High Yield's Second Act: What AI Revealed About Credit Quality

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Key Takeaways

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The combination of structural quality, reduced sector concentration, and growing issuer demand is what we mean when we say high yield may be entering its second act.

High yield was arguably one of the first novel financing channels of the 1980s and has remained a core part of the leveraged finance ecosystem, but its growth had stalled -- a mere 0.9% annualized over the past decade. What has changed recently is that structural quality improvements, evolving issuer preferences, and tightening loan and direct lending technicals are all converging at once.

A Quality Story, Not Just a Technical One

The high yield market has spent the better part of a decade quietly becoming something different from the asset class many investors remember. The “junk bond” label, inherited from a different era, has not kept pace with what the market represents today. At a record ~57% and 68% BB-rated composition, the U.S. and EU high yield market now sits closer in quality to the investment grade universe than to the more speculative end of the credit spectrum. That evolution did not happen overnight – it reflects decades of market development and issuer maturation, with COVID-era fallen-angels catalyzing a gradual migration of some of the highest-quality leveraged borrowers into the high yield bond market.

The composition contrast of the high yield index with the leveraged loan market is instructive. While the loan market is approximately 60% single-B rated, the high yield market has continued to see its BB cohort expand. In the U.S., the BB cohort has grown from $1.19 trillion in January 2026 to $1.25 trillion in May, while the CCC bucket shrunk from $213 billion to $193 billion over the same period. That divergence matters because it means the two markets represent meaningfully different risk profiles, and the distinction has become more consequential as dispersion across leveraged finance has widened.

EXHIBIT 1: % of Total U.S. High Yield by Seniority

Two additional dimensions of quality often go unobserved. The first is duration. At roughly 3 years, the market's effective duration sits near a 15-year low and well below its long-run average of approximately 4 years. That matters because while spreads appear tight (near the 96th percentile since the GFC), adjusting for lower duration tells a different story. The spread per unit of duration sits at only the 74th percentile, a meaningfully less stretched picture than the headline figure suggests. The second is structural seniority. First lien secured bonds now represent 33% of the market, an all-time high, with total secured exposure approaching 36% and 38% in the U.S. and EU respectively. The growth of the data center financing market in the U.S., now roughly 3% of the index and almost entirely secured, has been one of the more recent contributors to that trend. This reinforces to us that the composition of the high yield market is supported by high quality paper and protected by structure.

The software selloff earlier this year crystallized this point. Software represents roughly 3% of the U.S. and European high yield market, compared to approximately 13% of the U.S. leveraged loan market and over 20% in U.S. direct lending. When AI-driven disruption concerns triggered a broad repricing of software credit, the impact was proportional to exposure. Software loan bids fell to the lowest reading in four years, and the gap between software and non-software loan bids widened to more than eight points by end of Q1. High yield, with its structurally lower software concentration, held materially better. The asset class did not escape scrutiny, but it absorbed the shock differently, and we believe that difference is worth double-clicking into.

The quality story doesn't end at credit ratings. It carries into reporting and disclosure. Because high yield bonds are registered under securities laws (i.e. 144a registration), issuers are generally subject to a higher level of disclosure, including offering memorandums (OMs), quarterly earnings calls, and in many cases full 10-K and 10-Q filings.

EXHIBIT 2: U.S. High Yield by Sector Composition

A Shift in Financing

High yield has not historically been the first call for many sponsors. Call protection economics, the additional process associated with SEC registration requirements, and the preference for flexible floating-rate structures made leveraged loans and, more recently, direct lending the default financing channels for most sponsor-backed transactions.

As CLO appetite has grown more selective and direct lending terms and risk have tightened, the execution certainty that the bond market offers has become more valuable. A non-call high yield bond locks in a fixed cost of capital for a defined period, eliminates repricing risk, and accesses a differentiated investor base that is not subject to the same CLO-driven demand dynamics that have shaped loan market technicals in recent years. For issuers with stable cash flows and a view that rates will eventually move in their favor, paying a modestly higher coupon in exchange for structural certainty and call protection is an increasingly attractive trade.

Recent deal activity reflects this shift. As we highlighted in our recent note Beyond the Roar, U.S. high yield issuance reached a seven-month high in April 2026, and BB-rated paper accounted for 39% of new issuance year-to-date, an all-time high for any comparable period. Since then, the data has continued to move in the same direction. Year-to-date pro forma volume of $189 billion through early July is up more than 20% from the $157 billion priced at the same point last year. In Europe, high yield BB trailing twelve-month issuance is hovering near its all-time highs reached earlier this year. And the composition of that issuance tells the more interesting story. BB-rated paper has swung to a 59% share of month-to-date June supply, up sharply from 30% in May, while single-B issuance has collapsed to less than 9%, a 15-month low.

Transactions that would previously have been financed entirely in the loan market are increasingly requiring bond market participation to be completed, with EA Sports and Sealed Air being prime recent examples: the loan market could not absorb the transaction alone, and bond market participation was what got the deal done. We do not believe that outcome is an isolated episode, but rather a signal of something structural. In fact, ~7% of the loan market matures within two years, which means >$100bn of par value in the loan market will need to consider if high yield is a better option. This is in addition to the ~10% of the high yield market that matures within the next two years, the highest share since the pre-GFC period.

While new transactions have increasingly leaned on the high yield market, we believe upcoming refinancings are likely to include high yield in a more significant way. Asurion offers an instructive example. As recently as last year, Asurion was a loan-only issuer with approximately $12 billion outstanding across half a dozen tranches. Facing a near-dated maturity profile spanning 2026 through 2028, and with many existing investors already at capacity on the name, the company needed a new approach. By pivoting to high yield, it reached a differentiated investor base and priced $3.3 billion of secured bonds to repay existing tranches earlier this year. The paydown restored confidence in the loan market, drove those remaining tranches tighter, and made subsequent refinancings cheaper. The virtuous cycle that followed was not accidental, but rather a direct consequence of opening a new financing channel. Looking ahead, we expect many software issuers, particularly those demonstrating strong cash generation and consistent profitability, to follow a similar path. The high yield market offers not just an alternative, but in some cases, the better route.

What does this mean for investors?

The case for high yield today is not a bet on spread compression, but rather a structural reallocation thesis with multiple return paths. For allocators building exposure across both markets, the U.S. and European opportunity sets also don't move in lockstep — sector composition, issuer base, and rate-cycle timing differ enough that combining them adds a diversification benefit distinct from either market alone.

The first is the yield itself. With the ICE BoA High Yield index at roughly ~7.3% today, the asset class offers attractive absolute income at a moment when fixed-rate certainty is increasingly valuable. In Europe, ICE BoA European High Yield a current yield of ~5.5%, with FX hedged investors picking up an additional ~150 basis points of carry. A bond that locks in that coupon for five to eight years, with call protection, is a different proposition from a floating-rate loan that reprices every quarter in a volatile rate environment.

Notably, U.S. Morningstar LSTA leveraged loan index yields currently sit at 8.1%, ~100 basis points above the high yield bond index. For investors willing to move up in quality, that premium no longer reflects better fundamentals. It reflects software overhang, CLO technical pressure, and documentation concerns that have accumulated in the loan market. In other words, the loan market is offering more yield today precisely because it carries more risk. High yield, at current levels, may be the more compelling risk-adjusted entry point.

The second is the optionality embedded in the structure. When issuers refinance early, as they have done consistently in periods of improving credit access, investors who purchased at a discount capture returns well above the modeled yield to worst. When bonds are not called and remain outstanding above par, the coupon continues to compound, often delivering realized returns that exceed initial expectations. When M&A activity accelerates, bonds held at a discount get called at par, generating IRRs that spread tightening alone would never produce.

For allocators who have underweighted high yield or have not revisited the thesis in several years, the question is simple: does the portfolio reflect what this market has actually become, or what it used to be? Structural quality is improving, issuer demand is growing, and the absolute return relative per unit of risk taken is a compelling proposition. The first act was a decade in the making. The second is already underway.

An op-ed by Christopher Sheldon, published August 3, 2026 in the Financial Times

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