HAS DEFAULT BECOME THE LATEST BUZZWORD?

Kevin Flanagan — Head of Fixed Income Strategy
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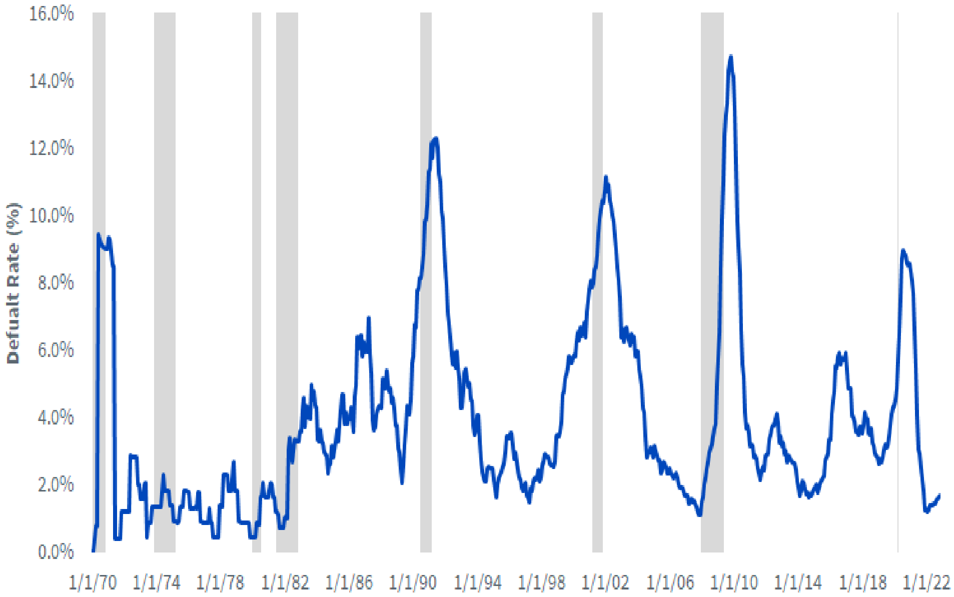
The discussion surrounding a possible default seems to be becoming a "hot-button" topic here early in the new year. Of course, one aspect of this conversation involves the current debt ceiling debate within the federal government, a topic we wrote about in our Minds on the Markets piece just last week. This blog post is going to focus on the other part of the default discussion: U.S. high-yield (HY) securities.

U.S. Speculative-Grade Default Rate vs. Recessions



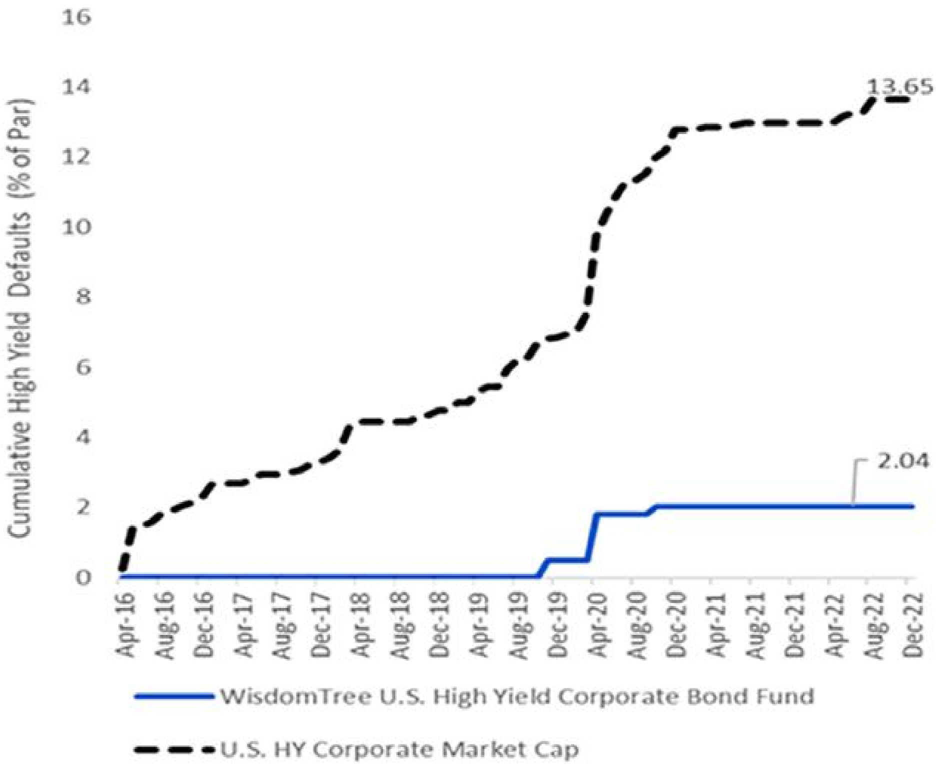
Sources: Moody's, St. Louis Fed, as of 1/20/23. Shaded areas indicate recession.

With a widely anticipated recession expected for the U.S. economy in 2023, the notion of elevated default rates occurring in the HY space has also garnered increasing attention. According to the latest data from Moody's, the U.S. speculative-grade default rate came in at 1.68%[1] for November 2022, moving very little over the prior 12-month period. This relatively steady performance followed on the heels of the rate reaching a COVID-19-related peak of just under 9% in August 2020.[1]

Questions have arisen as to whether the HY default rate can help foretell a potential recession. As the above graph illustrates, the results have been somewhat mixed on that front and didn't really provide much guidance from 1970 into the early 1980s. However, in the case of the 1990–1991 and 2001 economic downturns, an ascending trend did serve as a precursor for the recessions that followed. In both instances, the HY default rate not only rose ahead of the downturn, but it also continued to increase and remain elevated—even after the recession was "officially" deemed to have ended—before resuming a downward trajectory. In fact, default rates reaching "double-digit" territory was also the norm. For the record, there was no predictive value for the financial crisis and/or great recession. Interestingly, there was a modest uptick in the rate prior to the "COVID-19 recession," but the jury will remain "out" on this episode because we don't know if the U.S. economy would have avoided a recession or not if there had not been a pandemic.

From what I have read, it appears as if rating agencies are expecting the U.S. speculative-grade default rate to increase this year, rising anywhere from 3.75% to 4.8%.[2] As you can see, from a historical perspective, that number would definitely be on the low side, especially for the period covering the last 30 years.

Cumulative High Yield Defaults 3/31/26–12/30/22



Sources: Bloomberg, ICE, WisdomTree, as of 12/30/22. HY Corporate Market Cap is proxied by the Bloomberg Barclays US Corporate High Yield Index after 3/31/20. Prior to this date, HY Corporate Market Cap is proxied by the ICE BofA US High Yield Index. HY Corporate Market Cap was spliced due to data availability. Past performance is not indicative of future results. It is not possible to invest in an index.

Nevertheless, with recession and potential risk-off concerns remaining a prevalent part of the investment landscape discussion, an HY solution that recognizes this factor is an important consideration for investors. The WisdomTree U.S. High Yield Corporate Bond Fund (WFHY) employs a "screen for quality" approach that focuses on only public issuers and their attendant balance sheets. We found that eliminating the public issuer universe with "negative cash flow" can serve as an important quality screen and helps to address the elevated credit risk apparent in the market cap-weighted approach, with the goal being to mitigate credit concerns—i.e., default risk—that can arise from risk-off periods (recessions). As the above graph highlights, this strategy has been rather effective, as the U.S. HY market-cap default rate has been about 13.7%, while for WFHY, it has been only 2.0% since inception.

Conclusion

The bottom-line message is that "there's income back in fixed income," but in our opinion the current market environment has made it clear that a strategy that emphasizes fundamentally sound companies with strong cash flows, such as WFHY, is prudent in a time of economic uncertainty.

For definitions of terms in the charts above, please visit the glossary.

[1] Source: Moody's, https://www.moodys.com/.

[2] Source: "Default, Transition, and Recovery: The U.S. Speculative-Grade Corporate Default Rate Could Reach 3.75% by September 2023," S&P Global, 11/21/22.

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You cannot invest directly in an index.

DEFINITIONS

Default : A failure to meet the legal obligations (or conditions) of a loan.

High Yield : Sometimes referred to as "junk bonds," these securities have a higher risk of default than investment-grade securitie.

Speculative-Grade Bonds : Bonds that are believed to have a lower risk of default and receive higher ratings by the credit rating agencies, namely bonds rated Baa (by Moody's) or BBB (by S&P and Fitch) or above. These bonds tend to be issued at lower yields than less creditworthy bonds.

Default Rates : the frequency in which borrowers fail to fulfill their contractual obligations.

Moody's Investors Service (Moody's) : Moody's Investors Service, often referred to as Moody's, is the bond credit rating business of Moody's Corporation, representing the company's traditional line of business and its historical name. Moody's Investors Service provides international financial research on bonds issued by commercial and government entities.

Recession : two consecutive quarters of negative GDP growth, characterized generally by a slowing economy and higher unemploymen.

Downturn : A general slowdown in economic activity over a sustained period of time.

Risk-on/risk-off : refers to changes in investment activity in response to perceived risk. During periods when risk is perceived as low, investors tend to engage in higher-risk investments. When risk is perceived as high, investors tend to gravitate toward lower-risk investments.

Balance sheet : refers to the cash and cash equivalents part of the Current Assets on a firms balance sheet and cash available for purchasing new position.

Operating cash flow : Measure of the amount of cash generated by a company's normal business operations, calculated by adjusting net income for items like depreciation and changes in inventory and receivables.

Credit risk : The risk that a borrower will not meet their contractual obligations in conjunction with an investment.

Market capitalization-weighting : Market cap = share prices x number of shares outstanding. Firms with the highest values receive the highest weights in approaches designed to weight firms by market cap.

Default Risk : The risk that an issuer will be unable to make the payments on its debt necessary to satisfy its financial obligation to the investo.