

High-Yield Corporate Bonds Expect a More Sustainable Pace of Returns



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Rising Treasury yields may weigh on high yield for the balance of the year, but positive returns should continue with additional spread compression and coupon clipping.

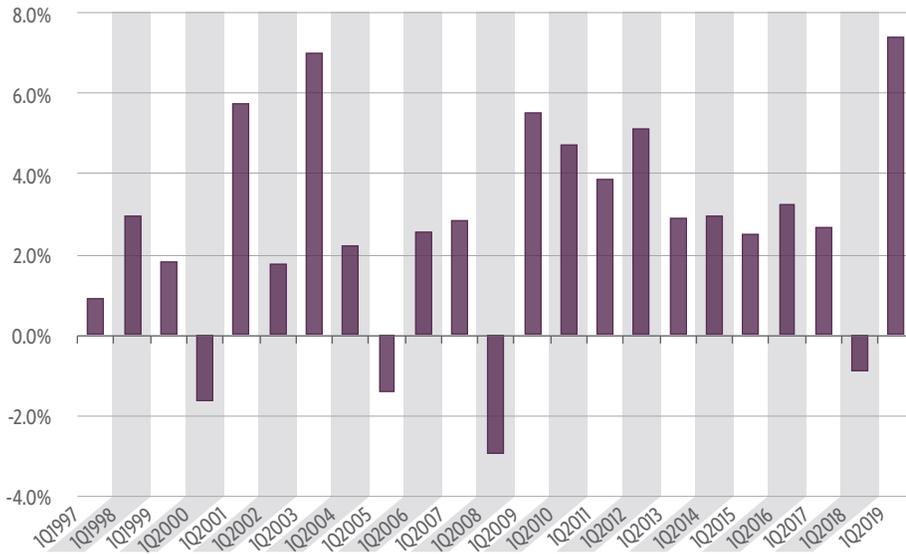
Since the market is no longer pricing in Fed tightening for the foreseeable future, a key investment theme this year has been extending duration. Based on net flows, high-yield mutual funds are capturing outflows from floating-rate bank loan funds and other sectors. This, coupled with a decline in rates, culminated in the high-yield corporate bond market's best first-quarter performance on record (see chart, top right). Spread compression was the biggest driver of positive performance, with total return of 7.4 percent and excess return of 6.3 percent over Treasurys.

Our Macroeconomic and Investment Research Group believes Treasurys are overbought and therefore expects a near-term bounce in yields. Higher rates would hinder returns but would mainly hurt BBs, whose average duration of 4.9 years is longer than the average durations of B-rated and CCC-rated bonds at 4.4 years and 4.0 years, respectively. Other factors that limit upside return potential include refinancing activity, which would decrease the coupon return (though this could be offset by new issue concessions), and default activity, which would lower loss-adjusted returns.

Our internal high-yield default model projects a slight pickup in default activity. As of the end of the first quarter 2019, the 12-month trailing par-weighted default rate stood at 0.6 percent, near historical lows, while our model projects it will pick up to about 3.0 percent by year-end. The par-weighted distress ratio, which historically has been a good predictor of directional changes in the default rate, was 6.5 percent as of the end of the first quarter. However, the distress ratio has overpredicted the default rate by an average of 10 percentage points historically (see chart, bottom right). If the market expected a meaningful pickup in defaults, the distress ratio would be much higher.

Low defaults, spread compression, and coupons should more than offset the negative impact of higher benchmark rates in the near term. We see better relative value in middle-market bonds as the experience of the fourth quarter drove investors to bonds of companies with larger capital structures that are considered to be more liquid. Middle-market structures could reverse some of the widening from last year, and should perform better than large capital structures.

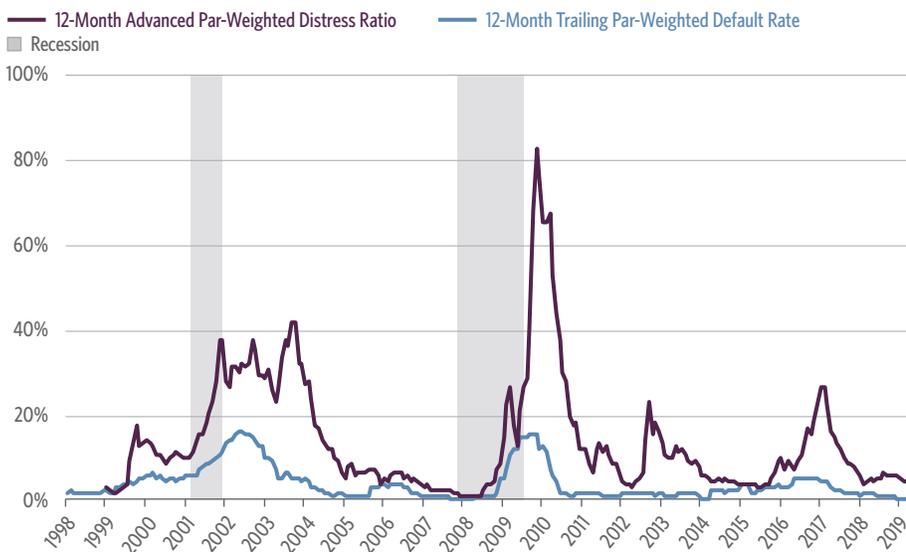
High-Yield Index Posted the Best Q1 Total Returns on Record



Source: Guggenheim Investments, ICE BofA Merrill Lynch. Data as of 3.31.2019.

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Distress Ratio Historically Overpredicts Realized Default Activity



Source: Guggenheim Investments, BofA Merrill Lynch Research, ICE Index Platform, Bloomberg. Data as of 5.31.2019.

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Investing involves risk. In general, the value of fixed-income securities fall when interest rates rise. High-yield securities present more liquidity and credit risk than investment grade bonds and may be subject to greater volatility. Asset-backed securities, including mortgage-backed securities, may have structures that make their reaction to interest rates and other factors difficult to predict, making their prices volatile and they are subject to liquidity risk. Investments in floating rate senior secured syndicated bank loans and other floating rate securities involve special types of risks, including credit risk, interest rate risk, liquidity risk and prepayment risk. Guggenheim Investments represents the following affiliated investment management businesses of Guggenheim Partners, LLC: Guggenheim Partners Investment Management, LLC, Security Investors, LLC, Guggenheim Funds Investment Advisors, LLC, Guggenheim Funds Distributors, LLC, GS GAMMA Advisors, LLC, Guggenheim Partners Europe Limited and Guggenheim Partners India Management. ©2019, Guggenheim Partners, LLC. No part of this article may be reproduced in any form, or referred to in any other publication, without express written permission of Guggenheim Partners, LLC.