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HIGH-YIELD CREDIT: WHAT'S IN YOUR WALLET?

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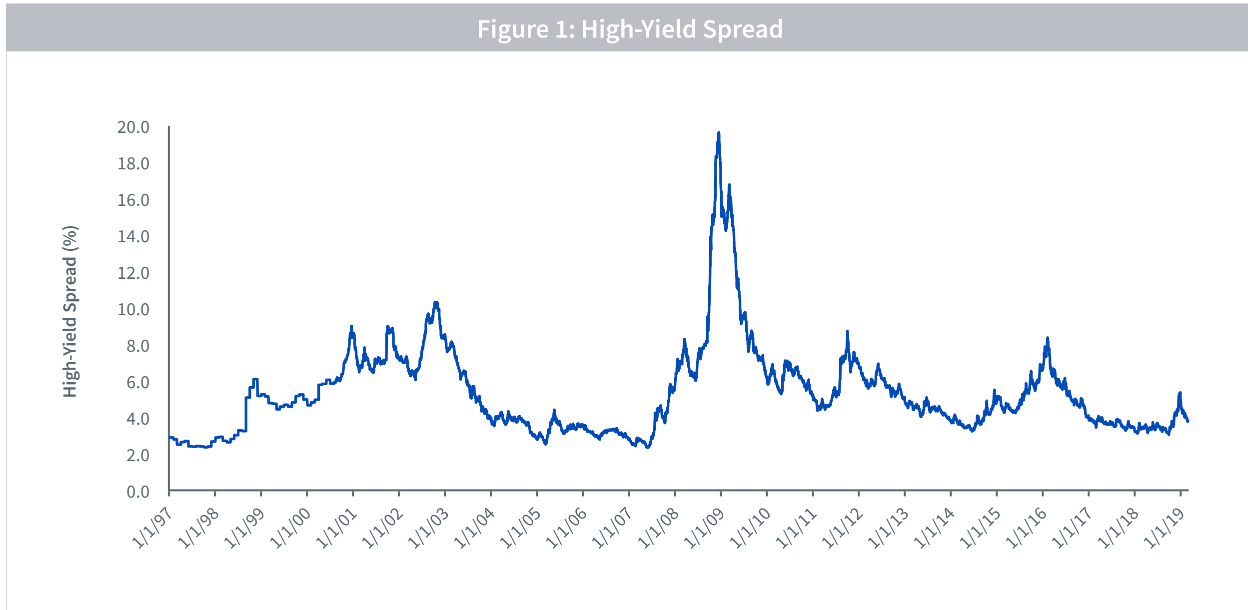
The most noteworthy story in the fixed income arena thus far in 2019 has come from the high-yield (HY)[1] sector. After enduring a difficult end to 2018, HY has essentially done a 180, and early in the new year it is the best-performing asset class in bond-land. That's the key, though—"early in the new year"—but what does the rest of 2019 have in store? In my opinion, the remainder of the year will more than likely not be that easy, and I suggest investors taking a closer look at their HY holdings and consider upgrading their credit quality[2].

SOME PERSPECTIVE ON RECENT MARKET TRENDS

On October 3 of last year, HY spreads[3] hit a low watermark of +303 basis points (bps)[4]. This represented the narrowest reading since 2007, or before the financial crisis and subsequent Great Recession. However, only three months later, the risk-off[5] trade during Q4 resulted in a rather considerable spread widening of 234 bps, bringing the overall level to +537 bps, the highest mark in almost three years.

Since reaching this near-term peak, spread levels have narrowed considerably, thus the outperformance mentioned at the beginning of this piece. To provide some perspective, as of this writing, HY differentials have come in by roughly 155 bps to +381 bps, retracing about two-thirds of the Q4 widening trend.

[1] High yield: Sometimes referred to as "junk bonds," these securities have a higher risk of default than investment-grade securities.
[2] Credit quality: A measure of a borrower's potential risk of default.
[3] High-yield bond spread: The amount of incremental income a bondholder receives for assuming credit risk, specifically that of companies rated below investment-grade credit.
[4] Basis point: 1/100th of 1 percent.
[5] 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.



Source: Bloomberg, as of 3/5/2019. Universe for HY is the Bloomberg Barclays U.S. Corporate High Yield Index. Past performance is not indicative of future results.

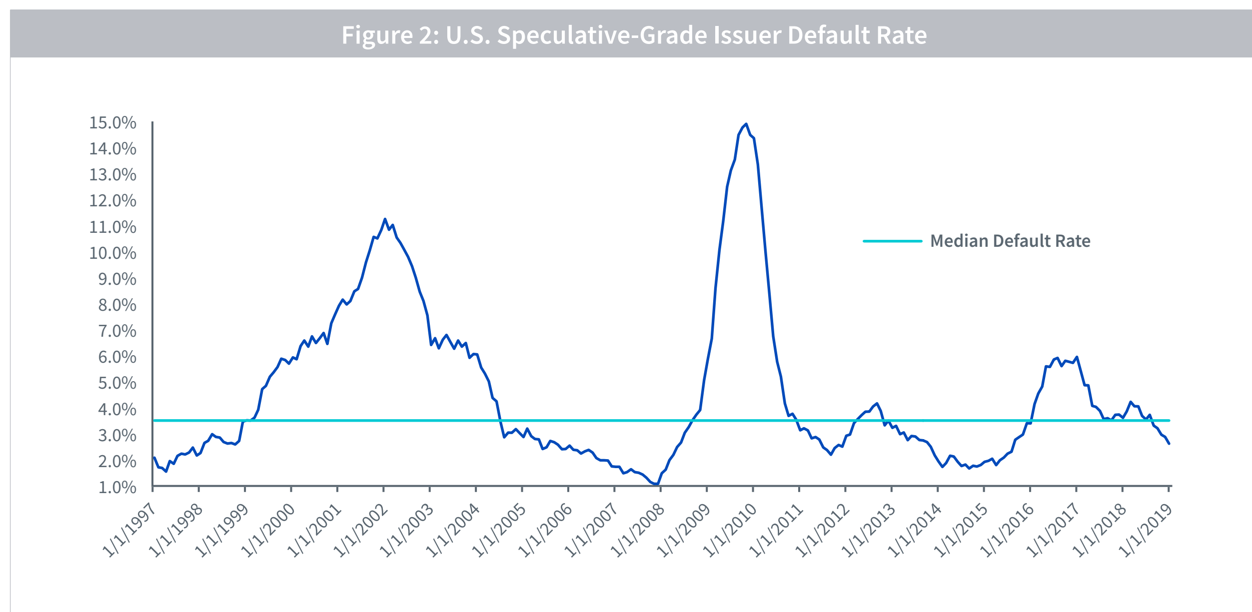
So, where does that put HY from a spread valuation perspective? As figure 1 illustrates, HY spreads were relatively stable from the beginning of 2017 through the third quarter of 2018. After posting a prior high point of +839 bps during the energy-induced sell-off in late 2015 through early 2016, differentials printed an average of +354 bps between the first quarter of 2017 and the third quarter of 2018. From a historical perspective, the graph highlights the need to remove the 2008–2009 period in order to get a true read on average spread levels over time. From 1994 through mid-2007 (the period prior to the financial crisis), the mean level for spreads was placed at +451 bps, and from 2009 through the present, the figure is just below +500 bps.

Given the outlook for some slowing in U.S. growth and where we are in the current credit cycle (toward the end), a simple reversion to the mean[6] is certainly a reasonable expectation. Doing the math, that could entail a spread widening of roughly 100 bps from where spreads resided as of this writing.

[6] Mean reversion: The concept that a series of returns has a tendency to return to its average level over longer periods, even if shorter periods can exhibit wide swings.

NOW BRING ME THAT HORIZON

What else could be on the horizon for 2019? Let's consider the outlook for any potential movement for default rates[7]. Last year and the opening months of 2019 have brought good news on the default front. According to Moody's credit rating agency, the U.S. speculative-grade issuer, or HY, default rate has been on a descending trajectory during the last 10 months and has posted outright monthly declines since July. In March 2018, the default rate hit a near-term peak of 4.2%, but as of January of this year, the measure has fallen to 2.6%, the lowest reading in almost three and a half years.



Source: Moody's, as of 2/1/2019. Universe for the issuers is the Moody's US Speculative-Grade (HY) Issuer Default Rate.

Interestingly, the default rate graph follows the 20-year pattern we saw in the spread chart, but the movement can trail spread activity timewise.

What should investors expect in 2019, and perhaps 2020? Certainly, the spread widening that occurred in Q4 pales in comparison to the prior three instances (late 2015/early 2016, financial crisis/Great Recession–late 2008, 2001–2002). Nonetheless, given the anticipated slowdown in U.S. growth, it seems reasonable to expect some reversal in the default rate later this year. Over the last 20 years, the median level has come in at 3.4%, so that's a starting point for where we might go. However, if the economy proves to be weaker than projected and/or another risk-off scenario should unfold, a move back above the 4% threshold could be possible.

[7] Default rates: The frequency at which borrowers fail to fulfill their contractual obligations.

QUALITY CONTROL WITH A TILT FOR INCOME

How can investors potentially mitigate their portfolios from HY default risk? Our research has identified a key factor to focus on when trying to foreshadow future downgrades and defaults. For the HY universe, it is important to note that a large majority of companies in distressed or weak financial conditions tend to begin with cash flow problems. Against this backdrop, our work revealed that companies with sustained negative free cash flow[8] often entered a distressed trading environment. It is important to keep in mind that within the HY sector there is less cushion on this front, and distress can lead to default concerns quickly. The WisdomTree approach eliminates all issuers with negative free cash flow and also removes the 5% with the lowest estimated liquidity. Once this quality and liquidity screen is applied, we then tilt weights back toward the bonds with more favorable income characteristics versus their sector peers.

CONCLUSION

Whether the HY market is at the end of this credit cycle, in a bear market[9] rally or just plain susceptible to a slowing economic growth backdrop, I feel investors should consider adjusting their fixed income portfolios to focus on improving credit quality. In addition, the recent narrowing in HY spreads offers the potential for an improved exit point to make credit quality adjustments as compared to the Q4 experience. The WisdomTree Fundamental U.S. Short-Term High Yield Corporate Bond Fund (SFHY) and the WisdomTree Fundamental U.S. High Yield Corporate Bond Fund (WFHY) emphasize such a qualitative approach, while also tilting toward income.

[8] Free cash flow: A measure of how much cash is left in a company after taking into account all the necessary expenses, including net capital expenditures.

[9] Bear market: A sustained downturn in market prices, increasing the chances of negative portfolio returns.

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There are risks associated with investing, including possible loss of principal. Fixed income investments are subject to interest rate risk; their value will normally decline as interest rates rise. High-yield or “junk” bonds have lower credit ratings and involve a greater risk to principal. Fixed income investments are also subject to credit risk, the risk that the issuer of a bond will fail to pay interest and principal in a timely manner or that negative perceptions of the issuer’s ability to make such payments will cause the price of that bond to decline. While the Funds attempt to limit credit and counterparty exposure, the value of an investment in the Funds may change quickly and without warning in response to issuer or counterparty defaults and changes in the credit ratings of the Funds’ portfolio investments. Please read each Fund’s prospectus for specific details regarding the Fund’s risk profile.

The Bloomberg Barclays U.S. Corporate High Yield Index measures the USD-denominated, high-yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below. Bonds from issuers with an emerging markets country of risk, based on Barclays EM country definition, are excluded.

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