Are High Yield Investors Getting Properly Paid for Default Risk?

Amid a softening U.S. economy, investors may be wondering about prospective default rates—and their potential impact on credit spreads.

Featured Contributor

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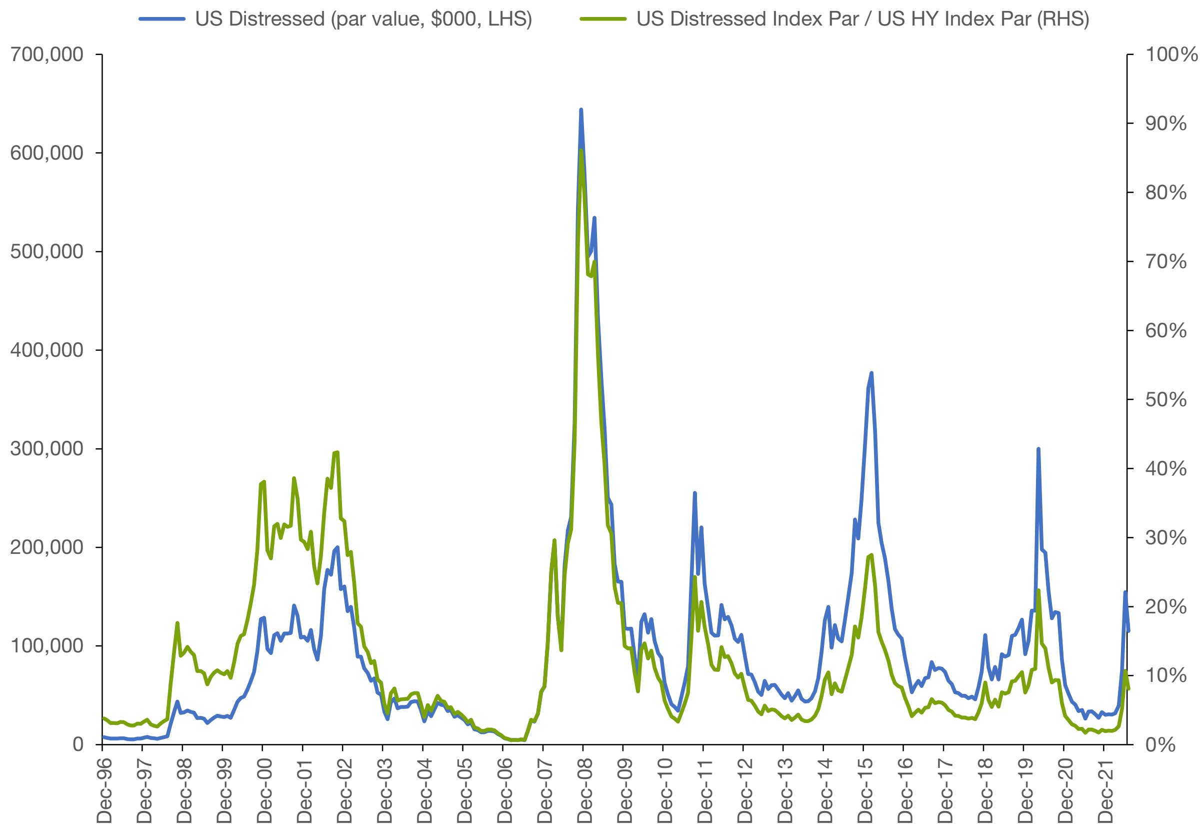
Figure 1. Tracking the U.S. High Yield Distress Ratio

Distress measures (as defined) for the U.S. high yield market as of July 31, 2022



Source: ICE BofA US High Yield Index and ICE BofA US Distressed Index. Data as of July 31, 2022. LHS=left-hand side of chart. RHS=right-hand side of chart. In this context, "distressed" refers to issues with an option-adjusted spread of 1,000 basis points (each basis point is one-one hundredth of a percentage point). Past performance is not a reliable indicator or guarantee of future results. Due to market volatility, the asset classes depicted in this chart may not perform in a similar manner in the future. For illustrated purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment. Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment.

Fixed-income market participants often like to distill bond investing into a series of logical math problems. But there are elements of discretion and art as well that go into approaching many of the questions they are looking to answer. One good example is the current debate around two key questions:

1. **What default rate is priced into U.S. credit?**
2. **Are investors being properly compensated for that risk?**

These questions are relevant for many reasons, including the uptick in defaults likely to come amid the expected deceleration of economic activity and global central-bank tightening. They are simple questions on the surface. But the broad topic is one that relies on a range of assumptions and interpretations of the questions themselves. To answer, we must first review what constitutes a credit spread.

We know that an all-encompassing credit spread above a risk-free benchmark rate is meant to compensate investors for two risk categories: loss given the possibility of default and, broadly, all other risks like portfolio liquidity, potential capital structure and operational changes, future issuance that could subordinate existing creditors, etc. We have some definitive math to approximate the first, but it's more of a subjective exercise for the latter, which we'll call the 'excess spread'. (For additional background, please see our June 2021 whitepaper, "Understanding Two Key Dimensions of Credit Spreads.")

How the Distress Ratio Guides Default Expectations

It makes sense to first hunt for one-year-forward default candidates from those credits that are already exhibiting some level of distress in current valuations. Credit investors commonly track the percentage of the high yield market with an option-adjusted spread above 1000 basis points (bp), otherwise known as the 'distress ratio'.

- As of July month-end, the U.S. high yield distress ratio was 8.1%, rising from just below 2% at the start of the year (see Figure 1). However, this measure improved over the course of the month by 2.6 percentage points, as you would expect, given the overall rally in high yield credit spreads during July.
- In our prior referenced work above, we found that the median ratio of the actual 12-month-forward default rate to the starting distress ratio was about 36%. We can't definitively state all defaults over a coming year come from those credits identified as under distress during that period, but academic work published elsewhere notes that the vast majority of defaulting names are indeed trading at distressed valuations within the year prior.
- So, if we just use that experience as a guide, and if the distress ratio did not change from the levels on July 29, it suggests an estimated 12-month-forward default rate of about 2.9% (=36%*8.1%). Right now, that's about the mid- to upper-end of the range of what most sell-side analysts have been calling for in high yield. Recall that the U.S. high yield, trailing-12-month default rate hit a COVID-19-era peak of about 6% in late 2020.
- Using 40% as the approximate long-term, average observed recovery rate on defaulted high yield bonds, and the current market starting price of approximately $90, imply an expected loss-given default of 1.45%, favorable relative to current spread levels.

As the discussion above may imply, coming up with a reasonably accurate, top-down, derived estimate on default-loss pricing at any one point in time depends on a range of factors and assumptions. Short of a full discussion here, in prior publications, we've pointed to the strong starting point of U.S. high yield credit metrics today, and the belief that corporate balance sheets are well positioned to counter the margin deterioration and adverse turn in credit metrics that would be expected in a softening U.S. economy. Further, we don't see specific at-risk sectors in the market today, unlike the weakness in energy leading to the commodity crisis of 2015-2016, which tells us defaults may be more focused on a narrower set of idiosyncratic risk stories in the coming years. That contrasts with the broader weakness of the credit markets in some of the recent default cycles.

The "Excess Spread" Available in U.S. High Yield

Given a range of potential default-loss outcomes, how are investors being compensated? Positive values that fall out for an assessment of this "excess spread" would reflect our long-standing view that credit spreads overpay investors for defaults. That outcome would also emphasize that investors embrace a strategic mindset (over a "market timing" approach) and collect this excess spread that remains after absorbing default losses. These positive values for excess spread are essentially risk premium that patient investors can capture, after adjusting current spread for future default losses. And it varies given investors' collective risk sentiment, tolerance, holding periods, market structure liquidity, etc. However, we can argue that at any point in time, the then-current credit spread of the broad investment-grade-credit corporate market could serve as a lower bound for the excess spread in high yield, given investment-grade credit is largely a default-risk-remote asset class with similar types of non-default risk as high yield.

In Figure 2, we show the excess spread based on a range of assumptions for the recovery rate and default rate, at the current Index option-adjusted spread (OAS) and price (+485 bps and $90.28, respectively). Note that except for a combination of particularly low recovery levels and/or high default rates that largely exceeded that of the COVID-19 pandemic, investors are collecting a positive risk premium that exceeds the OAS of the investment-grade market at today's valuations. Focusing just on a default assumption of approximately 3% (in line with the estimate derived from the distress ratio) and a 40% recovery leads to an excess spread of 318 bps today, for example.

Figure 2. Excess Spread on High Yield Based on Assumed Recovery and Default Rates

Excess spread in high yield market based on assumptions of option-adjusted spread of 485 basis points and an issue price of $90.28 (actual 7/31/2022 values)

		Default Rate Assumption (%)				
		1.0%	**3.0%**	**5.0%**	**7.0%**	**9.0%**
Recovery (%)	**25**	413	268	123	- 21	- 166
	30	418	285	151	18	- 116
	35	424	301	179	56	- 66
	40	429	318	207	95	- 16
	45	435	335	234	134	34
	50	440	351	262	173	83
	55	446	368	290	211	133

Source: Lord Abbett. Data as of July 31, 2022.

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Further, when some investors ask what default rate is being priced into the market, in reality, they may largely be asking for a worst-case scenario where the assumed excess spread is 0 bps. As shown in Figure 3, around current valuations and a recovery of 40%, the implied default rate is north of 8%, over twice as high as suggested by the distress ratio and a range of third-party estimates in the marketplace today.

Figure 3. Investors Appear to Be Overly Pessimistic about Potential Default Rates

Implied default rate based on assumptions of option-adjusted spread of 485 basis points and an issue price of $90.28 (actual 7/31/2022 values) and no excess spread

		Index OAS (bps)				
		300	**400**	**500**	**600**	**700**
Recovery (%)	**35**	4.6%	6.2%	7.7%	9.2%	10.8%
	38	4.0%	6.4%	8.0%	9.6%	11.2%
	40	5.0%	6.7%	8.3%	10.0%	11.7%
	43	5.2%	7.0%	8.7%	10.4%	12.2%
	45	5.5%	7.3%	9.1%	10.9%	12.7%
	48	5.7%	7.6%	9.5%	11.4%	13.3%
	50	6.0%	8.0%	10.0%	12.0%	14.0%

Source: Lord Abbett. Data as of July 31, 2022.

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Key Takeaways

So how should we respond to the simple question, "What default rate is priced into the U.S. high yield market?" The answer is, "It depends." But today's spread levels provide a good deal of excess spread even under dire default and recovery assumptions. There is plenty of uncertainty around the variables in the excess-spread calculation in any given year. That complexity offers a compelling reason to adopt a strategic, and actively managed approach to collecting income in leveraged credit, one that has the proven potential to provide investors with consistently attractive compensation for assuming default risk over multiple years.

CLOSE-UP — Under the Hood of "Excess Spread"

We discuss excess spread, the amount that high yield investors can capture in excess of projected default loss, extensively in this article. But how is it derived? First, let's start with two equations that are important in credit math:

Spread Compensation for Expected Defaults = (Index Option-Adjusted Spread [OAS] – Excess Spread)

Expected Loss Given Default = Default Rate * [(Index Price – Recovery)/Index Price]

And we know by definition:

Spread Compensation for Expected Defaults = Expected Loss Given Default

Thus:

(Index OAS – Excess Spread) = Default Rate * [(Index Price – Recovery)/Index Price], or

(Index OAS – Excess Spread) = Default Rate * (1 – Recovery/Index Price)

Determining all these factors leads us to our excess spread calculation:

Excess Spread = Index OAS – (Default Rate * (1 – Recovery/Index Price))

Unless otherwise noted, all discussions are based on U.S. markets and U.S. monetary and fiscal policies.

Asset allocation or diversification does not guarantee a profit or protect against loss in declining markets.

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The value of investments in equity securities will fluctuate in response to general economic conditions and to changes in the prospects of particular companies and/or sectors in the economy. While growth stocks are subject to the daily ups and downs of the stock market, their long-term potential as well as their volatility can be substantial. Value investing involves the risk that the market may not recognize that securities are undervalued, and they may not appreciate as anticipated. Smaller companies tend to be more volatile and less liquid than larger companies. Small cap companies may also have more limited product lines, markets, or financial resources and typically experience a higher risk of failure than large cap companies.

Fixed-Income Investing Risks

The value of investments in fixed-income securities will change as interest rates fluctuate and in response to market movements. Generally, when interest rates rise, the prices of debt securities fall, and when interest rates fall, prices generally rise. High yield securities, sometimes called junk bonds, carry increased risks of price volatility, illiquidity, and the possibility of default in the timely payment of interest and principal. Bonds may also be subject to other types of risk, such as call, credit, liquidity, and general market risks. Longer-term debt securities are usually more sensitive to interest-rate changes; the longer the maturity of a security, the greater the effect a change in interest rates is likely to have on its price.

The credit quality of fixed-income securities in a portfolio is assigned by a nationally recognized statistical rating organization (NRSRO), such as Standard & Poor's, Moody's, or Fitch, as an indication of an issuer's creditworthiness. Ratings range from 'AAA' (highest) to 'D' (lowest). Bonds rated 'BBB' or above are considered investment grade. Credit ratings 'BB' and below are lower-rated securities (junk bonds). High-yielding, non-investment-grade bonds (junk bonds) involve higher risks than investment-grade bonds. Adverse conditions may affect the issuer's ability to pay interest and principal on these securities.

Glossary & Index Definitions

A **basis point** is one one-hundredth of a percentage point.

The **default rate** measures either (i) the percentage of issuers or (ii) the percentage of the dollar value of the overall market in a given fixed-income asset class that failed to make scheduled interest or principal payments in the prior 12 months.

The **recovery rate** is the extent to which principal and accrued interest on defaulted debt can be recovered, expressed as a percentage of face value. The recovery rate can also be defined as the value of a security when it emerges from default or bankruptcy.

Spread is the percentage difference in current yields of various classes of fixed-income securities versus Treasury bonds or another benchmark bond measure. A bond spread is often expressed as a difference in percentage points or basis points (which equal one-one hundredth of a percentage point). The option-adjusted spread (OAS) is the measurement of the spread of a fixed-income security rate and the risk-free rate of return, which is adjusted to take into account an embedded option. Typically, an analyst uses the Treasury securities yield for the risk-free rate.

The **ICE BofA US High Yield Index** tracks the performance of US dollar denominated below investment grade corporate debt publicly issued in the US domestic market. Qualifying securities must have a below investment grade rating (based on an average of Moody's, S&P and Fitch), at least 18 months to final maturity at the time of issuance, at least one year remaining term to final maturity as of the rebalancing date, a fixed coupon schedule and a minimum amount outstanding of $250 million. The ICE BofA US Distressed High Yield Index is a subset of the ICE BofA US High Yield Index including all securities with an option-adjusted spread greater than or equal to 1,000 basis points.

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