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High-Yield Corporate Bonds

Attractive Yields and Limited Supply Support Performance

Credit challenges persist, but stable spreads and attractive yields lure investors.

The picture for the high-yield corporate bond market is mixed. Performance has been strong year to date, driven by attractive yields and the lack of new issuance. Meanwhile, defaults have increased. In the first half of 2023, 11.1 percent of bonds in the ICE BofA High Yield index were downgraded versus 9.7 percent upgraded, resulting in a negative net migration rate. We remain concerned about the effects of restrictive monetary policy and slowing corporate earnings growth, which suggest that more defaults and credit rating downgrades lie ahead.

The ICE BofA High Yield Index has returned over 6 percent year to date through the end of July, with strong performance across most industries. Yet defaults have increased as some companies wrestle with increasing interest expense and unsustainable leverage ratios. The high-yield corporate bond default rate increased from 1.5 percent to 2.4 percent, according to BofA Research, which remains below the historical average of 3.8 percent. Our forecast puts the 2023 default rate at 3.5 percent and 2024 at 5 percent—a benign cycle compared to history.

Most defaults over the last 12 months came from healthcare, followed by media companies and then telecom and technology companies. We continue to view this default cycle as one driven by idiosyncratic, credit-specific factors rather than industry-specific ones, in contrast to the last several cycles dating back to the 1990s. Many defaults today have been well-known stress situations that were priced with elevated spreads for over a year, thus the lack of a surprise element is avoiding meaningful spillovers.

Despite rising defaults, high-yield corporate bond spreads are 384 basis points over maturity-matched Treasurys, which is tighter than the decade average of 446 basis points and in the 34th percentile over this period. But yields stand at 8.4 percent, which is in the 88th percentile over the same timeframe.

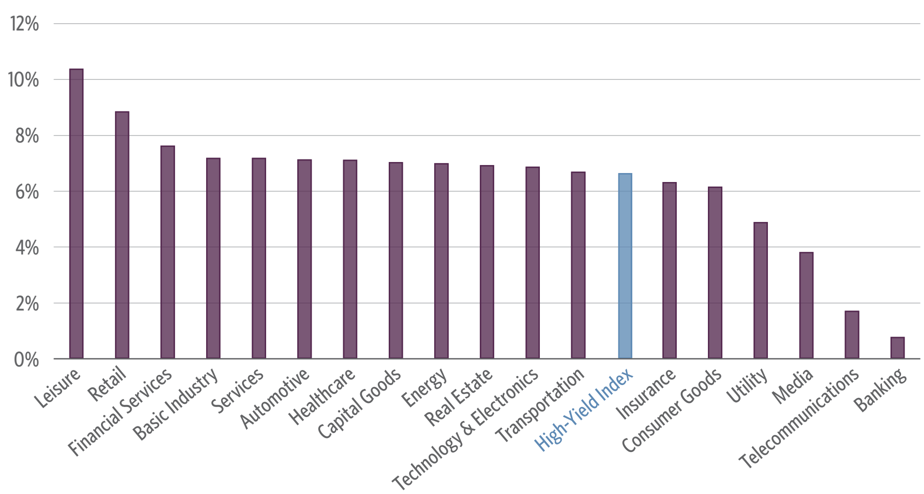
We believe high-yield bond spreads have limited room to tighten further, but current yields continue to appeal to investors, despite more cautious market sentiment surrounding the hardest-hit sectors. This element, combined with limited net new issuance, should keep spreads rangebound in the near term. We remain cautious in our credit selection though, focusing on issuer and industry diversification as well as moving up in the capital stack and looking for higher quality debt, given the broad-based nature of the current default cycle that is still in its early stages.

By Thomas Hauser and Maria Giraldo

The high-yield market has had strong year-to-date performance, buoyed by strong performance across most industries. This is in spite of rising defaults in the sector, which we believe are driven by credit-specific factors, rather than industry-specific ones.

The High-Yield Market Returned Over 6 Percent Year to Date

ICE BofA High Yield Index Total YTD Return by Industry



Source: Guggenheim Investments, ICE Data Indices. Data as of 7.25.2023.

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