High-Yield Corporate Bonds

High-Yield Issuers Were Resilient Amid Fed Tightening

Robust high-yield earnings supported low default activity last year.

Despite the poor returns of the Bloomberg U.S. Corporate High-Yield Index in 2022, the low high-yield default rate—0.8 percent per S&P as of Dec. 31, 2022 (1.5 percent par-weighted per BofA Research)—continues to demonstrate strong corporate fundamental performance and resilience to the Fed's tightening efforts. A major tailwind has been corporate earnings, with trailing 12-month earnings before interest, tax, depreciation, and amortization (EBITDA) through the third quarter up 61 percent compared to the prior comparable period, and on track to finish up 33 percent year over year in the fourth quarter. Excluding commodities, cash flows were still strong, tracking up 29 percent year over year.

The fourth quarter of 2022 saw a resurgence in demand for credit risk and a turnaround in high-yield corporate bond prices as a possible end to the Fed hiking cycle came more into focus. This rally extended into the first four weeks of 2023. Credit spreads tightened from 552 basis points to end the year at 469 basis points, and have continued to tighten. Yields fell from a 2022 high of almost 10 percent to 8 percent currently. After dipping to as low as 84 percent of par, high-yield corporate bond prices are now closer to 89 percent of par, offering a little less cushion than at the end of last year.

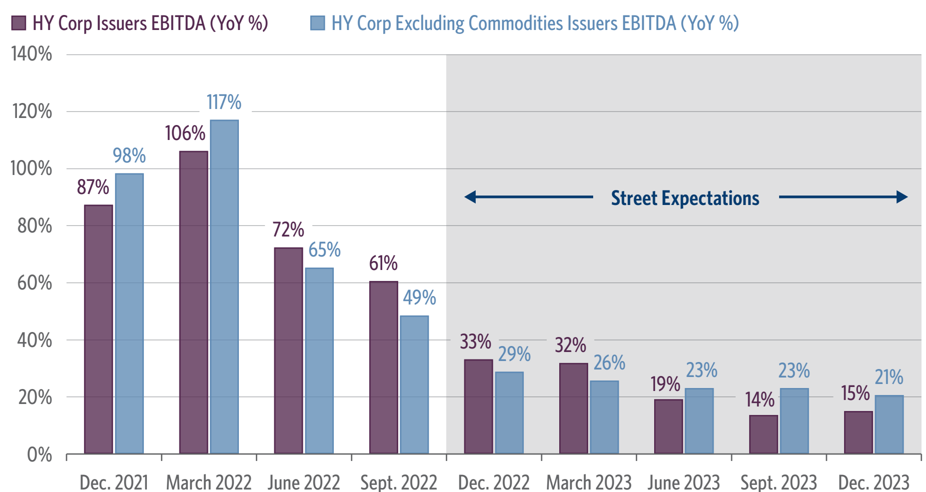
The elevated risk of recession in 2023 presents a meaningful challenge to leveraged borrowers. Wall Street consensus expects high-yield EBITDA to rise about 15 percent in 2023 for the group of over 350 high-yield companies that we track, including a 21 percent increase for non-commodity companies. These expectations may be too optimistic given the deteriorating economic backdrop, but we think the sector is still poised to weather a downturn better than in previous recessions. In addition to coming off of a strong earnings cycle, high-yield issuers' leverage is below 2019 levels, and interest coverage stands at over 5.0x.

While the sector's five-year duration was a drawback in 2022, we think it could be a benefit in 2023 if the emergence of a recession triggers a rally in U.S. Treasurys, thereby boosting returns. With yields still attractive in the current environment, we are positioning in sectors and issuers that we think are higher quality and likely to be more resilient in an economic downturn.

By Thomas Hauser and Maria Giraldo

We think the high-yield sector is poised to weather a downturn better than in previous recessions. In addition to coming off of a strong earnings cycle, high-yield issuers' leverage is below 2019 levels, and interest coverage stands at over 5.0x.

Strong High-Yield Corporate Earnings Supported Low Defaults in 2022



Source: Guggenheim Investments, S&P Capital IQ. Data as of 1.25.2023.

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