# High Yield Bond Market Changes Provide Support

Transformations have bolstered high yield for a modest downturn.

#### **KEY INSIGHTS**

- The high yield market's credit quality improvements stemming from recent changes have positioned the asset class well for a moderate economic downturn.
- Credit fundamentals of high yield issuers remain strong as companies have fortified their balance sheets and liquidity profiles to better weather a recession.
- Trends in individual issuance show fewer small, illiquid issues and an increase in secured issues.

In the roughly 15 years since the global financial crisis (GFC), the high yield bond market has improved in several ways. The overall credit quality of the market has improved, the credit profile of individual high yield issuers is stronger, and bonds from larger issuers as well as secured bonds account for an increasing proportion of the market. Before the GFC, a minority of the high yield bond market held average credit ratings of BB, near the highest end of the high yield rating spectrum. The percentage of the market that is rated BB has steadily increased, and today the majority of the high yield market is rated BB. Encouragingly, 20% of the high yield market was rated within two ratings upgrades of investment-grade status November 2023



Paul Massaro, CFA Head of Global High Yield Franchise



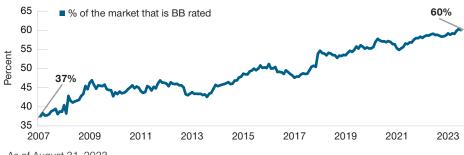
Rodney Rayburn, CFA Portfolio Manager, High Yield Bond Strategy



Jason Bauer, CFA Associate Portfolio Manager, High Yield

#### **BB** Composition of the High Yield Market

(Fig. 1) High yield credit quality has steadily improved



As of August 31, 2023.

Source: Credit Suisse. High yield market is represented by the Credit Suisse High Yield Index. © 2023 CREDIT SUISSE GROUP AG and/or its affiliates. All rights reserved.



...we feel the asset class is in a solid position should the economic outlook weaken. as of June 30, 2023, with 10% of the market within one credit rating upgrade.<sup>1</sup>

This change in market composition occurred over time, with lower-rated issuers migrating to the bank loan market or borrowing in the direct lending market. Those markets have meaningfully increased in size since the GFC. Concurrently, a significant number of issuers migrated from the investment-grade market to high yield upon credit rating downgrades. The entrance of these "fallen angels" to the high yield market accelerated in 2020 as pandemic-era restrictions negatively impacted many investment-grade corporates.

#### **High Yield Issuers Transformed**

The profile of the average high yield issuer has strengthened. This trend was accelerated by the uptick in fallen angels. Today, the average high yield issuer has a larger balance sheet and generates higher earnings than prior to the GFC. Considering the higher-quality bias and general financial flexibility afforded larger companies that generate more cash flow, we feel the asset class is in a solid position should the economic outlook weaken.

These transformations in high yield issuers have led to changes in new issues. With larger, higher-quality issuers dominating the high yield market, smaller-sized new issues have fallen dramatically. The larger issue sizes could improve liquidity in the high yield market.

## Credit Fundamentals Are Strong, and Balance Sheets Are Fortified

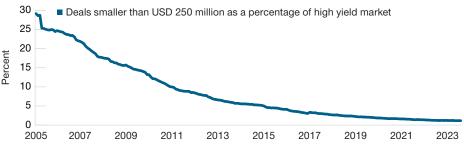
High yield credit fundamentals appear resilient despite a macro backdrop that could be challenging for risk assets. Since the GFC, refinancings have dominated high yield market new issuance as issuers capitalized on historically low interest rates. Following the initial shock from pandemic-related shutdowns, high yield issuance dramatically increased at attractive financing rates, strengthening issuers' balance sheet liquidity. Interest coverage metrics also increased, leaving issuers better able to meet their debt service obligations.

In addition, leverage for U.S. high yield issuers has decreased to its lowest level in over a decade. Despite expectations for a slowing economy, earnings have held up for most high yield issuers, especially in industries that had been severely depressed during the pandemic shutdowns, such as cruise operators.

Fortified balance sheets and resilient earnings place high yield issuers in a solid position heading into any economic downturn.

#### **Global High Yield Issues Under USD 250 Million**

(Fig. 2) Small issue sizes no longer prominent



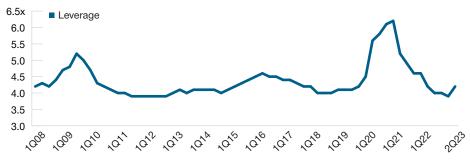
As of August 31, 2023.

Sources: J.P. Morgan Chase & Co. North America Credit Research. Based on J.P. Morgan North America Credit Research. Not from an index. Analysis by T. Rowe Price.

<sup>1</sup> T. Rowe Price analysis of J.P. Morgan data.

#### Average Leverage Ratio of U.S. High Yield Market Issuers

(Fig. 3) High yield issuers have reduced leverage



As of June 30, 2023.

Sources: J.P. Morgan Chase & Co. North America Credit Research. Based on J.P Morgan North America Credit Research. Not from an index.

#### More High Yield Issues Offering Enticing Features

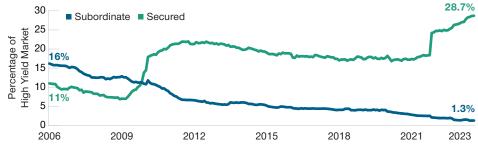
To combat rising inflation, the Federal Reserve has raised rates sharply. As a result, many issuers of bank loans, whose coupon payments are tied to short-term rates, have seen their interest costs increase. In order to balance this floating rate exposure, higher-quality bank loan issuers have opted to partially refinance their loans in the high yield bond market, benefiting from the certainty of fixed coupons while offering secured high yield bonds to replace their senior-secured<sup>2</sup> floating rate loans. These secured high yield issues place bonds on par with loans at the top of the capital structure, potentially offering creditors higher recovery rates in the event of any default.

Secured high yield bond issuance has recently accelerated, resulting in the highest secured allocation in history. In addition, the amount of junior or subordinate debt in high yield capital structures is at an all-time low, further bolstering recoveries in the event of default.

#### The High Yield Market Appears Resilient

The current default rate, while a backward-looking metric, is a good indication of the strength of the asset

#### **Seniority Structure of Global High Yield Market**



(Fig. 4) More high yield bonds appear higher in capital structure

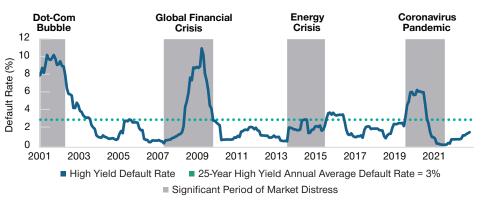
As of August 31, 2023.

Sources: J.P. Morgan Chase & Co. North America Credit Research. Based on J.P Morgan North America Credit Research. Not from an index. Analysis by T. Rowe Price.

<sup>2</sup> Senior-secured loans are debt instruments that are secured by collateral and hold a senior position in a company's capital structure should there be a default.

#### **Global High Yield Market Default Rates**

(Fig. 5) Defaults are running below the historical average



As of June 30, 2023.

Source: J.P. Morgan Chase & Co. North America Credit Research. Based on J.P Morgan North America Credit Research. Information has been obtained from sources believed to be reliable but J.P. Morgan does not warrant its completeness or accuracy. The index is used with permission. The Index may not be copied, used, or distributed without J.P. Morgan's prior written approval. Copyright © 2023, J.P. Morgan Chase & Co. All rights reserved.

class, in our view. The high yield default rate recently picked up but remains well below its long-term average.

Recent defaults have been largely idiosyncratic, including issuers who have defaulted in the past or that recently executed distressed debt exchanges. These defaults appear more company-specific rather than a result of systemic weakness in the high yield market.

Changes in the composition of the high yield market have improved the average quality of aggregate market. Amid a relatively low default rate, larger, higher-quality issuers and new supply offering more attractive characteristics have improved the high yield bond market, in our view.

#### INVEST WITH CONFIDENCE<sup>SM</sup>

T. Rowe Price focuses on delivering investment management excellence that investors can rely on—now and over the long term.

### T.RowePrice®

#### Important Information

This material is being furnished for general informational and/or marketing purposes only. The material does not constitute or undertake to give advice of any nature, including fiduciary investment advice, nor is it intended to serve as the primary basis for an investment decision. Prospective investors are recommended to seek independent legal, financial and tax advice before making any investment decision. T. Rowe Price group of companies including T. Rowe Price Associates, Inc. and/or its affiliates receive revenue from T. Rowe Price investment products and services. Past performance is not a reliable indicator of future performance. The value of an investment and any income from it can go down as well as up. Investors may get back less than the amount invested.

The material does not constitute a distribution, an offer, an invitation, a personal or general recommendation or solicitation to sell or buy any securities in any jurisdiction or to conduct any particular investment activity. The material has not been reviewed by any regulatory authority in any jurisdiction.

Information and opinions presented have been obtained or derived from sources believed to be reliable and current; however, we cannot guarantee the sources' accuracy or completeness. There is no guarantee that any forecasts made will come to pass. The views contained herein are as of the date written and are subject to change without notice; these views may differ from those of other T. Rowe Price group companies and/or associates. Under no circumstances should the material, in whole or in part, be copied or redistributed without consent from T. Rowe Price.

The material is not intended for use by persons in jurisdictions which prohibit or restrict the distribution of the material and in certain countries the material is provided upon specific request. It is not intended for distribution to retail investors in any jurisdiction.

#### DISCLOSURE CONTINUES ON THE FOLLOWING PAGE.

## T.RowePrice®

#### Important Information (cont.)

Australia–Issued by T. Rowe Price Australia Limited (ABN: 13 620 668 895 and AFSL: 503741), Level 28, Governor Phillip Tower, 1 Farrer Place, Sydney NSW 2000, Australia. For Wholesale Clients only.

**Brunei**—This material can only be delivered to certain specific institutional investors for informational purpose only. Any strategy and/or any products associated with the strategy discussed herein has not been authorised for distribution in Brunei. No distribution of this material to any member of the public in Brunei is permitted.

Canada—Issued in Canada by T. Rowe Price (Canada), Inc. T. Rowe Price (Canada), Inc.'s investment management services are only available to Accredited Investors as defined under National Instrument 45-106. T. Rowe Price (Canada), Inc. enters into written delegation agreements with affiliates to provide investment management services.

**DIFC**—Issued in the Dubai International Financial Centre by T. Rowe Price International Ltd which is regulated by the Dubai Financial Services Authority as a Representative Office. For Professional Clients only.

**EEA**–Unless indicated otherwise this material is issued and approved by T. Rowe Price (Luxembourg) Management S.à r.l. 35 Boulevard du Prince Henri L-1724 Luxembourg which is authorised and regulated by the Luxembourg Commission de Surveillance du Secteur Financier. For Professional Clients only.

Hong Kong—Issued in Hong Kong by T. Rowe Price Hong Kong Limited, 6/F, Chater House, 8 Connaught Road Central, Hong Kong. T. Rowe Price Hong Kong Limited is licensed and regulated by the Securities & Futures Commission. For Professional Investors only.

Indonesia—This material is intended to be used only by the designated recipient to whom T. Rowe Price delivered; it is for institutional use only. Under no circumstances should the material, in whole or in part, be copied, redistributed or shared, in any medium, without prior written consent from T. Rowe Price. No distribution of this material to members of the public in any jurisdiction is permitted.

Korea-This material is intended only to Qualified Professional Investors. Not for further distribution.

Mainland China—This material is provided to qualified investors only. No invitation to offer, or offer for, or sale of, the shares will be made in the mainland of the People's Republic of China ("Mainland China", not including the Hong Kong or Macau Special Administrative Regions or Taiwan) or by any means that would be deemed public under the laws of the Mainland China. The information relating to the strategy contained in this material has not been submitted to or approved by the China Securities Regulatory Commission or any other relevant governmental authority in the Mainland China. The strategy and/or any product associated with the strategy may only be offered or sold to investors in the Mainland China that are expressly authorized under the laws and regulations of the Mainland China to buy and sell securities denominated in a currency other than the Renminbi (or RMB), which is the official currency of the Mainland China. Potential investors who are resident in the Mainland China are responsible for obtaining the required approvals from all relevant government authorities in the Mainland China, including, but not limited to, the State Administration of Foreign Exchange, before purchasing the shares. This document further does not constitute any securities or investment advice to citizens of the Mainland China, or nationals with permanent residence in the Mainland China, or to any corporation, partnership, or other entity incorporated or established in the Mainland China.

Malaysia—This material can only be delivered to specific institutional investor. This material is solely for institutional use and for informational purposes only. This material does not provide investment advice or an offering to make, or an inducement or attempted inducement of any person to enter into or to offer to enter into, an agreement for or with a view to acquiring, disposing of, subscribing for or underwriting securities. Nothing in this material shall be considered a making available of, solicitation to buy, an offering for subscription or purchase or an invitation to subscribe for or purchase any securities, or any other product or service, to any person in any jurisdiction where such offer, solicitation, purchase or sale would be unlawful under the laws of Malaysia.

**New Zealand**—Issued by T. Rowe Price Australia Limited (ABN: 13 620 668 895 and AFSL: 503741), Level 28, Governor Phillip Tower, 1 Farrer Place, Sydney NSW 2000, Australia. No Interests are offered to the public. Accordingly, the Interests may not, directly or indirectly, be offered, sold or delivered in New Zealand, nor may any offering document or advertisement in relation to any offer of the Interests be distributed in New Zealand, other than in circumstances where there is no contravention of the Financial Markets Conduct Act 2013.

Philippines—ANY STRATEGY AND/ OR ANY SECURITIES ASSOCIATED WITH THE STRATEGY BEING DISCUSSED HEREIN HAVE NOT BEEN REGISTERED WITH THE SECURITIES AND EXCHANGE COMMISSION UNDER THE SECURITIES REGULATION CODE. ANY FUTURE OFFER OR SALE OF THE STRATEGY AND/ OR ANY SECURITIES IS SUBJECT TO REGISTRATION REQUIREMENTS UNDER THE CODE, UNLESS SUCH OFFER OR SALE QUALIFIES AS AN EXEMPT TRANSACTION.

Singapore–Issued by T. Rowe Price Singapore Private Ltd. (UEN: 201021137E), 501 Orchard Rd, #10-02 Wheelock Place, Singapore 238880. T. Rowe Price Singapore Private Ltd. is licensed and regulated by the Monetary Authority of Singapore. For Institutional and Accredited Investors only.

South Africa–Issued in South Africa by T. Rowe Price International Ltd (TRPIL), Warwick Court, 5 Paternoster Square, London EC4M 7DX, is an authorised financial services provider under the Financial Advisory and Intermediary Services Act, 2002 (Financial Services Provider (FSP) Licence Number 31935), authorised to provide "intermediary services" to South African Investors. TRPIL's Complaint Handling Procedures are available to clients upon request. The Financial Advisory and Intermediary Services Act Ombud in South Africa deals with complaints from clients against FSPs in relation to the specific services rendered by FSPs. The contact details are noted below: Telephone: +27 12 762 5000, Web: www.faisombud.co.za, Email: info@faisombud.co.za

Switzerland—Issued in Switzerland by T. Rowe Price (Switzerland) GmbH, Talstrasse 65, 6th Floor, 8001 Zurich, Switzerland. For Qualified Investors only.

Taiwan-This does not provide investment advice or recommendations. Nothing in this material shall be considered a solicitation to buy, or an offer to sell, a security, or any other product or service, to any person in the Republic of China.

Thailand—This material has not been and will not be filed with or approved by the Securities Exchange Commission of Thailand or any other regulatory authority in Thailand. The material is provided solely to "institutional investors" as defined under relevant Thai laws and regulations. No distribution of this material to any member of the public in Thailand is permitted. Nothing in this material shall be considered a provision of service, or a solicitation to buy, or an offer to sell, a security, or any other product or service, to any person where such provision, offer, solicitation, purchase or sale would be unlawful under relevant Thai laws and regulations.

UK—This material is issued and approved by T. Rowe Price International Ltd, Warwick Court, 5 Paternoster Square, London EC4M 7DX which is authorised and regulated by the UK Financial Conduct Authority. For Professional Clients only.

USA–Issued in the USA by T. Rowe Price Associates, Inc., 100 East Pratt Street, Baltimore, MD, 21202, which is regulated by the U.S. Securities and Exchange Commission. For Institutional Investors only.

© 2023 T. Rowe Price. All Rights Reserved. T. ROWE PRICE, INVEST WITH CONFIDENCE, and the Bighorn Sheep design are, collectively and/or apart, trademarks of T. Rowe Price Group, Inc.