



# High Valuations Balance Healthy Credit in Global High Yield

Credit analysis can expose value even amid tight credit spreads.

October 2021

## KEY INSIGHTS

- Credit spreads on global high yield bonds are well below historical averages, but we believe credit quality in the sector has probably never been better.
- With valuations looking fair, the Sector Strategy Advisory Group has a neutral tactical view of the overall sector.
- Our credit analysts are still finding attractive opportunities in individual credits through bottom-up fundamental analysis.



**Michael Connelly, CFA**

*Sector Strategy Advisory Group member and Co-portfolio manager, Global High Income Bond Fund*

With U.S. Treasury yields mired at low levels and credit spreads<sup>1</sup> on global high yield bonds<sup>2</sup> well below historical averages as of late September, yields in the below investment-grade sector are at record lows. The flip side of these tight spreads is that credit quality in the broad global high yield market has probably never been better. With valuations looking fair, the Sector Strategy Advisory Group<sup>3</sup> has a neutral tactical view of the overall sector. With that said, our credit analysts are still finding attractive opportunities in individual credits through bottom-up fundamental analysis.

## Strengthening Credit Quality

Some general trends in the global high yield market since the onset of

the pandemic have contributed to a strengthening of fundamental credit quality. The weakest credits defaulted during the peak of the crisis in 2020 and have left the market. At the same time, a flood of “fallen angels”—issuers downgraded from investment grade into the high yield universe—greatly increased the number of BB rated (the top rung of high yield ratings) credits in the market.

Credit quality in the sector is continuing to improve. Issuer leverage has been falling as profitability recovers, and underwriting standards for new issues have been largely reasonable, in part due to a lack of aggressively structured leveraged buyouts (LBOs). Technical conditions in the market are also supportive as the search for yield in the ongoing low rate

<sup>1</sup> Credit spreads measure the additional yield that investors demand for holding a bond with credit risk over a similar-maturity, high-quality government security.

<sup>2</sup> Represented by the ICE BofA Global High Yield Index.

<sup>3</sup> The T. Rowe Price Sector Strategy Advisory Group (SSAG) is comprised of select Fixed Income investment professionals, specializing in a range of disciplines, who collaboratively generate investment ideas that may be used in portfolios. Views are based on SSAG research and discussions, combining fundamental analysis from sector specialists with insights from our quantitative research experts and proprietary tools. Tactical views are short term in nature, are as of the latest SSAG discussions, and are subject to change. Neutral represents neither positive nor negative.

## Spreads and Yields Near Historical Lows

(Fig. 1) Spread and yield to worst,\* global high yield bonds\*\*



### Past performance is not a reliable indicator of future performance.

As of August 31, 2021.

Source: ICE Data Indices, LLC ("ICE DATA"), is used with permission. ICE DATA, ITS AFFILIATES AND THEIR RESPECTIVE THIRD-PARTY SUPPLIERS DISCLAIM ANY AND ALL WARRANTIES AND REPRESENTATIONS, EXPRESS AND/OR IMPLIED, INCLUDING ANY WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE OR USE, INCLUDING THE INDICES, INDEX DATA AND ANY DATA INCLUDED IN, RELATED TO, OR DERIVED THEREFROM. NEITHER ICE DATA, ITS AFFILIATES NOR THEIR RESPECTIVE THIRD-PARTY SUPPLIERS SHALL BE SUBJECT TO ANY DAMAGES OR LIABILITY WITH RESPECT TO THE ADEQUACY, ACCURACY, TIMELINESS OR COMPLETENESS OF THE INDICES OR THE INDEX DATA OR ANY COMPONENT THEREOF, AND THE INDICES AND INDEX DATA AND ALL COMPONENTS THEREOF ARE PROVIDED ON AN "AS IS" BASIS AND YOUR USE IS AT YOUR OWN RISK. ICE DATA, ITS AFFILIATES AND THEIR RESPECTIVE THIRD-PARTY SUPPLIERS DO NOT SPONSOR, ENDORSE, OR RECOMMEND T. ROWE PRICE OR ANY OF ITS PRODUCTS OR SERVICES.

\*The lowest possible credit spread and yield that can be realized on a bond that does not default.

\*\* Represented by the ICE BofA Global High Yield Index.

<sup>1</sup> A basis point is 0.01 percentage points.

environment has buttressed demand for below investment-grade bonds, while new issuance has declined from its 2020 highs.

### Easy Access to Liquidity

Also, issuers currently have easy access to liquidity by selling new bonds, borrowing from banks, or tapping the equity market through secondary stock offerings. Private credits can also sometimes obtain equity funding via a special purpose acquisition company (SPAC), which equity investors snapped up earlier in 2021. Many companies have used the proceeds from equity raises to pay down debt.

These credit-positive trends kept the default rate at unusually low levels after the initial pandemic-induced economic shutdowns. The U.S. high yield default

rate (excluding the energy sector) was only 0.58% over the 12 months through August 31, 2021, compared with an average annual default rate since 2005 of 3.88%.<sup>4</sup> Given the strong credit quality of the sector and robust economic growth currently, we anticipate that the default rate will remain near historic lows into 2022.

### Tight Credit Spreads

Credit spreads in global high yield are tight, or narrow, which we believe is an accurate representation of the strong current credit quality in the sector. As of August 31, the spread on the ICE BofA Global High Yield Index was 375 basis points (bp)<sup>5</sup> versus the 10-year average of 505 bp. Combined with U.S. Treasury yields that are still near historic

<sup>4</sup> Default rate data source: Bank of America. Default rate is weighted by par value outstanding.

<sup>5</sup> A basis point is 0.01 percentage points. Spreads and yield are based on the underlying bonds of the index. Shown for illustrative purposes only and is not indicative of any specific investment. Investors cannot invest directly in an index. Past performance is not a reliable indicator of future performance.

“There is a large volume of high yield bonds with improving credit quality that could move into the investment-grade universe...”

lows, this has pushed the yield to worst on the index to near record-low levels: 4.12% as of August 31. Also, credit curves in the sector are unusually flat—investors may gain an atypically small amount of additional spread by moving down in credit quality within the below investment-grade universe.

These broad trends—strong and improving overall credit quality accompanied by tight credit spreads—also generally apply for high yield markets outside the U.S. The European below investment-grade market has typically provided some additional spread relative to the U.S., but that extra spread is currently smaller than usual.

We are also seeing low levels of additional spread relative to the U.S. in most below investment-grade emerging market regions—the notable exception being the Asian high yield market, which is experiencing high levels of volatility stemming from the Chinese government’s attempt to curb excessive leverage among certain Chinese property developers (notably China Evergrande). While this volatility has caused the bonds of many Asian high yield issuers to decline, we have seen opportunities to add to our favorite higher-quality Asian bonds at what we believe are attractive discounts.

### **High Volume of Potential Rising Stars**

There is a large volume of high yield bonds with improving credit quality that could move into the investment-grade universe, where they would become “rising stars.” In U.S. high yield bonds, 9.5% of the Bloomberg U.S. High Yield Index was one rating move away from investment grade as of August 31 versus 7.0% at the end of 2019. A remarkable 23% of the U.S. index was two or fewer rating moves from investment grade, up from 15% on December 31, 2019.

This trend, which stems from both credit rating upgrades and fallen angels

entering the market, illustrates how much the overall credit quality of the sector has improved. It should also provide technical support for global high yield by removing a large volume of bonds from the market as they receive upgrades and gain investment-grade ratings.

### **Global High Yield Carry Still Attractive**

Although the narrow credit spreads limit the room for capital appreciation through spread compression, global high yield still offers attractive carry<sup>6</sup> relative to other credit sectors—most of which are near their own record-tight spread levels. One global high yield segment where we do see some potential for spread tightening is credits that could soon become rising stars.

We rely heavily on our global team of high yield credit analysts to select credits that appear to represent attractive value relative to their credit quality. This bottom-up analysis and security selection drive any industry overweights or underweights. We are currently finding some opportunities in segments most affected by the pandemic, where concerns about the delta variant have pressured prices. These areas include airlines (particularly bonds backed by airline mileage programs), domestic gaming, and automotive. We also have a long-standing overweight to the cable industry—particularly in Europe—which has benefited from stable business models. We are cautious on energy-related credits despite the recent runup in commodities prices.

### **Bank Loans Attractive vs. High Yield Bonds**

In many cases, we prefer to invest in bank loans over high yield bonds from the same issuer. Loans typically have below investment-grade credit ratings but are higher in the capital structure than bonds, giving them repayment priority in the event of default. Bank loan coupon payments adjust in line with changes in a

<sup>6</sup> Carry is interest income in excess of the cash rate.

benchmark short-term interest rate such as the three-month London interbank offered rate (LIBOR). This means that they have low duration.<sup>7</sup> Many loans currently provide spreads comparable to—or even better than—bonds with similar credit quality. The combination of low interest rate risk, lower exposure to commodities prices, strong technical support, and relatively high carry makes bank loans attractive in our view.

### **Potential Macro and Technical Risks**

While we are confident in these select opportunities in global high yield debt, we are monitoring several potential risks that could cause a sell-off and credit spread widening. The delta variant could have a larger-than-anticipated impact on growth, likely dragging commodities prices lower

(approximately 20% of the global high yield bond market is commodities-related) and weighing on the global economy in general. Pandemic-related fiscal stimulus is winding down, which will remove meaningful support from the bumpy economic recovery from the pandemic. Also, the new high yield issuance calendar for the fall looks busy, so the additional supply could create more challenging technical conditions in the global high yield market.

Barring a sharp increase in Treasury yields or a deep downturn in global growth, we anticipate that the ongoing search for yield will continue to support demand for global high yield bonds and bank loans.

### **WHAT WE'RE WATCHING NEXT**

Healthy demand from new collateralized loan obligations (CLOs), which are portfolios of bank loans structured into slices, or tranches, with varying levels of credit risk, has helped support technical conditions in the loan market. Although we do not anticipate a near-term downturn in new CLO formation, a meaningful deceleration could reduce the technical tailwind that has lifted bank loan prices.

<sup>7</sup> Duration measures a bond's or a bank loan's sensitivity to changes in interest rates.

#### **Additional Disclosure**

"Bloomberg®" and Bloomberg U.S. High Yield Index are service marks of Bloomberg Finance L.P. and its affiliates, including Bloomberg Index Services Limited ("BISL"), the administrator of the index (collectively, "Bloomberg") and have been licensed for use for certain purposes by T.Rowe Price. Bloomberg is not affiliated with T. Rowe Price, and Bloomberg does not approve, endorse, review, or recommend products. Bloomberg does not guarantee the timeliness, accurateness, or completeness of any data or information relating to its products.

## INVEST WITH CONFIDENCE®

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

To learn more, please visit [troweprice.com](http://troweprice.com).

# T.RowePrice®

## Important Information

*Call 1-800-225-5132 to request a prospectus or summary prospectus; each includes investment objectives, risks, fees, expenses, and other information you should read and consider carefully before investing.*

This material is provided for informational purposes only and is not intended to be investment advice or a recommendation to take any particular investment action.

The views contained herein are those of the authors as of October 2021 and are subject to change without notice; these views may differ from those of other T. Rowe Price associates. **Debt securities could suffer an adverse change in financial condition due to ratings downgrade or default, which may affect the value of an investment. Fixed income securities are subject to credit risk, liquidity risk, call risk, and interest rate risk. As interest rates rise, bond prices generally fall. Investments in high yield bonds involve greater risk of price volatility, illiquidity, and default than higher-rated debt securities. Investments in bank loans may at times become difficult to value and highly illiquid; they are subject to credit risk, such as nonpayment of principal or interest, and risks of bankruptcy and insolvency.**

**The fund is subject to market risk, as well as risks associated with unfavorable currency exchange rates and political economic uncertainty abroad.**

This information is not intended to reflect a current or past recommendation concerning investments, investment strategies, or account types, advice of any kind, or a solicitation of an offer to buy or sell any securities or investment services. The opinions and commentary provided do not take into account the investment objectives or financial situation of any particular investor or class of investor. Please consider your own circumstances before making an investment decision.

Information contained herein is based upon sources we consider to be reliable; we do not, however, guarantee its accuracy.

**Past performance is not a reliable indicator of future performance.** All investments are subject to market risk, including the possible loss of principal. All charts and tables are shown for illustrative purposes only.

T. Rowe Price Investment Services, Inc.

© 2021 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.