High-Yield Corporate Bonds

Turning the Corner

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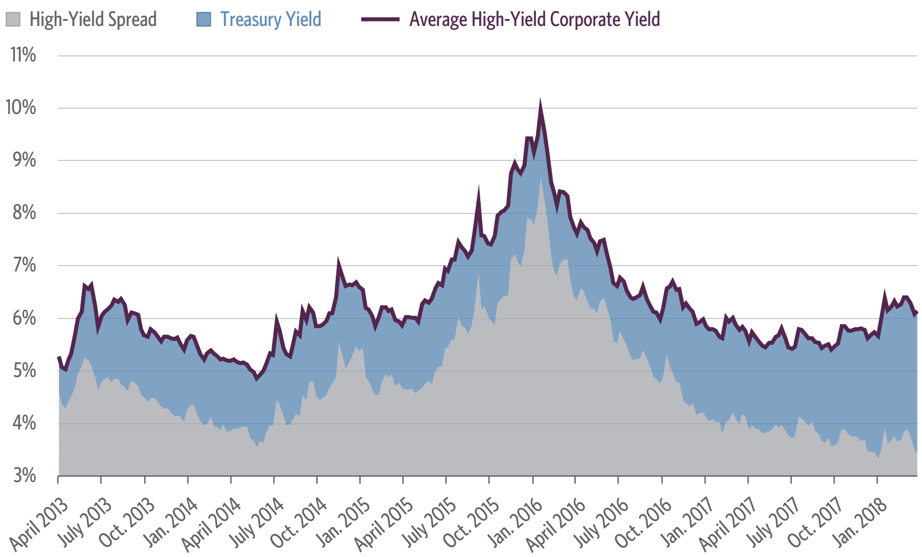
Demand for high-yield corporate bonds waned in the first quarter as Treasurys sold off, but signs of a turnaround are visible.

High-yield corporate bonds are trading at yields above 6 percent for the first time since December 2016, mostly due to the backup in benchmark Treasury rates (see chart, top right). While five-year Treasury yields rose 61 basis points year to date through April, spreads are 26 basis points tighter, continuously retesting cycle lows as higher yields attract income seekers back into the market.

Although we saw a pickup in volatility in the first quarter, we believe higher yields against a relatively benign credit backdrop will stem a mass exodus from the high-yield market. The ICE Bank of America Merrill Lynch High-Yield index posted a 0.9 percent loss on a total return basis, as higher-duration BB-rated bonds delivered their worst performance since the third quarter of 2015 with a 1.7 percent loss, compared to a 0.4 percent loss for B-rated bonds and a 0.5 percent gain for CCC-rated bonds. Since 10-year Treasury yields began to move higher in early September 2017, BB-rated bonds have returned -0.8 percent, the only rating category in leveraged credit to record a loss over this period.

The selloff in Treasurys caused some trepidation among leveraged credit investors as higher-duration BBs experienced negative price returns. Between January and March, high-yield mutual funds and exchange-traded funds experienced net outflows totaling $15.5 billion, but we expect a turnaround in demand. Funds saw a net inflow of $920 million in one week during April followed by the largest inflow in over a year of $3 billion (see chart, bottom right). We also note that primary dealer inventories of high-yield bonds have plunged, falling from approximately $5 billion at year-end 2017 to only $1 billion in mid-April, according to New York Federal Reserve Bank data. The last time dealer inventories fell to similar levels was in March 2016, when a swift pickup in demand caught dealers by surprise. To the extent investors are looking for opportunities in high yield as volatility levels off, we view B-rated credits relatively favorably in the current environment as they balance credit and duration risks and offer wider spreads compared to their own history than other rating categories.

High-Yield Corporate Bond Yields Top 6 Percent



Source: ICE Bank of America Merrill Lynch, Guggenheim Investments. Data as of 4.24.2018.

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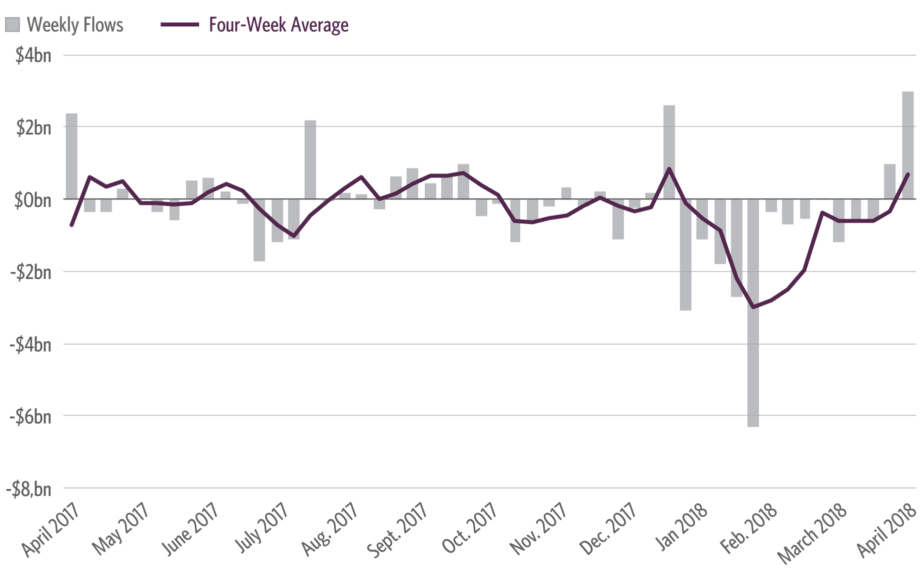
High-Yield Mutual Fund and ETF Flows Turn Positive



Source: Lipper, Guggenheim Investments. Data as of 4.18.2018.

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