultimately serves a greater purpose and believe investors should be compensated for the risks they take — in all market environments and any investment strategy. That's why we combine robust capital markets research, expert portfolio construction and comprehensive risk management in an effort to craft innovative and efficient solutions that seek to deliver targeted investment outcomes.

As engaged contributors to our communities, we consider it a great privilege to serve our investors and our communities with integrity, respect, and transparency.

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How helpful was this paper?

* Assets under management as of March 31, 2024.

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