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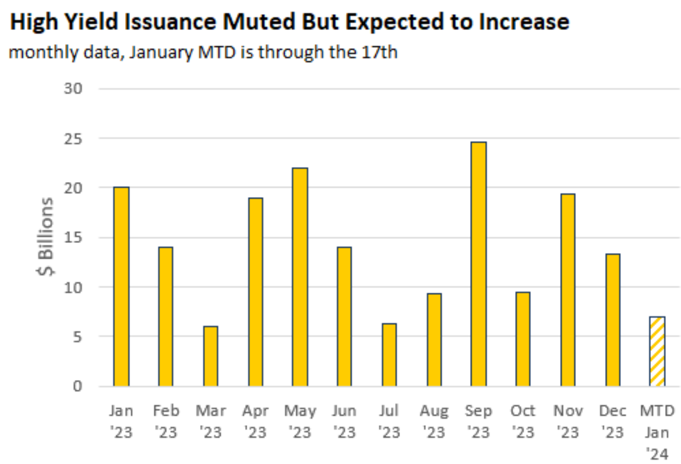
SKY Harbor Weekly Briefing

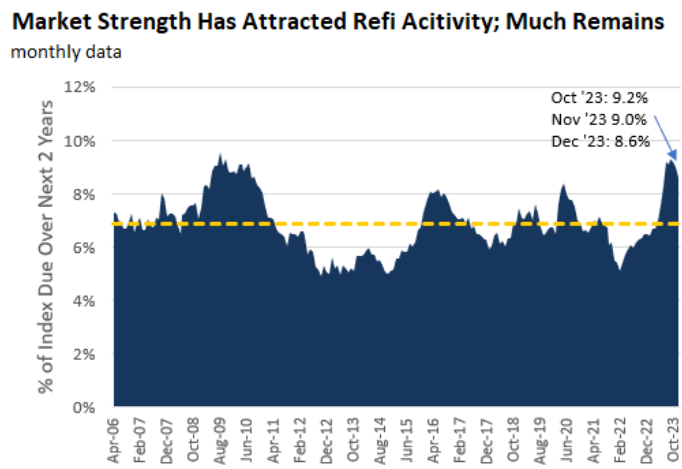
Chipping Away

US high yield bond markets have struck a somewhat subdued tone through the first few weeks of 2024, giving back a small portion of the outsized gains generated in the final two months of last year. Accordingly, new issuance has surprised to the downside, though taken in aggregate with a solid primary market calendar in November and December, the once daunting maturity "wall" continues to look increasingly manageable. In this *Weekly Briefing*, we take a look at refinancing activity thus far in January, and find significant improvement in our fundamental credit ratio simulation as a result of Treasury yield and index option-adjusted spread compression in recent months.

No Longer a Waiting Game

High yield bond issuance has underwhelmed thus far in January, coming in at approximately $7bn through the time of writing. However, taking into account relatively healthy November and December volumes, **the percentage of the ICE BofA US High Yield Index (H0A0) maturing in the next 24 months has moderated, now sitting at 8.6%.** Though above the trailing 20-year average of approximate 6.9%, the refinancing hurdle has come down 60 bps relative to our initial analysis, which is contained in an October '23 *Weekly Briefing* entitled "Not Yet Up Against a Wall").

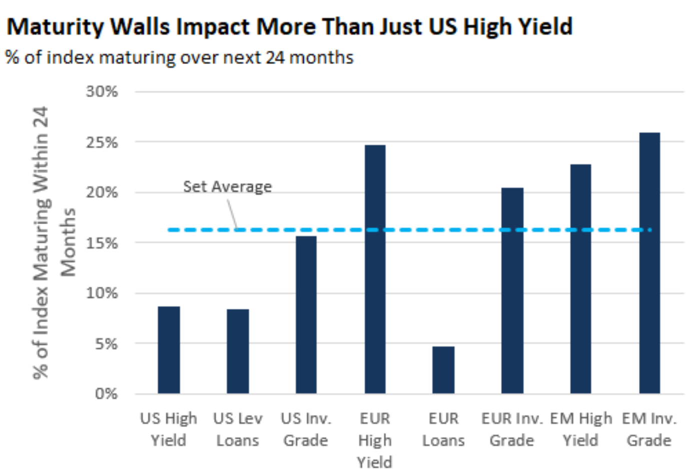


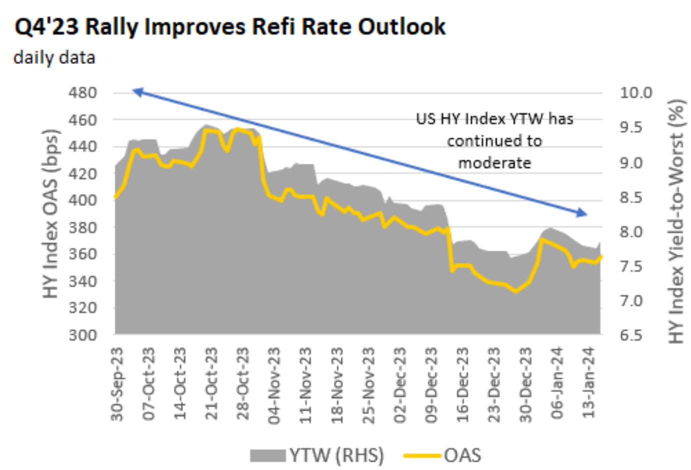


Source: SKY Harbor, JP Morgan, BofA Merrill Lynch

Rate Rally Reduces Refi Hurdle

Importantly, and as demonstrated below (left side), **US high yield is not the only market with near-term refinancing needs**. A rapid repricing of rates since the Fed embarked on an aggressive hiking cycle back in March '22 has made existing coupons look attractive to a range of issuers, compelling many to sit on the sidelines and postpone action until cuts begin. With time to wait now dwindling, **an aggressive refinancing push has begun, just not in the high yield space**. More specifically, the investment grade market has already seen over $100bn of new deals price since the new year, and roughly 60 deals have launched in the leveraged loan space since early December. As such, though issuance has been slow to materialize for high yield bonds, we suspect volumes will ramp once ancillary market activity cools. Additionally, and as noted below (right side), H0A0 **yield compression over the last few months now position bond issuers to refinance with a smaller uptick in interest expense than originally feared**, which should alleviate fundamental credit ratio degradation in the coming quarters.





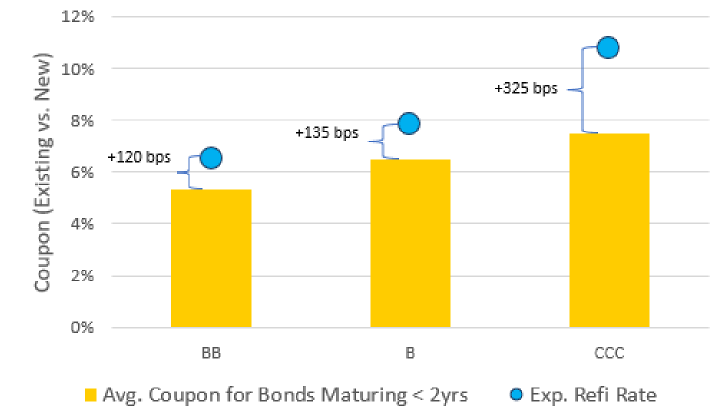
Source: SKY Harbor, BofA Merrill Lynch, ICE Data Indices

Coupon Step-Ups on the Decline

We now estimate that just under $120bn of high yield debt will need to be refinanced over the next year, assuming issuers remain averse to letting bonds go current on their balance sheets. With this in mind, we re-constructed our analysis from last October, breaking down the universe of bonds maturing in < 2 years (period ending December 31, 2025) by rating bucket, and comparing average coupons of bonds likely to be refinanced to market yields for paper with similar ratings and of a tenor commensurate with primary market activity (5 to 7 years). As demonstrated below, **we find an implied average cost uptick of ~ 165 bps for refinanced debt across the index as a whole, with CCCs facing the most daunting step change (nearly +325 bps)**. Importantly, the uptick has fallen significantly across all rating buckets since our original analysis, with the CCC hurdle looking increasingly manageable as coupon step-ups declined from +690 bps at the start of Q4'23 to +325 bps today.

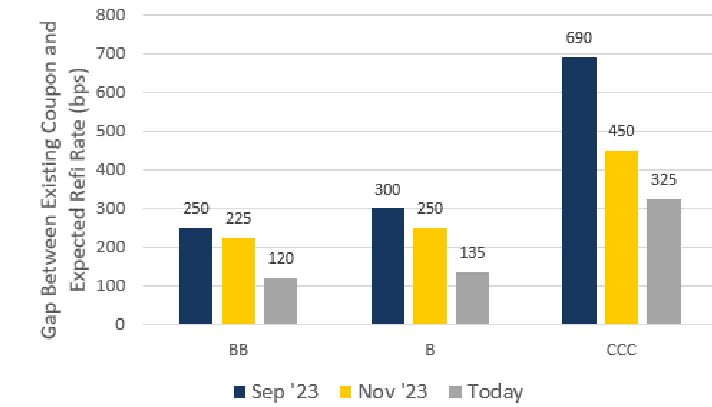
Expected Coupon Uptick Still Most Severe for CCCs...

maturities through December '25, by face value



...But Repricing Looks Less Daunting

expected uptick evolution



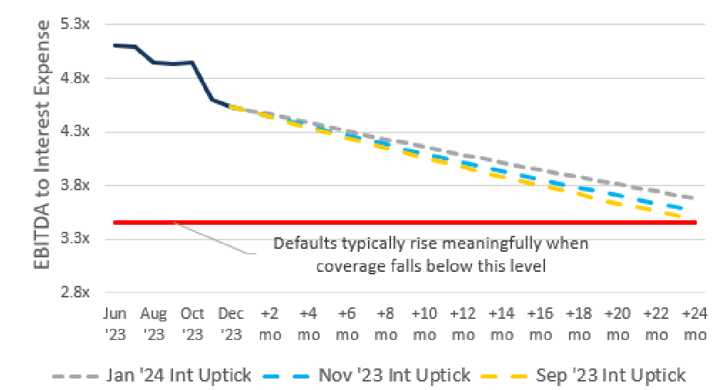
Source: SKY Harbor, ICE Data Indices

Re-Simulating the Path of Interest Coverage

How impactful is this moderation in expected coupon uptick? If we overlay our estimate of intermediate-term EBITDA growth (-3%), assume debt balances grow at a rate commensurate with inflation, increase interest expense linearly as existing coupons are swapped for new issuance, and (admittedly quite conservative) assume no free cash flow for opportunistic debt reduction, **we find that recent yield compression keeps interest coverage .3x higher over a 2-year period, and comfortably above the asset class "danger zone"** (index defaults have historically moved up aggressively when coverage falls below 3.4x, as denoted by the red line in the left chart below). More importantly, on the CCC side, the difference between a 690 bps interest expense uptick (from the Sep '23 analysis) and the 325 bps uptick (today's estimate) prevents average coverage from dipping below 1.0x over a 2-year period for the rating cohort. As such, these recent trends bode well for default and credit loss mitigation for our asset class.

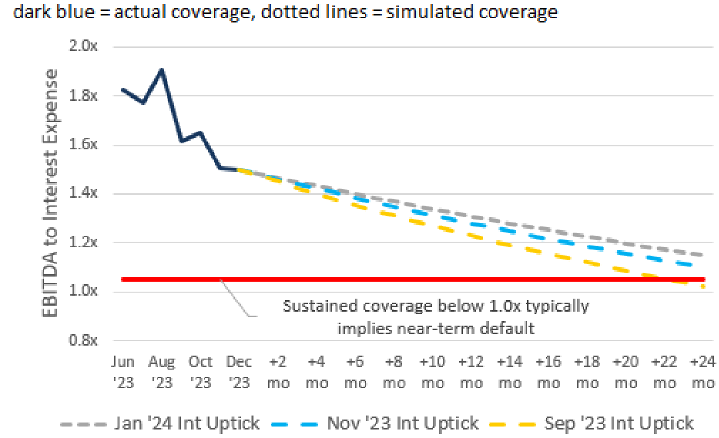
HY Index Int. Coverage Path Improving; Stays Above Danger Zone

dark blue = actual coverage, dotted lines = simulated coverage



CCC Int. Coverage Now Expected to Stay Above 1.0x

dark blue = actual coverage, dotted lines = simulated coverage



Source: SKY Harbor, BofA Merrill Lynch, ICE Data Indices, Bloomberg

An Improving Outlook

With the maturity wall getting closer, an uptick in issuer interest expense has become inevitable. However, treasury yield and index OAS compression in recent months reduces the expected repricing headwinds for issuers in our market, which improves the outlook for fundamental credit ratio migration. While we continue to focus on earnings resilience and balance sheet strength in the current market environment, we acknowledge a reduction in pressure on CCC interest coverage metrics continues to alleviate default risk. As such, we have opportunistically reduced our underweight to the more speculative parts of the high yield index, identifying several attractive total return opportunities as maturity wall concerns dissipate.

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