

U.S. High Yield: What's Priced In?

Published June 28, 2023

Kevin Flanagan

Head of Investment and Fixed Income Strategy

The “hawkish pause” from the Fed has captured the lion’s share of the headlines in the bond market of late, and rightfully so. Against this backdrop, investors have been left to wonder: where is that recession nearly everyone was expecting by now? One area within the U.S. fixed income arena where this discussion will continue to percolate is high yield (HY). More importantly, just what has already been factored into the equation?

With the Fed raising rates at a historical pace in this cycle and recession still a topic of conversation, the default rate becomes an integral part of the HY conversation. Heading into this year, the U.S. speculative-grade default rate was residing at historically low levels. To provide some perspective, according to Moody’s, the average default rate for 2022 came in at 1.49%, or visibly below the long-run average of 3.94%. Needless to say, given the expected unfavorable economic outlook and significantly higher rate setting, it was widely anticipated the default rate would rise this year. Through May, this was the case, as the reading has increased to a little over 3%, still below the long-term average.

Based on the lagged effects of Fed rate hikes, a further increase in the U.S. speculative-grade default rate seems to be a reasonable expectation as we move further into the year. In fact, if the timing for the widely anticipated economic downturn gets pushed into early 2024, it is also reasonable to expect elevated default readings continuing into next year as well. Based on rating agencies’ projections, the default rate could rise into the 4%–5% vicinity. However, from a historical perspective, that number would definitely be on the low side. During prior recessionary periods of the last 30 years, double-digit readings were being registered.

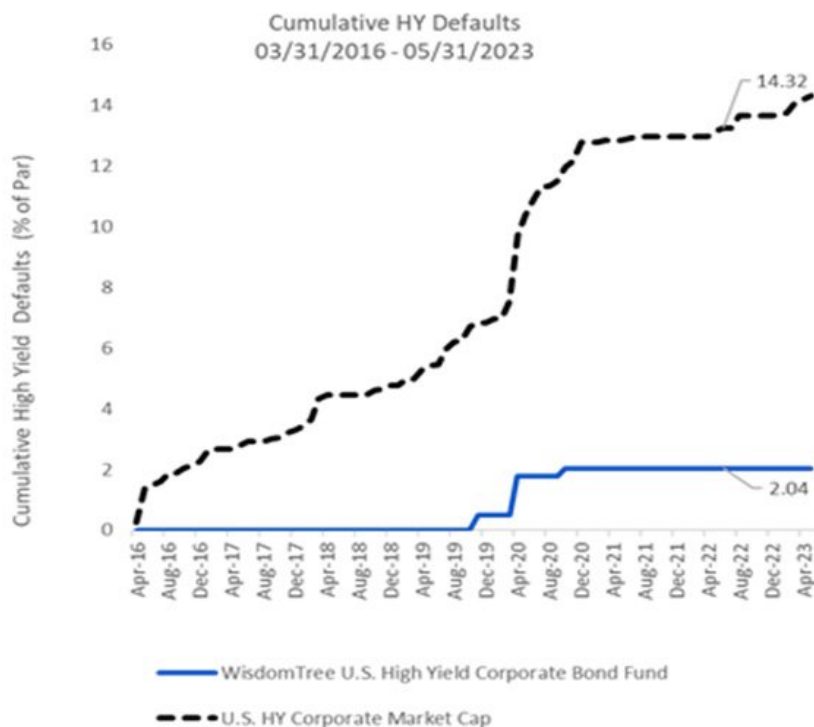
High-Yield Credit Spreads



Sources: WisdomTree, FRED, 1/2/15–6/21/23. High-Yield Credit Spreads measured by ICE BofA U.S. High-Yield Index Option-Adjusted Spread. Past performance is not indicative of future results.

For definitions of terms in the graph above please visit the [glossary](#).

A key metric for valuations in the HY sector comes from spread data. If negative news in the form of higher default rates is expected, spreads would typically widen, especially if defaults were being considered a worrisome development. As the above graph illustrates, HY spreads have actually been range-bound thus far in 2023. There's no doubt HY spreads have widened from their 2021 low watermark (+262 basis points (bps)), but they have remained roughly within their new elevated band of 400 bps to 500bps, leading me to believe that the default rate setting outlined here may have already been discounted for the most part.



Sources: Bloomberg, ICE, WisdomTree, as of 6/22/23. HY Corporate Market Cap is proxied by the Bloomberg U.S. Corporate High Yield Index after 3/31/20. Prior to this date, HY Corporate Market Cap is proxied by the ICE BofA U.S. High Yield Index. HY Corporate Market Cap was spliced due to data availability. It is not possible to invest in an index. Past performance is not indicative of future results.

For definitions of terms in the graph above please visit the [glossary](#).

Nevertheless, with concerns about recession and a potential risk-off remaining a prevalent part of the investment landscape discussion, a HY strategy 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 14.3%, while for [WFHY](#), it has been only 2% since inception.

Conclusion

The bottom-line message is that we believe “[there’s income back in fixed income](#)”, but 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.

Important Risks Related to this Article

There are risks associated with investing, including the 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 Fund attempts to limit credit and counterparty exposure, the value of an investment in the Fund may change quickly and without warning in response to issuer or counterparty defaults and changes in the credit ratings of the Fund’s portfolio investments. Please read the Fund’s prospectus for specific details regarding the Fund’s risk profile.