FIXED INCOME INSIGHTS / 2Q 2024

The Calm Before...

Weitz | INVESTMENT MANAGEMENT

U.S. Treasury interest rates continued to climb in the second quarter of 2024, although more modestly than they did in the first quarter. Large rate increases across the yield curve in April were mostly reversed in May and June, leaving overall base rates 10 to 20 basis points higher at quarter end. The chart below provides a view of rates across the yield curve.

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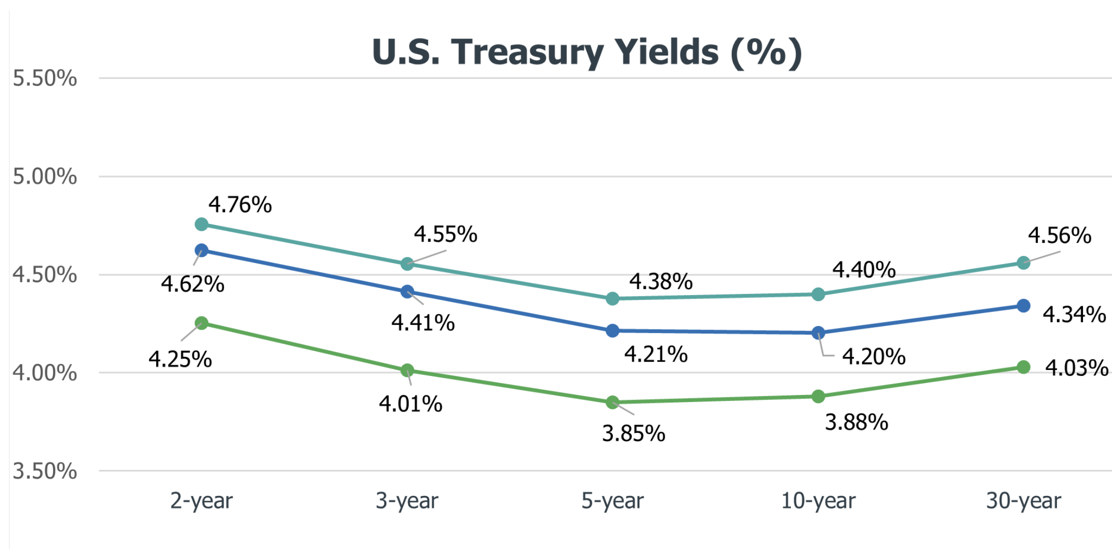
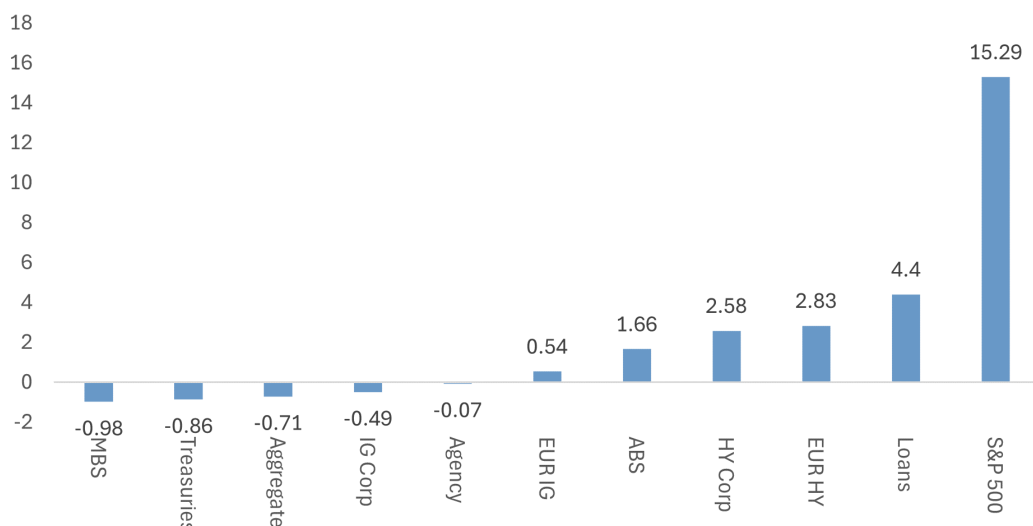


Although credit spreads (particularly high yield) widened in April, they finished the second quarter only slightly wider than where they began. The table below provides a year-to-date breakdown of total returns across various asset classes. Within the fixed-income universe, floating-rate (loans), high-yield, and asset-backed securities (ABS) best weathered the base rate increases through higher coupon income and generally shorter average lives.



Source: Bloomberg, S&P LCD, Morgan Stanley Research

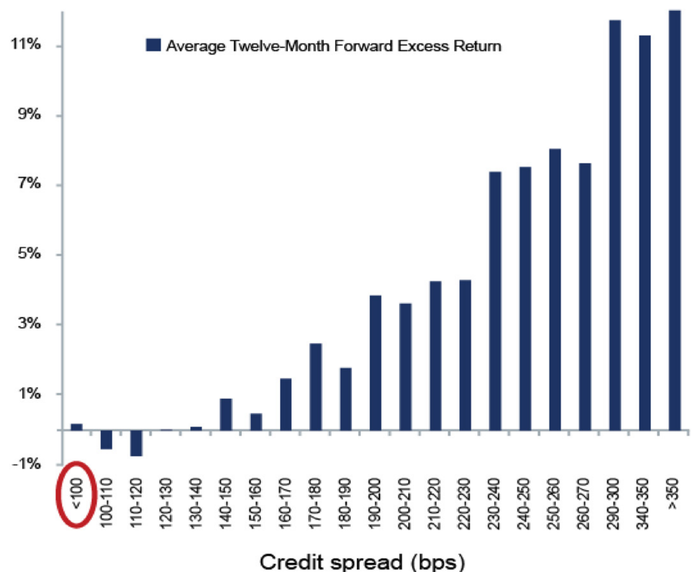
The Calm Before the......More Calm?.....or Less Calm??

While of course we monitor what is going on in the macro environment, we've repeatedly stressed that we're not in the forecasting business. However, surveying and studying historical trends can help inform today's investment decisions. For example, for the past 25 years (which included three recessions: the dot-com bubble of the late 1990s, the 2008/2009 Great Financial Crisis (GFC), and the COVID pandemic of the present decade), investment-grade credit spreads (measured monthly) spent less than 15% of the time at levels lower than where they were on June 30, 2024 (96 basis points above comparable U.S. Treasury yields). During that same timeframe, investment-grade credit spreads spent more time at levels double the current spread (or higher) and have averaged 50%+ more than where they ended the second quarter. The graph below compares spreads and yields using the JP Morgan US Liquid Index (JULI). It portrays the potential dilemma that fixed income investors face of arguably expensive (low) credit spreads against all-in returns (yield) that are well above the 10-year average. All-in yield buyers being lured by the picture on the right may not be paying enough attention to the view on the left, since spread is ultimately what gives an investor protection for taking credit risk.

Source: J.P. Morgan. As of 6.18.2024

Maybe we'll have "more calm" than we've already experienced, but more often than not, history has been full of surprises. And like high stock valuations, multi-decade-low credit spreads, like now, rarely generate excess forward returns relative to U.S. Treasuries, as the graph illustrates.

Spreads in isolation cannot tell the whole story unless put in the perspective of overall base rates. Overlaying today's spread environment on top of the nearly 10 years of the Federal Reserve's zero interest-rate policy (ZIRP) would provide a different context when speaking of the opportunity set. But when viewed from today's base rates and across time, the extra return for assuming credit risk is placed in its proper perspective. The graph below, depicting credit spreads (measured by option adjusted spread (OAS)), as a percentage of overall return (measured by yield-to-worst (YTW)), visually illustrates how low the current spread environment is compared to its history.



Source: J.P. Morgan

In the worldwide search for yield, investors are willing to accept less return for credit risk than they have in most periods – less than the long-term average – and even less than the post-GFC average. History will, of course, grade investor behavior as to whether today's spread levels represent some amount of investor complacency.

US IG OAS as a % of YTW

There invariably will be, and are, select areas of investment opportunity, particularly given our ability to seek out the most attractive risk-adjusted opportunities both within and outside of broad bond indexes. Casting a wider net across the fixed income landscape – particularly across securitized products that have meaningful structural enhancements and where higher income relative to bond indexes is available – remains a meaningful advantage in today's environment.

Overall, the credit cycle appears quite mature and current credit spreads don't appear to fully reflect the real challenges in the economic backdrop (e.g., sticky inflation, slowing employment, and slow-to-slowing economic growth). Combined with continued global uncertainty and tensions, an election year, and a seeming melt-up in mega-cap U.S. growth stocks (particularly semiconductors), even more caution than normal seems warranted. By maintaining a liquid (e.g., Treasuries and agency mortgage-backed securities) and overall 'up-in-quality' portfolio positioning that can generate higher income returns than respective indexes, we are well positioned to continue navigating calm waters. In particular, we are in a strong position to be liquidity providers if/when the investment environment becomes more turbulent.

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Portfolio composition is subject to change at any time. Current and future portfolio holdings are subject to risk.

Definitions: Basis point (BPS) refers to a unit of measurement that is equal to 1/100th of 1%, or 0.01%. Spreads are measured by ICE BofA which is a group of indexes that track the performance of U.S. dollar-denominated debt issued in the U.S. domestic market. The **Bloomberg U.S. Aggregate Bond** Index is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market. The **Bloomberg U.S. Corporate High Yield Bond** Index measures the U.S. dollar-denominated, high yield, fixed-rate corporate bond market. The **Bloomberg U.S. Corporate Investment Grade** Index is a broad-based benchmark that measures the investment grade, fixed-rate, taxable, corporate bond market. The **Bloomberg U.S. Mortgage-Backed Securities** (MBS) Index tracks fixed-rate agency mortgage-backed pass-through securities guaranteed by Ginnie Mae, Fannie Mae, and Freddie Mac. The **Bloomberg U.S. Securitized** Index is a subset of the Bloomberg U.S. Aggregate Bond Index that includes MBS Pass-through, ABS, CMBS and covered assets. The Bloomberg U.S. Treasury Index measures U.S. dollar-denominated, fixed-rate, nominal debt issued by the U.S. Treasury. The **Bloomberg U.S. Treasury Bill** (T-Bill) Index tracks the market for treasury bills issued by the U.S. government. U.S. Treasury bills are issued in fixed maturity terms of 4, 8, 13, 17, 26 and 52 weeks. **Investment Grade Bonds** are those securities rated at least BBB- by one or more credit ratings agencies. **Non-Investment Grade Bonds** are those securities (commonly referred to as “high yield” or “junk” bonds) rated BB+ and below by one or more credit ratings agencies. **Effective yield i**s the return on a bond that has its interest payments (or coupons) reinvested at the same rate by the bondholder. Effective yield is the total yield an investor receives, in contrast to the nominal yield—which is the stated interest rate of the bond's coupon. **Option Adjusted Spread:** A “spread” compares the interest rate on a particular bond against a “base line” bond (typically a U.S. Treasury bond). When a bond issuer (or bondholder) has the option to exercise a right (for example, if the issuer can call a bond before its stated maturity date), then the “Option Adjusted Spread” takes into account the possibility that this option might be exercised—so a bond's Option Adjusted Spread may be more (or less) than its regular spread.

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