High-Yield Corporate Bonds

Cracks Are Forming

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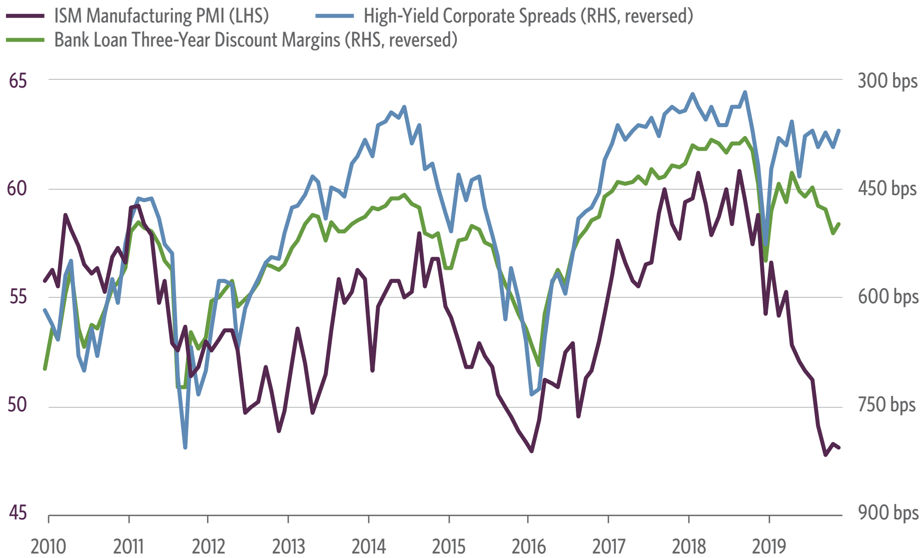
Investors should continue to limit exposure to CCCs despite recent cheapening because of the asymmetry of potential spread outcomes.

A decline in U.S. manufacturing activity in recent years has coincided with widening high-yield credit spreads, but that has not been the case this year at the index level. High-yield spreads tightened 5 basis points over the third quarter of 2019 and as of Oct. 18 are 122 basis points tighter since the start of the year. Meanwhile, the U.S. manufacturing sector is clearly in recession, with two consecutive months of ISM Manufacturing PMI prints below 50 (see chart, top right). Similar slumps in manufacturing activity have resulted in spread widening, but that has not been the case this year. Spreads have widened for securities carrying the lowest rating (CCCs), however, signaling rising concern about credit.

The ICE BofA Merrill Lynch High-Yield Constrained index delivered a return of 1.2 percent in the third quarter, bringing total returns to 11.5 percent year to date. The best year-to-date performance has come from BBs, with a total return of 13.0 percent, followed by single Bs with a return of 11.2 percent, and finally CCCs, trailing with a total return of 6.0 percent. For the quarter, CCCs lost 2.4 percent, while BBs and Bs held on to positive returns of 2.1 percent and 1.1 percent, respectively.

Averaging almost 1,000 basis points in the third quarter, CCC spreads appear to be on a path similar to late 2015, when spreads ultimately peaked at 2,000 basis points. Current CCC spreads might look appealing to those who do not foresee a repeat of 2015–2016, but research suggests spreads are more likely to widen than tighten from here. Weighing the upside potential of spreads tightening against the downside that they may widen another 1,000+ basis points, we believe the value offered in CCCs does not justify the risk (see chart, bottom right). Instead, we continue to find value in BBs, and especially single Bs, which are not trading as much above par as BBs.

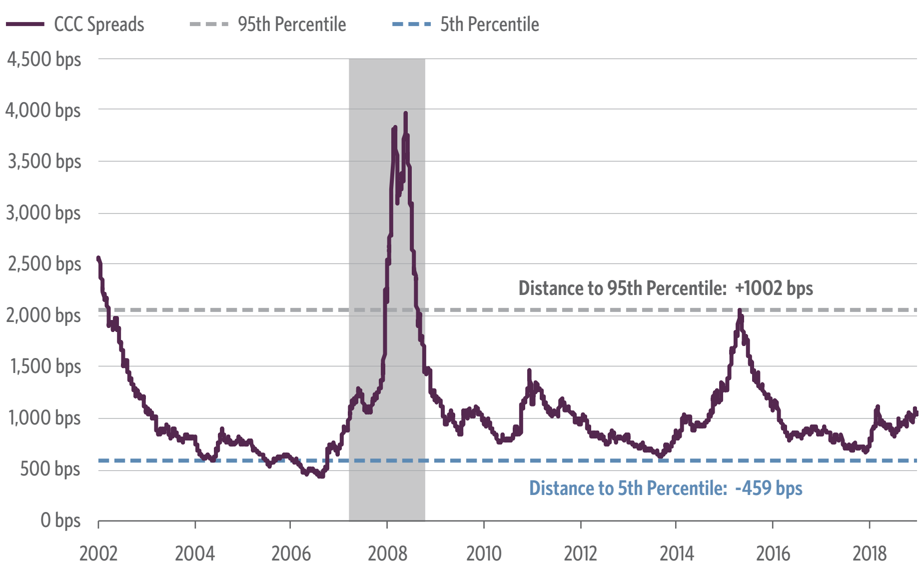
Spreads Resist the Slowdown in Manufacturing Activity



Source: Guggenheim Investments, Bloomberg, Bloomberg Barclays Indexes, Credit Suisse. Data as of 11.30.2019.

The U.S. manufacturing sector is in recession, with several consecutive months of ISM Manufacturing PMI prints below 50, but credit spreads remain tight at the index level. Similar slumps in manufacturing activity have resulted in spread widening, but that has not been the case this year.

The Asymmetry of Potential Spread Outcomes Looks Unappealing



Source: Guggenheim Investments, ICE Index Services. Data as of 10.18.2019. Shaded area represents recession.

Weighing the upside potential of spreads tightening against the downside that they may widen another 1,000+ basis points, CCC spreads do not compensate investors for the risk.