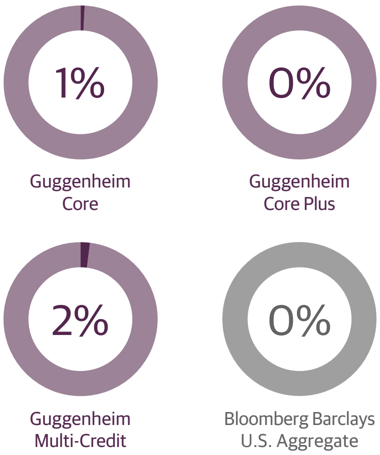
High-Yield Corporate Bonds

Demand Shifts from Floating to Fixed



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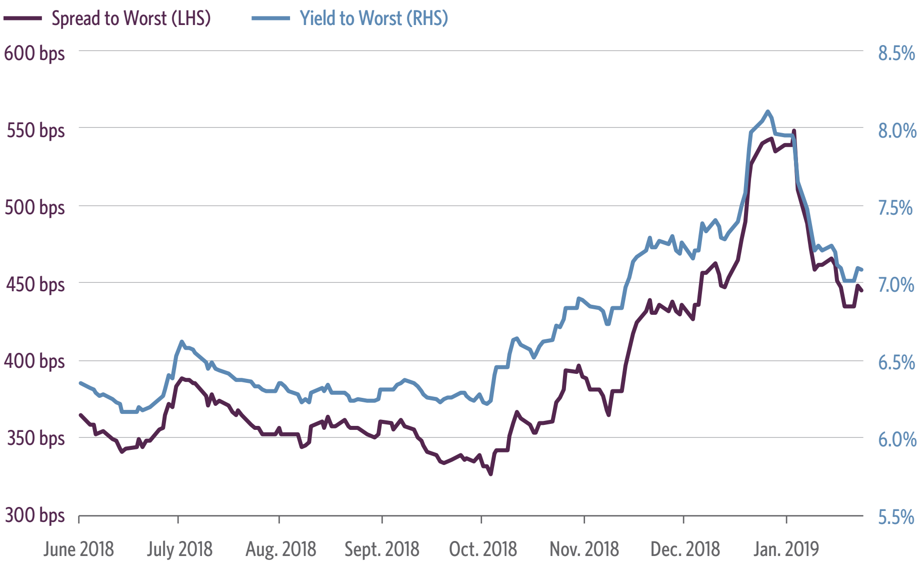
While high-yield bond spreads have recovered some of the ground they lost in the fourth quarter, we caution against adding too much spread duration at this point in the cycle.

In the early weeks of 2019, high-yield corporates have retraced almost half of the spread widening that occurred in the fourth quarter of 2018. Spreads widened by 200 basis points in the fourth quarter, but have tightened in 2019 (see chart, top right). At this pace, we may even revisit post-crisis tights of 327 basis points. Our Macroeconomic and Investment Research Group believes the Fed will be forced to pause its rate hiking campaign through the first half of 2019 as it reacts to the recent tightening in financial conditions. We expect this pause to support high-yield corporate returns in the near term. The rally in oil also supports some upside for energy credits, which still comprise 15 percent of the high-yield market. Our Macroeconomic and Investment Research Group's oil model puts West Texas Intermediate prices closer to $70 per barrel in the second half of 2019.

The ICE BofA Merrill Lynch Constrained High-Yield index lost 4.7 percent in the fourth quarter. In a stark reversal from previous quarters, lower quality significantly underperformed higher quality. BBs and Bs lost 3.0 percent and 4.9 percent in the quarter, while CCCs lost 10.3 percent on a total return basis. We had expected this reversal to occur at some point this year, given very stretched valuations in CCC corporates relative to Bs and BBs at the end of the third quarter of 2018. However, the recent selloff pushed relative value back in favor of CCCs, allowing the lower quality tranches to outperform higher quality in the rebound. High-yield corporates are up year to date, providing a healthy start to 2019 performance.

As the December freeze in activity thawed, we saw a healthy supply of high-yield corporates. After shutting down for five weeks in late 2018, year-to-date high-yield corporate bond issuance is now tracking above every year since 2015 (see chart, bottom right). Anecdotally, we find many deals to be oversubscribed as the Fed's pause has shifted demand from floating-rate to fixed-rate assets. Though high-yield fund flows were somewhat shaky to start the year, they are beginning to see strong inflows with two of the last four weeks ending Feb. 6 recorded as the largest weekly inflows since mid-2016. This demand dynamic may continue while the Fed is on pause. However, given fading tailwinds and slowing global growth, we remain cautious in our approach to credit investing, and would not look to add much spread duration at this point in the cycle.

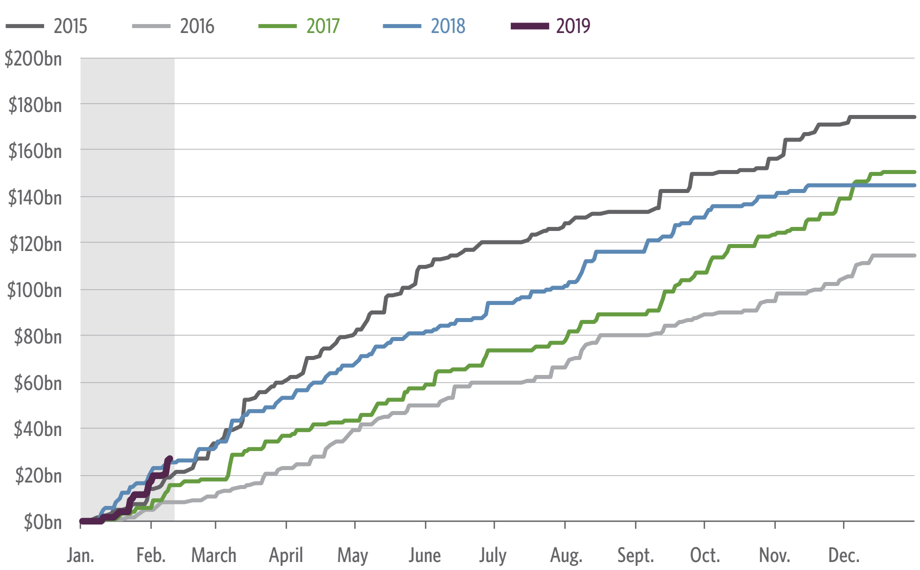
High-Yield Bonds Have Retraced Almost Half of the Widening from Last Quarter



Source: Guggenheim Investments, ICE Bank of America Merrill Lynch. Data as of 1.24.2019.

High-yield corporates have retraced almost half of the spread widening that occurred in the fourth quarter. Spreads widened by 200 basis points in the fourth quarter of 2018 but have tightened in 2019.

High-Yield Issuance Has Rebounded and Is in Line with Recent Years



Source: Guggenheim Investments, S&P LCD. Data as of 2.8.2019.

After the December freeze in activity thawed, high-yield corporate issuance is now tracking the pace of the last few years.