Market Outlook | January 2024

# U.S. Leveraged Credit in 2024: Yields Offer a Buffer for the Next Leg of the Credit Cycle

Despite economic uncertainty and rising defaults, we believe leveraged credit in the U.S. continues to offer attractive return potential, supported by compelling yields, a favorable technical backdrop and steady demand.

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VOYA INVESTMENT MANAGEMENT

## Executive summary

### Resilient performance in 2023

Despite initial concerns of a U.S. recession, global financial markets showed resilience in 2023. A backdrop of fiscal support, steady corporate earnings and positive investor sentiment led to strong performance in risk assets, including leveraged credit. High carry and healthy market technicals outweighed fundamental concerns, resulting in double-digit returns for senior loans and high yield bonds.

### Favorable supply and demand dynamics

We expect the leveraged credit market to continue benefiting from a favorable technical backdrop in 2024. Net issuance remains low, while demand continues at a steady clip. Refinancing activity will likely be the primary driver of supply, with a potential uptick in mergers and acquisitions (M&A) activity. However, the market may face challenges as collateralized loan obligations (CLOs) exit their reinvestment period and refinancing needs increase.

### Fundamentals and defaults

With policy rates likely at peak levels and a decelerating corporate earnings environment, fundamentals in leveraged credit faced growing pressure in 2023. Leverage and interest coverage metrics exhibited negative trends, and defaults and downgrades increased. While defaults are expected to tick higher, the majority of borrowers should continue to meet their debt obligations. Downgrade activity is likely to decelerate, but certain sectors, such as healthcare and telecom, may face continued challenges.

### Sector views

We anticipate late-cycle dynamics will continue to drive a wide dispersion of outcomes and an uptick in defaults. The resulting relative-value opportunities will provide an environment ripe for credit pickers. For example, although we expect challenging dynamics to continue for sectors such as healthcare, software, telecom, media and communications, we also see opportunities associated with TV broadcasters, surgical centers, energy and insurance brokers.

### Return expectations

Despite the potential for increased defaults and challenges in certain sectors, leveraged credit in the U.S. remains attractive in 2024. Compelling yields, a supportive technical backdrop, and steady demand should continue to provide attractive returns. Active credit selection will be crucial in navigating the market, and while risks exist, the overall outlook for leveraged credit remains positive.

## Review of 2023

**Coming off a challenging 2022, global financial markets proved resilient,** climbing a wall of uncertainty around monetary policy, inflation and both economic and corporate growth. There was a widespread view that the U.S. would enter a recession in 2023, with debate focused on the severity of the "landing." Though the impact of historic Fed tightening on the broader economy has yet to fully play out, some general themes took shape: disinflation in goods prices offset stubborn inflation in services, and labor markets proved largely immune to rate hikes, supporting consumer spending. This created a supportive backdrop for risk assets as recession expectations faded.

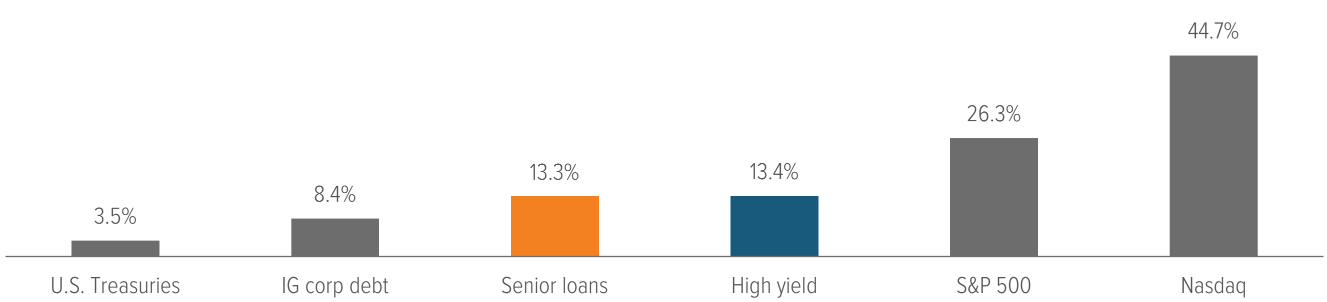
**Still, the "higher for longer" rate environment wasn't without casualties, especially in more vulnerable and rate-sensitive pockets of the economy.** Several U.S. regional banks faced depositor withdrawals and ultimately insolvency. Across the Atlantic, Credit Suisse, with its own longstanding issues, experienced a liquidity crisis and was absorbed by UBS. As the health of the financial system became more heavily scrutinized, lending pulled back, leading to substantial stress in commercial real estate. The Federal Reserve, U.S. Treasury Department and Federal Deposit Insurance Corp. (FDIC) acted quickly to prevent widespread panic, creating a much-needed liquidity backstop by taking some depository institutions into receivership and forming an emergency lending program for banks.

**While these events created headline risks, the U.S. economy powered on despite sluggish growth globally.** A key driver was burgeoning fiscal support that helped counteract monetary policy effects, residual consumer strength and steady corporate earnings. As the year progressed, investor sentiment became increasingly buoyed by soft-landing optimism and changing expectations on the timing of rate cuts. The positive sentiment intensified during the last two months of the year, and financial markets rallied sharply.

**All told, risk assets exceeded even some of the most optimistic expectations from the beginning of the year.** Equity markets were rejuvenated by AI enthusiasm and the performance of the "Magnificent 7." Elevated yields and tighter spreads provided attractive returns in fixed income spread sectors. The positive backdrop was also evident in leveraged credit, where high carry and healthy market technicals outweighed potential fundamental concerns. Putting things into perspective, senior loans and high yield bonds registered double-digit returns and, in fact, produced some of their highest total returns on record.

**Exhibit 1. Risk assets experienced strong gains in 2023**

2023 total return




As of 12/31/23. Source: Source: LCD, Barclays, Bloomberg. See endnotes for index definitions and additional disclosures.

## Spotlight on leveraged credit

**A key driver of loan performance in 2023 was elevated carry,** as all-in yields hovered above 8% to start the year. Specifically, with SOFR comfortably above 5% during the year, senior loans benefited from over 40 bp of monthly coupon income. High yield bond prices were highly discounted to start the year (in the mid-80s), exhibiting attractive price convexity.

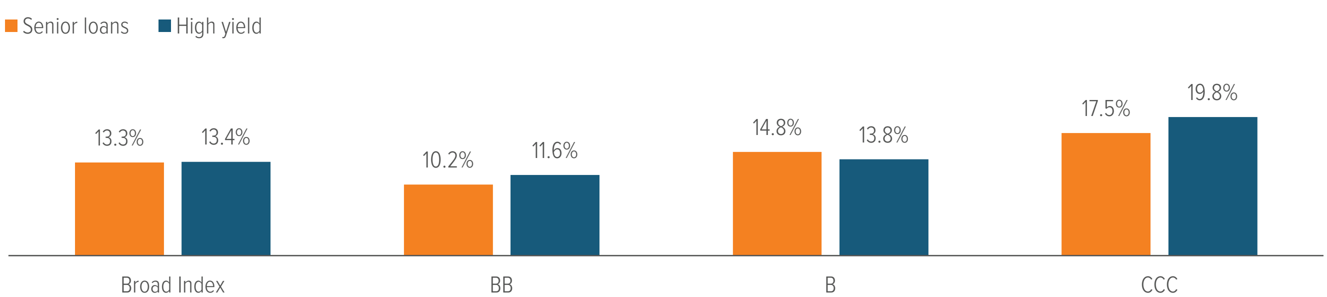
**Further boosting returns was a strong technical picture, driven by a growing imbalance between supply and demand.** Given the increased yields, investor demand for leveraged credit was healthy, while the high-rate environment provided less incentive for borrowers to issue new debt. Another incremental source of demand creating a strong positive technical was cash buildup in portfolios in the form of coupons, maturities, refinancings and repayments. These proceeds needed to be reinvested in the secondary market given the absence of material primary market activity. Meanwhile, corporate fundamentals fared better than expected and didn't exhibit significant deterioration. As a result, outperformance across the lower-quality spectrum was a dominant narrative within leveraged credit (Exhibit 2).

**However, single-name dispersion remained elevated, and the leveraged credit market felt increasingly bifurcated.** A bevy of topical situations and sectoral themes developed during the year on the back of poor earnings or negative headlines. Several sectors traditionally viewed as defensive or stable—healthcare, media/cable and telecom—were increasingly under scrutiny for a combination of idiosyncratic stories or sectoral challenges stemming from developing secular trends and macro headwinds. Consequently, a sizable portion of defaults and downgrades were concentrated within these sectors.

**We expect many of the same themes to play out in 2024.** Market technicals and high carry should still provide support, but there's less upside embedded in the returns outlook following strong performance and tighter valuations in 2023. Furthermore, the persistence of late-cycle dynamics may continue to stress fundamentals. And there is no shortage of macro risks in 2024—from below-trend growth, to ongoing and potential new geopolitical risks, to political dysfunction in Washington during a presidential election year.

**Exhibit 2. Risk appetite was robust in leveraged credit**

2023 total return by credit rating




As of 12/31/23. Source: LCD, Barclays, Bloomberg. See endnotes for index definitions and additional disclosures.

### Supply and demand

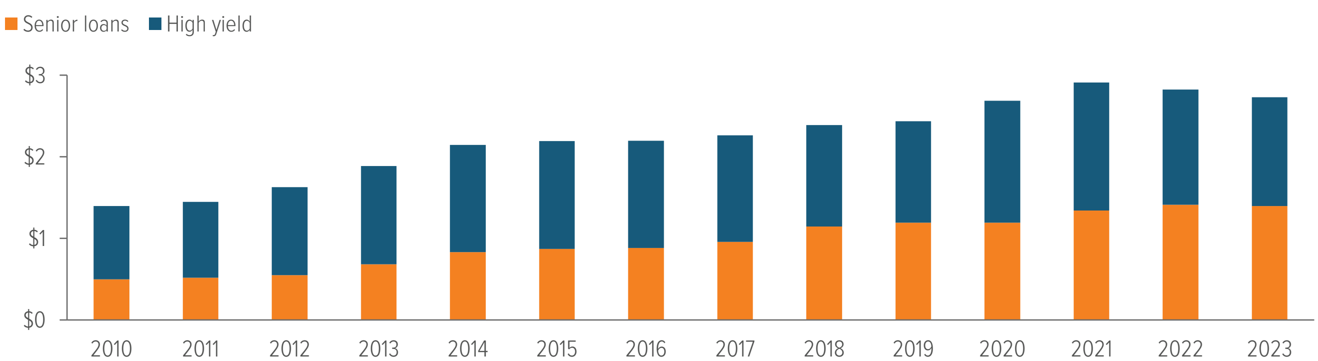
**We expect a continued supportive technical backdrop in 2024, as net issuance creation remains low while demand continues at a steady clip.** In 2023, when factoring in repayments, supply experienced a net shortage relative to demand. Accordingly, the size of both the senior loan and high yield markets contracted, as measured by the total outstandings of their respective indexes (Exhibit 3). In fact, senior loan outstandings shrunk for only the second time since 2010, as repayment activity was elevated. A key driver was the growing presence of private credit and increased bond-for-loan takeout activity, given cheaper funding costs available in the high yield market. High yield, on the other hand, saw more than $80 billion of "rising stars" leave to the investment grade market.

**The typical growth drivers for leveraged credit—M&A and leveraged buyout (LBO) transactions—were virtually nonexistent in 2023** due to the increased cost of funding. For context, the last year such activity dropped below $100 billion was 2012. Most of the issuance volume was concentrated in refinancing transactions, including amend-and-extend (A&E) deals. The latter was particularly relevant for the loan market. While this was a popular method of extending maturities for higher-rated borrowers, an increasing share of lower-rated borrowers tapped into the private credit/direct lending space for funding needs. Overall supply volumes for the senior loan and high yield markets totaled just $234 billion and $176 billion, respectively. While this was an improvement over the prior year, aggregate issuance levels in both markets were still among the lowest since the global financial crisis, at about $100 billion below their annual averages for the respective periods.

**Persistently high equity valuations and expensive debt financing will remain hurdles for any significant deal activity and net new issuance,** despite ample dry powder in the private equity/sponsor community. As such, we expect only a slight uptick in M&A activity in 2024. Given the nearly $230 billion of loan and bond maturities coming due across the leveraged credit space in the next two years, we believe refinancing activity should continue to be the primary driver of supply (Exhibit 4). For loans in particular, a potential negative catalyst is that a significant portion of CLOs—which are the dominant buyers of loans—will exit their reinvestment period in 2024. CLOs have constraints on investing in new loans once they are in the post-reinvestment phase, which may ultimately limit their ability to participate in A&E transactions. With nearly 10% of the high yield market coming due in the next two years, we expect to see more refinancing issuance. Some companies that have stayed on the sidelines until now (out of preference for low coupon payments) won't have the same luxury in 2024.

**Exhibit 3. Consistent repayment activity and rising-star upgrades caused leveraged credit markets to shrink**

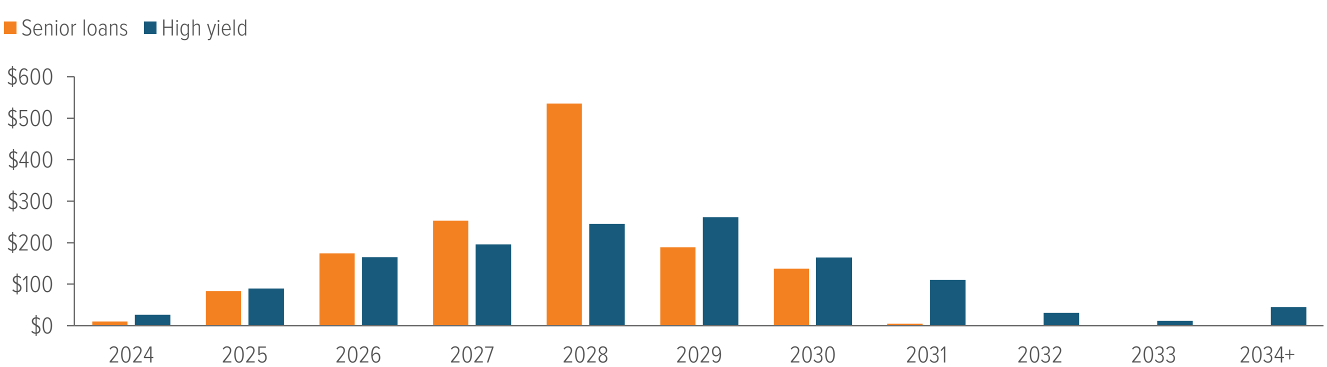
Par outstandings, $ trillions




As of 12/31/23. Source: LCD, Barclays, Bloomberg. See endnotes for index definitions and additional disclosures.

**Exhibit 4. Maturities are limited in 2024 but will become more pronounced in coming years**

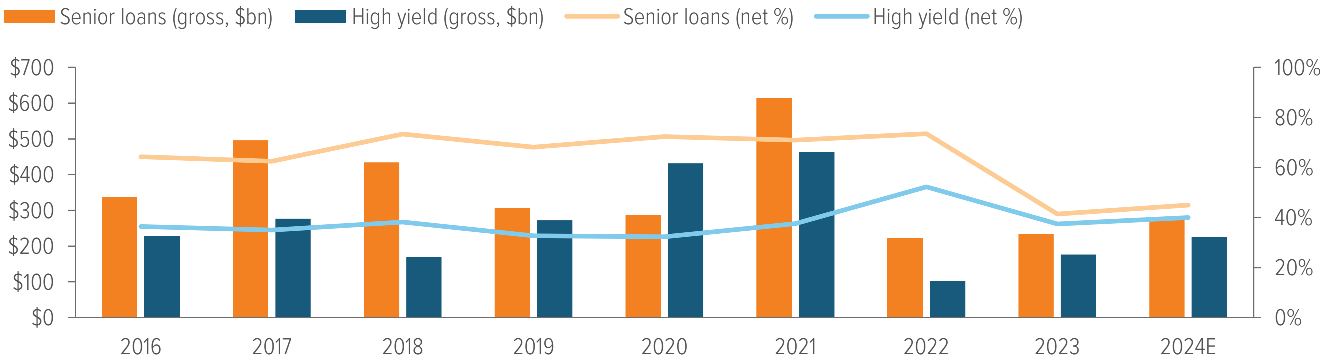
Maturities by year, $ billions




As of 12/31/23. Source: LCD, BofA Global Research. See endnotes for index definitions and additional disclosures.

**Exhibit 5. Leveraged credit issuance should increase modestly next year**

Annual institutional issuance




As of 12/31/23. Source: LCD. See endnotes for index definitions and additional disclosures.

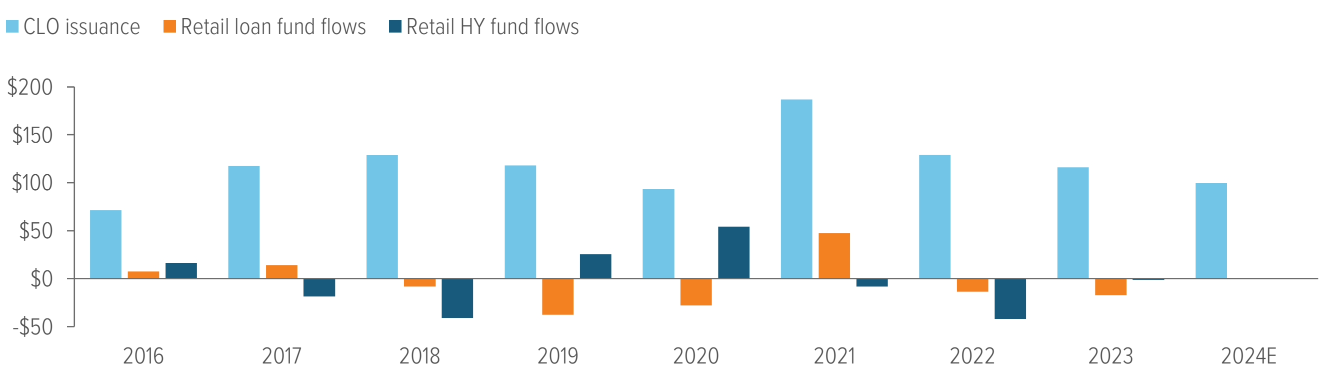
**Most importantly, we expect markets to remain open to meet financing needs.** The continued need to address maturities and a potential improvement in M&A formation likely mean capital market activity will increase slightly in 2024 but remain below recent annual averages. We project $250–300 billion and $200–250 billion of issuance in loans and high yield, respectively (Exhibit 5).

**Across the measurable areas of investor demand, appetite for leveraged credit was somewhat mixed.** Despite strong performance in both senior loans and high yield, outflows from retail mutual funds and ETFs persisted for much of the year. Retail investors, traditionally known to be "yield-based buyers," broadly fled leveraged credit given attractive yields available in cash products and better-rated parts of fixed income. Morningstar estimated outflows of roughly $17 billion and $1 billion during the year for senior loans and high yield, respectively. However, the last two months saw strong inflows, particularly into high yield, amid the broad market rally and anticipation of falling rates. Retail flows are expected to ebb and flow in 2024, corresponding to general investor sentiment. We project greater upside for high yield flows as fears of higher rates subside.

**Meanwhile, CLOs remained a significant portion of the senior loan investor base,** with their ownership of the senior loan asset class now close to 70%. A credit to their attractive yields, floating-rate features and structural protections, demand for CLO debt tranches continued at a healthy clip in 2023. Total CLO issuance amounted to roughly $116 billion, exceeding consensus expectations at the start of the year of around $90 billion (Exhibit 6). It's worth noting that issuance was dominated by managers with captive or internally sourced equity, given the prevailing challenged arbitrage during the year.

**Exhibit 6. CLO issuance should continue to support loan demand**

$ billions




As of 12/31/23. Source: LCD, Morningstar. See endnotes for additional disclosures.

**We project similar or slightly lower CLO issuance levels in 2024, barring a material tightening in AAA liability spreads.** AAA spreads remain relatively wide versus IG corporates and other parts of the securitized market, while U.S. banks haven't been active buyers of CLO AAA tranches due to regulatory requirements. Until there is further clarity around these overhangs, we don't see a catalyst for meaningfully tighter AAA spreads or a spike in CLO supply above 2023 levels. That said, we believe middle market loan CLOs will continue to gain traction, albeit from a small base, relative to broadly syndicated loan CLOs. As noted previously, private credit markets remain an alternative and growing source of funding for borrowers.

### Fundamentals and defaults

**It's no surprise that fundamentals in leveraged credit came under growing pressure in 2023,** with policy rates reaching likely peak levels in the midst of a decelerating corporate earnings environment. The culmination of these events led to rising default activity and more downgrades. We expect a trend of weaker topline growth as pricing power diminishes against a backdrop of disinflation and weaker consumer demand. This may lead to margin erosion, with lower-rated issuers incrementally impacted due to elevated borrowing costs.

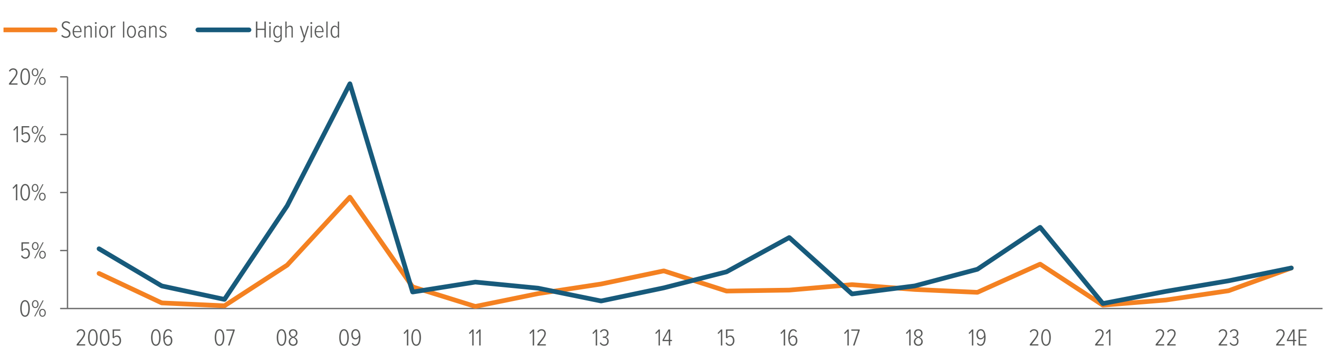
**Leverage and interest coverage metrics enter the new year at manageable levels but have recently exhibited negative trends.** We expect further degradation in 2024, particularly for the senior loan market. For loan borrowers, elevated base rates won't ease anytime soon and will continue to negatively impact lower-rated segments of the market. In addition, with a relatively higher concentration of single-B risk, the senior loan asset class is naturally more vulnerable to higher rates. With high yield less exposed to floating-rate capital structures, the coupon reset from refinancing maturing debt will create a negative trajectory for interest coverage ratios over time.

**Sustained higher interest rates, nearing maturity walls and slowing GDP growth likely mean defaults will tick higher.** For loans, we believe trailing 12-month default rate averages will exceed the historical average of 2.7% and remain above 3% on a par basis throughout 2024–25. Furthermore, because the loan index does not factor distressed exchanges into its default calculations, the true credit loss experience may be understated. High yield likely lands in a similar range as senior loans under the same criteria, but we believe senior loans face the risk of a more severe and prolonged default cycle. Our view is informed by a greater sensitivity to higher rates and a higher prevalence of lower single-B issuers in the loan market. Regardless, we believe the vast majority of borrowers will continue to meet their debt obligations in 2024 and we expect only a gradual increase in defaults, without any significant or sudden spikes.

**Away from defaults, we expect continued downgrade activity across leveraged credit.** Consistent with observed trends in 2023, senior loans will likely remain more susceptible to negative ratings actions given the immediate transmission of higher rates. Lower-quality issuers in stressed sectors contributed meaningfully to the increased pace of downgrades in 2023, which led to an uptick in CCCs. Such a dynamic is expected to continue in the new year. However, with a sizable portion of the market already downgraded in 2023, and with easing Fed policy providing a potential reprieve on borrowing costs, the pace of downgrades should decelerate from the elevated levels seen in the last 12 months.

**Exhibit 7. Default activity should continue to pick up across leveraged credit**

Default rate

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## Sector views and market opportunities

In the last few years, many sector themes formed across leveraged credit: **Healthcare and software have become prominent areas of stress** because of highly levered floating-rate capital structures, topline deceleration, wage pressure and idiosyncratic execution issues. Additionally, **telecom, media and communications have faced secular declines and structural challenges** due to new, disruptive technologies and changing consumer preferences. We expect the same dynamics to continue in 2024 as business models and capital structures come under further pressure.

**While we maintain a cautious view on these sectors, we also see opportunities:**

- We are more constructive on television broadcasters, where political advertising will increase during the election cycle, and less constructive on radio broadcasters, which won't benefit to the same degree.
- Healthcare providers have faced challenges in recent years, but we've recently grown more constructive due to increasing volumes and easing wage pressure. One example is surgical centers, which have seen increased demand for elective procedures following the Covid-induced slowdown.
- The energy sector, which is a much larger component of the high yield market than the loan market, should continue to benefit from high commodity prices and increased consolidation within the space.
- Insurance brokers also appear well positioned in the current environment given high retention rates, stable margins and attractive free cash flow generation.

**In contrast, we are less constructive on other markets:**

- We are cautions on any consumer-reliant business models with weaker credit profiles given our view of moderating consumer strength in 2024. Diminished excess savings and slower wage growth should dent spending.
- The global backdrop for cyclical sectors, such as metals and chemicals, is likely to remain challenging. Contributing to the sluggish growth story has been a weak recovery in China and a mild recession in parts of Europe.

**Given the bifurcation across leveraged credit, we anticipate relative value opportunities.** The increasingly evident late-cycle dynamics will continue to create a greater dispersion of outcomes and lead to an uptick in defaults. As a result, we believe 2024 will present a credit picker's environment. While a growing number of distressed assets may default, many will not, creating opportunities for active managers. Considering the market's elevated coupons, still-discounted prices, the prospect of a gradual uptick in defaults, and only slightly wider projected credit spreads, conditions would need to turn significantly more negative than we anticipate to produce negative total returns in 2024 across leveraged credit.

## Return expectations

We believe return prospects in leveraged credit remain attractive, with upside potential somewhat capped by 2023's strong performance. High all-in yields should continue to boost returns and provide a cushion against modestly wider credit spreads. Although defaults are likely to pick up, default candidates are well-defined given their already distressed trading levels, which should help lessen the credit loss impact on performance in 2024. As a result, **we forecast a potential total return range of 5–7% for senior loans in 2024,** with attractive beginning yields offsetting front-end rate cuts and an increase in defaults. Furthermore, senior loan repricings are likely to see an uptick in the early part of the year, with a decent portion of issuers currently trading above par, which should create a potential modest drag on nominal loan spreads.

**For high yield, we forecast a range of 5.5–7.5% in total returns.** Spreads should move wider from historically tight levels given lingering concerns, which will be partially offset by an expected rally in rates. Broad market volatility will continue to remain prominent given the uncertainties that lie ahead. As such, individual credit selection will be a key driver of performance.

**We would welcome the chance to further discuss opportunities and positioning in leveraged credit markets.**

## About our team

The Voya Leveraged Credit team manages $26.3 billion in assets across U.S. and European broadly syndicated senior loans, U.S. public high yield, European high yield, and CLO mezzanine.[1] The 37-member investment team has an average of 17 years of investment experience, spanning multiple market cycles.

The team benefits from the knowledge and market insights of more than 250 experienced professionals across the Voya fixed income platform, including insights from our macro and quant research teams.

To help investors access opportunities in senior loans and high yield debt, we offer our strategies through a variety of vehicles, including:

- Institutional separate accounts
- Retail SMAs
- Mutual funds
- Collective investment trusts
- Structured products (U.S. and European CLOs)

[1] As of 09/30/23.

### A note about risk

**Principal risks for senior loans:** All investing involves risks of fluctuating prices and the uncertainties of rates of return and yield. Voya's senior loan strategies invest primarily in below investment grade, floating rate senior loans (also known as "high yield" or "junk" instruments), which are subject to greater levels of liquidity, credit and other risks than are investment grade instruments. There is a limited secondary market for floating rate loans, which may limit a strategy's ability to sell a loan in a timely fashion or at a favorable price. If a loan is illiquid, the value of the loan may be negatively impacted and the manager may not be able to sell the loan in order to meet redemption needs or other portfolio cash requirements. The value of loans in the portfolio could be negatively impacted by adverse economic or market conditions and by the failure of borrowers to repay principal or interest. A decrease in demand for loans may adversely affect the value of the portfolio's investments, causing the portfolio's net asset value to fall. Because of the limited market for floating rate senior loans, it may be difficult to value loans in the portfolio on a daily basis. The actual price the portfolio receives upon the sale of a loan could differ significantly from the value assigned to it in the portfolio. The portfolio may invest in foreign instruments, which may present increased market, liquidity, currency, interest rate, political, information and other risks. These risks may be greater in the case of emerging market loans. Although interest rates for floating rate senior loans typically reset periodically, changes in market interest rates may impact the valuation of loans in the portfolio. In the case of early prepayment of loans in the portfolio, the portfolio may realize proceeds from the repayment that are less than the valuation assigned to the loan by the portfolio. In the case of extensions of payment periods by borrowers on loans in the portfolio, the valuation of the loans may be reduced. The portfolio may also invest in other investment companies and will pay a proportional share of the expenses of the other investment company.

**Principal risks for high yield bonds:** All investing involves risks of fluctuating prices and the uncertainties of rates and return and yield inherent in investing. High-yield securities, or "junk bonds," are rated lower than investment grade bonds because there is a greater possibility that the issuer may be unable to make interest and principal payments on those securities. As interest rates rise, bond prices may fall, reducing the value of the portfolio's share price. Debt securities with longer durations tend to be more sensitive to interest rate changes than debt securities with shorter durations. Other risks of the portfolio include, but are not limited to, credit risk, other investment companies' risks, price volatility risk, the inability to sell securities and securities lending risks.

## Index definitions

*An investor cannot invest directly in an index, and index performance does not reflect the deduction of any fees, expenses or taxes.* Index comparisons have limitations, as volatility and other characteristics may differ from a particular investment. The **S&P 500 Index** is an unmanaged index that measures the performance of securities of approximately 500 of the largest companies in the United States. The **Nasdaq Composite Index** measures all domestic and international common stocks listed on the Nasdaq Stock Market. The Bloomberg U.S. Treasury Index is an unmanaged index that includes public obligations of the U.S. Treasury. Treasury bills and certain special issues, such as state and local government series (SLGS) bonds, as well as U.S. Treasury TIPS and STRIPS, are excluded. The **Bloomberg U.S. Corporate Index** measures the performance of investment grade, USD-denominated, fixed-rate, taxable corporate bond market securities. The **Morningstar LSTA Leveraged Loan Index** is an unmanaged total return index that captures accrued interest, repayments and market value changes. The Bloomberg U.S. High Yield Index covers the universe of fixed-rate, non–investment grade debt. Eurobonds and debt issues from countries designated as emerging markets are excluded, but Canadian and global bonds of issuers in non-EMG countries are included. The **Bloomberg Corporate High Yield Index** is an unmanaged index that measures the performance of fixed income securities generally representative of corporate bonds rated below investment grade. Bloomberg® is a trademark and service mark of Bloomberg Finance L.P. and its affiliates (collectively “Bloomberg”). Bloomberg or Bloomberg’s licensors own all proprietary rights in the Bloomberg Indexes. Bloomberg does not approve or endorse this material, nor guarantee the accuracy or completeness of any information herein, nor make any warranty, express or implied, as to the results to be obtained therefrom and, to the maximum extent allowed by law, shall not have any liability or responsibility for injury or damages arising in connection therewith.

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