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Market Commentary

Weekly perspective on current market sentiment April 14, 2021

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Last Week's S&P 500 Index: +2.7%

Spread basics, part 2

Key takeaways

- High-yield and investment-grade credit spreads narrowed dramatically over the last 12 months as the economy bounced back.
- We believe these credit spreads can be used to monitor the level of stress in the financial system and the strength of the economic recovery.

Last week's edition of Market Commentary addressed the concept of the yield spread between "risk free" U.S. Treasury securities and bonds issued by entities such as corporations, which are not backed by the "full faith and credit" of the U.S. Treasury. In short, investors consider fixed income securities of corporations to have a higher risk of default, and, therefore, they carry a higher yield than the U.S. Treasury's risk-free debt. That makes sense to us. In addition, there are varying degrees of credit-worthiness among corporations. Some bond-issuing companies are considered more risky than others and fall into the high-yield (HY) category. They carry a higher yield, and a wider spread relative to Treasuries, compared to those deemed "good" credit risks based on characteristics such as strong balance sheets and dependable revenue streams. Strong credits fall into the investment-grade (IG) category.

Part one of the discussion we started last week reminded our readers where our guidance stands in terms of HY and IG debt as we recently moved our recommendations to neutral from favorable for both due to spreads collapsing to pre-pandemic levels as confidence in the breadth of the economic recovery increased relative to the year-ago panic period. This week, we want to make some brief comments on how to interpret this narrowing in spreads relative to the yield on U.S. Treasury securities. We consider the level of spreads to be a good indicator of the magnitude of financial stress in the system and risks to the economic recovery and corporate viability.

When financial stress is anticipated to increase along with economic headwinds to the point where defaults are perceived likely to rise, credit spreads generally widen to reflect this increased risk. But the exact opposite has occurred. Also consider that the price of bonds rated below investment grade tend to react more negatively than higher-rated debt issued by better-quality companies when investors are worried about financial stress. Based on the current levels of HY and IG spreads, investors do not appear to be worried there is stress in these sectors, particularly in the HY segment of the fixed income market. We agree.

Our outlook continues to call for the recovery to continue. We expect robust economic growth here at home as well as meaningful growth abroad. We believe the stock market is likely on track for additional gains and interest rates are poised to rise modestly.

Note that while we currently prefer stocks over bonds as the economy improves, we continue to believe there is a place for fixed income in portfolios. We recommend a full allocation to both HY and IG fixed income segments. Many of the positive factors that pushed spreads lower remain in place, and we will continue to monitor spreads as a key indicator to help gauge stress in financial markets and the strength of the ongoing economic recovery.

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