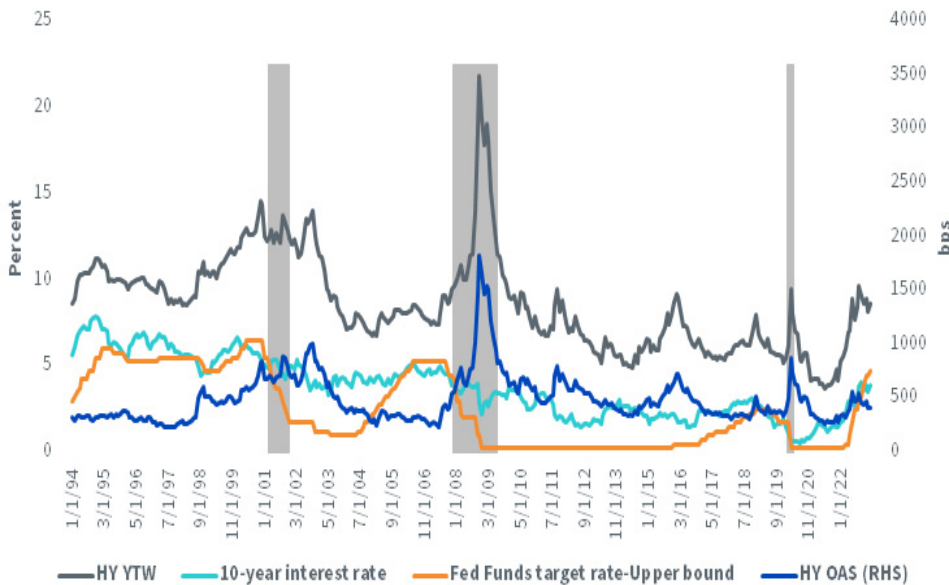

WEATHERING A POTENTIAL RECESSION BLOW IN HIGH-YIELD CORPORATES

Rick Harper – Chief Investment Officer, Fixed Income and Model Portfolios
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Market participants have faced a lot of challenges in recent years, but none has been more impactful than the [Federal Reserve's](#) decision to raise interest rates by 450 [basis points \(bps\)](#) in the last year to combat persistent high [inflation](#). In its quest to lower the pace of economic activity and bring down the generational-high inflation, the Fed has increased the prospect of a [recession](#) and potential distress in corporate [bond markets](#), particularly for lower-quality borrowers. The tightening of [monetary policy](#) by other [central banks](#) around the globe has also fed this concern. However, with the increase in risk-free interest rates and widening in corporate [spreads](#), investors would be remiss not to notice the attractive yield and spread levels in the high-yield (HY) market, which have not been seen since the [2007-2009 global financial crisis](#).

Depending on one's view about whether [Fed tightening](#) can deliver a soft versus hard economic landing, different assumptions could be made about the future path of spreads and [interest rates](#). In this piece, we look past the favorable scenario of a soft landing to focus on what risks high-yield investors might face if a harder landing emerges, given current valuation levels and using past recessionary periods as a guide.

Over the past 30 years, there have been three recessionary periods during which high-yield spreads rose by an average of 630 bps. As of February 28, 2023, high-yield spreads and the [yield to worst \(YTW\)](#) were 412 bps and 8.63%, respectively. If the market settles on the notion of a hard landing in the near future, and assuming the aforementioned average spread widening during a recession, high-yield spreads could widen by 478 bps more from current levels (spreads have already widened by 152 bps from the trough of 268 bps on 6/30/21). By keeping risk-free interest rates unchanged, this would result in an annualized 5% loss. However, with an average drop of 118 bps in the 10-year interest rate during these recessionary periods, the average loss would come down to 1.7%.



Sources: Bloomberg, NBER, as of 02/28/23. Shaded areas indicate recession.

It is worth mentioning these results are skewed by the massive 1,264 bps spread widening between 2007 and 2009. By removing this period from our analysis, HY [OAS](#) and the 10-year interest rate have on average widened by 313 bps and narrowed by 84 bps, respectively, during the other two recessions. This means 161 bps of extra widening from current levels. Assuming these moves, the HY market could provide a solid positive return of 6.4% for the year.

Lofty yield levels in the HY market have provided investors with a cushion to absorb potential losses from deteriorating corporate fundamentals and increases in spread levels. As a matter of fact, in order to lose all this protection and break even in their investment, an investors' base case would center around a 303 bps or more increase in spreads in the upcoming year, with no change in risk-free interest rates. However, with the average fall in interest rates during recessions, investors could potentially expect a positive return for the year.

High-Yield Corporate

		Spread movement (bps)					
		-100	-50	0	50	100	303
Rates movements (bps)	-100	14.3%	12.8%	11.4%	10.0%	8.6%	2.8%
	-50	12.9%	11.4%	10.0%	8.6%	7.2%	1.4%
	0	11.5%	10.1%	8.6%	7.2%	5.8%	0.0%
	50	10.1%	8.7%	7.2%	5.8%	4.4%	-1.4%
	100	8.7%	7.3%	5.9%	4.4%	3.0%	-2.8%

Source: Bloomberg, as of 02/28/23.

In conclusion, investors will likely navigate choppy waters in the next couple of years when it comes to markets and the Fed. However, the HY market is well-positioned to absorb potential spread widening and produce a positive return for the year. This provides an excellent opportunity for long-term investors.

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DEFINITIONS

Federal Reserve: The Federal Reserve System is the central banking system of the United States.

Basis point: 1/100th of 1 percent.

Inflation: Characterized by rising price levels.

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

Bond market: The bond market—often called the debt market, fixed-income market, or credit market—is the collective name given to all trades and issues of debt securities. Governments typically issue bonds in order to raise capital to pay down debts or fund infrastructural improvements.

Monetary policy: Actions of a central bank or other regulatory committee that determine the size and rate of growth of the money supply, which in turn affects interest rates.

Central bank: Refers to the the monetary authority of any country.

Spread: Typically refers to a difference between a measure of yield for one asset class and a measure of yield for either a different subset of that asset class or a different asset class entirely.

The Global Financial Crisis: Refers to the period of extreme stress in global financial markets and banking systems between mid 2007 and early 2009.

Fed tightening: Refers to the Federal Reserve enacting monetary policies that have the overall impact of reducing the availability of credit, which is widely thought to have the potential to slow economic growth.

Interest rates: The rate at which interest is paid by a borrower for the use of money.

Yield to worst: The rate of return generated assuming a bond is redeemed by the issuer on the least desirable date for the investor.

Option-adjusted spread (OAS): Represents a measure of income. Spread represents the portion of the bond's yield that compensates investors for taking credit risk. OAS adjusts the spread to take into account embedded options within the bond (if any).