High-Yield Corporate Bonds

Default Rates Should Remain Stable, if Slightly Elevated, in 2024

Expect more downgrades, but default rates should remain manageable.

The evolving macroeconomic environment in 2023 led to elevated uncertainty, restricted lending, and C-suite anxiety. This climate forced companies that missed revenue or cash flow targets to restructure debt and slash costs, as soaring inflation eroded margins. The par-weighted default rate on the ICE BofA High Yield Index ended 2023 at 2.4 percent, up from a low level of just 1.5 percent in 2022. The fixed-rate nature of high-yield bond coupons and the relatively low amount of maturing bonds meant that there weren't many interest or payment defaults. According to BofA research, defaults in the index were almost evenly split between bankruptcy and distressed exchange.

Many of the same credit themes that drove trends in 2023 are likely to carry into 2024, but some headwinds are fading. The dearth of maturities in 2024 should again help keep payment defaults to a minimum. In the high-yield index, over 50 percent of bonds by amount outstanding were issued in 2020 and 2021 when yields were very low, which has supported interest coverage ratios. Scheduled maturities are spread out over the next five years, with the peak as a share of outstanding happening in 2029. Sentiment is improving as financial conditions have eased substantially with the decline in rates since October, which should help issuers access capital markets at reasonable spreads if needed. High-yield corporate bond spreads tightened from 481 basis points to 339 basis points by year-end.

A more gradual credit deterioration story is likely to spread out over the next several years. Although we expect the Fed to start easing this year, we do not believe short-term interest rates will return to decade lows. This means that most borrowers will still need to adjust to a higher interest rate environment once their debt comes due or as borrowing needs arise. The slow-moving impact of this factor on the high-yield market can already be seen in the shifting credit profile of the index over the past couple of years. While the high-yield index remains mostly comprised of BB-rated bonds (47 percent of the index as of Dec. 31, 2023), that share has gradually fallen from almost 55 percent in mid-2021. In its place, single B-rated bonds have gained 6 percentage points to a 39 percent share.

Taking into account the combination of positive factors (recent easing in financial conditions, the index's concentration in BB-ratings, the upcoming Fed easing cycle) against negative factors (the market's continued adjustment to higher interest rates and the ongoing lagged impact of inflation on costs), we believe the default environment in 2024 will resemble 2023. We expect to see more downgrades than upgrades and a higher frequency of restructuring unsustainable leverage profiles. But the par-weighted default rate for the index will likely land again in the 2.5–3 percent range, which should be manageable for the high-yield market.

By Thomas Hauser and Maria Giraldo

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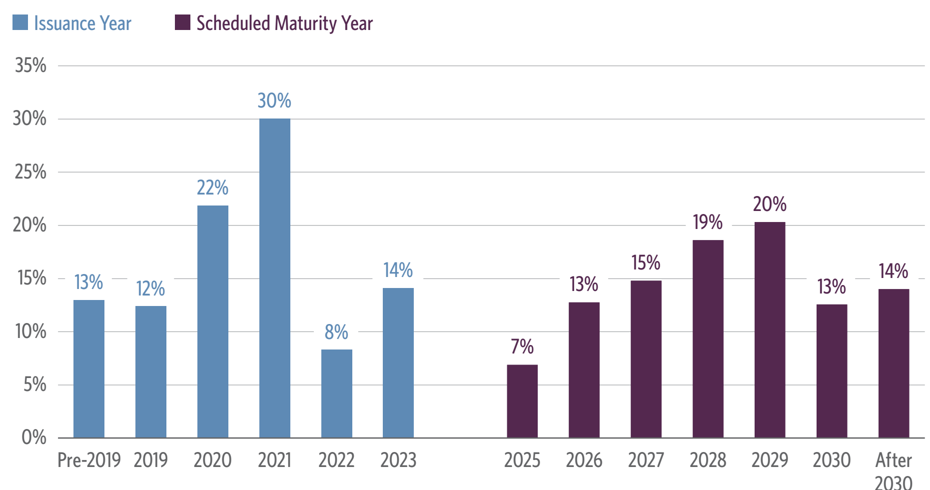
The Majority of the High-Yield Market Was Issued in 2020 and 2021



Source: Guggenheim Investments, ICE Index Services, Bloomberg. Data as of 1.23.2024.

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