Chart of the Week

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Are Low Default Rates a Reason to Reach for Higher Yields?

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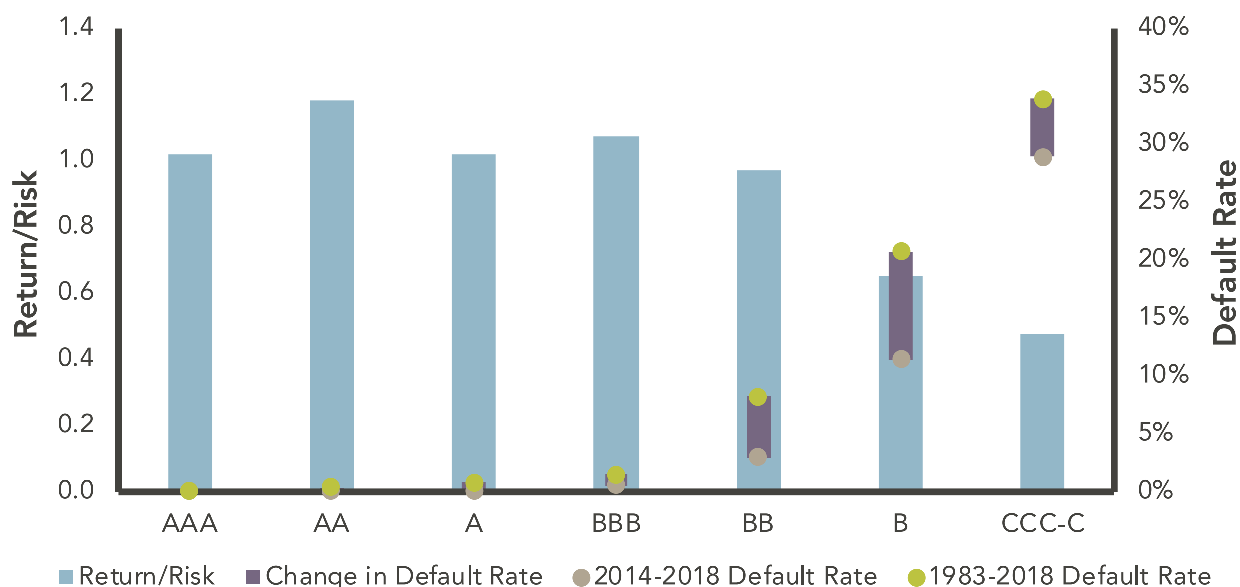
Recent economic environment has been hospitable for low default rates, but future is uncertain



Notes: Default rates are cumulative issuer-weighted 5-year averages. Return/Risk is calculated as Return/Standard Deviation.
Sources: Moody's Credit Rating Agency, FRED, Bloomberg

As indicated in Moody's 2018 Annual Defaults Report, recent default rates on corporate debt have been significantly below long-term historical averages. Is this as positive for forward returns as one would think?

This week's chart of the week shows recent corporate default rates against the longer-term averages and the return/risk ratio. As expected, the default rates are lower across the board and especially so in the sub-investment grade space. B rated debt has the largest change in default rate at 9.3%, leaving the trailing 5-year default rate at nearly half of its longer-term average. Lower default rates have been great for returns, so what's the risk?

Just as equity analysts extrapolate recent high company earnings growth into the future, the risk is that credit analysts extrapolate the unordinarily low default rate into the future. The recent economic environment has been hospitable for low default rates with steadily increasing corporate margins and an increased ability to pay down debt. As some investors move into more volatile and lower quality debt to chase the higher yield that these bonds offer, the return per unit of risk decreases because the default rate increases by more than the additional yield benefit. If default rates were to increase and revert to the mean, lower credit rating bonds would be hit especially hard.

However, active investment managers strive to mitigate some of these risks. They can tilt their portfolios to higher quality bonds or choose bonds that they believe are rated incorrectly by rating agencies, thus lowering their portfolio's default rate. In total, the recent low default rates have been great for trailing returns, however the future environment is uncertain and the strategy of reaching for higher yield may not perform as it has in recent history.

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