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The Changing Nature of Public Credit

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Key takeaways

- **The average credit quality in the public high yield bond universe has improved over time.**
- **This increase in quality may be partly due to private credit's growth as an asset class as well as the fact that many lower quality borrowers have opted to issue floating rate loans instead of high yield bonds over the past decade.**
- **While the yields available on high yield bonds are essentially as high as they have been in almost a decade, this is mostly driven by higher interest rates across the board (i.e., higher yields on Treasuries) rather than the market perceiving great risk and/or demanding a higher reward.**
- **There is a risk that if rates remain elevated for a longer term, refinancing at higher rates on existing debt could lead to deterioration in debt servicing ability.**

Introduction

In recent years, a multitude of trends have been influencing the public credit environment and shaping the nature of the asset classes within them. This research note aims to identify a handful of these trends and briefly describe how they have molded the public credit market.

Increased credit quality

The high yield bond market has seen a trend of increased average credit quality over the past decade. As shown below in Figure 1, the composition of the Bloomberg US Corporate High Yield Index has evolved from Ba quality representing 37% of market value in December 2000 to 49% in May 2024. This has been offset by decreasing exposure to B and Caa-rated bonds.

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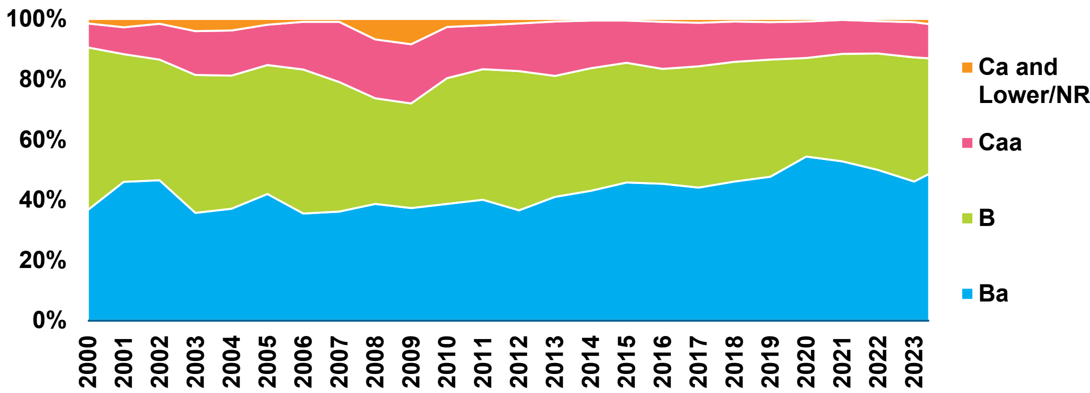

FIGURE 1
Credit Quality of the Bloomberg US Corporate High Yield Index

Source: Barclays Live, as of May 31, 2024. "NR" refers to not rated.

This trend of increased credit quality has occurred in tandem with a general decrease in high-yield option-adjusted spreads ("OAS") since the Global Financial Crisis ("GFC"). Lower credit spreads also imply a belief by investors that the market is exhibiting higher quality (i.e., less risk).

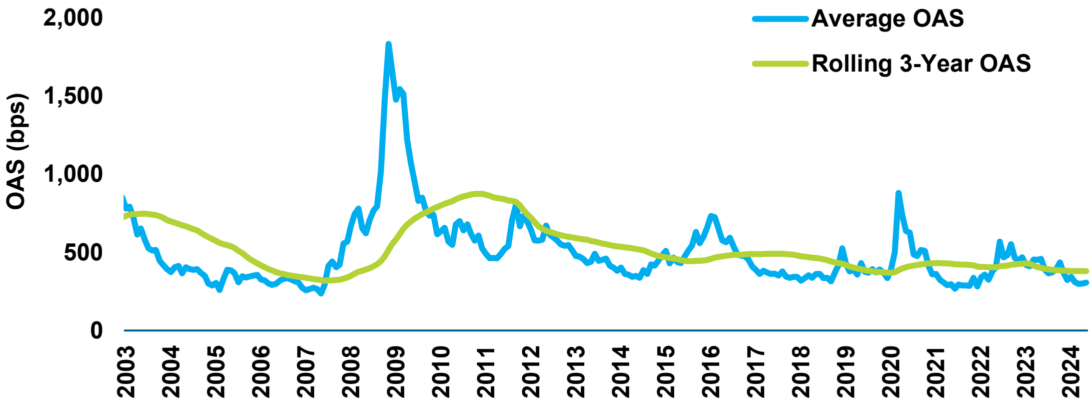

FIGURE 2
OAS for the Bloomberg US Corporate High Yield Index

Source: Barclays Live, as of May 31, 2024. "OAS" refers to option adjusted spreads.

Perhaps one of the reasons for this trend in high yield is that, over the last 15 years, lower quality issuers have increasingly opted to issue floating rate loans instead of high yield bonds. Figure 3 below shows how B exposure within the Morningstar LSTA Leveraged Loan index increased from 25% in January 2000 to 62% in May 2024.

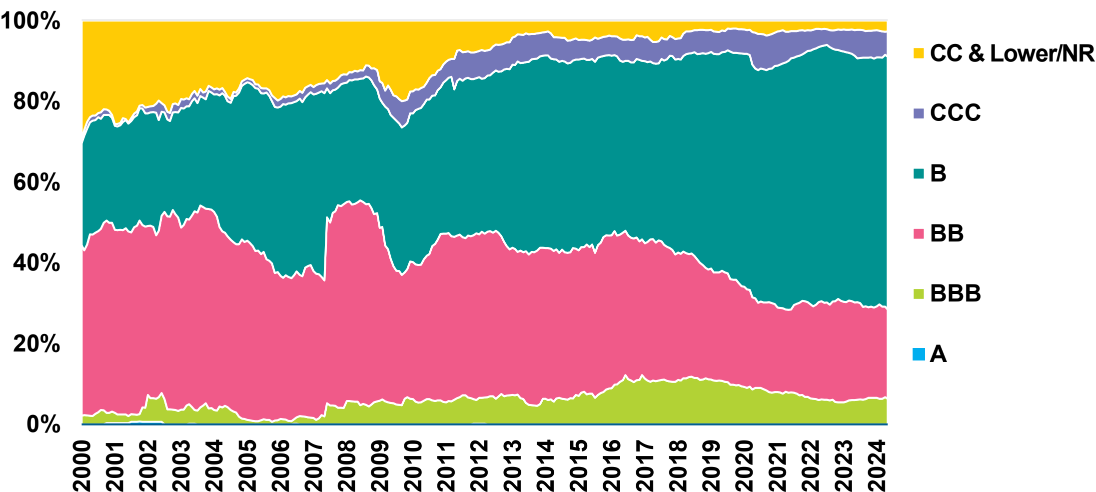

FIGURE 3
Market Composition of the Morningstar LSTA Leveraged Loan Index

Source: KKR, as of May 31, 2024 Represents composition based on market value.

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Perhaps counter-intuitively, however, the average discounted spread for leveraged loans has remained fairly low (post GFC) despite the substantially greater proportion of B-rated loans (see Figure 4).

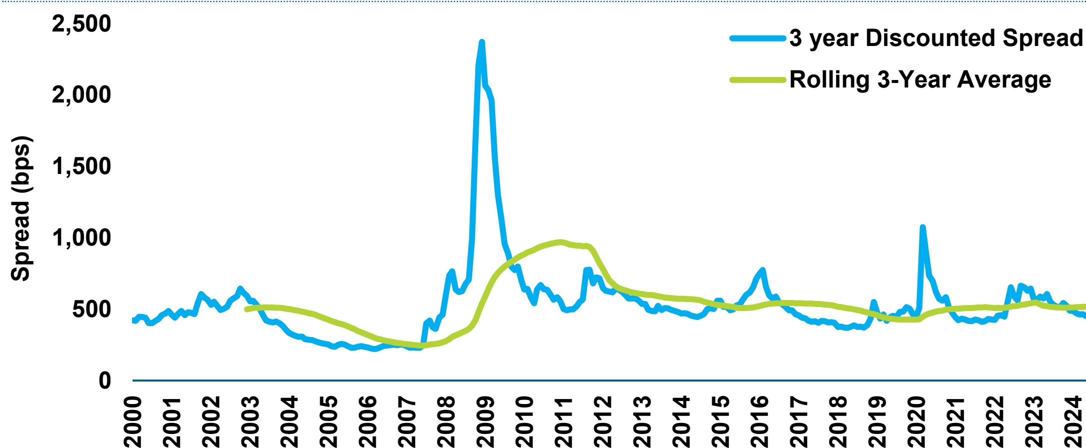

FIGURE 4
Discounted Spread for Leveraged Loans

Source: KKR, as of May 31, 2024. 3 year discount spread of the Morningstar LSTA Leveraged Loan Index.

Private credit's growth as an asset class is also potentially keeping credit quality higher in the public credit markets. Many borrowers have opted for privately negotiated loans from non-bank lenders when they cannot access public loan and high yield credit markets. The growth of private credit has resulted in a large alternative lending asset class that privately refinances deteriorating credits without the typical default process exhibited in public market high yield and bank loans, potentially keeping public default rates lower.

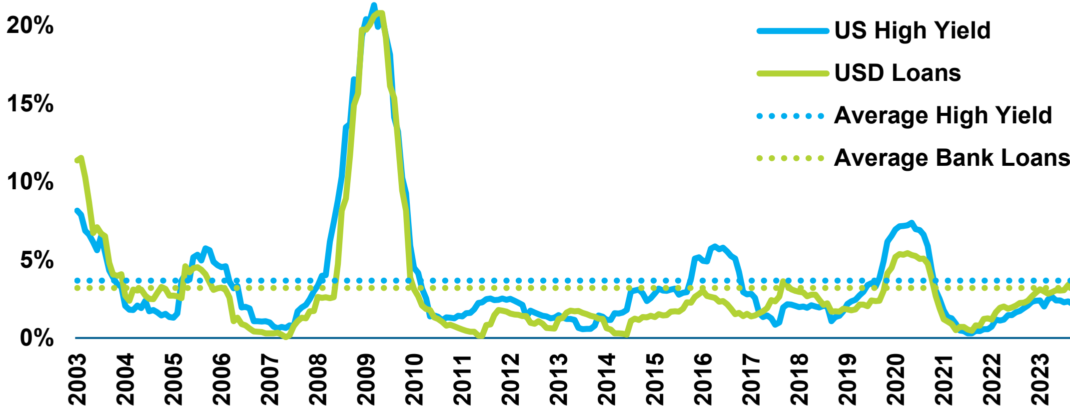

FIGURE 5
High Yield and Bank Loans Historical Default Rates

Source: Monthly default estimates from KKR as of May 31, 2024. Average default rate July 1, 2003 to May 31, 2024. Default Rate, "Par Default Rate," trailing-12m, captures bankruptcies, missed payments, and distressed exchanges. US High Yield rated USD bonds from US corporate issuers. USD loan rates based on D rated loans from S&P.

Higher yields across the board

In the last year, 10-year Treasury yields have reached their highest levels since before the GFC. This has pushed up the yield for all manner of bonds, including high yield corporate bonds. And unlike more recent spikes in yield like the one associated with the COVID pandemic in early 2020, these higher yields have lasted for an extended period and are likely to continue so long as Treasury yields remain elevated.

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Figure 6 below shows that Treasury yields as a percentage of the total yield for US Corporate High Yield bonds have averaged 34% over the last 10 years, but have been at a 10-year high for the past six months at around 62%.[1] It is important to note that these higher yields do not reflect higher risk expectations, given that the option adjusted spread of roughly 308 basis points is below its 10-year average of 425 basis points.[2]

[1] Source: Barclays Live, as of May 31, 2024.

[2] Source: Barclays Live, as of May 31, 2024.

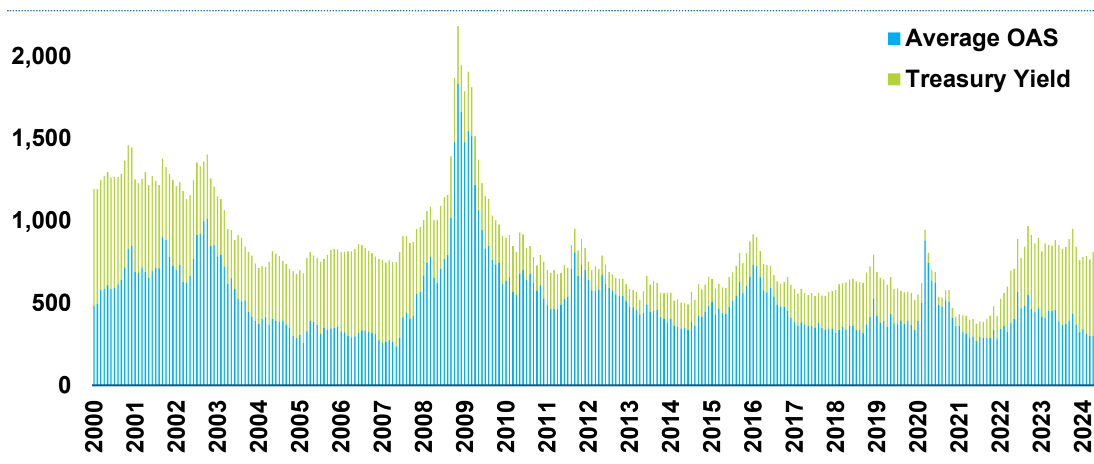

FIGURE 6
Composition of Yield for US Corporate High Yield Bonds

Source: Barclays Live, as of May 31, 2024.

While borrowing costs for new issues have increased (as seen in the higher yield demanded by the market), the ability to pay existing debts remains strong for both high yield and bank loan issuers (see Figure 7 below). Many corporations took advantage of the low-rate environment that existed prior to 2021 to issue or refinance their debt. Hence, until this low-rate debt comes due (and potentially needs to be refinanced at higher rates), these borrowers will likely have relatively low debt servicing costs.

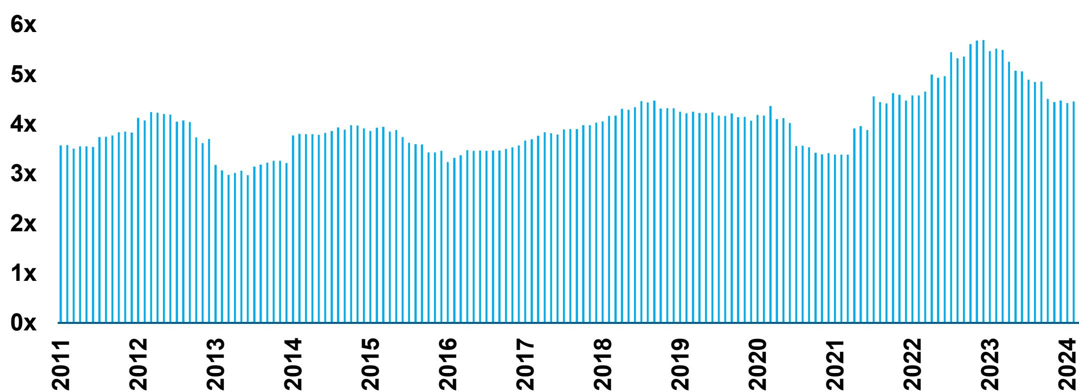

FIGURE 7
High Yield Interest Coverage Ratio

Source: KKR, as of May 31, 2024.

A "maturity wall" refers to the period during which (usually a large amount of) existing debt comes due or approaches maturity. For the high yield market, it is quite common for maturities to be spread out fairly evenly over 4-6 years as most high yield bonds are issued with a maturity of five or seven years. The refinancing of any bonds issued before 2022 will likely occur at a higher interest rate. The maturity wall for bank loans is not as evenly distributed, with a notable peak in 2028 that

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represents approximately one-third of outstanding loans. If short-term rates remain elevated for the next 3-5 years, the refinancing cost could be even higher for bank loans.

Each "wall" (i.e., the debt maturing in each year) on its own may not pose a particular threat to the market, but cumulatively they may affect borrowers' willingness and ability to repay (or refinance) their debts if rates remain elevated. However, this presumes that little changes in the outstanding maturity profile. Historically, the credit markets have done a good job at pushing out large maturity walls and/or spreading them out more evenly. Moreover, corporations with strong balance sheets and cash flow should have greater flexibility to refinance or even de-lever (i.e., reduce their debt burden).

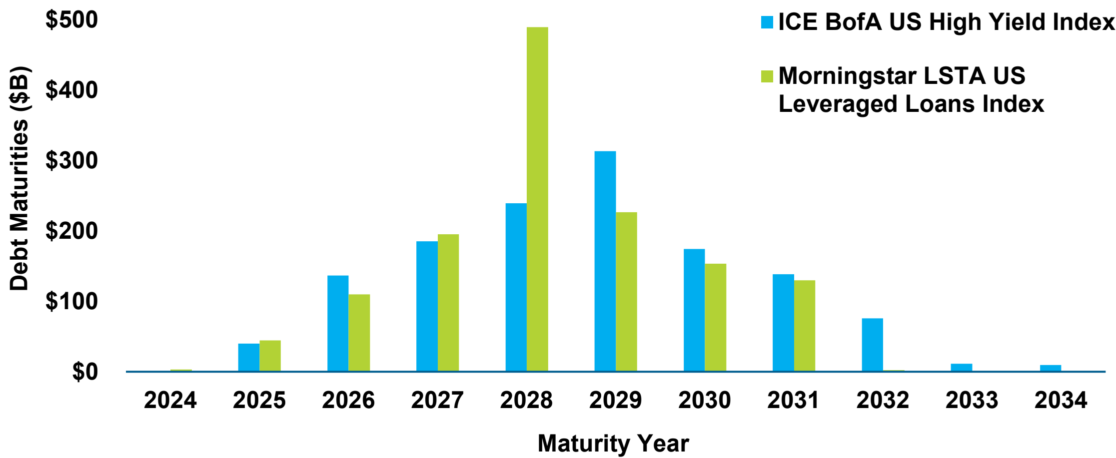

FIGURE 8

"Maturity Wall" for US High Yield Bonds and Leveraged Loans

Source: KKR, as of May 31, 2024. Note that some loans in the leveraged loan index have maturity dates in the past. These loans have defaulted but have not yet been repaid and are therefore still in the index. These D-rated loans are excluded from the chart.

Net issuance is down

Since 2022, there has been a slowdown in issuance, particularly in the high yield bond markets. This is likely related to the elevated level of interest rates, as the higher costs of debt present a higher hurdle rate for companies considering whether to issue new debt to finance capital expenditures. It is possible that some companies are delaying issuance until borrowing costs fall sufficiently to justify debt-financed expansion. It is possible that these companies will eventually decide that elevated interest rates represent a "new normal" and will adjust their expectations and start to borrow again.

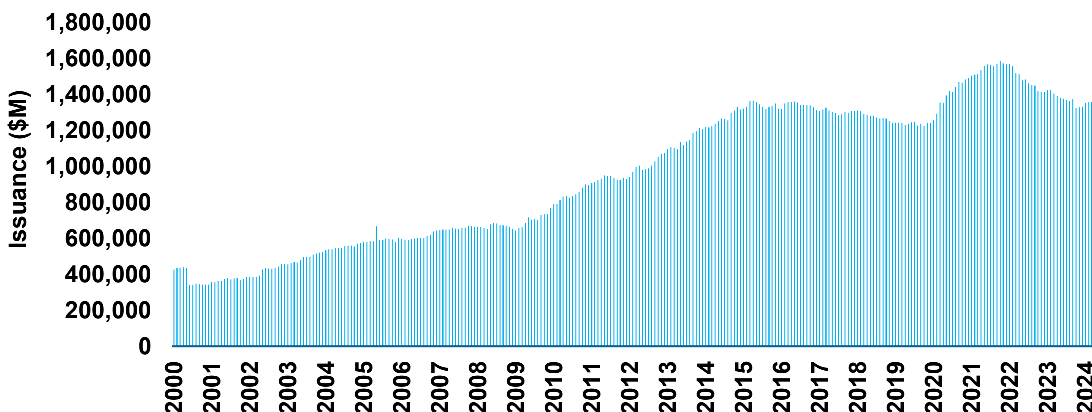

FIGURE 9

US Corporate High Yield New Issuance

Source: Barclays Live, as of May 31, 2024. Depicts outstanding amount.

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Conclusions

The universe of public high yield bonds now exhibits higher average credit quality compared to the past. This shift is partly due to many lower quality borrowers choosing to issue floating rate debt over the last decade. Consequently, the average credit quality of the bank loan market has declined. While the yields on high yield bonds are currently as high as they have been in almost a decade, this increase is primarily driven by higher interest rates for all types of bonds rather than the high yield market perceiving significant risk or demanding a higher reward. Looking ahead, there is a risk that if rates remain elevated for a longer term, refinancing at higher rates on existing debt could lead to deterioration in debt servicing ability.

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