High-Yield Corporate Bonds

Breaking the Resistance


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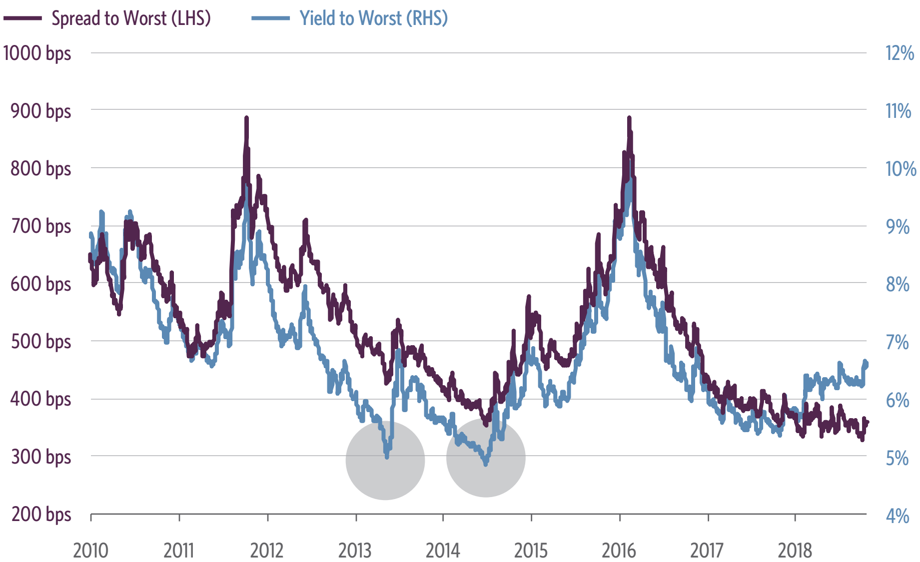
Resistance to spread tightening lifted in the third quarter as yields rose on the back of higher benchmark rates.

Investors appear to have a dual requirement for absolute and relative yield based on our observation of trading patterns over the last several years. The few times average high-yield corporate bond yields have fallen through 5 percent, the ICE Bank of America Merrill Lynch U.S. High-Yield index has been quick to sell off to get yields back above this bogey (see chart, top right). Spreads found resistance at around 340 basis points at the beginning of the year and the few times they have broken through this level they have reversed. The market will temporarily accept tighter spreads as Treasury rates rise, but not for extended periods. While five-year U.S. Treasury yields rose 22 basis points from August to the end of September, spreads on high-yield corporate bonds tightened by 43 basis points, and in early October they set a new cycle low of 327 basis points before backing up due to spillover from the broader equity market selloff.

The ICE BofA Merrill Lynch Constrained High-Yield index delivered a 2.4 percent total return for the quarter. Lower quality continues to outperform higher quality but to a lesser degree than earlier in the year. BBs and Bs each delivered a 2.3 percent gain in the quarter, compared to a 2.8 percent gain for CCCs bonds. Year to date, CCCs have outperformed BBs and Bs by 5.5 percent and 2.7 percent, respectively.

The relatively strong performance of CCC credit compared to BBs and Bs meant a significant shift in relative value earlier in the year that is coming back into balance in the fourth quarter. On a yield-to-worst basis, CCCs offered only 4.7 percentage-point yields over BBs in October compared to a historical average of 7.9 percent. As of Oct. 31, the yield differential widened to 5.3 percentage points. We think there is more pain to be felt in CCCs. On a spread basis, CCCs offered less than 500 basis points over BB spreads in September. When CCC bonds have traded inside of 500 basis points over BBs in the past, they have underperformed BBs over the following 12 months by nearly 4 percentage points, on average (see chart, bottom right).

High-Yield Corporate Bond Yields See Resistance at 5 Percent



Source: ICE Bank of America Merrill Lynch, Guggenheim Investments. Data as of 10.22.2018.

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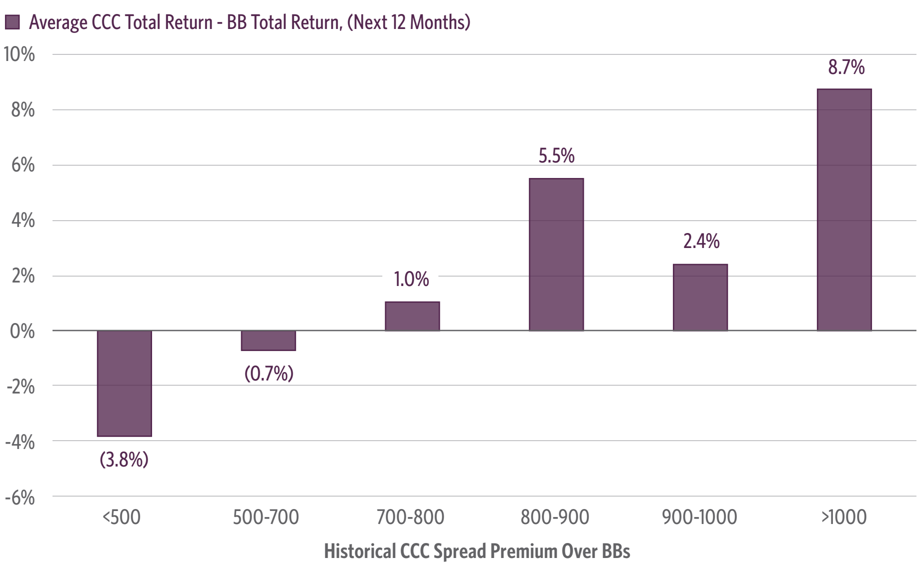
CCCs Could Underperform BBs over the Next 12 Months



Source: ICE Bank of America Merrill Lynch, Guggenheim Investments. Data as of 9.30.2018.

On a spread basis, CCCs offer less than 500 basis points over BB spreads, compared to an average of 688 basis points. This does not bode well for future returns. When CCC bonds have traded inside of 500 basis points over BBs, they have underperformed BBs over the following 12 months.