

MONEY IN MOTION: WHAT'S IN THE PRICE?

Kevin Flanagan — Head of Fixed Income Strategy

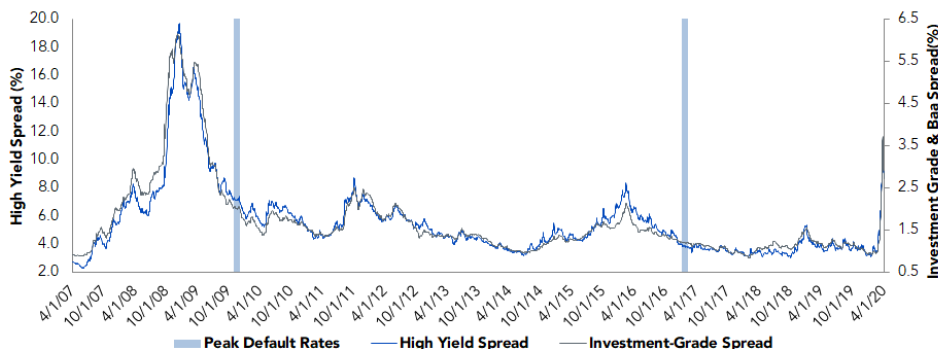
04/08/2020

The “Money in Motion” series of blogs continues this week with our focus turning to the U.S. [corporate bond](#) market. As I mentioned last week, the turmoil in the [financial markets has afforded investors the opportunity for a portfolio review](#). A recurring theme from my investor calls over the last week or so has been [valuations](#) in both the [investment-grade \(IG\)](#) and [high-yield \(HY\)](#) corporate arenas. The overarching question is whether current valuations represent a renewed buying opportunity. This brings me to the more pertinent query: what’s in the price?

Just some quick context. U.S. corporates experienced some of their worst weeks in March, pushing [spread](#) levels out to their widest readings since the financial crisis. By March 23, the day of the [Federal Reserve’s \(Fed\)](#) latest policy measures announcement, IG spreads had widened by roughly 275 [basis points \(bps\)](#) from late February, to hit +373 bps. During the same time frame, HY differentials ballooned an incredible 750 bps to +1,100 bps.

Back to those Fed announcements. Perhaps the most important of these policy measures are the [primary market corporate credit \(PMCCF\)](#) and [secondary market corporate credit \(SMCCF\)](#) facilities. These are brand new to the Fed’s playbook and allow the policymakers to buy U.S. IG corporates as well as IG corporate bond ETFs. Combined with the Fed’s [commercial paper funding facility \(CPFF\)](#), they provide a clear avenue for IG corporations to access funding, especially for vitally important short-term funding needs.

Investment-Grade Spread (RS) vs. High-Yield Spread (LS)



Source: Bloomberg, as of 4/3/20. Past performance is not indicative of future results.

As a result, both IG and HY spreads have come off their widest points, narrowing by roughly 90 bps and 160 bps respectively, as of writing. Nevertheless, the absolute levels remain historically high. One could argue that these visibly elevated levels have priced in what appears to be the inevitable increase in both downgrades and defaults. In the case of IG, a number of well-known brand names, such as Ford and Delta, have recently been downgraded to junk status, but spread levels still narrowed.

What about HY? This is where things get really interesting. Prior to this most recent bout, there were three other periods of spread widening going back to the financial crisis. As the graph clearly illustrates, in two out of these three periods (2008–2009 and 2016–2017), HY spreads hit their widest points 11 months before the default rate hit its high point. The other period when HY differentials rose in a sizable fashion was 2011, but that instance did not result in a spike in the default rate. For the record, according to Moody’s, the U.S. speculative-grade peak default rate for the two periods was 14.7% and 5.9% respectively. It ended 2019 at 4.2%.

What does this tell me? If history is any guide, the March surge in HY spreads, to their second-highest reading on record, has already priced in the increase in default rates that should be forthcoming.

So, what are fixed income investors to do? I'm under no illusion that volatility has gone away, and fully acknowledge economic challenges remain. Our base case for U.S. corporates envisions a sawtooth narrowing² spread pattern going forward.

While the expression is usually "don't fight the Fed," perhaps a better mantra for U.S. IG corps should be "follow the Fed's lead." Although the SMCCF is slated to be buying in the zero to five-year maturity range of the IG market, I suspect the IG corporate market in general should be a beneficiary of this policy.

For investors looking to enter the HY market, we offer two solutions for consideration. The [WisdomTree Interest Rate Hedged High Yield Bond Fund \(HYZD\)](#) provides an avenue into HY as well as a rate-protection angle. Screening for quality³ is as important as ever. The [WisdomTree U.S. High Yield Corporate Bond Fund \(WFHY\)](#) could provide a "core plus" solution with this attribute.

¹Wide readings Typically that means price went down and yields went up

²Meaning up and down or back and forth like the teeth in a saw, but the broader trend is a decreasing one

³Using our methodology to 'screen' companies that may not have healthy balance sheets

Important Risks Related to this Article

There are risks associated with investing, including the possible loss of principal. High-yield or "junk" bonds have lower credit ratings and involve a greater risk to principal. Fixed income investments are subject to interest rate risk; their value will normally decline as interest rates rise. The Fund seeks to mitigate interest rate risk by taking short positions in U.S. Treasuries, but there is no guarantee this will be achieved. Derivative investments can be volatile, and these investments may be less liquid than other securities, and more sensitive to the effects of varied economic conditions.

Fixed income investments are also subject to credit risk, the risk that the issuer of a bond will fail to pay interest and principal in a timely manner, or that negative perceptions of the issuer's ability to make such payments will cause the price of that bond to decline. The Fund may engage in "short sale" transactions where losses may be exaggerated, potentially losing more money than the actual cost of the investment and the third party to the short sale may fail to honor its contract terms, causing a loss to the Fund. While the Fund attempts to limit credit and counterparty exposure, the value of an investment in the Fund may change quickly and without warning in response to issuer or counterparty defaults and changes in the credit ratings of the Fund's portfolio investments. Due to the investment strategy of certain Funds they may make higher capital gain distributions than other ETFs. Please read each Fund's prospectus for specific details regarding the Fund's risk profile.

For standardized performance and the most recent month-end performance click [here](#) NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

For more investing insights, check out our [Economic & Market Outlook](#)

View the online version of this article [here](#).

IMPORTANT INFORMATION

U.S. investors only: Click [here](#) to obtain a WisdomTree ETF prospectus which contains investment objectives, risks, charges, expenses, and other information; read and consider carefully before investing.

There are risks involved with investing, including possible loss of principal. Foreign investing involves currency, political and economic risk. Funds focusing on a single country, sector and/or funds that emphasize investments in smaller companies may experience greater price volatility. Investments in emerging markets, currency, fixed income and alternative investments include additional risks. Please see prospectus for discussion of risks.

Past performance is not indicative of future results. This material contains the opinions of the author, which are subject to change, and should not to be considered or interpreted as a recommendation to participate in any particular trading strategy, or deemed to be an offer or sale of any investment product and it should not be relied on as such. There is no guarantee that any strategies discussed will work under all market conditions. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This material should not be relied upon as research or investment advice regarding any security in particular. The user of this information assumes the entire risk of any use made of the information provided herein. Neither WisdomTree nor its affiliates, nor Foreside Fund Services, LLC, or its affiliates provide tax or legal advice. Investors seeking tax or legal advice should consult their tax or legal advisor. Unless expressly stated otherwise the opinions, interpretations or findings expressed herein do not necessarily represent the views of WisdomTree or any of its affiliates.

The MSCI information may only be used for your internal use, may not be reproduced or re-disseminated in any form and may not be used as a basis for or component of any financial instruments or products or indexes. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an "as is" basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each entity involved in compiling, computing or creating any MSCI information (collectively, the "MSCI Parties") expressly disclaims all warranties. With respect to this information, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including loss profits) or any other damages (www.msci.com)

Jonathan Steinberg, Jeremy Schwartz, Rick Harper, Christopher Gannatti, Bradley Krom, Tripp Zimmerman, Michael Barrer, Anita Rausch, Kevin Flanagan, Brendan Loftus, Joseph Tenaglia, Jeff Weniger, Matt Wagner, Alejandro Saltiel, Ryan Krystopowicz, Jianing Wu, and Brian Manby are registered representatives of Foreside Fund Services, LLC.

WisdomTree Funds are distributed by Foreside Fund Services, LLC, in the U.S. only.

You cannot invest directly in an index.

DEFINITIONS

Corporate Bonds : a debt security issued by a corporation.

Valuation : Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.

Investment grade : An investment grade is a rating that signifies a municipal or corporate bond presents a relatively low risk of default.

High Yield : Sometimes referred to as "junk bonds," these securities have a higher risk of default than investment-grade securities.

Spread : Typically refers to a difference between a measure of yield for one asset class and a measure of yield for either a different subset of that asset class or a different asset class entirely.

Federal Reserve : The Federal Reserve System is the central banking system of the United States.

Basis point : 1/100th of 1 percent.