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# THE CREDIT CYCLE: OPPORTUNITY EXISTS, BUT BE SELECTIVE

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Our base case is that the [credit cycle](#) will not turn in 2020. Investors will likely continue to seek income in higher-[yielding](#) fixed income assets.

An important topic in credit strategy research in 2019 was the high [return dispersion](#) across corporate bond markets. Investors appear more discerning between good and bad bonds.

Given this situation, we are advocating for an up-in-quality trade for [high yield \(HY\)](#) investors who rely on [fundamentals](#) as opposed to credit ratings agencies.<sup>1</sup>

## Animal Spirits, But Tread Cautiously...

Following a decreased probability of risks boiling over (e.g., hard [Brexit](#), escalations in the U.S./China trade war) and a reversal in [Federal Reserve \(Fed\) rate hikes](#), [animal spirits](#) were revived in 2019.

The result?

In 2019, the [S&P 500 Index](#) returned 31.5% and U.S. HY option-adjusted spreads narrowed 190 [basis points \(bps\)](#), with the highest quality rung of the market outperforming: [BBs](#).<sup>2</sup>

But what's driving this?

We believe investing in [quality](#) was a prudent approach for 2019 and will continue into 2020. While an outright [recession](#) is not our base case, U.S. growth is still expected to remain moderate, at best. In terms of corporate bond fundamentals, debt levels are elevated with the [nonfinancial corporate debt/GDP ratio](#) at 47%, near historic highs<sup>3</sup>.

## Going Up in Quality for 2020

The [Bloomberg Barclays U.S. Corporate High Yield Index](#) has a [yield to worst](#) of 5.19%<sup>4</sup>. If the credit cycle runs on, as we believe it will, investing in U.S. High Yield could be advantageous for investors seeking income.

It's our belief that discerning between strong and weak credits will be a significant factor for total returns in 2020. One way to do this is by allocating to bonds with a higher credit rating.

This was a rewarding trade in 2019, with high-yield BBs outperforming high-yield CCCs by roughly 600 bps.<sup>5</sup> But it looks like the easy money in this trade may be behind us. We therefore recommend an up-in-quality trade but doing so using security selection and investing in bonds with stronger fundamentals.

WisdomTree's approach to high-yield credit investing is to isolate high-quality, high-yield bonds while still seeking a comparable income profile to the high-yield bond market.<sup>6</sup>

When designing our rules-based approach, our goal was to screen the high-yield bond market to potentially avoid defaults/problematic credits.<sup>7</sup>

## Strategy Effectiveness

We track corporate fundamentals and defaults closely. In the table below, we break out

the 10 largest defaults within the credit universe of corporate bonds and bank loans through 2019.

**Largest Defaults of 2019 as of Oct. 31**

Default Date	Company	Bonds (\$)	Loans (\$)	Bonds (\$) + Loans (\$mm)	Average Annual Free Cash Flow (5 yr) *	Weight in WisdomTree U.S. High Yield Corporate Bond Fund	Weight in WisdomTree U.S. Short-Term High Yield Corporate Bond Fund
7/1/19	Weatherford International	6,164	285	6,449	-448	-	-
2/28/19	Windstream	6,048	1,749	7,797	136	0.50%	-
8/15/19	EP Energy	4,280		4,280	-159	-	-
4/1/19	Hexion	3,486		3,486	Private Issuer	-	-
10/1/19	Acosta	800	1,967	2,767	Private Issuer	-	-
10/29/19	Murray Energy	814	1,727	2,541	Private Issuer	-	-
7/15/19	Sanchez Energy	2,250		2,250	-457	-	-
5/1/19	Sable Permian Resources	2,104		2,104	Private Issuer	-	-
4/1/19	Monitronics International	585	1,073	1,658	154	-	-
2/19/19	Affinion Group	682	837	1,519	Private Issuer	-	-

Sources: JP Morgan, FactSet, as of 10/31/19. Past performance is not indicative of future results. Weights subject to change.

While many factors are important, cash flow is a good place to start when evaluating the strength of an issuer, as cash balances are easier to track than other accounting variables. We see in the table above that over the past five years, most of the issuers either have been private issuers (providing less disclosure than publicly traded companies) or have generated negative free cash flow, two of our quality screens.

**Portfolio Impact<sup>8</sup>**

Avoiding some of the biggest defaults of the year serves as strong validation for our process. In the table below, we summarize the overall default statistics for the WisdomTree High Yield Funds in 2019 through October, as well as that of the broad high yield universe as proxied by the [ICE BAML U.S. High Yield Index](#).

**Defaults in High Yield in 2019 through Oct. 31**

Type	Name	Cumulative Defaults (% Par)	# of Defaulting Issues Held	# of Defaulting Issuers Held
Fund	WisdomTree U.S. High Yield Corporate Bond Fund (WFHY)	0.50%	1	1
Fund	WisdomTree U.S. Short Term High Yield Corporate Bond Fund (SFHY)	0.00%	0	0
Index	ICE BofAML U.S. High Yield Index	1.93%	41	13

Sources: WisdomTree, ICE BofAML, as of 10/31/19. Past performance is not indicative of future results. Weights subject to change. % Par is an alternative method of weight calculation. Instead of aggregating by market value, bonds are aggregated by the notional of the debt, which is the dollar amount the investor expects to receive when a security matures.

Please click the Funds' respective tickers for standardized performance: [WFHY](#), [SFHY](#).

The [WisdomTree U.S. High Yield Corporate Bond Fund \(WFHY\)](#) managed to significantly improve the total par value as well as the total number of defaults in 2019 through October 31 versus the ICE BofAML U.S. High Yield Index.

The same story is true for the [WisdomTree U.S. Short-Term High Yield Corporate Bond Fund \(SFHY\)](#), which had no defaults in 2019.

It's our belief that the WisdomTree approach to high-yield investing captured quality investments through our fundamental screens, and the number of defaults could be a good proxy for the strategy's ability to filter out bad bonds.

<sup>1</sup>An up-in-quality trade for HY is investing in the securities with higher credit quality per a rating agency or with stronger fundamentals relative to comparable securities.

<sup>2</sup>Source: Bloomberg, as of 12/31/19. U.S. HY is a proxy for the [Bloomberg Barclays U.S. Corporate High Yield Index](#). High-yield BBs are proxied by the [Bloomberg Barclays Ba U.S. High Yield Index](#). BB is a credit rating assigned by a credit rating agency. Credit ratings represent the highest of each portfolio constituent as currently rated by Standard and Poor's, Moody's or Fitch. Ratings are generally measured on a scale that ranges from AAA (highest) to D (lowest). Ratings from AAA to BBB are considered investment-grade.

<sup>3</sup>WisdomTree, Federal Reserve, as of 9/30/19.

<sup>4</sup>Bloomberg, as of 12/31/19.

<sup>5</sup>Source: Bloomberg, as of 12/31/19. High-yield BBs are proxied by the Bloomberg Barclays Ba U.S. High Yield Index. High-yield CCCs are proxied by the [Bloomberg Barclays Caa U.S. High Yield Index](#).

<sup>6</sup>The U.S. high-yield bond market is proxied by the Bloomberg Barclays U.S. High Yield Bond Index.

<sup>7</sup>We consider problematic credits within the U.S. high yield universe to be those which trade at very low prices.

<sup>8</sup>Any views or analysis relating to the [WisdomTree U.S. High Yield Corporate Bond Fund \(WFHY\)](#) or the [WisdomTree U.S. Short-Term High Yield Corporate Bond Fund \(SFHY\)](#) are provided by Kevin Flanagan.

#### Important Risks Related to this Article

There are risks associated with investing, including 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 each Fund's prospectus for specific details regarding the Fund's risk profile.

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For the top 10 holdings of WFHY please visit the Fund's fund detail page at <https://www.wisdomtree.com/investments/etfs/fixed-income/wfhy>

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](#)

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**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.

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## DEFINITIONS

**credit cycle**: the process in which the pricing of and access to credit evolves over time.

**Yield**: The income return on an investment. Refers to the interest or dividends received from a security that is typically expressed annually as a percentage of the market or face value.

**High Yield Corporate (Bond)**: a type of corporate bond that offers a higher rate of interest because of its higher risk of default.

**Fundamentals**: Attributes related to a company's actual operations and production as opposed to changes in share price.

**Brexit**: an abbreviation of "British exit" that mirrors the term Grexit. It refers to the possibility that Britain will withdraw from the European Union.

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

**Rate Hike**: refers to an increase in the policy rate set by a central bank. In the U.S., this generally refers to the Federal Funds Target Rate.

**S&P 500 Index**: Market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor's Index Committee designed to represent the performance of the leading industries in the United States economy.

**Basis point**: 1/100th of 1 percent.

**BB-Rated**: The least speculative bucket of non-investment grade status for S&P. These issuers may be vulnerable to adverse business and economic conditions ultimately impacting their ability to meet financial commitments.

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

**Yield to worst**: The rate of return generated assuming a bond is redeemed by the issuer on the least desirable date for the investor.

**ICE BofAML US High Yield Index (H0A0)**: The ICE BofAML US High Yield Index tracks the performance of the universe of US dollar denominated below investment grade corporate debt publicly issued in the US market.