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Investment Institute

Market Commentary

Weekly perspective on current market sentiment | April 7, 2021

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Last Week's S&P 500 Index: +1.6%

Spread basics

Key takeaways

- High-yield and investment-grade corporate spreads have fallen dramatically as the prospects for economic recovery have improved.
- We recently reduced our rating on both of these fixed income segments to neutral from favorable as a result.

We recently downgraded our recommendations on high-yield (HY) and investment-grade (IG) corporate debt in the fixed income asset class from favorable to neutral. Much of our underlying rationale revolved around the theme of "spread compression." 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 recent fixed income adjustments. 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 six-to-18-month tactical opportunities can add value.

The market considers U.S. government Treasury securities to be "risk free" as they are backed by the "full faith and credit" of the U.S. Treasury. Given that perception, other fixed income (non-Treasury) securities would typically offer a yield higher than U.S. Treasuries of a similar duration (a measure of a bond's interest rate sensitivity) because they are considered to carry higher risk. Corporations can go out of business. The more risky the chance that the corporation might not be able to pay off bond holders, the wider the spread between the risk-free rate and the yield on their debt. Some corporations are far more risky 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 risk.

The yield spread between these riskier companies (HY) and the risk-free rate will be wider than for corporations deemed more reliable and less risky (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.

Early in an economic cycle, as business prospects improve, credit spreads tend to narrow as investors are more willing to take on risk for both HY and IG bonds. For example, in late March of last year HY spreads were a touch over 1,100 basis points (bp, 100 basis points equals 1%). Now the spread has tumbled to nearly 300 bp as economic prospects have greatly improved and investors are more willing to take on risk. Spreads would be expected to increase when economic activity slows and uncertainty causes investors to seek out more safety.

HY and IG credit spreads have fallen back below their prepandemic levels that prevailed for most of 2019. As a result, we downgraded our recommendations to neutral. Investors can benefit by understanding these fixed income spread basics.

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