U.S. HIGH YIELD: WHAT'S PRICED IN?

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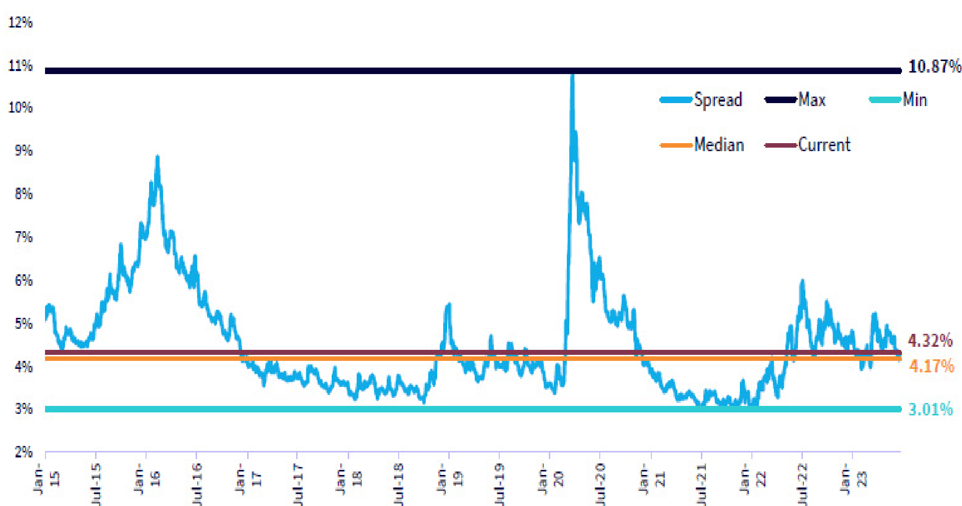
The "hawkish pause" from the Fed has captured the lion's share of the headlines in the bond market of late, and rightfully so. Against this backdrop, investors have been left to wonder: where is that recession nearly everyone was expecting by now? One area within the U.S. fixed income arena where this discussion will continue to percolate is high yield (HY). More importantly, just what has already been factored into the equation?

With the Fed raising rates at a historical pace in this cycle and recession still a topic of conversation, the default rate becomes an integral part of the HY conversation. Heading into this year, the U.S. speculative-grade default rate was residing at historically low levels. To provide some perspective, according to Moody's, the average default rate for 2022 came in at 1.49%, or visibly below the long-run average of 3.94%. Needless to say, given the expected unfavorable economic outlook and significantly higher rate setting, it was widely anticipated the default rate would rise this year. Through May, this was the case, as the reading has increased to a little over 3%, still below the long-term average.

Based on the lagged effects of Fed rate hikes, a further increase in the U.S. speculative-grade default rate seems to be a reasonable expectation as we move further into the year. In fact, if the timing for the widely anticipated economic downturn gets pushed into early 2024, it is also reasonable to expect elevated default readings continuing into next year as well. Based on rating agencies' projections, the default rate could rise into the 4%–5% vicinity. However, from a historical perspective, that number would definitely be on the low side. During prior recessionary periods of the last 30 years, double-digit readings were being registered.

High-Yield Credit Spreads



Sources: WisdomTree, FRED, 1/2/15–6/21/23. High-Yield Credit Spreads measured by ICE BofA U.S. High-Yield Index Option-Adjusted Spread. Past performance is not indicative of future results.

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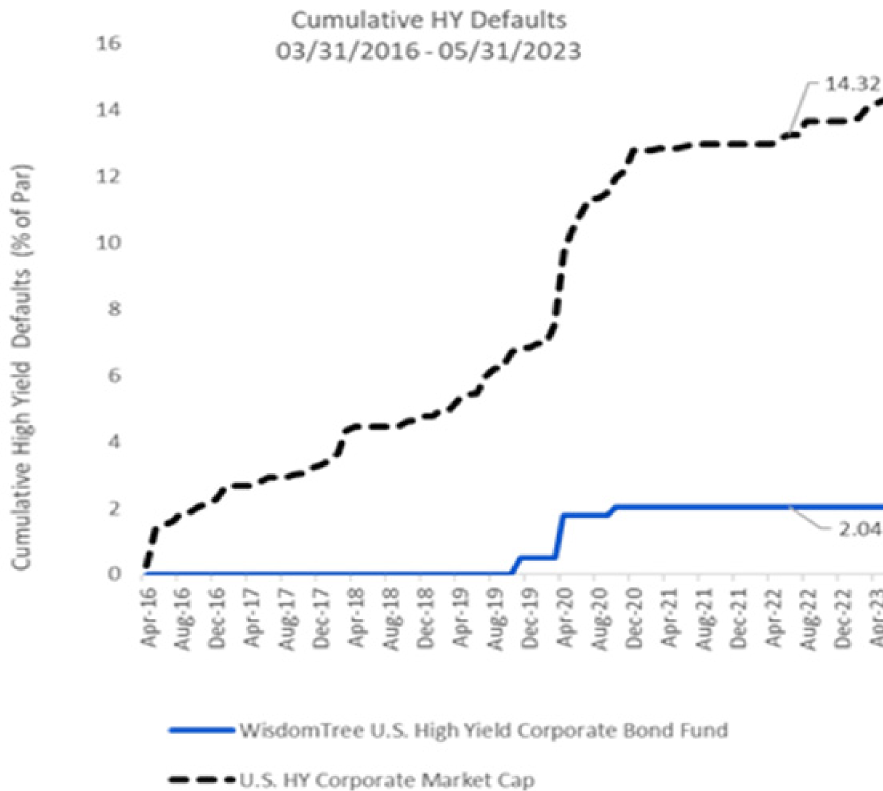
For definitions of terms in the graph above please visit the glossary.

A key metric for valuations in the HY sector comes from spread data. If negative news in the form of higher default rates is expected, spreads would typically widen, especially if defaults were being considered a worrisome development. As the above graph illustrates, HY spreads have actually been range-bound thus far in 2023. There's no doubt HY spreads have widened from their 2021 low watermark (+262 basis points (bps)), but they have remained roughly within their new elevated band of 400 bps to 500bps, leading me to believe that the default rate setting outlined here may have already been discounted for the most part.



Sources: Bloomberg, ICE, WisdomTree, as of 6/22/23. HY Corporate Market Cap is proxied by the Bloomberg U.S. Corporate High Yield Index after 3/31/20. Prior to this date, HY Corporate Market Cap is proxied by the ICE BofA U.S. High Yield Index. HY Corporate Market Cap was spliced due to data availability. It is not possible to invest in an index. Past performance is not indicative of future results.

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Nevertheless, with concerns about recession and a potential risk-off remaining a prevalent part of the investment landscape discussion, a HY strategy that recognizes this factor is an important consideration for investors. The WisdomTree U.S. High Yield Corporate Bond Fund (WFHY) employs a 'screen for quality' approach that focuses on only public issuers and their attendant balance sheets. We found that eliminating the public issuer universe with "negative cash flow" can serve as an important quality screen and helps to address the elevated credit risk apparent in the market cap-weighted approach, with the goal being to mitigate credit concerns, i.e., default risk, that can arise from risk-off periods (recessions). As the above graph highlights, this strategy has been rather effective, as the U.S. HY market cap default rate has been about 14.3%, while for WFHY, it has been only 2% since inception.

Conclusion

The bottom-line message is that we believe "there's income back in fixed income", but the current market environment has made it clear that a strategy that emphasizes fundamentally sound companies with strong cash flows, such as WFHY, is prudent in a time of economic uncertainty.

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DEFINITIONS

Hawkish : Description used when worries about inflation are the primary concerns in setting monetary policy decisions.

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

Bond market : The bond market—often called the debt market, fixed-income market, or credit market—is the collective name given to all trades and issues of debt securities. Governments typically issue bonds in order to raise capital to pay down debts or fund infrastructural improvements.

Recession : two consecutive quarters of negative GDP growth, characterized generally by a slowing economy and higher unemploymen.

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

Default Rates : the frequency in which borrowers fail to fulfill their contractual obligations.

Speculative grade : Speculative-grade bonds are issued by companies perceived to have a lower level of credit quality compared to more highly rated, investment-grade, companies.

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.

Basis point : 1/100th of 1 percent.

Risk-on/risk-off : refers to changes in investment activity in response to perceived risk. During periods when risk is perceived as low, investors tend to engage in higher-risk investments. When risk is perceived as high, investors tend to gravitate toward lower-risk investments.

Quality : Characterized by higher efficiency and profitability. Typical measures include earnings, return on equity, return on assets, operating profitability as well as others. This term is also related to the Quality Factor, which associates these stock characteristics with excess returns vs the market over tim.

Balance sheet : refers to the cash and cash equivalents part of the Current Assets on a firms balance sheet and cash available for purchasing new position.

Credit risk : The risk that a borrower will not meet their contractual obligations in conjunction with an investment.

Market capitalization-weighting : Market cap = share prices x number of shares outstanding. Firms with the highest values receive the highest weights in approaches designed to weight firms by market cap.