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Investment Institute

Market Commentary

Weekly perspective on current market sentiment **May 30, 2024**

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Last week's S&P 500 Index: +.03%

Spread basics

Key takeaways

- Treasury securities are considered to be low risk as they are backed by the "full faith and credit" of the U.S. Treasury.
- Non-U.S. Treasury securities would typically offer a higher yield because they are considered to carry higher risk.

Strategists often speak about spreads widening or narrowing, and it is important to understand these concepts when investing in fixed income. We encourage investors to understand how spreads might typically move at any given point in the economic cycle.

So what exactly are we talking about when we discuss credit spreads? More clarity here should help our regular readers to better understand the "why" when looking at our current fixed-income positioning. It should also help readers think about where we are in the economic cycle, which is key to making tactical decisions in one's overall investment plan. While we encourage investing for the long haul, taking advantage of 6-to-18-month shorter-term tactical opportunities can add value.

U.S. government Treasury securities are considered to be very low risk by the market, as they are backed by the "full faith and credit" of the U.S. Treasury. Given that perception, other fixed-income (non-U.S. Treasury) securities would typically offer a yield higher than U.S. Treasuries of a similar maturity because they are considered to carry higher risk. After all, corporations can go out of business. The higher the probability that a corporation might not be able to pay off bondholders, the wider the spread between the U.S. Treasury debt yield and the yield on the company's debt. Some corporations are perceived to be far riskier than others due to a wide variety of reasons, including leverage, markets served, breadth of products, and management decision-making. Investors want to be compensated with a higher yield for taking on more uncertainty.

The yield spread between these riskier companies (high yield, or HY) and a U.S. Treasury security are typically wider than for corporations deemed more reliable and less risky (investment grade, or IG). For example, companies that have been in business for decades and have strong balance sheets and dependable revenue streams will typically be able to sell debt to investors that carries a lower yield relative to companies with weak balance sheets and less dependable revenues.

In the current cycle, however, HY and IG spreads have narrowed to levels not seen since 2021 even as the economy weakens and earnings growth deteriorates. Spreads would normally be expected to increase when economic activity slows and uncertainty increases. But HY and IG credit spreads have fallen back to their pre-pandemic lows seen in 2018 – 2019.

We currently carry a neutral rating on IG credit. While these yield spreads remain relatively narrow, the yields are higher than many other IG fixed-income options and support our neutral guidance. In terms of HY bonds, we currently carry an unfavorable rating, as yield spreads in this fixed-income segment remain narrow as well and we focus on quality. Widening of both IG and HY spreads may occur should economic concerns arise. Investors can benefit by understanding these fixed income spread basics.

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Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. **Bonds** are subject to market, interest rate, price, credit/default, liquidity, inflation and other risks. Prices tend to be inversely affected by changes in interest rates. **High yield (junk) bonds** have lower credit ratings and are subject to greater risk of default and greater principal risk. Although **Treasuries** are considered free from credit risk they are subject to other types of risks. These risks include interest rate risk, which may cause the underlying value of the bond to fluctuate.

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