High-Yield and Bank Loan Outlook Report: Up the Escalator, Down the Elevator

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An uptick in corporate defaults in 2019 will mark the beginning of a prolonged period of stress in the corporate bond market.

Here are the key takeaways from our latest High-Yield and Bank Loan Outlook report:

■ Market volatility will force the Federal Reserve to pause rate hikes in the first half of 2019 as an ongoing decline in equity prices, widening credit spreads, and tighter financial conditions foreshadow higher defaults in the next 12 months, but we believe it will resume tightening monetary policy later in the year.

■ We continue to believe that with real GDP growth running above potential, unemployment below full employment and falling, and core inflation near the 2 percent target, the 2019 data should be solid enough for the Fed to hike two times later in 2019.

■ Spread widening in the fourth quarter implies an increase in the 12-month trailing issuer-weighted high-yield default rate to 3.2 percent this year, from 1.8 percent currently. A lack of credit availability compared to recent years presents upside risk to this projection.

■ A Fed pause may support tighter credit spreads early in the year, but with investor confidence having been badly damaged, we believe 2019 will not be friendly to borrowers once the Fed resumes hiking interest rates.

■ Recent market volatility reminds us that risky asset returns typically follow an “up the escalator, down the elevator” motion—performance is slow and steady on the way up, but swift and steep on the way down, which supports a gradual de-risking as we have been recommending for several quarters.

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