GUGGENHEIM

High-Yield Corporate Bonds

High-Yield Returns Boosted by Duration

While default risk is rising, the sector's performance should continue to benefit from being higher quality relative to history and positive technicals from lack of new issuance.

High-yield returns are strong to start the year despite ongoing volatility. We remain defensive and are staying up in quality in our portfolios, but as we explained in the second quarter High-Yield and Bank Loan Outlook, the expression of this theme does not always translate into a preference for higher credit ratings. The rating agencies have been cutting credit ratings at a faster pace than they are raising them, which makes current ratings less reliable. Proprietary credit views are crucial in this environment. We are focusing on debt seniority, cash flow stability, strong interest coverage, and business profile, among a variety of other metrics, all of which can make a B-rated credit more attractive than a BB-rated credit in this environment. A continued lack of primary issuance should provide a technical tailwind.

Attention has turned to the Fed's quarterly Senior Loan Officer Opinion Survey on Bank Lending Practices, which asks if banks are tightening or easing underwriting standards on loans made to a variety of borrowers. This survey already showed before the banking crisis in March that a net 45 percent of banks have tightened underwriting standards for large/medium commercial and industrial loans, the most since the height of the COVID pandemic in 2020. Tighter lending standards historically lead a rise in the default rate among high-yield corporate bond issuers, so while credit spreads are 21 basis points tighter from the start of the year at 448 basis points, they had widened to as much as 535 basis points over the back half of March.

We share concerns over the default outlook as we move toward recession, which we expect to begin in the second half of 2023, but it is important to balance these views against market expectations. At current spread levels, we believe the implied default rate of the high-yield index is 4.3 percent. Since the market tends to overshoot, spreads could widen further as liquidity conditions worsen and as other calendar events, such as the debt ceiling debate, increase implied volatility in options markets across rates and equities. However, an acceleration in default volumes is priced in already, and some issuers and sectors may be oversold.

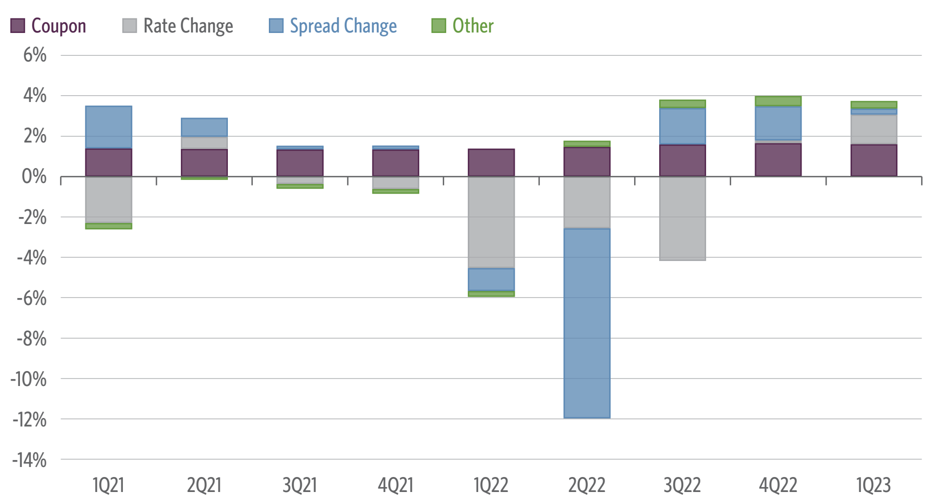
The sector is likely to continue to benefit from duration in a risk-off environment. Despite growing concerns over the default outlook at the start of 2023, the ICE BofA U.S. High-Yield Index gained 4.2 percent through April 24 as curve changes boosted returns by 1.2 percent on top of returns attributable to coupon, amortization, and spread tightening. Given our view that duration will benefit the sector while coupons continue to help cushion returns, we believe high-yield corporate bonds are attractive to income seekers with yields remaining near 8.5–9 percent.

By Thomas Hauser and Maria Giraldo

The sector is likely to continue to benefit from duration in a risk-off environment, while coupons help cushion returns.

Coupons and Duration Have Supported Total Returns in 2023

ICE BofA U.S. High-Yield Index Quarterly Total Return Attribution by Factor



Source: Guggenheim Investments, ICE Index Services. Data as of 4.24.2023. Past performance does not guarantee future results.