High-Yield Corporate Bonds

A Fundamentally Stable Credit Environment

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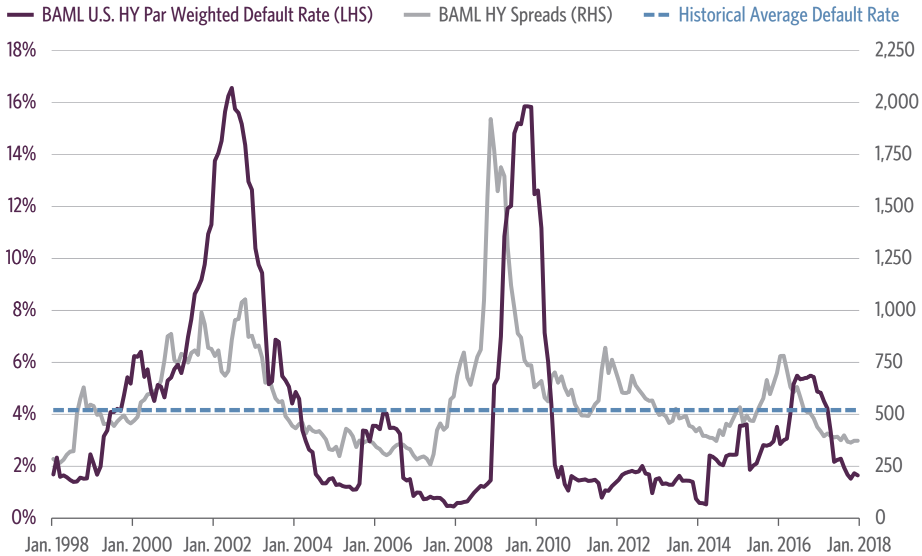
Tax reform will be a key driver of performance for high-yield corporate bonds in 2018.

Positive fundamental factors underlying the corporate sector continue to underscore our constructive stance on high-yield corporate credit as we enter what our macroeconomic team believes to be the penultimate year before a recession. Average leverage ratios and interest coverage ratios improved in 2017 on the back of strong earnings growth. As fundamentals improved, the 12-month par-weighted trailing default rate in the Bank of America Merrill Lynch High-Yield index fell to just 1.65 percent by year end, compared to a historical average default rate of 4.15 percent (see chart, top right). We believe credit risk should remain benign in 2018.

High-yield corporate bonds lost steam in the fourth quarter, with the Bank of America Merrill Lynch High-Yield index delivering 0.4 percent total return with spreads wider by 5 basis points. High-yield spreads tightened by an average of 66 basis points in 2017. Total return for the year was consistent with our expectations of mostly earning coupon income plus some limited price upside. The high-yield corporate bond market returned 7.5 percent in 2017, with mixed returns by rating. BB-rated, B-rated, and CCC-rated bonds delivered 7.3 percent, 6.9 percent, and 9.3 percent total returns, respectively.

Tax reform will be a key driver of performance for high-yield corporate bonds this year. The reduction in the corporate tax rate from 35 percent to 21 percent is expected to help boost cash flow primarily for smaller, domestically focused companies given that they typically pay the highest effective tax rates. This description generally applies to high-yield borrowers, especially BB-rated and B-rated companies. We believe this could be the catalyst for further spread compression between high-yield and investment-grade corporate bonds, where the premium remains at the 2005–2007 average level and above historical lows (see chart, bottom right). We are concerned that the inability of borrowers to deduct interest expense above 30 percent of earnings before interest, taxes, depreciation, and amortization going forward will likely hurt many CCC-rated companies that already pay interest expense above this threshold. This change does not impact our strategy significantly, which has been focused on higher-quality borrowers for some time, but we believe it could spell trouble for 10–15 percent of the high-yield market. Investors should safeguard portfolios for a potential rise in CCC-issuer spread volatility by the end of the year.

Low Credit Default Rates Point to Benign Risk Environment in 2018



Source: Bank of America Merrill Lynch, Guggenheim Investments. Data as of 12.31.2017.

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Lower Corporate Tax Rates Could Spur Further Spread Compression

Source: Bloomberg, Guggenheim Investments. Data as of 1.22.2018. Shaded areas represent periods of recession.

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