

U.S. HIGH-YIELD DEFAULT RATES DOUBLE...QUALITY MATTERS

Kevin Flanagan – Head of Fixed Income Strategy
09/30/2020

While March seems like a long time ago (at least for me), the repercussions of perhaps the worst two-week period in the U.S. [high-yield \(HY\)](#) arena are now showing through some five to six months later. Interestingly, the news seems to have flown under the radar up to this point, but according to Moody's, speculative-grade default rates in the U.S. have been increasing at a rather swift pace through the summer months. Naturally, from a fixed income portfolio perspective, this development underscores our thesis that screening for quality within the HY sector remains of paramount importance.

Before I get into the default numbers, let's take a look at recent developments within the HY market. [Spread levels](#) have been on a noticeable downward trajectory from their peak level on March 23. At its "wide," the spread had spiked to 1,100 [basis points \(bps\)](#) (the second highest on record), representing an incredible 750 bps increase from about the President's Day holiday. Since then, the reading has narrowed by 580 bps, retracing about 77% of the aforementioned widening (see graph).

High-Yield Spread



Source: Bloomberg, as of 9/24/2020.

Back to the default numbers. As I've written before, HY spreads and default rates have an interesting relationship. Using the previous two periods of spread widening, the peak in high-yield spreads occurred 11 months prior to the peak in default rates in both instances. It appears as if history is repeating itself on this front. When the high watermark in HY spreads was printed in March, the U.S. speculative-grade default rate for the month was 4.9%, according to Moody's. For August, that number had risen to 8.7%. For more perspective, the December 2019 level was 4.3% while the year-ago reading was only 3.2%. It certainly seems as if the default rate is heading back toward double digits for this cycle, and if the prior trend holds, the peak will register around February 2021. For the record, the number got up to 14.7% following the financial crisis/great recession, an all-time record. In fact, there have been only three other times the default rate was in double-digit territory in the modern era.

Fixed Income Solutions

We continue to believe there is relative value in the U.S. HY market, but as I

mentioned, screening for quality is of paramount importance. The [WisdomTree U.S. High Yield Corporate Bond Fund \(WFHY\)](#) follows this approach by focusing solely on public issuers and eliminating those with negative [cash flow](#). This strategy is designed to mitigate potential default risk, a key factor to consider given the expected HY backdrop in the months ahead.

Unless otherwise stated, all data sourced is Bloomberg, as of September 24, 2020.

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 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.

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

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.

Basis point: 1/100th of 1 percent.

Cash flows: a measure of how much cash a business generates after taking into account all the necessary expenses, including net capital expenditures.