Audio Transcript: Looking Past Spreads for Opportunities in High Yield
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Katie Klingensmith [00:00:01] Welcome, everybody, to today's conversation as part of Brandywine Global Around the Curve podcasts. I'm Katie Klingensmith with Brandywine Global, and I'm delighted to be joined by my colleague, Bill Zox. Bill is a lead on a number of strategies that focus on high yield and corporate credit, both in the US and globally. And this is always important, but particularly interesting right now, given that there has been quite a bit of concern that with the success of many credit strategies and spreads very tight. But I think a lot of people are wondering if credit markets and credit investing will be quite as exciting going forward. So with that Bill, that's the elephant in the room. Welcome and get us started. Do you really feel like credit spreads being so tight can justify folks going into this space right now?

Bill Zox [00:00:57] Nice to talk to you, Katie. Credit spreads are tight. I will stipulate that at the outset. They are about 30 or 35 basis points wider than their tights in early March. So, they have widened a bit. But I will stipulate that they are tight. But that's not the only factor. We also have yields at about 8.3% in the US high yield market right now, which is a very attractive yield. And the dollar price is just a bit above $0.91 on the dollar. So, that's a very attractive price for credit. And, you also have very strong fundamentals right now. Defaults have leveled out in the mid 2% range, which is well below long-term historic averages. And you've had very good inflows into the asset class until the last couple of weeks. But, we still see tremendous demand outside of the US for those yields. And, you know, basically net supply, meaning supply other than refinancing, has been very muted in compared to this strong demand. So, the technicals have been very strong. So, these are a number of factors that have led to considerable strength in the high yield market. And I think that the market is set up fine from here, even with tight spreads. All these other factors are also important and very constructive for the high yield market.

Katie Klingensmith [00:02:41] So, we're going to dive into so many different parts of that. But just to reiterate a really important point. Spreads are relatively tight. They've been tighter. But you don't think that's fundamentally misaligned with the risks and the opportunities in the space.

Bill Zox [00:02:56] That's right. I mean, I think that the outlook is strong. I mean, remember, high yield management teams have had two years, almost two years now, to prepare for higher interest rates and potential recession. They've had good access to capital, say all but maybe the bottom 10% of the high yield market. Those management teams have had good access to capital the entire time, and it's actually improving this year. So, you know, defaults, as I said before, they're running in the mid 2% range. They've leveled out over the last 5 or 6 months. And, you know, spreads can only get so wide when the fundamentals are this strong and the technicals are this strong in terms of the supply and demand in the marketplace. So, you know, spreads are tight, that's an important risk that managers have to address. But there's still plenty of opportunity in the high yield market. And I think that the supply and demand fundamentals will continue to be favorable going forward.

Katie Klingensmith [00:04:08] But even if they're favorable, there are so many wild cards in the macro space right now. Do you feel like there's so much potential for interest rate volatility that this is too tricky of a space right now? Or is that something that both issuers and investors can reasonably manage?

Bill Zox [00:04:25] Yeah. I mean, I think that the interest rate volatility, I'll separate it into to two things. I mean, the most important thing for credit is, is the Fed done hiking? And I think that, look, the Fed clearly does not want to hike anymore. That's I think very, they've made that very clear. The timing and the amount of rate cuts is very uncertain. That's why we've seen this pick-up in interest rate volatility in recent months. But that kind of interest rate volatility is much less of an issue for credit. Credit struggled along with all financial assets in the first half of 2022, when we were just starting to contemplate how high the Fed might have to get to return inflation to 2%, how weak the economy would have to get. How tight financial conditions would have to get. All of those questions. But now, if the question is just, you know, when will the Fed start to cut, and how many cuts over what period of time? That's less of an issue for high yield. It's much more of an issue for core fixed income, where again, as I said at the outset, you're starting in the market with an 8.3% yield in high yield. If you're looking at a 5-year Treasury, it's 4.65%; 10-year Treasury at 4.6%. Cash at five and a quarter or so. You have to make some assumptions about why you would move out of cash into the 5-year, the 10-year, let alone the 30-year part of the Treasury curve. You have to probably assume some capital gains or some rate cuts, you know, over a well-defined period of time to justify that move. But when you're starting with 8.3% and very limited defaults in the high yield market, I think it's an easier step to take for investors. So, again, I'm not going to argue that spreads at about 340 basis points in the high yield market today are on the tight side of things. But that's not the only consideration.

Katie Klingensmith [00:06:47] Right. The total return package still seems very attractive.

Bill Zox [00:06:50] Right. And the carry in particular. And timing is much more important if you're investing in fixed income where you're not, where you're giving up the carry, you know, relative to cash. But for high yield, you have a very significant excess yield, you know, compared to cash. It gives you time to see how these factors play out. As long as you steer away from the defaults. And the fundamentals are strong, access to capital is strong. So, it's not that difficult to steer away from defaults in high yield right now. And the defaults are coming from the part of the market where investors, they're very aware of the default risk in this part of the market. It's the bottom 5 to 10% of the market. You're not seeing a jump to defaults where credits are going from $0.90 on the dollar to $0.30 on the dollar or something like that. We're not seeing that. It's not the kind of environment where you're getting surprises like that.

Katie Klingensmith [00:08:00] So, the carry can justify managing through a certain amount of volatility. Relatively easy to avoid a lot of defaults. But what happens if rates are just higher for quite a bit longer?

Bill Zox [00:08:12] Yeah. Un the high yield, US high yield market, it's largely a fixed rate market. And so much of the financing was put in place in 2020, 2021. You know, probably 60%+ of the market was financed at very low coupons in 2020, '21. But those bonds are not coming due until, you know, more like '27, '28. So right now, higher for longer for the next couple of years, if you have a fixed rate capital structure, it's not that much of an issue in the high yield market because we're talking about refinancing coupons, you know, more like from 2018, 2017. And the incremental cost of capital is not that material. Most issuers have spaced out their maturities. So, it's just not that material. And we've already largely addressed 2025 maturities and making great progress on 2026. So, this is more of a concern in 2026, once you start to look at the '27 and '28 maturities that were, where the coupons are extremely low, and we'll have to see where rates are at that time. Now, if you have floating rate debt, which would be the loan market and the private credit market, entirely floating rate markets. It's just a question of to what extent that floating rate risk was

hedged. That's more of an immediate concern because, you know, they've already experienced, the 500-basis point increase in SOFR is already impacting their cost of capital to the extent that they have not hedged it. So, it's more of an issue for that part of the market. And where you have overlap, where you have high yield, fixed rate, high yield issuers that also have floating rate debt, it can be more of an issue.

Katie Klingensmith [00:10:13] Bill, just to drive home this point. I know you and team have emphasized, really for a couple of years, that sure, maturity wall is an important concept. It's just not upon us. So, even if the Fed keeps rates where they are for another year or two, we're not going to see some massive wave of forced refinancing and potentially some solvency issues as a result.

Bill Zox [00:10:35] I think that is right. I think that if rates continue to be at these levels into 2026, and we start to address the 2027, 2028 maturities, the incremental cost of capital will increase much more, and that could become more of an issue at that time. But for a fixed rate borrower. That's right. A couple more years before it becomes that much of an issue.

Katie Klingensmith [00:11:04] Clearly, this is all about the Fed. What about globally and especially thinking about some other central banks that seem closer to considering cutting rates?

Bill Zox [00:11:14] Yeah, I think that the maturity walls have not been addressed to the same extent outside the US, probably because the issuers expect the rate cuts to start in the next few months. And, I would assume that once we start to see those rate cuts that the issuers will become, you know, more aggressive about refinancing their maturities. So, right now, we have not seen much issuance outside the US. That could pick up once the central banks start to cut. That could also lead to more US issuers considering those markets to issue some debt, you know, in other currencies and other markets.

Katie Klingensmith [00:12:04] So, that makes it actually an interesting time to be thinking about global credit portfolios. If those dynamics, those rate, policy rate dynamics and financing opportunities start to diverge more across the globe.

Bill Zox [00:12:17] That's right. It could definitely create opportunities for US investors and US issuers to look at markets outside the US.

Katie Klingensmith [00:12:30] Interesting. But would you characterize this with the dynamics perhaps varying between the US and those other countries, do you think we're at the beginning of a new credit cycle? or is this just a really long period of policy transition?

Bill Zox [00:12:42] Yeah, I mean, that is a very interesting question. I think that had we discussed this at the beginning of 2022, we would have said, absolutely. It's just a question of how severe it gets. But at this point, it looks like it's just a very long process of normalization with, you know, we're two years and a quarter into it. And defaults have leveled out at, you know, in the mid 2% range. Long-run averages are more like mid 3%, high 3% range. So, it looks like it's just normalization, not an actual default cycle. And then the question is, you know, there's several different cycles going on at the same time. The economic cycle. I mean, we could still have a recession over the next 12 to 18 months. And the question is, would a recession at this point lead to a true default cycle? And to me, that's not even clear at this point because there's been it's, you know, two years almost

that the issuers have had to prepare, as I've been saying, and they've had access to capital. I don't even know, you know, whether a recession in, say, 12 to 18 months would lead to a default cycle at this point.

Katie Klingensmith [00:14:11] That's clearly a risk. Are there other big picture risks to this otherwise pretty sanguine approach to US and global credit?

Bill Zox [00:14:21] Yeah, I mean, I think that the risk is largely in the big capital structures that their debt is not sustainable at these interest rate levels. And, you know, these are big issuers. They're in the news. We're seeing, you know, you will see defaults in this part of the market. And maybe even more importantly, you're seeing liability management exercises. Sometimes, it could be creditor-on-creditor violence. It could be owner-on-creditors violence. You're seeing, you know, some fairly intense processes where the excessive leverage is being addressed. And this is probably the biggest risk in the market, but it's also a very significant opportunity if you're in the right part of the capital structure, and you're invested at the right price. So, this is probably the most interesting part of the market right now where I think that the access to capital for these big companies is probably better in many cases than the market anticipates. And this is where we're seeing private credit, as one example, come in and commit significant capital in a safer part of the capital structure. If you're involved in the right place and at the right price, that could be to your benefit as an investor. If you're not in the right place, you know, you could be wiped out. You could be crammed down. So, it's sort of treacherous. Our approach in many markets is just to stay away from these big capital structures. That's a big advantage that we have, is that we're structured so that we do not have to invest if we don't see the opportunity, but we're also looking for opportunities in this space.

Katie Klingensmith [00:16:24] Just to bring it all together. I'm sure we could spend another easily half an hour talking about some of the specific opportunities. But where do you see emerging opportunities right now?

Bill Zox [00:16:37] I think that other than what we just talked about, it's really looking for the laggards. You know, one thing that you have to do in this environment, you addressed it several times in this conversation, is if the spreads are too tight, you've got to sell and look for opportunities where the spreads still represent reasonable value. So, that means combing through the laggards and identify the laggards that still offer value. They're not laggards for a good reason. They're laggards for some invalid reason. And then either stick with those positions if you already own them, maybe add to those positions. Or maybe move around in the capital structure in those positions, as there's dislocations within capital structures all the time. So, you can improve your position within a particular issuer's capital structure. So, you know, it's hard to generalize in this environment that there's one, to call it an emerging opportunity. It's not really, I wouldn't call it emerging. It's more of the opposite end of the spectrum. It's, you know, something that has not benefited from this tremendous rally in risk assets that we've seen from the beginning of November, end of October last year. You know, up until, through March of this year. It's been a little bit soft in April, but not, you know, not too dramatic of a pullback. So, it's really more looking for the laggards than an emerging opportunity, I think.

Katie Klingensmith [00:18:26] Bill, you're talking about finding opportunities among laggards. Is there a particular area or an example?

Bill Zox [00:18:33] Yeah, Katie. One industry that does come to mind is the cable industry. And this is kind of a classic example right now where there's a negative feedback loop

between the debt and the equity, meaning the equity is weak day after day after day. And that leads to wider credit spreads. And the wider credit spreads, you know, are probably causing some concern for the equity holders. And maybe that's why the equity is weak day after day. And so cable, you know, is an industry. It does face some competitive pressures that have intensified in recent years from fixed wireless and fiber overbuilders. But it's an industry where the underlying strength of the business is still there. That cable connection delivering high speed internet to your home is still a very valuable asset, in our view. So, that's one where I think the management teams have to start focusing more on bringing their credit spreads in, and that will give them a chance to then get a better multiple on the equity. But, you know, that's one where we are finding significant opportunities on the debt side that, you know, that they have not participated much in this rally since late October, early November.

Katie Klingensmith [00:20:10] Well, Bill Zox, it's been wonderful to have I think a little bit of optimism and certainly lots of insights around the US and the global high yield and broad credit opportunities. Thank you so much for participating.