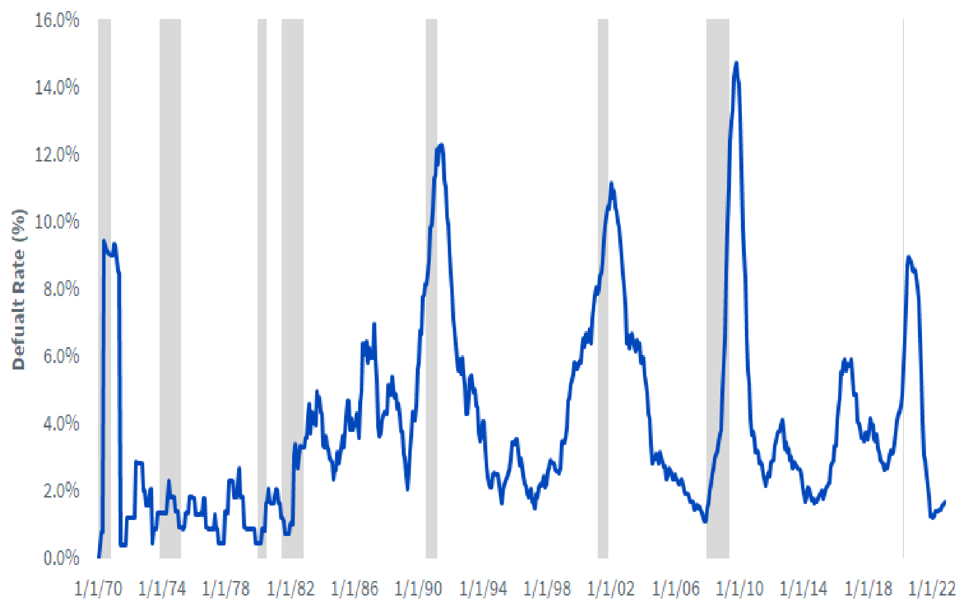
HAS DEFAULT BECOME THE LATEST BUZZWORD?

Kevin Flanagan – Head of Fixed Income Strategy
01/25/2023

The discussion surrounding a possible default seems to be becoming a "hot-button" topic here early in the new year. Of course, one aspect of this conversation involves the current debt ceiling debate within the federal government, a topic we wrote about in our Minds on the Markets piece just last week. This blog post is going to focus on the other part of the default discussion: U.S. high-yield (HY) securities.

U.S. Speculative-Grade Default Rate vs. Recessions



Sources: Moody's, St. Louis Fed, as of 1/20/23. Shaded areas indicate recession.

With a widely anticipated recession expected for the U.S. economy in 2023, the notion of elevated default rates occurring in the HY space has also garnered increasing attention. According to the latest data from Moody's, the U.S. speculative-grade default rate came in at 1.68%[1] for November 2022, moving very little over the prior 12-month period. This relatively steady performance followed on the heels of the rate reaching a COVID-19-related peak of just under 9% in August 2020.[1]

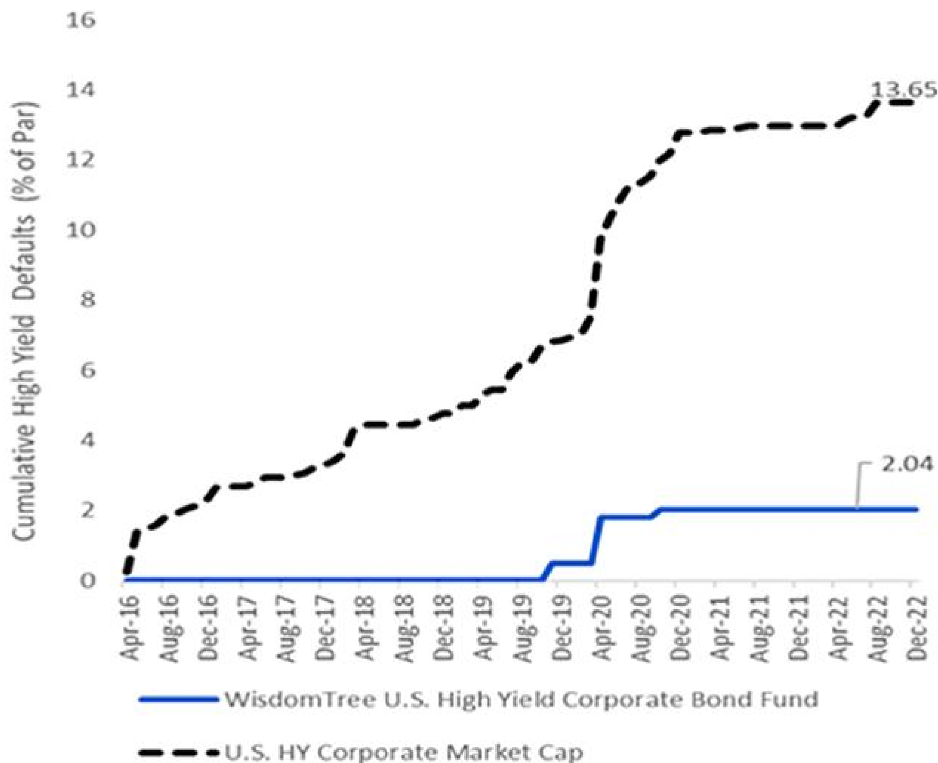
Questions have arisen as to whether the HY default rate can help foretell a potential recession. As the above graph illustrates, the results have been somewhat mixed on that front and didn't really provide much guidance from 1970 into the early 1980s. However, in the case of the 1990–1991 and 2001 economic downturns, an ascending trend did serve as a precursor for the recessions that followed. In both instances, the HY default rate not only rose ahead of the downturn, but it also continued to increase and remain elevated—even after the recession was "officially" deemed to have ended—before resuming a downward trajectory. In fact, default rates reaching "double-digit" territory was also

WisdomTree®

the norm. For the record, there was no predictive value for the financial crisis and/or great recession. Interestingly, there was a modest uptick in the rate prior to the “COVID-19 recession,” but the jury will remain “out” on this episode because we don’t know if the U.S. economy would have avoided a recession or not if there had not been a pandemic.

From what I have read, it appears as if rating agencies are expecting the U.S. speculative-grade default rate to increase this year, rising anywhere from 3.75% to 4.8%.[2] As you can see, from a historical perspective, that number would definitely be on the low side, especially for the period covering the last 30 years.

Cumulative High Yield Defaults 3/31/26–12/30/22



Sources: Bloomberg, ICE, WisdomTree, as of 12/30/22. HY Corporate Market Cap is proxied by the Bloomberg Barclays US Corporate High Yield Index after 3/31/20. Prior to this date, HY Corporate Market Cap is proxied by the ICE BofA US High Yield Index. HY Corporate Market Cap was spliced due to data availability. Past performance is not indicative of future results. It is not possible to invest in an index.

Nevertheless, with recession and potential risk-off concerns remaining a prevalent part of the investment landscape discussion, an HY solution 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 13.7%, while for WFHY, it has been only 2.0% since inception.

Conclusion

The bottom-line message is that “there’s income back in fixed income,” but in our opinion 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.

For definitions of terms in the charts above, please visit the glossary.

[1] Source: Moody’s, https://www.moodys.com/.

[2] Source: "Default, Transition, and Recovery: The U.S. Speculative-Grade Corporate Default Rate Could Reach 3.75% by September 2023," S&P Global, 11/21/22.

Important Risks Related to this Article

There are risks associated with investing, including the possible loss of principal. Fixed income investments are subject to interest rate risk; their value will normally decline as interest rates rise. High-yield or “junk” bonds have lower credit ratings and involve a greater risk to principal. 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. 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. Please read the 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.

Related Funds

+ WisdomTree U.S. High Yield Corporate Bond Fund
+ WisdomTree Floating Rate Treasury Fund
+ WisdomTree Yield Enhanced U.S. Aggregate Bond Fund

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

Default : A failure to meet the legal obligations (or conditions) of a loan.

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

Speculative-Grade Bonds : Bonds that are believed to have a lower risk of default and receive higher ratings by the credit rating agencies, namely bonds rated Baa (by Moody's) or BBB (by S&P and Fitch) or above. These bonds tend to be issued at lower yields than less creditworthy bonds.

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

Moody's Investors Service (Moody's) : Moody's Investors Service, often referred to as Moody's, is the bond credit rating business of Moody's Corporation, representing the company's traditional line of business and its historical name. Moody's Investors Service provides international financial research on bonds issued by commercial and government entities.

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

Downturn : A general slowdown in economic activity over a sustained period of time.

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.

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.

Operating cash flow : Measure of the amount of cash generated by a company's normal business operations, calculated by adjusting net income for items like depreciation and changes in inventory and receivables.

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.

Default Risk : The risk that an issuer will be unable to make the payments on its debt necessary to satisfy its financial obligation to the investo.