

High yield bonds: No longer junk but still high yield

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INTRODUCTION

Within fixed income, high yield bonds reflect an area of credit that has been structurally transformed. The evolution of the high yield market is evident when viewing the quality of the asset class by rating, fundamentals and issuer characteristics. These market shifts operate in tandem with portfolio allocation criteria – liquidity, correlation and risk-adjusted returns.

This paper outlines how the high yield bond market has fundamentally changed since the Global Financial Crisis and how it compares to other markets within leveraged finance. High yield bonds can offer attractive risk-adjusted returns with features that can limit downside risks while offering total return potential through active management.

THE EVOLUTION OF HIGH YIELD

The high yield bond market originated in the 1980s as the primary financing tool for leveraged buyouts, with banks aggressively underwriting highly leveraged transactions and using high yield bonds as the subordinated, last piece of leveraged buyout (LBO) capital structures. This continued through the 2000s until the 2008 financial crisis triggered sweeping regulatory changes, including the 2013 Leveraged Lending Guidelines and Dodd-Frank reforms, which imposed stricter underwriting standards, leverage limits and higher capital requirements on banks.

These regulatory guardrails fundamentally transformed the market, resulting in a significant quality shift: today’s high yield market features lower average leverage multiples, stronger credit profiles (more BB/B versus CCC-rated issuers), and broader issuer purposes beyond pure LBO financing, while the broadly syndicated loan and private credit markets have absorbed much of the riskiest LBO activity that once dominated high yield issuance.

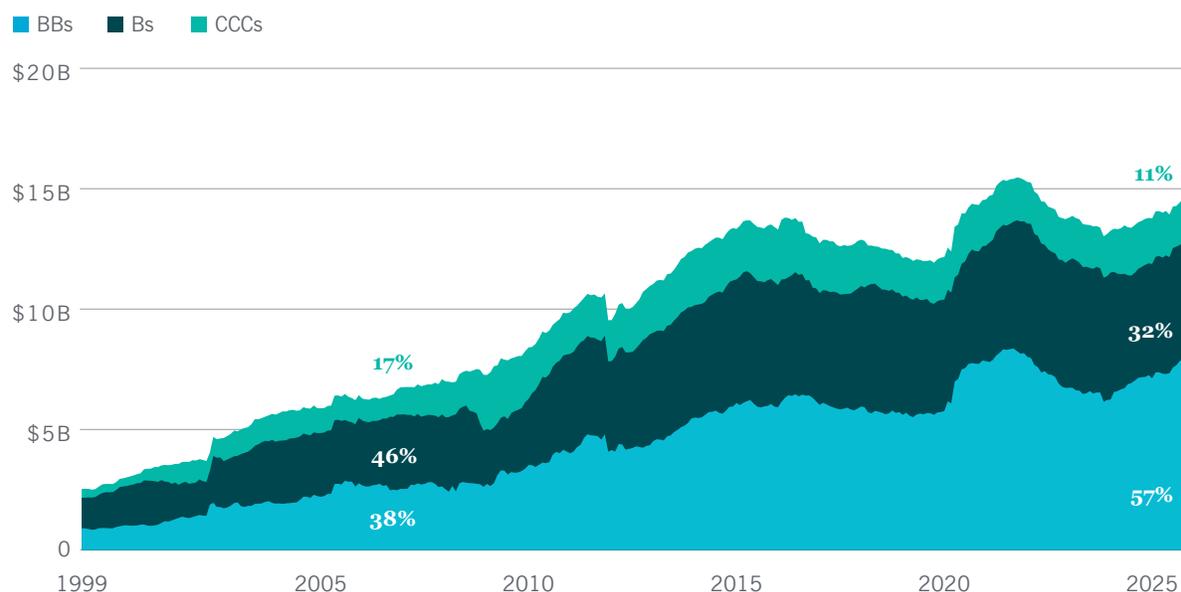
When we view the high yield market by quality, it is apparent that the rating-cohort composition has fundamentally changed. Prior to 2008, the high yield market had a BB-rated composition of roughly

38% and a CCC-rated composition of roughly 17%. This is a notable departure when we look at the current composition, which stands at roughly 57% BB-rated and 11% CCC-rated (Figure 1).

Fifteen years ago, in the aftermath of the financial crisis, the high yield market was heavily populated by private equity-backed companies resulting from LBOs, often smaller and mid-sized businesses with aggressive capital structures, higher leverage ratios and lower interest coverage. Today, the high yield market increasingly features larger, established public companies with investment-grade operations but non-investment-grade ratings. These issuers tend to be well-capitalized with stronger balance sheets, lower leverage multiples and healthier interest coverage ratios.

The shift reflects both regulatory constraints on aggressive LBO financing and broadening of the asset class to include more operating companies accessing the market for general corporate purposes, refinancing or strategic acquisitions rather than pure financial engineering. The public versus private composition has shifted toward more public issuers as the broadly syndicated loan market and the upper-middle market of private credit have captured much of the private equity-backed, highly leveraged financing that once dominated high yield bond issuance.

Figure 1: Size of different credit quality segments of the U.S. high yield market



Data source: BofA Global Research. Data reflects credit quality dispersion of the ICE BofA US High Yield Index as of 31 Dec 2025. Performance data shown represents past performance and does not predict or guarantee future results.

As we analyze salient differences within the high yield market relative to the past, one question arises: Where has the risk gone?

RISK HAS MOVED TOWARD PRIVATE CREDIT AND LOWER-QUALITY LOANS

As regulatory constraints tightened on banks following the Leveraged Lending Guidelines and other post-crisis reforms, private credit funds emerged as alternative lenders willing to provide financing for the most aggressive LBO transactions that banks could no longer support. These direct lenders operate outside of traditional banking regulations and can offer flexible terms, minimal covenants and higher leverage multiples that exceed what regulated banks will underwrite.

The upper-middle market segment of private credit has absorbed much of the riskiest lending activity, particularly for smaller and mid-sized sponsor-backed LBOs. These loans typically feature higher leverage ratios (often exceeding 6x debt-to-EBITDA), and with investor demand outpacing deal activity, there has been an increase in deals coming with weaker structural protections, limited financial maintenance covenants and subordinated positions in capital structures. The borrowers are frequently private companies with limited operating history

or more established businesses that are not able to access the broadly syndicated loan or high yield bond markets.

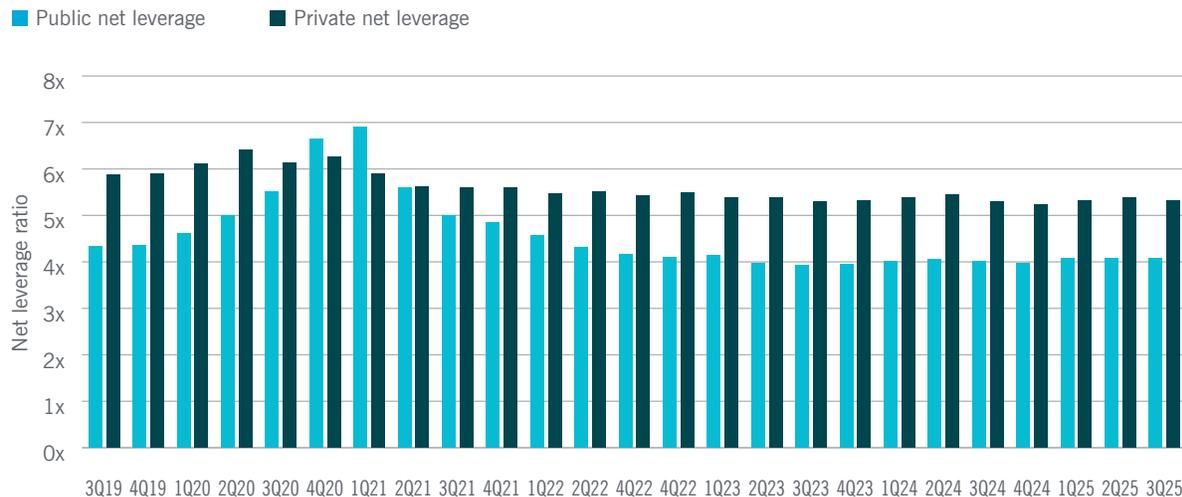
More recently, within the broadly syndicated loan market, lower quality, highly levered deals have grown as a share of issuance, though this quality mix can fluctuate during market cycles.

The result is a tiered credit landscape: the high yield bond market has moved upmarket toward larger, more established issuers with better credit profiles, while the riskiest credit exposure now resides in the upper-middle market segment of private credit and the lower-quality segments of the broadly syndicated loan market (Figure 2).

THE PUBLIC MARKET EDGE: TAKING ADVANTAGE OF VOLATILITY

High yield bonds provide investors with liquidity, with the market trading ~\$10B per day, which not only is essential to effectively manage risk in this dynamically shifting economic landscape, but also provides alpha opportunities unavailable in certain less liquid, buy-and-hold asset classes. We are currently operating in a credit pickers market, which affords an opportunity for managers with a proven investment process to identify attractive value within dislocation.

Figure 2: Leverage among public and private loan issuers



Data source: JPMorgan as of 31 Dec 2025.

Their prices reflect two competing forces: the contractual coupon payments pulling toward par and the market’s evolving assessment of default probability pushing prices away from par. The opportunity active managers can exploit in high yield comes from positioning for price appreciation during spread compression phases and avoiding price depreciation during spread widening. A buy-and-hold approach that works in private markets cannot be applied to public markets, as volatility should not be viewed as solely a negative component, but rather an opportunity to drive true alpha. The asset class rewards those who understand that returns are fundamentally driven by changes in credit perceptions across economic cycles, manifesting primarily through price appreciation and depreciation rather than steady income accumulation.

HIGH YIELD VALUATIONS

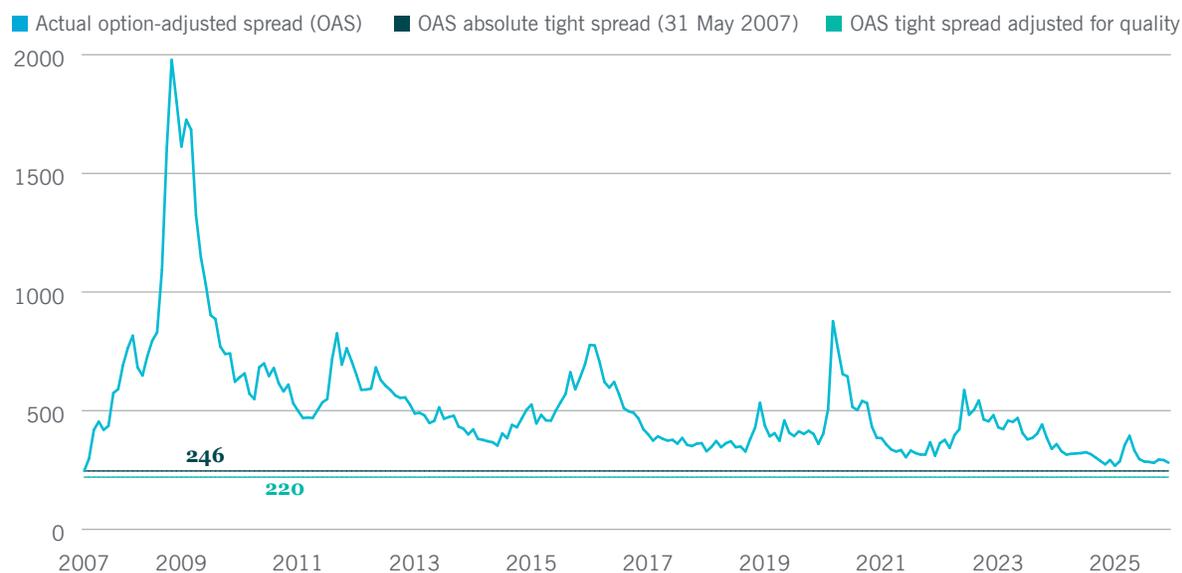
High yield bond spreads have tightened considerably, reflecting strong investor demand and generally benign credit conditions, yet valuations remain fundamentally sound when assessed against the structural transformation. Additionally,

robust technical support given fund flows, limited new issuance in certain periods and institutional demand have reinforced valuations without creating excessive froth.

Despite tight spreads by historical standards, high yield bonds continue to offer attractive risk-adjusted returns and appropriate compensation for the credit risk investors are assuming. The tightening of spreads reflects genuine improvement in issuer quality rather than irrational exuberance – today’s high yield market features lower leverage, stronger interest coverage and more resilient business models that justify narrower risk premiums compared to the past. When we adjust our assessment of spreads for a market that is more secured and of a higher quality composition, we find that high yield spreads should be even tighter than current levels (Figure 3). When evaluated against expected default rates and recovery values, current spread levels provide adequate compensation for anticipated credit losses, particularly given the migration of the riskiest borrowers away from high yield (Figure 4).

From a portfolio context, high yield bond exposure has proven to limit downside risk and/or capture alpha across several different rate environments

Figure 3: Market composition suggests spreads should be even tighter



Data source: Bloomberg as of 31 Dec 2025.

(Figure 5), which in today’s landscape adds complementary benefits among other traditional fixed income asset classes.

We believe high yield investors are being fairly compensated at current spread levels

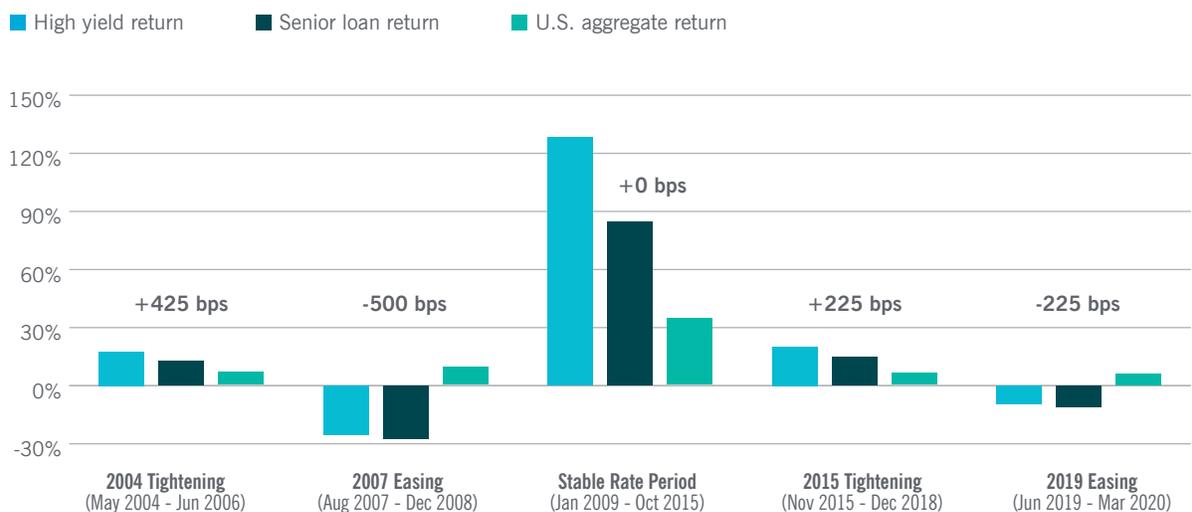
given the combination of meaningful carry income, limited interest rate sensitivity from relatively short duration, and a historically low default environment.

Figure 4: High yield spreads and defaults



Data sources: Bloomberg and BofA Global Research as of 31 Dec 2025.

Figure 5: High yield performance during rising and falling rate environments



Data source: Bloomberg as of 31 Dec 2025. Performance data shown represents past performance and does not predict or guarantee future results. Representative indexes: High yield: ICE BofA US High Yield Index; Senior loan: S&P UBS Leveraged Loan Index; U.S. aggregate: Bloomberg US Aggregate Bond Index Different benchmarks, economic periods, methodologies, and market conditions will produce different results. Reflects monthly data and not the precise timing of Federal Reserve rate decisions.

IN SUMMARY

We believe high yield bonds present a compelling investment opportunity given the convergence of strong credit fundamentals—including lower leverage ratios, improved interest coverage, and higher-quality issuers—with supportive technical factors such as consistent investor demand and manageable supply dynamics. The structural evolution of the market toward larger, more established public companies has enhanced credit quality while maintaining attractive risk-adjusted returns that appropriately compensate investors for the actual risk being assumed, even at tighter spread levels. The combination of solid fundamentals, favorable technicals and improved market quality can create opportunities for active managers to add value through selective positioning, particularly during volatility in public markets. High yield bonds may be considered a core holding for investors seeking income generation, total return potential and diversification within portfolios.

For more details on how high yield bonds can play a role in your portfolio, please consult with your local Nuveen representative or visit nuveen.com.

Endnotes

Sources

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